1 July 2017
EDR Review Secretariat
Financial System Division
Markets Group
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Sent in Word and PDF Formats

Dear Colleagues

Supplementary Issues Paper (Paper)
Review of the Financial System External Dispute Resolution (EDR) Framework

The Financial Services Council (**FSC**) has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies.The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Thank you for the opportunity to provide a submission on this topic. Our comments follow.

Background

1. We note that on 2 February 2017 we lodged a submission with the Review Panel on the EDR Framework (**February Submission**). We also expressed views on the merits or otherwise of establishing a compensation scheme of last resort (**CSLR**). We lodged with our submission a report by Professor Pamela Hanrahan in relation to other avenues and approaches which might be considered, rather than a CSLR being adopted (**Hanrahan Report**).
2. The Paper details the history of the Review Panel's processes and notes that following the amendment of the Review Panel's Terms of

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Reference, the Panel was required to undertake *two separate but related tasks*:

- *make recommendations on the establishment, merits and potential design of a compensation scheme of last resort; and*
- *consider the merits and issues involved in providing access to redress for past disputes.*

Copies of the February Submission and the Hanrahan Report are **attached**.

Executive Summary

3. Our views, and submission, by way of summary only at this stage are as follows-
   (a) For the reasons stated in our February submission, our view remains that as a matter of public policy or interest, the case for the introduction of such a more universal CSLR has not been established;
   (b) If, contrary to our submission, the concept of a CSLR is accepted, the scheme should **not** be introduced at least until such time as the recommendations in the **St John Report**[1]have been reviewed and measures introduced to address the issues that lead to licensees being unable to meet their consumer compensation obligations. Following implementation of the revised arrangements they need to be given an appropriate time to "work through" the financial sector to see if there then is an imperative for a CSLR. In this regard, we refer to the detailed comments we have made below concerning the St John and Hanrahan Reports;
   (c) Further, prior to the introduction of a CSLR, the reforms in progress to improve the competence and professionalism of advisers should be fully implemented and changes to the legislative breach reporting framework should be made to encourage and assist licensees to report and deal with "bad apples" **and** an assessment then made as to whether the necessity for such a scheme exists;
   (d) Moreover, the economic and industry specific implications of such a scheme do need to be given serious consideration having regard to the **Cadence Report**. This demonstrates the high cost of introduction of such schemes. In the result, ultimately a significant proportion of these costs would be borne by consumers and investors in the financial services industry;

[1] Expressions in bold are defined subsequently in our submission.

(e) A CSLR does not represent good public policy for the following reasons-

(i) CSLRs inherently promote moral hazard – for instance smaller, less-capitalised licensees could adopt less risk-adverse approaches and behaviours in the expectation that if something goes wrong, the scheme will "pick up the tab";

(ii) CSLRs generally are suggested as having a coverage that is wider than financial advice failures and include product failures-this gives rise to significant on-going liabilities for the scheme;

(iii) based on the proposals put forward for consideration by this review there is the suggestion that CSLRs have the very real potential to be retrospective in nature. It is neither good policy or equitable to enforce retrospective policy on an industry for the failings of other financial services providers. If the CSLR is retrospective, there is the prospect of the scheme having to address not only current FOS unpaid determinations but also future determinations relating to events that may date back a number of years. No modelling appears to have been undertaken to determine the size of the liabilities relating to this 'tail'. There also is an issue as to whether unpaid determinations or judgments of other tribunals and courts would fall within this process. The discussion in the Paper does not comprehensively analyse these issues or their potential impact;

(iv) a CSLR will be costly for those entities which are well-capitalised;

(v) CSLRs require funding and the precise parameters and scope of that funding is unclear;

(vi) any CSLR, ultimately, will be an additional cost to industry which is passed on to the consumer, either directly or indirectly.

