



Compensation Scheme of Last Resort

Overview

The FPA has previously opposed the establishment of a Compensation Scheme of Last Resort (CSLR) as a first step in providing compensation for unpaid determinations from financial services complaints.

Paying compensation must primarily be the responsibility of the party whose behaviour gave rise to the complaint. Holding financial services firms and practitioners responsible for their own behaviour is an essential component of professionalisation and necessary to improve standards.

The FPA continues to believe that the first step in ensuring consumers are able to access compensation is to address the underlying causes of unpaid determinations.

The Government must address the role of professional indemnity (PI) insurance in the regulation of financial services. Financial services firms and practitioners are required to hold PI insurance as a condition of their license. In part, PI insurance is intended to cover liabilities from financial services complaints and ensure that licensees are able to pay compensation when a complaint is made against them. In practice, failure to hold adequate and appropriate PI insurance is a major cause of licensees not paying compensation when it is due.

The St John review considered these issues in 2012 and made recommendations to improve the effectiveness of PI insurance. These included addressing the quantum and coverage of PI insurance and recommending ASIC take a proactive role in monitoring whether licensees are complying with their PI insurance obligations. To date, the Government has not taken any action on these recommendations and problems with PI insurance continue to be a major cause of unpaid determinations.

A CSLR would transfer responsibility for paying compensation from the party subject to the complaint to the financial services sector as a whole. This is a significant departure from the principle of individual responsibility and should only be taken as a genuine last resort for providing compensation to consumers. A CSLR should not replace proper action by the regulator to hold parties responsible for their own misconduct or poor performance.

In designing a CSLR, the Government should have regard to the nature of financial services complaints, the need to balance equity in funding the CSLR with a sustainable funding model, and the role of a CSLR in promoting confidence in the financial services sector.

The FPA has reflected these issues in its answers to the questions posed by Treasury in its consultation paper. In summary, a CSLR should have the following parameters:

- A CSLR should have a broad coverage that reflects AFCA's jurisdiction to hear financial services complaints for multiple financial services classes and appropriately apportion responsibility between them. It should provide a holistic and integrated approach to external dispute resolution (EDR) which promotes consumer confidence in the financial services sector.

- Compensation limits for a CSLR should mirror AFCA's compensation limits, to provide a simple and fair approach for consumers who have been unable to recover compensation from the responsible party in the first instance. A CSLR should have the ability to further alter or qualify the compensation payable to ensure it remains sustainable and within its available funding.
- The approach to funding a CSLR should reflect the broad risks of different financial services classes and the exposure that each class brings to the CSLR. However, it should balance this principle against the need to establish a broad and robust funding base for a CSLR, with all financial services classes making a contribution.
- A CSLR should include a method of calculating funding between licensees in a single financial services class that is as simple as possible to minimise administration costs and reflects existing industry funding models, such as the ASIC industry levy. For example, a per planner approach to funding for financial advice licensees would be simple and equitable. A CSLR should avoid using complex metrics to approximate risk at a firm-level.
- A CSLR should focus on maintaining a stable and predictable industry levy, with a focus on limiting the burden on firms and practitioners. An industry levy should have a maximum growth rate each year and the CSLR should seek to manage its cashflow with the available funding.
- Finally, the obligation to participate in a CSLR should be seen as an opportunity for all financial services participants to take responsibility for identifying and reporting misconduct and poor performance. Demanding higher standards throughout the financial services sector will reduce the number of consumer complaints that require compensation and the call on a CSLR to provide funding in the long term.

Coverage, beyond personal advice

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

A CSLR should have a broad coverage and include any financial services classes that are subject to AFCA's jurisdiction. A broad approach would achieve three things.

Firstly, by mirroring AFCA's jurisdiction it would complement a comprehensive EDR arrangement for financial services. This would ensure that compensation is available for any AFCA determination and consumers are not unfairly excluded from the CSLR based on the specific financial services class or classes to which their complaint relates. It would also reinforce AFCA's practice of looking at complaints holistically and apportioning responsibility between different financial services classes where a complaint covers multiple parties.

The recommendation of the Ramsay report that a CSLR only covers financial advice was made at a time when other types of complaints were excluded from EDR processes. This is no longer the case. AFCA's jurisdiction covers a range of financial services classes

reflecting the reality that a single complaint from a consumer can cover multiple licensees that are providing a variety of financial and credit advice and products.

