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Manager, Redress and Accountability Unit
Financial Sector Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

By email: CSLR@treasury.gov.au

Dear Treasury,

AFA Submission – Compensation Scheme of Last Resort

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for over 70 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

The Board of the AFA is elected by the Membership and all Directors are currently 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

The AFA has previously opposed the introduction of a Compensation Scheme of Last Resort, particularly where it was proposed that the scheme be focused solely on financial advisers. Whilst we are disappointed at the lack of information on previous unpaid determinations, we believe that it is quite likely that a significant amount of unpaid determinations identified as related to financial advisers, were actually due to product failures. In many cases this will be where the client has taken action against the adviser, as it was no longer possible to take action against the failed product provider.

We recognise in the context of both the Royal Commission recommendation and the Ramsay Inquiry, that the Government is determined to implement a Compensation Scheme of Last Resort (CSLR). We therefore have taken the position that we acknowledge this outcome and propose that the scheme

be a broad based scheme and that responsibility for loss is applied to financial service providers on a proportional basis and where the loss is fully or partially the result of a product failure, that the scheme will cover the proportion of the loss, that would have applied to the product provider.

It is unfortunate that the information on previous unpaid determinations is not available to assess the likely impact of a range of recent changes, including the commencement of AFCA and the new rules that apply in the case of complaints to AFCA. Nonetheless, we question the reliability of previous unpaid determinations as an indicator of future unpaid determinations.

AFA's Responses to the Discussion Paper Questions

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

As expressed above, it is our view that the Ramsay recommendation, that the scheme only apply initially to financial advisers, was based upon a lack of understanding of the linkage between product failures and unpaid financial advice determinations.

We also believe that it is critically important to take into account the additional consumer trust that will emerge as a result of the introduction of a compensation scheme of last resort, that applies to all financial services consumers. This increase in consumer trust will benefit all participants in the financial services industry and it is therefore sensible and appropriate that all participants share in the costs of the establishment and administration of the CSLR.

We are conscious that there is some feedback opposing the inclusion of Managed Investment Schemes (MIS) in the Compensation Scheme of Last Resort. As we believe that the failure of MISs has driven significant consumer loss in the past, and can be expected to be an important element in future cases of unpaid determinations, we would strongly oppose the exclusion of MISs from the CSLR. The failure of MISs and MIS operators cannot be excluded from the CSLR.

We support a broad coverage model that includes all current members of AFCA.

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

We appreciate the rationale for the exclusion of court and tribunal decisions, noting that there is no information available on these matters and therefore it is difficult to build the scheme in the absence of that information. We are not aware of any unintended consequences that might arise as a result of the initial exclusion of court and tribunal decisions.

We do not support the exclusion of voluntary members of AFCA. We understand that there are only a limited number of voluntary members. However, in any case, if they wish to voluntarily join AFCA, then they should be bound to any judgements that are made against them and if they are unable to pay, then this should be covered by the CSLR. We do not support the exclusion of voluntary members of AFCA, and would suggest that the extent to which people choose to voluntarily join AFCA might suggest that they should be members, which might mean that the Government should consider legislative change to address the situation that these matters might highlight.

3. To what extent should the funding model be based on risk?

We believe that the cost of the scheme should be split into the following two parts:

- The overall establishment and administration costs, which should be paid by all members, potentially on the basis of the size or scale of the entity, which might be measured in terms of the gross revenue of the business.
- Claim costs, which should be covered on a risk basis from the firms that operate in the same or similar business lines to the party responsible for the unpaid determination.

4. How should risk be assessed?

We would caution against undertaking a risk assessment on the basis of historical measures of unpaid determinations as this may not take into account fundamental changes to different sectors of the market, including regulatory change and structural change that has occurred since the unpaid determinations were experienced. For example, in financial advice, there have been huge changes over the last seven years, including the introduction of a best interests duty, increases in education standards, the removal of commissions and changes in industry standards.

In addition, the issues that contributed to losses in the past, such as agri-business schemes, no longer exist in the marketplace. Other matters may have arisen as a result of the consequences of the Global Financial Crisis, which we would expect were unlikely to re-occur on that same scale, at least in the short term.

Potentially, the risk assessment process could leverage information available from recent AFCA unpaid determinations experience and sensible assessments of the key determinants of risk on a sector by sector basis.

5. Should the funding model assess risks at the individual financial firm level or at the financial service class level?

One of the key principles of the establishment of the scheme should be retaining a relatively simple cost efficient model. The idea of establishing an individual firm level risk model would involve significant data gathering and complexity that would significantly impact the cost of administration. It is reasonable to include some individual firm level measures such as scale in the funding model, however assessing risk at the individual firm level, is a particularly complex exercise that may expose the model to manipulation.

