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13 August 2021

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AFA Submission - Compensation Scheme of Last Resort: Proposal Paper

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 Proposal Paper.

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 subsequent insolvency of the relevant 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 up to the start of the CSLR.

However, the AFA and the professional advisers who make up its membership cannot support the structure of a scheme which expects financial advisers, primarily small business operators, to pick up 76.6% of the cost. Costs which will inevitably have to be borne in large part by the consumers of financial advice who more than

ever need high-quality reasonably priced advice, which has the potential to significantly reduce the Government's financial liabilities.

This initiative is perceived by the advice profession as another example of oppressive regulation that comes on top of existing regulatory cost pressures, including the recent announcement of a substantial increase in the ASIC Funding Levy and the expectation of a further increase due to the Single Disciplinary Body.

It is time the Government listened to the profession and the hard-working Australians they serve. Imposing yet another regulatory cost burden demonstrates a lack of awareness and understanding on the part of the Government. We will address the cost impact in further detail below.

We have some serious reservations about the proposed design of this scheme and suggest that there are some core questions that need to be addressed as part of this process:

1. Are the objectives of the compensation scheme of last resort sufficiently clear?
2. Has enough been done to minimise the need for a compensation scheme of last resort?
3. Is the scope of the scheme both adequate and fair?
4. Is the proposed cost of the scheme reasonable?
5. Does it make sense to apply a minimum threshold level of $1,000 for the CSLR Levy invoices?
6. Is AFCA the most appropriate body to operate the scheme of last resort?
7. Are the various caps and controls appropriate?
8. 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, however we need to make the point that the cost per financial adviser is substantially understated (approximately 20%) and is seemingly based upon the wrong number of financial advisers. This is particularly concerning given that the number of financial advisers is publicly available data, and cost is such a big issue in the financial advice sector.

Are the objectives of the compensation scheme of last resort sufficiently clear?

It is our understanding that the objective of the CSLR is to compensate financial services consumers who are the beneficiary of a determination by AFCA, when the benefit has not been paid due to the financial firm refusing to pay or being unable to pay due to insolvency. A determination by AFCA is likely to be awarded on the basis of a mistake by a financial firm or through inappropriate conduct or misconduct.

It is important to note that awards should not be made on the basis of underperformance of investments, however it should apply in the case of investment losses that are attributable to misrepresentation, fraud or other forms of misconduct by product providers. We therefore believe that it is appropriate that the CSLR should have scope to address product failures, where the loss is attributable to misconduct, and where an award could be made by AFCA. The inclusion of some unpaid determinations in the design of the CSLR, and the exclusion of others, such as product failures, seems to lack equity and clarity of purpose.

We believe that it is appropriate that the scheme focus on unpaid determinations by AFCA, as opposed to other matters, whether that be through the courts or otherwise.

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 believe that more work needs to be done to look at the issues of Professional Indemnity Insurance and capital adequacy. We believe that capital adequacy for financial firms, and financial advice licensees 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. It may also be the case that more can be done with respect to early identification of firms that are at risk of insolvency. We are supportive of a review being undertaken in this area of risk management and mitigation and are open to the option of sensible reforms to address this.

We do not believe that it is acceptable for the Government to move ahead with a scheme that will result in the good operators paying a higher price for the misconduct of a small minority, unless more is done to address this issue. 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. This is further grounds for suggesting that the establishment costs and the annual administration costs are totally excessive and unreasonable.

It should also be noted that all the significant cost increases that are being forced on financial advice licensees and businesses at the moment through layers of regulatory reform and additional red tape, only increases the risk of financial advice firms becoming insolvent in the future. It will also inevitably be reflected in an increase in the cost of advice, depriving more and more hard-working Australians from achieving financial security and, through that, increasing their reliance on Government support.

Is the scope of the scheme both adequate and fair?

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 noted who historically was responsible for 78% of unpaid determinations:

> *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 astonished that managed investment schemes have been excluded from the proposed scope of the scheme, particularly given FOS evidence that they are the second largest contributor. How is this outcome possible? At least credit providers have been included.

It is important to note that many advisers will also be caught more than once through the inclusion of mortgage brokers and insurance distributors as separate subsectors and will end up paying multiple levies.