Matching AFCA's jurisdiction would ensure consistency in the treatment of unpaid EDR determinations and provide clarity for consumers seeking redress through EDR.

Secondly, a broad approach is necessary to ensure the sustainability of funding for the CSLR. To have the confidence of consumers, a CSLR must be credible and provide some assurance that funding will be available for unpaid determinations into the future.

Limiting the CSLR to a single financial services class, such as financial advice, would narrow the funding model and make it vulnerable to changes in the size of that class and its ability to pay. As Treasury's own modelling shows, this problem will be even more acutely felt when confronting a large, unexpected event.

Thirdly, by including a broad range of licensees across the financial services sector, the CSLR would provide an incentive for all participants to take responsibility for identifying and reporting misconduct and poor performance. This has been an area of failure in the past. Industry participants holding each other to account is an essential part of eliminating misconduct and necessary to restore the public's trust in the financial services sector.

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

A CSLR should only apply to AFCA determinations in the first instance. A major concern is the lack of reliable data that establishes the likely quantum of unpaid determinations. This problem is worse when considering court and tribunal decisions, where reliable data is not available and particularly given these jurisdictions are not subject to the same compensation limits as AFCA determinations. Without adequate data to inform a decision, extending a CSLR to include court and tribunal determinations risks its sustainability and confidence in it being able to provide compensation when required.

Funding arrangements

3. *To what extent should the funding model be based on risk?*
4. *How should risk be assessed?*
5. *Should the funding model assess risks at the individual financial firm level or at the financial services class level?*
6. *Should a risk-based funding model apply to all CSLR costs?*

Our primary concern is the need to provide a sustainable funding base for the CSLR by including a wide range of financial services classes and that participants in these classes make an equitable contribution to the funding of a CSLR.

To promote equity, the division of funding between classes should have some relevance to the level of risk in each class and the potential exposure it brings to the CSLR. This is particularly important for the managed investment scheme sector, where the

consequences of a single failure could include substantial compensation payments to affected consumers.

An assessment of risk at the financial services class level should consider the potential exposure of the CSLR to claims for compensation relating to that class. Ideally, this assessment should be made based on contemporary data, given rapid changes in the regulation of financial services in recent years which are likely to affect exposure levels.

However, regardless of any assessment of risk we consider it appropriate for all participants in the financial services industry to contribute a share of funding. All participants in the financial services industry will benefit from the increased public confidence that results from establishing a CSLR. A financial contribution to a CSLR will also provide incentive for all firms and practitioners to identify and report misconduct and poor performance where it occurs.

Within financial services classes – that is, between individual firms and practitioners - the apportionment of funding should be as simple as possible to minimise administration costs. In our view, there is unlikely to be an accurate and cost-effective way to assess risk at a firm level. As such, fundraising should be distributed between firms based on their ability to pay, rather than an approximation of their risk level.

It would not be equitable to use an approximation of risk to increase the levy and ascribe a level of culpability to any firm that is not directly responsible for an unpaid determination.

7. *To what extent should the funding model be based on a firm's ability to pay?*
8. *How should ability to pay be assessed?*
9. *What are suitable universally available metrics to assess a firm's ability to pay?*

Within each financial services class, the division of funding should reflect each participant's ability to pay. In the case of financial advice, it would be equitable for larger firms to pay proportionally more than smaller firms, so as not to disadvantage one over the other based on their particular business model or structure.

The calculation of a firm's ability to pay should be as simple as possible to reduce administrative complexity and cost. It would be appropriate to consider how this is achieved through existing models such as the ASIC industry levy.

A per planner fee would be simple to administer and would adequately reflect the size of each firm and its potential to raise revenue. By contrast, flat rate fees per licensee would result in small businesses and sole practitioners contributing the same funding as large licensees. This is inequitable and would discriminate between firms based on their business model and size. It would effectively incentivise consolidation in the sector and may have a negative impact on competition.

Other existing metrics that have been suggested as a proxy for a firm's ability to pay, including funds under management, revenue, and profitability, are either not universally used across the financial advice sector or are subject to inaccuracies that would reduce their usefulness. We do not recommend that a CSLR consider these as a measure of a

firm's ability to pay, nor would we recommend an attempt to create new benchmarks for the same purpose.

10. How should the funding model address unexpected costs?

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

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

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

The FPA has a considerable concern about adding additional calls for funding to financial advice firms that are already struggling with rapidly rising regulatory costs and levies. Decisions on the administration of a CSLR must be cognisant of the limited ability of financial advice firms to respond to unexpected increases in a funding levy.

