7 February 2020

The Treasury
Langton Crescent
PARKES ACT 2600
By email: CSLR@treasury.gov.au

Dear Sir/Madam

Re: Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort – Discussion Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment to the Treasury on Implementing Royal Commission Recommendation 7.1 – *Establishing a Compensation Scheme of Last Resort – Discussion Paper*.

AFMA broadly supports establishment of the CSLR for the purpose of establishing an industry-funded safety net for covering unpaid determinations and compensation to consumers and small businesses in the event of them being unfulfilled by financial service providers that are not covered by an existing scheme.

It is incumbent on Treasury to ensure that the scheme design is robust, targeted, fair and efficient. There are risks that the scheme, if not appropriately calibrated, may result in an ill-defined scope and funding arrangements that do not attribute costs fairly back to firms in the relevant industry, and do not confer any discipline on administrative costs.

Please find our general comments and responses to the specific questions below. We trust they are of assistance. If you would like further information, please do not hesitate to contact me via the Secretariat.

Yours sincerely

Damian Jeffree

Senior Director of Policy

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7900 Email: secretariat@afma.com.au

Definition of small business

AFMA is concerned that the proposed definition of 'small business', while aligned with the definition used by AFCA does not work efficiently in the financial markets context.

AFCA's definition of 'small business' includes businesses that have less than 100 employees.

In financial markets it is not uncommon for funds to manage many billions of dollars with modest staffing levels far below this threshold. We also note that Australian branches of foreign entities, including banks may contain very few staff locally while representing large foreign firms. These are large firms under any reasonable definition.

It may not be appropriate or efficient to include firms of this nature in the definition of small business. These firms are likely to have other avenues of recourse available to them, and their inclusion in a scheme designed for consumers may have the effect of reducing funds available for others in the scheme.

We suggest the use of one of the existing definitions of small business that would better focus the scheme such as the ATO small business definition:

> *'You are a **small business** entity if you are a sole trader, partnership, **company** or trust that: operates a **business** for all or part of the income year, and has an aggregated turnover less than $10 million (the turnover threshold)'*

In the alternate the ASIC definition could be used of annual revenue of less than $50 million, less than 100 employees, and consolidated gross assets of less than $25 million. While the ATO definition is preferred we accept that the ASIC definition has greater consistency with the AFCA definition.

Evidence-based regulation

AFMA bases our approach to good regulation on the ICSA Principles for Better Regulation.

These principles suggest regulation is only appropriate where there is a demonstrable market failure, is targeted for specific objectives, is proportionate to the scale of problem complexity and is risk-based.

In the financial markets, as Treasury is aware, there are extensive protections and mechanisms already in place to protect consumers. We differentiate here between financial markets and the management of investment products that may (or may not) be traded on them such as managed investment schemes[1].

Securities are held directly through the HIN system or are held in trust for consumers. Client monies are held in trust in segregated accounts. Extensive arrangements are in place to ensure the system can address issues stemming from the failure of clearing

[1] In the same way that financial market issues can be separated from issues of corporate governance in companies that may be traded on them.

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members of the exchange, or the clearing house itself. There are capital requirements for brokers as well.

In addition, the National Guarantee Fund (NGF) is well established and capitalised with net assets of $96.4 million as at 30 June 2019. The NGF provides clearing and settlement protection in addition to compensation related to specific ASX-related claims.

These systems and protections have generally functioned well when called upon, and where shortcomings have been identified, improvements have been implemented.

In addition, many of the larger firms that supply financial markets services are prudentially regulated Australian Deposit-taking Institutions (ADIs). This further decreases the risks of failures ever negatively affecting consumers.

Against this backdrop it is not clear that there is an identified failure of existing arrangements in relation to financial markets that needs to be addressed.

While we understand that the data available to identify unaddressed risks is limited in scope and quality, it is essential for good policy processes that this be made available so that good policy processes can be applied, and the response can be made risk-based and proportionate to the problem. We welcome Treasury's commitment in this regard and look forward to reviewing the data in due course.

If the risks Treasury is seeking to address are theoretical and to this point unsubstantiated with example cases, then actuarial modelling of the risks would be an appropriate alternative way of assessing those risks.

In the absence of data supportive of the establishment of a scheme to respond to cases that have emerged or actuarial modelling of the potential risks then it may be impossible to progress a soundly based policy response.

While we would be supportive of extension of the scheme to parts of the financial markets if the data or actuarial modelling were to support it as a proportionate response, at present we suggest the focus be maintained on the areas where there are known to be issues, and consistent with the recommendations of the Ramsay Review maintain an initial scope of personal financial advice.