(f) The overseas examples of CSLR, particularly that in the United Kingdom, does not augur well for any proposed Australian CSLR, particularly in the context of costs to industry and thus the broader economic impact and ultimately consumers and investors;

(g) If, contrary to our submission, it is determined to introduce a CSLR, in addition to the other matters we have mentioned at paragraph (b) above, then there are other conditions which should be placed on such a scheme to prevent the risk of potentially open-ended scope and unintended consequences. For example, that scheme must have clear parameters and be limited to advice matters which have been or could have been

the subject of **AFCA** determinations and then only in respect of events which occur on or after the commencement date of the CSLR-otherwise there is a real and significant risk in this regard of unfair retrospectivity being applied to the scheme.

Our detailed comments, expanding on these general themes, follow.

General Observations

4. The rationale for a potential CSLR is that in some circumstances financial services providers do not meet client compensation claims awarded by FOS, most commonly due to lack of financial resources. FOS has noted that between 1 January 2010 and 30 June 2016, 32 financial services providers[2] were unwilling or unable to comply with FOS determinations. As at 30 June 2016 the unpaid determinations amounts to $12,611,859 or $16.6m including interest and inflation.[3]

5. As part of the Future of Financial Advice Reforms a detailed review of compensation arrangements for retail consumers was undertaken and a report issued by Mr. Richard St John – *Compensation Arrangements for Consumers of Financial Services* (**St John Report**) in 2012. Mr. St John observed that retail consumers are generally able to recoup losses attributable to misconduct by licensees that they have dealt with. Following review of current arrangements, the St John Report concluded it would be possibly counter-productive to introduce a more comprehensive scheme of last resort.

6. The St John Report recommended priority first be given to putting licensees in a position where they can themselves meet compensation claims from retail clients through a more rigorous approach to compliance by licensees so that they will be in a position to compensate their own clients through their insurance arrangements and the capital resources they have at risk.[4] Mr. St John envisaged that a more stringent approach to licensing would be focused on licensees who are seen to pose most risk and that they would not impose a significant regulatory burden across the board.[5]

7. The St John Report noted that there were limited regulatory measures to protect consumers from licensee insolvency and therefore it would be inappropriate to require more responsible and financially secure licensees to underwrite the ability of other licensees

[2] Thirty-two financial services providers over 6 years did not meet their obligations. FOS noted they had over 13,500 members in the 2015-2016 Annual Review (see page 22). This is a very small proportion of members in any given year who are unable to meet FOS determinations.
[3] Page 52 – FOS 2016 Submission Review of the Financial EDR Framework
http://www.fos.org.au/custom/files/docs/fos-submission-to-edr-review.pdf
[4] Page iv St John Report.
[5] Page iv St John Report.

to meet their compensation claims against them[6]. In short, that Report recommended that the regulatory framework for advisers and licensees should be 'made more robust and stable before a safety net, funded by all licensees, is suspended beneath it'[7].

8. The **St John Report also cautioned against introducing a CSLR** to underpin compensation arrangements '**as a shortcut'** of remedying deficiencies in the current regime **as it would not address the underlying problems**. It would not improve standards of licensee behaviour or lead to licensees having greater responsibility for their own conduct.[8]

9. We confirm the summary comments made in our February submission, (at pages 13 to 14), as follows-

> *By their nature compensation schemes of last resort, (**CSLR**) represent poor public policy because of, at least, the following material outcomes and risks which would severely erode any perceived consumer benefits:*
>
> *1. CSLR inherently promote moral hazard – for instance smaller, less-capitalised licensees could adopt less risk-adverse approaches and behaviours in the expectation that if something goes wrong, the scheme will "pick up the tab";*
>
> *2. CSLR generally are suggested as having a coverage that is wider than financial advice failures and include product failures-this gives rise to significant on-going liabilities for the scheme;*
>
> *3. CSLR have the very real potential to be retrospective in nature. This raises the prospect of the scheme having to address not only current FOS unpaid determinations but also future determinations relating to events that may date back a number of years. No modelling has been undertaken to determine the size of the liabilities relating to this 'tail'. There also is an issue as to whether unpaid determinations or judgments of other tribunals and courts would fall within this process;*
>
> *4. CSLR will be costly for those entities which are well-capitalised;*
>
> *5. CSLR require funding and the precise parameters and scope of that funding is unclear;*
>
> *6. CSLR, ultimately, will be an additional cost to industry which is passed on to the consumer, either directly or indirectly.*

[6] Page iii St John Report.
[7] Pages iii and iv St John Report.
[8] Page 143 (2012) St John Report.