6. Should a risk based funding model apply to all CSLR costs?

We believe that the risk based funding model should only apply to claim costs, and that a scale based measure should apply for the establishment and administration costs. The consumer trust benefit of the establishment and operation of the scheme applies to all financial services clients and therefore it is appropriate that the establishment and administration costs be broadly allocated.

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

It is our view that the funding model for the establishment and administration costs should be based upon the scale of the entity and the amount of relevant business that is undertaken. It may be appropriate to measure this in terms of revenue or another measure of the scale of business activity.

In our view, the term ‘ability to pay’, provides the wrong message, as this implies an element of cross-subsidisation.

In our view, the scale of the business directly impacts the level of activity and the level of risk and is therefore the appropriate basis to assess the level of funding for establishment and administration costs.

8. How should ability to pay be assessed?

As discussed above, we do not support the use of the term ‘ability to pay’, as this implies the use of a measure unrelated to the scale of the business or the level of activity. A greater level of ability to pay may actually be a strong indicator of a reduced risk of an unpaid determination, and is therefore not likely to be a good driver for funding, in what is fundamentally expected to be a user pays model.

In terms of choosing the right measure, it depends upon the overall preference for both the level of simplicity and the level of specificity. This might dictate whether a universal measure should apply across all members of the scheme, versus individual measures for specific groups of members. A universal measure might be the level of overall business revenue, whilst a specific measure could be something like the number of financial advisers within the licensee. Other specific measures would need to be identified and developed for other sectors or groups.

9. What are suitable universally available metrics to assess a firm’s ability to pay?

As previously stated, we do not agree with the use of the term or the concept of ‘ability to pay’.

A universal measure could be the revenue of the business, which is a good indicator of the level of activity for that business.

10. How should the funding model address unexpected costs?

Retaining confidence in the sustainability of the CSLR is critically important, whilst at the same time it is essential that the funding of unexpected losses does not fundamentally impact the viability of a sector of the financial services market. We therefore support the idea of the building of a buffer of capital and the CSLR having access to a broad source of funds to meet the needs that might emerge in the event of a major loss scenario. We would also suggest that the CSLR should have access to borrowing funds from the government, that could be progressively repaid over a sensible and reasonable timeframe in the case of a major emergency.

The response to unexpected costs, as might be suggested by a single case or related cases of entity failures, will ultimately depend upon the scale of the loss and the size of the market for whom funding can be obtained (i.e. how broadly it can be shared). Where the scale of the loss is moderate and the impacted sector has greater capacity to fund the required resources, then this can more readily be covered by a special levy. Where it is much larger and the sector has reduced capacity to fund it, then other options need to be considered.

11. Is it better to avoid levy volatility or funds being tied up in a capital base that may not be often used?

We support the objectives of avoiding volatility in the levy and also an unnecessary build up in the capital base, however we appreciate that there needs to be a sensible balance and from time to time, more drastic action may need to be taken to ensure sufficient cashflow and capital is available.

This balance can probably be addressed by identifying an appropriate capital base for longer term sustainability and then setting this as a cap. It may also be sensible to define a range of acceptable levies that can apply, and then having the CSLR operate within this range, subject to the agreed cap.

12. If a CSLR capital base is to be established, what is a suitable minimum capital requirement?

A sensible capital base would be two to three times annual claims payments, however it may need to take into account other sources of funding and the level of risk of a one-off major event.

13. If levies are to be collected after the CSLR becomes aware of unexpected additional costs, how will financial firms manage this?

It is important to ensure that additional levies to deal with unexpected additional costs do not threaten the stability of the sector that is impacted. This should be assessed on the basis of the level of risk confronting the sector, and the breadth of the sector or the capacity to respond to a short term unexpected call for additional funds.

The need for significant additional levies would depend upon the level of capital that was held and whether there is any ability to obtain loan funding to cover any short-term deficiency.

It is also important to ensure that the CSLR communicates early on the prospect for the need for an additional levy to cover unexpected additional costs. Ideally, with adequate communication, this would not come as a surprise for impacted firms.

14. Should a maximum cap apply to the annual levies that can be imposed on participating financial firms?

We would support the establishment of a maximum annual levy cap, although noting that there would need to be a capacity to exceed this in extreme circumstances, if the viability of the scheme was at risk.

15. If a maximum cap is imposed, what is an appropriate metric for this cap (for example, gross revenue from covered financial services)?

As discussed above, we have proposed an administration based funding model that would be applied across all financial services firms and a risk based claims funding model. If the cost of claims are to be recovered on a sector by sector or business line basis, or sector grouping basis, then it may be appropriate to determine separate measures for each sector, business line or sector group.

16. If a maximum cap is imposed, what should the maximum cap be?

It is our view that more analysis and modelling needs to be done in order to determine what a maximum cap might be.

17. If a maximum cap is imposed, what mechanisms should the CSLR have to avoid going into deficit (for example, an ability to raise further levies from financial firms that are yet to reach the maximum cap and/or to further limit compensation so that expenditure is kept under the effective annual maximum for the scheme)?

