17 August 2021

Director
Redress Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

CSLR@treasury.gov.au

Dear Director

RE: Compensation Scheme of Last Resort

AFMA welcomes the opportunity to make comment on Treasury's consultation on the Exposure Draft for the Compensation Scheme of Last Resort (CSLR/the scheme). The AFMA membership includes providers of retail financial advice and securities dealers which would be directly affected, while most of our membership could be caught under the potentially leviable financial firm categories listed in Appendix D.

AFMA's primary concerns are around ensuring that the governance arrangements and incentives are appropriately calibrated to ensure balanced and sustainable outcomes for the scheme, and that to the greatest extent possible firms in sectors with little to no connection to a failed firm are not required to contribute to funding matters connected to the failed firm.

We trust our comments are of assistance in building a scheme that will efficiently deliver the outcomes the Government intends in a stable way over the long term. We are thankful for the opportunity to provide feedback at the recent productive and helpful roundtable and would be pleased to provide further information as the scheme moves towards commencement.

Please do not hesitate to contact me via the Secretariat for more information or explication.

Yours sincerely

Damian Jeffree

Senior Director of Policy

Governance

AFMA is supportive of the move to have the rules relating to eligibility, paying claims, and levying financial firms in primary legislation and/or regulations rather than in scheme rules set by the scheme operator. This approach is less likely to result in scope creep over time, and more likely to remain aligned closely with Parliament's intentions.

Scope creep and increasing scheme size are the key risks for the scheme and we encourage Treasury to review the relevant checks and balances to ensure the scheme is kept stable in the long term.

AFMA is particularly concerned that the proposed governance arrangements may introduce unnecessary conflicts of interest in relation to the relationship of AFCA with the CSLR.

We are cautious about the proposed administrative and service help proposed to be provided by AFCA to CSLR. Given the potential for conflicts of interest in the interactions between these two organisations with CSLR partly funding and creating cost savings for the AFCA, an abundance of caution might suggest a greater degree of operational separation.

AFMA is opposed to CSLR Co being a subsidiary of AFCA Limited. Being so reliant on AFCA may introduce a culture of deference to the parent entity (which we note again it will partly fund) that could risk CSLR not delivering on its mandate with the required independence.

AFMA is similarly concerned with the proposal to have an AFCA industry director and an AFCA consumer director for the same reasons. The proposed arrangements would risk tilting CSLR Co to be overly influenced by an organisation to which it should have independence.

If there is to be one or more AFCA industry directors on the CSLR Board then it important that they are balanced out by industry representation with an equal number of full directorships allocated to the industry (e.g. two as proposed).

Payment arrangements

AFMA supports reasonable steps being required of AFCA before passing costs onto the CSLR. The existence of the CSLR substantially reduces incentives for AFCA to enforce compliance with compensation determinations by providing that claimants will be paid regardless and AFCA will receive its fees in a process that is likely to require less effort.

Given the change in incentives for AFCA AFMA supports regular independent reviews of whether AFCA is taking all reasonable steps to avoid passing claims onto the CSLR scheme.

AFMA is strongly supportive of the exclusion of market participants from the scheme in recognition of the long standing, well capitalised and well-functioning National Guarantee Fund the SFE Fidelity Fund and ASX Supplementary Compensation Fund which cover matters related to listed markets.

Compensation Cap

AFMA strongly supports the $150,000 cap on claims under the CSLR. Capping claims at a reasonable amount is a strict requirement for there to be the possibility of accurate actuarial estimates of total claims. Previous experience with the NGF suggests that a cap places schemes on a surer footing, which benefits claimants, and contributing firms are subject to less unknowable risk.

Payment of AFCA fees

AFMA does not support the CSLR paying all AFCA fees in relation to complaints against insolvent financial firms. AFCA services are provided free of charge and are funded by AFCA member contributions of various types.

In most cases the insolvent firm (and firms of a similar risk profile) would have made previous contributions through at least the annual AFCA fee, and it is appropriate therefore that some of some AFCA funds are hypothecated towards providing AFCA services, even if that firm is no longer solvent.