Coverage

Scope

We support an initial coverage of financial advice. While AFMA members that provide financial advice have not had issues with unpaid determinations it is recognised that such unfair outcomes have been an issue in the case of some smaller providers and this should be addressed.

We would not support extension to broking and financial markets businesses at this time until further information is available and assessed.

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Areas should be added to the scheme with care as it is unlikely that areas will ever be removed from the scheme, and there is a risk that if inappropriate areas are included then this could result in an inefficient scheme.

Treasury should proceed carefully and incrementally in building the scheme and implement good policy processes to assess the cost benefit analysis for each potential sector carefully and fully before inclusion in the scheme.

Prudentially Regulated Entities

AFMA does not support the inclusion of prudentially regulated entities in the scheme. Such inclusion is unnecessary given that the very low risk of failures of these entities.

It is not an efficient outcome for the economy to go to extensive lengths to limit the risk of unmanaged failure of firms and then put in place an extensive scheme to bring risks to zero.

Treasury's commitment to sustainable economic growth can only be achieved through support for economically efficient processes. Duplicative processes that endeavour to remove all risk are likely to be inherently inefficient.

Prudential risks are not zero but they are very low and have improved since the HIH collapse.

We do not agree that the proposal put forward as 'mid-tier' is a reasonable middle way as the name might suggest. ADIs are prudentially regulated as entities and activities within the entity as a whole when the prudential stability of the entity is considered by regulators. Even where these activities may not be directly prudentially regulated, the reporting by the entity and prudential supervision will ensure the risks they pose to the viability of the entity are very low.

Funding

At a general level we caution against some UK design elements such as basing funding on an ability to pay and sector cross subsidisation both of which are fundamentally unfair. While the UK has had pre-eminence in regulatory matters previously it is important that each regulatory scheme is assessed on its merits. Where there are flaws in scheme fairness and design these should not be copied locally.

We divide our concerns around funding into two areas. Firstly, we note matters relating to the administrative costs of the scheme.

Administrative Costs

We believe the administrative costs should not be funded in the same way as the compensation pool(s). There are good public policy reasons for preferring government involvement in the administrative funding.

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There is a public good element to the provision of a CSLR. As such it is appropriate that there is a meaningful government contribution to the administrative burden that the scheme produces.

We proposed that administrative costs of the CSLR to be divided equally (50-50) between the government and the industry. This type of arrangement has precedents elsewhere. We note that FMA in New Zealand has 25% of its total funding met by government[2] to reflect the public and private good of its operation.

Soft Budget Syndrome

An argument for including a governmental stake in the scheme administration costs is that this will keep a check on the expansion of funding costs since industry experience shows that costs tend to trend higher over time when borne entirely by industry. This is known as soft budget syndrome.

Kornai (1986) suggests "the 'softening' of the budget constraint appears when the strict relationship between the expenditure and the earnings of an economic unit (firm, household, etc.) has been relaxed, because excess expenditure will be paid by some other institution".

For Treasury to achieve an efficient administrative outcome it should put in place measures that will naturally lead to the administrative costs being managed.

Compensation Pool Funding

The scope of the compensation funding should recognise that there are limits to the self-funding nature of the scheme if the Government wishes to avoid tail-risk events having severe effects on particular industries. There is an explicit requirement for trade-offs between Treasury's interest in scheme resilience and affordability. Large events may have the potential to critically impact industries that have already been made marginal by regulatory initiatives. For large events it may be appropriate to consider a role for the dispersion of costs through the tax system rather than risking significant damage to particular industries. We suggest that there may be an incompatibility between designing a scheme for relatively low level payments in normal times and then requiring this same scheme to accommodate losses in the hundreds of millions. It may be of benefit to consider these as by nature different types of events with different systemic impacts and preferable solutions.

Separate to the administrative costs, the funding for specific costs of compensations/pay-outs should be based on a relative risk model. This is the only efficient and fair mechanism open to adoption if Treasury is to meet its objectives.

[2] https://minterellison.co.nz/our-view/consultation-on-fma-funding-and-levies

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As noted in the discussion paper and earlier in the Ramsay Review to keep the incentives in place for firms then there needs to be a direct link between the risk a firm creates and its costs for the proper incentives to be preserved.

Risk must be reasonably and accurately assessed. While we appreciate that a firm by firm calculation may not be practical, at a minimum the risks must be adjusted on a reasonable actuarial basis for the risk of failure of each category including size (and if included prudential status) of firms in addition to assessments based on activity.

AFMA suggests that the 'ability to pay' basis for industry levy determination is fundamentally an unfair approach to funding. For a scheme designed to increase consumer fairness this would be a particularly incoherent outcome.