10. In relation to the 2012 St. John Report and the Hanrahan Report, we made the comments,(page 16), set out below, which we also confirm-

> *Based on the St John report and the Hanrahan research, more appropriate and effective policy outcomes, are likely to include at least the following approaches:*
>
> *(i) a detailed review and consideration of capital adequacy for AFSL licensees (as is currently the case with REs and RSEs) to "cover" potential liabilities;*
> *(ii) the raising of the level of professional indemnity insurance, with the support of ASIC and the general insurance industry;*
> *(iii) …other steps should be taken to strengthen the regulatory framework before consideration is given to a CSLR. These are*
> *A. the reforms to improve the competence and professionalism of advisers announced by the Government, but not currently due to be fully implemented until 2024, should be finalised;*
> *B. changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have those representatives dealt with;*
>
> *…*

11. In addition to the above, the recommendations from the St John Report should be reviewed and consultation take place on strengthening the existing system to improve licensing standards and place greater responsibility on licensees for their own conduct.

12. We also confirm the comments made in our February submission concerning the international comparisons for CSLR. It remains our view that these kinds of schemes have the potential to be extremely costly and potentially, give rise to virtually open-ended liability. As the Review Panel is aware, the FSC has commissioned economic modelling of a CSLR. The outcomes demonstrate the high cost of introduction of such schemes. We discuss this in further detail below. In the result, it seems to us that ultimately a significant proportion of these costs would be borne by consumers and investors in the financial services industry.

Cadence Economics (Cadence) Research on CSLR

13. As the Review Panel is aware, the FSC engaged Cadence to model potential costs of a CSLR, whose object would be to compensate retail

clients who suffer losses due to insolvency of an AFS licensee in the event of inappropriate advice, negligence, fraud or other actions. Cadence prepared a report in June 2017, a copy of which is **attached (Cadence Report).**

14. Included in the Report is the scheme costing should claims be limited to either $500,000 or $1 million. Based on the Cadence modelling, the direct annual scheme costs are expected to increase to $120 million or $125 million for those respective scenarios. These outcomes are detailed at page 4 of the Cadence report.

15. The costs of a CSLR were modelled over a 20-year period, to allow the consideration of how scheme costs could evolve over the life of the scheme.

16. Loss parameters were calibrated using historical data to develop a 3 tier probability loss model, that incorporated:

(a) 'Business as usual' loss tier, with an expected frequency of 17.5 years out of 20 years of the scheme;
(b) 'Major loss' (recession or single event failure) loss tier, with an expected frequency of 2 years out of 20 years of the scheme;
(c) 'Catastrophe' (GFC or major industry failure) loss tier, with an expected frequency of 0.5 out of 20 years, or a 1 in 40 year event.

17. The main results of the *Monte Carlo* simulation[9] show that:

(a) An advice only scheme, with the current FOS cap of $309,000 per claim, would cost the industry around $105 million per annum to fund;
(b) An advice and product scheme, with the **current** FOS cap of $309,000 per claim on advice claims, and an 80% cap on aggregate product losses, would cost the industry $310 million per annum to fund.