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 know that some will come forward with the moral hazard argument and oppose the proposition that prudentially regulated entities should be included in the scheme. We believe that it is appropriate to remind everyone that consumer confidence in the financial system is in the best interests of all participants in the financial system. We would also highlight the similarity in the argument that has been used on financial advisers about the ASIC Funding Levy and how they should be prepared to pay for the cost of investigation and enforcement action against unlicensed operators or those who are operating outside their licence terms. This is being argued on the basis that this enables broader confidence in the system. If this argument is to be accepted, then it would equally apply to the issue of the scope of the CSLR.

It is not clear to us what mechanisms are available to adjust the in-scope subsectors in the future and whether this can be done through regulation, rather than legislative change.

We also believe that it is appropriate to make the point that financial advisers will be seemingly funding three quarters of the $5m capital reserve over the first three years. If financial advice is no longer the main driver of unpaid determinations by that point, then they will have funded the vast bulk of the capital reserve that will be left for the benefit of other subsectors. This is also inequitable and unfair.

Given the proposed inequitable starting position, with financial advisers picking up 76.6% of the cost of the scheme, what measures will be in place to ensure that the allocation of costs is fair and what visibility will there be of the amount of levies raised for each in-scope subsector versus the compensation payments for that subsector? What public reporting will be provided on the operation of the scheme and the funding of the scheme?

Is the proposed cost of the scheme reasonable?

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.

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.

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.

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.

We note that it is proposed that the CSLR entity would reimburse AFCA for certain costs and ASIC for other costs. Where financial advisers are picking up more than 75% of the cost of the scheme, we would like to have much greater visibility of these transfer payments to AFCA and ASIC. On page 25, there is a statement relating to the levy that "These funds will also be used to pay unpaid AFCA fees". We are unsure what this

means, however the CSLR should not be used as a mechanism to pay AFCA fees that are unpaid by member firms.

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.

Does it make sense to apply a minimum threshold level of $1,000 for the CSLR Levy invoices?

We note the suggestion that the imposition of a minimum threshold of $1,000 for any invoice for the CSLR Levy is to limit the economic impact upon smaller businesses. In a financial advice context this is not valid, as the majority of financial advisers are authorised representatives of a licensee and even if they are authorised by larger licensees, they are still small businesses. The licensee will invariable pass this cost on to the advisers. This would mean that small businesses that are authorised by a larger licensee, pay the levy, when some who have their own licence would not pay. It is also counter intuitive, as it is more likely that it will be the smaller licensees who are responsible for unpaid determinations.

The only other reason to justify the application is to offset the cost of issuing and collecting invoices. We would assume that ASIC is by now relatively efficient in doing this and thus cannot see that this would justify the decision to impose a threshold. It should be incorporated into the existing ASIC invoice cycle.

It might be helpful to explain the impact on the financial advice population. The following table sets out the number of licensees with 1, 2 and 3 advisers and the total number of advisers in these licensees. The total of 2,314 advisers who belong to licensees with 3 or less advisers represents about 12% of all financial advisers on the Financial Adviser Register. The inclusion of all advisers in this calculation will reduce the amount of the levy by approximately 12% for the remainder of financial advisers.

Number of Advisers	Licensees	Advisers	Cumulative Advisers
1	781	781	781
2	402	804	1,585
3	243	729	2,314

We do not support the proposal for a minimum threshold. It would only create additional inequity and moral hazard.

Is AFCA the most appropriate body to operate the scheme of last resort?

For a number of reasons, we question whether the right solution is to have AFCA establish a new subsidiary to operate the CSLR. We appreciate that this has been the thinking to this point, however for the following range of reasons we think that it is appropriate to review this proposal:

- Setting up a new entity with a new Board of Directors is adding unnecessarily to the cost.
- There is a conflict of interest in AFCA being responsible for the scheme and paying themselves for work that they do in the management and pursuit of unpaid determinations.
- There is additional and unnecessary complexity in having AFCA, ASIC and the CSLR Co all involved in this exercise.
- Having ASIC responsible for the invoicing and having the money move through Consolidated Revenue into the CSLR Co is inefficient and risks a lack of transparency.

There is no justification why it should be set up as a subsidiary of AFCA. We believe that it is appropriate to consider the option of the CSLR being run and administered by ASIC, without the need for the establishment of a new company and the appointment of a new and separate board of directors.