If the fair allocation of costs produces outcomes that are unaffordable for small firms and it is a desired public good policy outcome that these costs be lower for these small firms then it may be appropriate to make these costs more affordable through funding from general revenue drawn from efficient taxes rather than artificially increasing the burden on firms that have not contributed to the problem that these smaller firms create.

Unexpected Costs

AMFA supports a small capital buffer as proposed but cautions against the large buffer approach that has been used with the NGF. Large buffers are an inefficient drain on firms.

Sustainability and Affordability

AFMA is concerned that the proposals around the maximum cap look to metrics related to ability to pay rather than maintaining relevant proportional contributions.

Dealing with large payouts is when scheme fairness will be most impactful on participants and therefore it is imperative that fairness continues at such times.

If the maximum cap is set on revenue metrics then any scheme fairness derived from funding based on the risk created by a firm could be lost for larger firms. These firms could potentially have a much higher cap under such an arrangement and this would distort the contributions away from being risk based.

Any caps to contributions to the scheme should be done in terms of a maximum multiple of the contributions during normal times. If there are public policy reasons for further limiting these for smaller firms then the difference should be borne by revenues derived from efficient taxes rather than being levied on firms merely because they are large.

Compensation

AFCA provides remedies for which firms that are responsible for the actions are liable to pay.

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While certainly complementary to the AFCA service, the CSLR should be designed as a backstop service where claims based on AFCA remedies will be effectively mostly paid by firms other than the firm that caused the action in the event there is an outstanding claim against a firm.

The scheme with monies mostly from firms other than the one which has caused the issue will generally be better placed to pay outstanding monies than the firm that has caused the issue. This is likely to make the scheme a more attractive source for consumers wishing to have their claim settled promptly, however, there may be valid policy reasons to encourage consumers to pursue their claims through the ordinary processes against the firm that is responsible for their loss rather than against the scheme and therefore effectively against all other firms in the sector.

We would welcome more information on what the likely effects of setting the scheme limits the same or differently to AFCA could be, including perhaps at a high percentage of the AFCA remedy.

Scheme Evolution

If efficiently implemented the scheme should involve limited numbers of staff. While this is an appropriate outcome it increases a number of risks.

In the event of a large failure which may place a burden of hundreds of millions or even billions of dollars on the economy these national strategically important economic decisions are unlikely to be best addressed by the resources of a small independent agency. These decisions could critically damage important nation industries and create inefficiencies in the economy.

In the event that decisions on such matters were made by the agency it may be difficult for the Treasurer to intervene at a later stage. As such there should be a firm delegated limit to the size of the matters that the CSLR can deal with before matters must be escalated to the Minister.

A small agency also raises the potential for drift from the intention of Parliament and the Minister over time.

We propose that this risk could be managed through the following measures:

- Periodic reviews of CSLR by the government.
    - An evidence-based review of administration costs and industry levies on an annual basis.
    - General review of the scheme on the whole every three years.
- Government appointed independent audit of the efficiency with which the scheme delivers its services. The industry being the co-funder (if administration costs are borne both by government and industry) should be offered the opportunity to provide inputs in the independent audit process.

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Treasury consultation process

AFMA notes Treasury's indications around its interest in receiving novel and innovative ideas, and that it is familiar with the main arguments more generally.

We would like to note the importance of consultation processes continuing to engage fully with those consulted and all the arguments raised. Consultation processes that do not actively consider the balance of arguments at each occasion risk becoming exercises in form only.

AFMA supports early, extensive and empowered engagement with the industry to approach the policy in the best possible manner. This involves including industry and other parties at the ideas stage before a proposal is prepared. An issues paper can assist in this purpose.

We recommend Treasury consider the work of Archon Fung in the influential 2006 article *Varieties of Participation in Complex Governance*[3] which outlines three dimensions - scope of participation, mode of communication and decision, and extent of authority – constituting the 'Democracy Cube' of participatory design. Fung offers this classification to assess the inclusiveness of consultation processes along the three axes of the cube. At present, Australian regulatory processes tend to fall towards the left corner of Fung's cube, indicating lesser inclusion and consultation in democratic governance.

Treasury may find benefit in using Fung's work perhaps in conjunction with feedback processes to review the functional effectiveness of its consultation processes.

[3] Fung, Archon (2006), 'Varieties of participation in complex governance', Public Administration Review, 66 (S1), 66–75. http://faculty.fiu.edu/~revellk/pad3003/Fung.pdf Revisited in 2015 in Fung, Archon. "Putting the Public Back into Governance: The Challenges of Citizen Participation and Its Future." Public Administration Review 75.4 (July/August 2015): 513–522. http://archonfung.net/docs/articles/2015/Fung.PAR2015.pdf

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