We note that under the EDR Framework proposals and draft legislation released by Treasury on 9 May 2017, the Australian Financial Complaints Authority (**AFCA**) will commence operations with:

- unlimited monetary jurisdiction for superannuation disputes;

[9] Monte Carlo simulations are used to model the probability of different outcomes in a process that cannot easily be predicted due to the intervention of random variables.
http://www.investopedia.com/terms/m/montecarlosimulation.asp

- $1 million limit on the size of non-superannuation consumer disputes (a 100 per cent increase on the current limit);
- a minimum $500,000 compensation cap for non-superannuation consumer disputes (a 62 per cent increase on the current cap);
- $5 million small business credit facility limit (a 250 per cent increase on the current limit)
- $1 million compensation cap for small business disputes
- (a 224 per cent increase on the current cap); and
- no monetary limits or compensation caps for disputes relating to guarantees supported by a mortgage or other security over the guarantor's primary place of residence.

Depending on the precise scope and parameters of any final CSLR, the overall costs could vary considerably as noted by Cadence.

18. The second round (indirect) impacts of the scheme were also modelled. This found that the deadweight loss of the scheme was approximately 47 cents per dollar raised. That is for each $1 raised in CSLR levies, an additional $0.47 of economic cost is borne by the national economy.

A number of scheme designs were tested (full results provided in table below).

CSLR annual cost estimates

	Annual direct costs $m	Annual indirect costs $m	Annual total cost $m	Direct cost per planner[1] $	Direct cost per AFSL[2] $	Direct cost per $1m FUM[3] $
Base case (advice only)	**105**	**49**	**154**	**4,549**	**28,354**	**323**
Wide scenario (incl Product Failures)	310	146	456	13,473	83,977	956
Claims capped at $500k	120	56	176	5,218	32,525	370
Claims capped at $1m	125	59	184	5,441	33,916	386
Eligible unpaid determinations $16m	106	50	156	4,602	28,687	327
Eligible unpaid determinations $116m	114	53	167	4,937	30,770	350
Recession frequency 12.5%	115	54	168	4,980	31,043	354
GFC frequency 5%	165	77	242	7,154	44,593	508
GFC claims ineligible	45	21	65	1,937	12,073	138
SLR admin costs removed	103	48	151	4,462	27,812	317
SLR admin costs x2	107	50	157	4,636	28,896	329
SLR Reserves $500m	143	67	210	6,220	38,770	442

1. Assumes 23,000 financial advisers on the Financial Advisers Register able to provide personal advice (ASIC Annual Report 2015-16)
2. Based on 3,690 AFS licensees licensed to provide personal advice (ASIC Annual Report 2015-16)
3. Based on estimate of $324 billion retail funds subject to levy (See: Rainmaker Table 34 FUM, Volume 15, Number 3, SEP Quarter 2016)

Key Assumptions

Loss Tier	**Advice**	**Product**	**Probability of Event**
'Business as usual'	$4million per occurrence (Based on FOS Data 2010 to 2016, and accounting for FOS determinations limited to $309k per claim)	$8 million (assumed 2 times advice failure claims paid based on historical experience)	87.5%
'Major loss' (recession or single event failure)	$400m per occurrence (representing 80% of total loss due to FOS determinations limited to $309k per claim)	$800m per occurrence (representing 80% of total loss due to FOS determinations limited to $309k per claim)	10.0%
'Catastrophe' (GFC or major industry failure)	$2.4 billion (Based on Storm Financial, Opes Prime, Deakin, and representing 80% of total loss due to FOS determinations limited to $309k per claim)	$4.8 billion (Based on WestPoint, Timbercorp, and representing 80% of total loss due to FOS determinations limited to $309k per claim)	2.5%

Other key assumptions include:

- CSLR administration cost at $2 million per annum
- **Retrospective eligible unpaid determinations are excluded.**

19. The Cadence Report notes the following ***key sensitivities***-

(a) Costs are driven primarily by the size of the advice and product loss (severity) used in each of the three loss tiers, and the probability (frequency) attached to this loss.

- In particular, introducing consideration of a 'major loss' and 'catastrophe' event significantly increases the annual funding cost of the scheme.