Financial advice firms are already having to manage variation in other government fees and charges. For example, the ASIC funding levy has increased by 26% over the estimate for the current year. This sort of volatility makes it extremely difficult for firms to budget for their regulatory costs.

Fundraising for the CSLR should focus on avoiding volatility and giving firms a reasonable expectation on how much they will need to pay for a funding levy in the coming years.

There are a number of measures that a CSLR could consider in addressing unexpected costs. One method would be to spread large compensation payments over a number of years to smooth their impact on cashflow and the need to increase the funding levy. A CSLR could also borrow to provide unexpected compensation payments with repayments being recouped over future years' funding levies. Both options would assist in reducing year-on-year volatility and providing a predictable funding requirement for industry.

Another option would be to develop a capital base for the CSLR in advance of potential unexpected costs in the future. However, a capital base would also have to be funded by the industry levy and any funding raised for this purpose would be in addition to that required satisfy a CSLR's yearly compensation payment. Given the FPA's concern about the ability of financial advice firms to manage increasing regulatory costs, we cannot support any option that increases the amount that firms have to pay beyond that which is needed to satisfy actual expenditure by the CSLR.

A capital base could be slowly accumulated should actual compensation payments in a given year be less than anticipated, with the balance contributed to an ongoing capital fund. There may even be justification to be conservative in estimating yearly CSLR expenditure, thereby making a surplus more likely. However, the FPA cannot support a higher industry levy of the scale needed to build a significant capital base in the short term.

14. *Should a maximum cap apply to the annual levies that can be imposed on participating financial firms?*
15. *If a maximum cap is imposed, what is an appropriate metric for this cap (for example, gross revenue from covered financial services)?*
16. *If a maximum cap is imposed what should the maximum cap 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)?*

To ensure some predictability in the industry levy and to protect firms from unrestrained levy increases, it would be appropriate to consider a cap on the industry levy. This could take the form of a maximum increase in the year on year levy amount, such as a maximum 10 per cent increase on the previous years' levy amount.

Using other metrics to estimate a cap based on the size of a business is problematic for financial advice. As noted above, suggested metrics such as funds under management, revenue and profit are not consistently used or potentially inaccurate.

Management of the CSLR should have a full range of options in adjusting compensation payments to ensure the ongoing viability of the CSLR within the proposed funding envelope.

Compensation to be paid

18. *How should compensation limits be used by the CSLR to balance the interests of consumers and those funding the scheme?*
19. *If the CSLR compensation limits are to be lower than AFCA's claim limits, what limit would be appropriate?*

It would be appropriate and in the interests of providing a seamless EDR service for a CSLR to mirror the compensation limits used by AFCA. This would be easily understandable and promote confidence among consumers. Management of a CSLR may choose to further alter or qualify the compensation payable to ensure the CSLR remains viable and operates within its available funding.

20. *How should the CSLR manage claims associated with large unexpected failures?*
21. *Should the CSLR be able to spread compensation payments over time and, if so, what would an appropriate maximum time period be?*

As above, a CSLR should prioritise stability and predictability in its calls for funding via an industry levy. This may become challenging should a CSLR be confronted with large unexpected failures. To the extent possible, a CSLR could spread compensation payments over multiple years to reduce their impact on yearly fundraising. A maximum of three years is likely appropriate, as an excessively lengthy period would undermine public confidence in the scheme.

As an alternative, or in addition to spreading compensation payments over multiple years, a CSLR could also use borrowings to smooth the impact of compensation payments on yearly fundraising. Treasury should examine the possibility of a CSLR accessing concessional financing to enable this approach, given it would be extremely low risk debt.

Any large unexpected failure should trigger consideration by the Government over what led to the failure and whether there are regulatory changes that need to be made. A CSLR should not alleviate the need for regulatory action to protect consumers.

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?

It should be within the powers of CSLR management to determine additional compensation limits and other measures relating to compensation payments to ensure the sustainability of the scheme.

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

As with general compensation limits, the FPA would support applying the same limits for legal and professional costs as used by AFCA.

Managing scheme evolution

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?

Core components of a CSLR should be established through legislation, including the mechanism to raise funding through an industry levy and the principles on which the levy calculations should occur. Management of the CSLR should be responsible for setting the annual levy amounts, consistent with the legislation and a cap on yearly growth.

Management should also have wide discretion over the quantum and manner in which compensation is paid, to ensure the sustainability of the CSLR.