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 have the invoicing capacity, the investigative resources and the powers necessary to pursue such matters. Under this design, it would not be necessary for any payment to be made from ASIC to AFCA, for their normal work in reviewing claims and chasing up the payment of unpaid determinations.

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 particularly unclear how the levy could progress from the $10 million cap on the five in-scope subsectors to the total annual cap of $250 million. This seems like a huge leap. There is an inadequate 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. In our view, the $250 million total cap is excessive. If this was to be 76.6% charged to financial advisers, then it would amount to as much as $11,000 per adviser in just one year.

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. This is an effective way to balance the competing priorities of compensating consumers for loss and carefully managing the costs of the scheme.

Understanding the Cost per Adviser

We have undertaken an assessment of the modelling in tables 2 and 3, including to assess the impact of the threshold on the cost per adviser. Our analysis, however, reveals that this table is based upon a very flawed understanding of the number of financial advisers on the Financial Adviser Register. When adjusted for the current number of advisers in licensees with 1, 2 and 3 advisers, it suggests that this modelling is based upon around 23,400 advisers, when the actual current number is little more than 19,000. If calculated on the basis of the current total number of advisers (we have used 19,500), this would result in a cost per adviser that was at least 20% more than the amounts that have been stated. In the context of the current cost of financial advice and all the commentary on the ASIC Funding Levy, it is really disappointing that this mistake has been made, and the cost per adviser materially understated.

	Year 1 2 or more advisers	Year 2-3 3 or more advisers	Year 4+ 4 or more advisers
Total Cost	12,271,993	7,447,180	6,170,774
Stated Cost per Adviser	544	341	291
Derived Number of Advisers	22,559	21,839	21,205
Add Non-Charged Advisers	781	1,585	2,314
Total Underlying Advisers	23,340	23,424	23,519
Corrected No. of Charged Advisers	18,719	17,915	17,186
Corrected Cost per Adviser	656	416	359

This highlights that the projections in Tables 2 and 3 are based upon a substantial overestimation of the number of financial advisers. The correction set out in the table above is based upon a more recent estimate of the current number of financial advisers (we have used 19,500). In reality, the number of financial advisers will have fallen substantially further by the time the CSLR has commenced. There are estimates of the number falling to as low as 15,000 over the next couple of years. The cost per adviser numbers included in tables 2 and 3 materially misrepresent the real cost.

Payment for Unpaid Determinations Prior to the Scheme Commencement

We note the proposal that the outstanding unpaid determinations as at the commencement of the scheme would be paid for by the 10 largest financial institutions in the country. There has been some confusion about this, however it is important to be clear that this is with respect to all financial institutions, including the banks and insurance companies, and not just financial advice licensees. Clarity on this is important.

On this basis, we are supportive of this proposal, and believe that it is appropriate that the banks, who have played such a large role in the financial advice sector up until very recently, and who were so prominent in the hearings at the Banking Royal Commission, would be expected to contribute to the resolution of matters that remain outstanding at the commencement of this scheme.

Reviews of the Compensation of Last Resort Scheme

We note the proposal that the scheme should be reviewed every five years. We do not think that this is appropriate, particularly at the start of the life of such a scheme. We would suggest that a review after a period of three years would be more appropriate.

Timeline

We note the timeline in section 6 on implementation. The timeline does not include a commencement date, however it is our view that this scheme should start no sooner than 12 months after the legislation has been passed and preferably on the basis of a 1 July start date, so that it aligns with the current ASIC Funding Levy cycle.

Integrity Measures

We are supportive of the integrity measures, however we believe that more can be done to pursue payment of unpaid determinations. We believe that this could be achieved more effectively by ASIC performing the functions of a compensation scheme of last resort.

Concluding Comments

The AFA supports the establishment of a Compensation Scheme of Last Resort, however we do not accept the exclusion of investment product providers from the scope and believe that the cost of establishment and annual administration need to be substantially reduced.

It is our view that a lot more work needs to be done to address all the issues, before this scheme is ready to be progressed. We would also request that additional analysis is provided on the level of unpaid determinations and the main reasons why they remain unpaid.

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,

Helen Morgan-Banda
Chief Executive Officer
Association of Financial Advisers Ltd