Futher, removing all AFCA costs from AFCA members in the likely significant percentage of cases involving insolvent firms would remove a key incentive for AFCA to keep its costs efficient in relation to claims involving that portion of its activities. AFCA members are better placed to put pressure on AFCA to keep its costs efficient, in contrast CSLR levied firms will be less likely to be so.

AFCA members should contribute a significant share (perhaps half) of the AFCA incurred costs in relation to insolvent firms. Furthermore, we would suggest as a measure to ensure a baseline of efficiency that the maximum AFCA costs recoverable from the CSLR should not exceed more than a third of the compensation amount paid by the CSLR.

Funding arrangements

AFMA agrees with limiting, to the greatest extent possible, the costs of unpaid determinations to financial firms licenced to provide the same type of financial product or service. Finance is not a monolithic industry and the connection between financial firms in unrelated areas can readily be no more than between any two other areas of the economy. The limited arguments in favour of firms that are not responsible for financial losses paying for those created by an unrelated firm, diminish even further when there is a limited connection between even sub-sectors the firms are in. There is likely more validity in paying these losses from general revenue rather than a curious mix of firms in unrelated business areas.

While firms within a sector might be in a position to understand and support government policy that is likely to reduce the chances of an individual firm causing losses for investors and failing in a way that does not leave appropriate funds available to cover these losses, for firms from different sectors this is unlikely to be the case. For example, financial advisors while in a position to understand and support good policy in relation to financial advice, are unlikely to be in a position to support good government policy in relation to credit intermediaries. Yet in the event of a failure of a credit intermediary they could well be exposed

through a number of the funding mechanisms. We note in particular the 'potentially leviable' firms are very unlikely to have much to do with a large increase in determinations that have originated in the leviable sectors. We suggest that the scheme should not include these firms as a source of scheme funding unless these firms had an active role in relation to a large failure.

We are concerned that the proposed funding arrangements may not give enough consideration to the varying levels or retail engagement across different firms that may hold retail AFSLs. We encourage Treasury to ensure the ASIC metrics used for each sub-sector are limited to retail activity (e.g. for Securities Dealers, measurement of "annual *retail client* transaction turnover"), and to consider a funding model similar to the AFCA membership levy that also focuses on a variety of different retail client metrics (rather than merging institutional and wholesale client activity into those metrics).

Many larger financial services firms have now limited their provision of retail financial service or products given the regulatory complexities, risks and costs required to provide those services in a sustainable compliant way. Firms that hold licences but do not provide retail services, or only offer them in a very limited way, should only be charged proportionate to the risks they create. Some firms with a small remaining retail footprint are likely to completely withdraw from the retail space and cease AFCA membership if the costs and risks of CSLR are not proportionate to their activity and risk.

Unpredictability of Funding Arrangements

The unpredictability in relation to the funding levy and the potential impact of a 'black swan' event present serious risks for financial services firms. Firms cannot budget for CSLR costs with confidence when the Special Funding Levy could take the total levy up to the Scheme Cap of $250 million per annum. A large Opes Prime or HIH Insurance type corporate collapse could result in widescale claims on CSLR via AFCA. The industry seeks to understand more around the treatment of claims on CSLR for which failed firms do not present a defence at AFCA.

Impact on the advice sector

ASIC has recognised that financial advice is no longer affordable for the majority of Australians. This state of affairs has been driven by over a decade of increasing regulatory costs and burdens.

The Government has indicated an interest in reviewing the affordability of advice. However, the CSLR scheme runs directly against the aim of improving advice affordability as it is likely to further increase costs for advisors and thereby the cost of advice for Australians.

We suggest as a matter of consistency and increasing understanding that Treasury model the likely increase in the cost of advice (and potential decrease in advisors) created by the scheme in normal years and years of maximum claim in advance of scheme establishment to ensure that in a procyclical future time the scheme does not have unintended consequences. Increasing scheme costs at a time of decreasing numbers of advisors could lead to an undesirable increasing of costs per advisor.

Ministerial determinations

AFMA supports the proposed system of Ministerial determinations over leaving questions of sourcing excess funding requirements to the CSLR entity.

The Ministerial determinations should be accompanied by an explanatory statement as to why the particular subsectors not related to firm or sector that caused the overrun are being targeted. We support the determinations being subject to the normal Parliamentary disallowance processes.