(b) With average claims at $120, 000 representing only one-third of the $309,000 cap, the impact of capping only reduces the CSLR funding requirements in the order of 10% to 20%.

- That is the current scheme covers around 80% of the loss distribution, while a $500,000 cap would cover 92 per cent and cost 10% more, while a $1 million cap would cover 98% and cost 20% more.

(c) Average 20 year CSLR costs are only marginally impacted by including retrospective claims that are known. If eligible unpaid determinations were $116 million, annual scheme funding costs would increase to $114m per annum for the advice case only case. However, this does not consider the timing of the payments and implies an assumed low cost of capital.

- A key issue with the modelling around this aspect is that a stochastic model cannot account for behavioural changes, for example-increased filing of claims with FOS from previous failures.

Comments

20. Having made these opening comments, we now will address the specific questions raised in the Paper, adopting for convenience the headings in the Paper.

SCOPE
Questions — Scope and principles
1. Is the Panel's approach to the scope of these issues appropriate? Are there any additional issues that should be considered?
2. Do you agree with the way in which the Panel has defined the principles outlined in the Review's Terms of Reference? Are there other principles that should be considered?

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21. As a broad proposition, we do not have any specific objections to the Panel's approach to the scope of the issues nor the principles as such. However, the Principles do not appear to take into account the potential economic impact of such a CSLR, with the flow-on effect from industry to the broader economic matrix. The Cadence Report does consider these issues. In our view, more detailed modelling and consideration of these impacts must occur

and be subject to a fulsome and appropriate review. This impact should be reviewed in light of the mischief the CSLR is intended to address and whether there might be other more efficient ways of addressing the issue such a strengthening the licensing framework in accordance with Mr St John's recommendations and outlined in the Hanrahan report. We note Mr. St John's warning that the CSLR should not be used as a shortcut to remedying deficiencies in the current regime, as it will not address the underlying problems to improve licensing standards and place greater responsibility on licensees for their conduct.

As we have said, both the St. John and Hanrahan Reports outline useful approaches in this regard.

22. Considering the implications from an advice perspective alone, the Cadence research shows that the annual costs of a CSLR are significant and estimated to cost $105 million annually. Financial advice businesses have been subject to significant regulatory reform costs in recent years through the introduction of the Future of Financial Advice reforms and we have received anecdotal feedback to indicate that the cost of reform is impacting the viability of advisory practices.

23. There are further significant costs expected to be incurred by advice industry participants in relation to the industry funding model for ASIC, ongoing funding of the new Financial Adviser Standards Education Authority and costs associated with increased professional standards and education requirements. Further, the financial sector will bear the costs of the proposed AFCA. Whilst we have been supportive of many of these reforms, consideration needs to be given to the impact of further regulatory reform and the ability of businesses to continue to absorb the cost of further regulatory change while still ensuring quality financial advice is available to, and affordable for, consumers.

24. We also express reservations as to the scope of the CSLR as outlined in the Paper and as expressed at paragraph 37. For example, it is stated that the CSLR potentially could apply where …

> the consumer or small business did not pursue their dispute with the EDR scheme for other unspecified reasons (for example, because of personal circumstances, the costs of pursuing the dispute or emotional distress).

25. In our view, the CSLR if introduced should truly be that and only be available after all other reasonable and available avenues have been exhausted. Rights of access to the CSLR should be permitted only with approval of an independent body in other circumstances.

26. It is worth noting Mr. St John's observations that there are limited regulatory measures to protect consumers from licensee insolvency and the regulatory framework for advisers and licensees should be *made more robust and stable before a safety net, funded by all*

licensees, is suspended beneath it[10]. We question whether all other available avenues can be appropriately exhausted without strengthening the existing licensing framework.