We would recommend that the following mechanisms are available to deal with a funding deficiency:

- Access to retained capital and borrowed funds;
- Capacity for additional risk based levy for impacted sectors or sector groups; and
- Emergency broad additional administration funding in the case of an emergency where additional risk based sector funding is not possible or would put the viability of the sector at risk.

In addition to this, other options could be considered, however would not be ideal, such as a reduced percentage payout or a delay in payment.

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

We believe that it is important to recognise that this is a compensation scheme of last resort and that the objective here is to ensure that impacted clients are not left completely uncompensated. We therefore recommend that the scheme is set up to pay out a percentage (we proposed 80%) of the AFCA determination. It is our view that this sets a sensible balance and ensures that there is an incentive for the claimants to continue to seek the funds from the original financial service provider until it is evident that this will not be possible.

We recognise that it may be unnecessarily administrative and more complex to apply this 80% limit to all minor claims and would therefore suggest that 100% of claims be paid out to a certain threshold (for instance \$25,000), and then 80% of the amount above this threshold.

We do not favour a model where the percentage that is paid out varies over time depending upon other factors such as the level of claims or an unexpected large loss. Having different percentage payout ratios apply over time, will undermine confidence in the CSLR. It may be more acceptable that in certain cases of a related matter, where there is a big exposure, that the payout ratio is reduced.

19. If the CSLR compensation limits are to be lower than AFCA's claim limits, what limit would be appropriate?

We support the use of the current AFCA caps as the maximum level of payment, subject to the additional reduction as set out by the recommendation above, that payments above a threshold (i.e. \$25,000), would be subject to an 80% payout ratio.

20. How should the CSLR manage claims associated with large unexpected failures?

As we have discussed above, the CSLR could utilize the following options:

- Accessing the existing capital reserve;
- Seeking borrowed funds to cover a short term gap;
- Additional risk-based levies of the impacted sector or sector groups; or
- A Broad-based additional administration levy.

Other measures could be possible such as a further reduced payout ratio for specific large one-off events.

21. Should the CSLR be able to spread compensation payments over time and, if so, what would an appropriate maximum time period be?

We do not support the option of extending payments over time. This is not in the best interests of impacted clients and would involve additional complexity and administration costs. This would, in our view be a last resort measure, that would be applied in the event of an incapacity to resolve the matter through some other means.

22. Should the CSLR be able to impose an additional compensation limit to unpaid determinations associated with a single specific large failure and, if so, what would an appropriate limit be?

We would not favour this option, although we do recognise that it could be an option to assist in the resolution of a particularly large unexpected loss. Rather than a reduced cap, we would suggest that a reduced payout ratio may be a preferable option. This would need to be done on a case by case basis that complied with pre-set criteria.

23. How should compensation for legal and professional costs be limited?

We believe that it is important to ensure that consumers have access to a free complaints service (as is achieved by AFCA), and that they should not be unnecessarily forced to split any claim benefit with a legal firm. We also think that it is important to be very careful with respect to the role of other parties seeking to facilitate complaints on behalf of clients. We therefore support the cap that is currently applied by AFCA. Allowing for higher legal and professional cost payouts will add additional incentives that may not contribute to the best outcome for consumers.

As recommended above, we believe that the payment should be limited to 80% of the unpaid determination above a certain threshold (i.e. \$25,000). Which would mean that where the determination was for an amount greater than \$25,000, the cap that applied to the legal fees would be 80% of \$5,000, or \$4,000.

24. What aspects of the design and operation of the CSLR should be determined by the CSLR and what aspects should be prescribed in legislation?

It is our preference that the legislation and the regulations address the bulk of the details of the operation of the scheme and there be little, if any, powers that are delegated to the CSLR. In this way the design will be in the legislation and the operational parameters would be approved by the Minister, although most likely be subject to analysis and recommendation by the management within the CSLR.

We favour a prescriptive approach, where the model is clearly defined, and the intervention of the Minister can be kept to a minimum and where the CSLR is largely in an operational capacity. It is our view that this will help to minimise the administration costs of the CSLR.

Concluding Remarks

The AFA is very concerned about the rapidly increasing costs that are impacting financial advice practices at present and the Compensation Scheme of Last Resort is just one more additional cost that will place pressure on the viability of these practices. We nonetheless acknowledge the Government's determination to implement a CSLR, and therefore realise that it will proceed. As part of this, we would like to ensure that it is designed and implemented in a sensible manner, where the benefit of the scheme is broad, and the funding reflects the benefit that is derived by broader confidence in the financial services sector.

The AFA welcomes further consultation with Treasury should clarification of anything in this submission be required and we may be contacted on 02 9267 4003.

Yours sincerely,

Phil Anderson

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Association of Financial Advisers Ltd