Scheme cap

While AFMA supports the scheme cap, given it is for each year and it will be for a quarter of a billion dollars it will allow the scheme to be a potentially heavy burden on industry for multiple years. It may well be procyclical in the cases of large failures partly caused by difficult trading conditions. Under such a scenario it could have potentially significant unintended consequences for affected industries and their customers.

APRA's views should be sought on the prudential treatment of the off balance sheet exposure for banks, noting their previous interest in NGF exposures.

For significant breaches of the subsector caps we suggest the Ministerial determinations should include as a matter of course, or recommendation, modelling on the likely impact of the additional charges on affected sectors. Metrics could include the likely increase in the cost of financial advice and the likely number of firms that will be significantly impacted.

$1000 minimum levy threshold

While we recognise the inefficiency in collecting levies from firms where costs would exceed or be a large part of the monies collected, our preliminary view is that the $1000 minimum is too high. An efficient collection system should be able to collect levies far smaller than this and still return a large percentage of the collected funds after costs.

Further shifting costs onto a smaller pool of leviable entities would increase the inequities in the scheme. Large firms are already disadvantaged as they are far less likely to cause a need for a determination but will be billed more.

Administration costs

The administration costs appear too high at $3.7 million p.a., and particularly against the intended average yearly payout with administrative costs taking an estimated 46% of yearly levies of the mature scheme. This appears to be an inefficient result. For comparison SEGC expenses for 2019 were $1,234,000 and in 2019 SEGC paid 233 claims totalling $7.8 million. The SEGC figures appear more reasonable and proportionate to the task required of the CSLR operator.

AFMA would suggest that more efficient implementation mechanisms be considered that can deliver the same outcomes at lower cost. The main work of the operator is to "assess CSLR claims in line with the

scheme eligibility criteria outlined in legislation and reach a conclusion to award or deny compensation". This is a reasonably mechanical process and may be suitable to outsourcing to firms with claim assessment experience on a tender basis. Residual functions might be managed by existing government resources.

Payment of CSLR administrative costs

AFMA is concerned that the proposed arrangements to fully recover all administrative costs from leviable firms creates a moral hazard and removes all incentives to keep administrative costs under control.

Industry experience with full cost recovery is that it trends upwards in costs significantly over time and there are no incentives for Government to intervene, or regulators to limit costs or increases.

Noting the public good element of the scheme outcomes, AFMA suggests that the administrative component be 50% paid by the Government in order to have a meaningful amount that is subject to scrutiny by a party in a position to drive efficiencies and avoid the known moral hazard and poor efficiency outcomes associated with full admin cost funding.

Establishment costs

Similarly, the establishment costs at $6.3 million also appears high. Some of these costs might be avoided by a lighter presence based on an outsourced model. Changes to ASIC cost recovery is listed as a significant upfront cost. If these are excessive consideration might be given to alternative methods for billing.

Estimated ongoing levies

We note concerns from others that the data may underestimate the ongoing costs of the scheme given issues with previous practices around not accepting further complaints when firms went into receivership. We defer to others in relation to these concerns but note that it is important that affected firms have an accurate understanding of the likely scheme costs before it is established. AFMA would also support the operator providing the breakdown of how costs have been calculated each year when bills are sent to leviable firms.

Incentives to reduce unpaid determinations

We note that the scheme removes and does not replace incentives for ASIC and the Government to address the underlying causes of unpaid determinations. For example, industry has noted the potential for better enforcement of capital requirements by ASIC could help reduce unpaid determinations, in the presence of a CSLR scheme there is likely to be less pressure from those that have experienced a loss due to a failed firm to ensure these capital requirements are being met.

We suggest that incentives such as a meaningful contribution to the scheme determination costs by ASIC might assist align priorities to address the causes of unpaid determinations. In the alternate Treasury should consider mechanisms to restore the incentives for regulators and policy makers.

Scope

We support the use of the ASIC industry funding model (ASIC IFM) or its successor for the purpose of determining categories of firms.

We note the known issue of what in reality are wholesale investors using the AFCA scheme and are concerned that CSLR funds should not be expended on wholesale investors who have other more appropriate avenues for recourse.