27. In similar vein, we are concerned at the further observation at paragraph 37 that access could be permitted where the monetary value of the dispute exceeded the EDR scheme's monetary limits at the time, but could potentially fall within the monetary limits of the new Australian Financial Complaints Authority (once established). This is connected with the issue of legacy claims which we discuss below. However, if this is a concern, there ought to be some transitional period for introduction of such claims to the AFCA rather than imposing such a cost on the CSLR at the outset. For example, if a claim arose in the twelve months prior to the commencement of the CSLR but at that time exceeded the FOS jurisdiction but would fall within the AFCA jurisdiction had it been in existence at the time, such a claim should be able to be made to the CSLR. Alternatively, consideration ought to be given to the AFCA jurisdiction having such a limited retrospective operation.

28. The paper discusses the topic of redress for past disputes in some detail in terms of principles and scope. Our view is that if a CSLR is to be established then it ought to be **prospective only** (subject to some limited exceptions such as those discussed in the previous paragraph). Inherently, retrospectivity which has a real and significant impact on rights and liabilities ought not to be accepted as an appropriate course. The way in which the principles and scope are cast in the Paper raises the prospect of the CSLR having to address not only currently existing unpaid FOS determinations, but also future determinations relating to events that may date back a number of years. So far as we are aware, no modelling has been undertaken to determine the size of the liabilities relating to this 'tail'. We suspect that this could potentially be a long and sizeable tail. There also is an issue as to whether unpaid determinations or judgments of other tribunals, apart from AFCA, and courts would fall within this process. Certainly, the implication from the Paper is that they should be so included (paragraph 35). It is not clear to us why this should be the case.

COMPENSATON SCHEMES OF LAST RESORT

Questions — Existing compensation arrangements

3. What are the strengths and weaknesses of the existing compensation arrangements contained in the Corporations Act 2001 and National Consumer Credit Protection Act 2009?

[10] Pages iii and iv St John Report.

4. What are the strengths and weaknesses of the National Guarantee Fund, the Financial Claims Scheme and Part 23 of the Superannuation Industry (Supervision) Act 1993?

5. Are there other examples of compensation schemes of last resort that the Panel should be considering?

29. It is not clear to us that, at this stage, there is any particular benefit to be obtained by undertaking an exhaustive review and analysis of existing compensation arrangements as discussed in the Paper. The circumstances in which compensation can be claimed differ and as the Paper notes only some of these are targeted compensation schemes. These schemes cover losses associated with the following-
    (a) Where a market participant of the Australian Securities Exchange becomes insolvent and fails to meet its obligations to a person who had previously entrusted property to it;
    (b) Bank deposits and general insurance policies related to an Australian Prudential Regulation Authority (APRA) regulated entity in the event of insolvency: the Financial Claims Scheme[11]; and
    (c) Fraudulent conduct or theft related to APRA regulated superannuation funds: Part 23 of the *Superannuation Industry (Supervision) Act 1993* (Cth.) (**SIS**)[12]
30. After describing these targeted schemes the Paper goes on to state-

> *48. Given the existence of unpaid EDR determinations, it is clear this framework is not delivering effective outcomes for some of its users.*

With respect, it is not clear to us that the comparison and conclusion is correct and appropriate. The targeted schemes are quite specific in their scope and necessarily limited to areas falling within the relevant jurisdiction. If there is an issue with the framework then it is because that framework never was intended to be of more general and universal application- which appears to be the assumption underlying the Panel's comment.

31. In our view, these particular schemes discussed above are appropriate and adequate for the circumstances for which they were created. They were never intended to be schemes of

[11] The Financial Claims Scheme protects, subject to limits, retail clients of authorised deposit taking institutions (**ADI**s) and policyholders of APRA regulated general insurance companies from potential loss due to the failure of these institutions.

[12] Part 23 SIS makes provision for the grant of financial assistance to APRA regulated superannuation funds that have suffered loss as a result of fraudulent conduct or theft. The loss must also have caused a substantial diminution of the superannuation fund leading to difficulties in the payment of benefits.

universal application applying to all unsatisfied claims in respect of participants in the relevant industry sector. They are schemes which apply in specified circumstances only. We also note, that the Financial Claims Scheme and Part 23 SIS, relate to products and services which are prudentially regulated and have a robust financial and risk management framework in place to ensure the entities providing those products and services can meet their obligations. Prudential oversight significantly reduces the risk that the providers subject to the oversight are able to meet their obligations first and foremost whilst simultaneously significantly reducing the risk that a person will need to call on the targeted compensation scheme or that the losses of one providers will need to be funded by other market participants.

32. The Paper also discusses the following compensation arrangements-

(a) Firm level compensation arrangements, and;
(b) Compensation arrangements involving professional indemnity insurance.

The obligation to have these arrangements in place is sourced in the Corporations Act for financial services providers. As the Paper points out, these approaches were not intended to cover all of the circumstances in which a loss might be incurred by a consumer. Thus, the Paper refers to ASIC *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees, paragraph RG126.23,* and the range of matters including the following which were not intended to be covered by the arrangements-

- product failure or general investment losses;
- all possible consumer losses relating to financial services;
- claims for loss solely as a result of the failure (for example, through insolvency) of a product issuer (that is, it is not intended to underwrite the products of a product issuer); or
- a return on a financial product that has not met expectations.

For the reasons stated in our February submission and supported by the Hanrahan Report our view remains that as a matter of public policy or interest, the case for the introduction of such a more universal CSLR covering losses of this kind has not been established. We also further note that Mr. St John's recommendations for addressing the underlying problems and strengthening the licensing regime have not been implemented.

33. In our February Submission, we outlined the issues we believe exist with ex-Australian CSLRs. Given those comments and the

limitations of those schemes, we do not think they represent alternatives that the Panel should be considering.

34. In relation to question 5, regarding other compensation schemes of last resort that may be considered by the Panel, we refer the Panel to the Government Consultation Paper on *Reforms to address corporate misuse of the Financial Entitlements Guarantee Scheme- Consultation Paper*[13] . This paper contains a useful analysis of the kinds of sharp practices that can arise following the creation of moral hazard. The Financial Entitlements Guarantee (**FEG**) scheme also serves as an example of unexpected cost increases that can arise, even during a relatively stable economic periods.

Questions — Evaluation of a compensation scheme of last resort

6. What are the benefits and costs of establishing a compensation scheme of last resort?

7. Are there any impediments in the existing regulatory framework to the introduction of a compensation scheme of last resort?

8. What potential impact would a compensation scheme of last resort have on consumer behaviour in selecting a financial firm or making decisions about financial products?

9. What potential impact would a compensation scheme of last resort have on the operations of financial firms?

10. Would the introduction of a compensation scheme of last resort impact on competition in the financial services industry? Would it favour one part of the industry over another?

11. What flow on implications might be associated with the introduction of a compensation scheme of last resort? How could these be addressed to ensure effective outcomes for users?

12. What other mechanisms are available to deal with uncompensated consumer losses?

13. What relevant changes have occurred since the release of Richard St. John's report, Compensation arrangements for consumers of financial services?

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35. In our February submission we outlined in detail our views of the benefits and costs of establishing a CSLR. In short, we accept that the impact of uncompensated losses is important for the individual consumers affected. However, in summary we have concerns about the cost, inequity, impact on competition and

[13] Australian Government Consultation Paper *Reforms to address corporate misuse of the Financial Entitlements Guarantee Scheme* May 2017, (**FEG Paper**)

innovation, and moral hazard a CSLR necessarily introduces. In addition, there exist significant challenges in structuring a robust and efficient funding model. We have detailed our specific concerns in the February submission and these are articulated further in the Hanrahan Report.

36. A CSLR necessarily would act as an inhibition to competition and for that matter, innovation. Smaller entities and start-ups may be unwilling or unable to meet the cost of any CSLR levy and be deterred or indeed unable to enter the sector.

37. In our view, the economic implications of the introduction of a CSLR have not been appropriately considered nor have the implications for sectors within the industry been considered. The Cadence Report is an initial attempt to articulate some of those concerns. Clearly, more extensive work is required to be undertaken in this area by Government and industry. In particular, an inherent bias may be created in favour of sectors subject to such a scheme, depending on the scheme parameters, compared with those not subject to the scheme. This is another aspect of "moral hazard' as outlined in our February submission and the Hanrahan report.

38. The risk of moral hazard is clearly demonstrated by the prevalence of misuse of the FEG scheme, which is currently the subject of Government consultation.[14] As reported by Ministers Kelly O'Dwyer and Michaelia Cash, the costs of the FEG scheme have increased dramatically over the period 2012-13 and 2015-16, up 75% on the previous 4 year period and there is evidence of corporate structuring to shift the cost of employee entitlements to the FEG scheme.[15] The Consultation Paper for this review notes that a survey of 650 FEG scheme claims showed that one in seven cases were the subject of 'sharp practices'.[16]

39. We have detailed in the February submission other steps we believe should be taken before it is clear as a matter of policy that a CSLR is required. In summary, these are-

> (a) A detailed review and consideration of capital adequacy for AFSL licensees (as is currently the case with REs and RSEs) to "cover" potential liabilities;
> (b) the raising of the level of professional indemnity insurance, with the support of ASIC and the general insurance industry (for example, holders of AFSLs should be required to hold insurance cover that reflects the guidelines required by the Professional Standards Council, including in relation to run-off cover) ;

[14] Ibid.
[15] Foreword to FEG Paper.
[16] Page 5 FEG Paper.

> (c) Other steps should be taken to strengthen the regulatory framework before consideration is given to a CSLR. These are
>
> > (i) the reforms to improve the competence and professionalism of advisers announced by the Government, but not currently due to be fully implemented until 2024, should be finalised;
> > (ii) changes to the legislative breach reporting framework should be made to encourage and assist licensees to report 'bad apple' representatives to ASIC and have those representatives dealt with;
> > …
>
> Further, it is arguable that a rethink and recalibration of the ASIC approaches to the "first-tier "protections under the Corporations Act for consumers needs to occur.

40. Since the time of the release of the St. John Report we do not believe there have been any relevant changes as such which ought to alter the conclusions in that Report. We do note however that there is a legislative progression to professionalism in the advice industry and the considerable restrictions applying to conflicted remuneration. These are themes taken up in the Hanrahan report and we confirm our support of those views. In short, these processes should be allowed to continue and settle in before it is clear that a CSLR is required and desirable as a policy matter.

Questions — Potential design of a compensation scheme of last resort

14. What are the strengths and weaknesses of the ABA and FOS proposals?

15. What are the arguments for and against extending any compensation scheme of last resort beyond financial advice?

16. Who should be able to access any compensation scheme of last resort? Should this include small business?

17. What types of claims should be covered by any compensation scheme of last resort?

18. Should any compensation scheme of last resort only cover claims relating to unpaid EDR determinations or should it include court judgments and tribunal decisions?

19. What steps should consumers and small businesses be required to take before accessing any compensation scheme of last resort?

20. Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be able to independently review the EDR determination or

should it simply accept the EDR scheme's determination of the merits of the dispute?
21. If a compensation scheme of last resort was established and it allowed individuals with a court judgment to access the scheme, what types of losses or costs (for example, legal costs) should they be able to recover?
22. Should litigation funders be able to recover from any compensation scheme of last resort, either directly or indirectly through their contracts with the class of claimants?
23. What compensation caps should apply to claims under any compensation scheme of last resort?
24. Who should fund any compensation scheme of last resort?
25. Where any compensation scheme of last resort is industry funded, how should the levies be designed?
26. Following the payment of compensation to an individual, what rights should a compensation scheme of last resort have against the firm who failed to pay the EDR determination?

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41. Our view is that a CSLR should **not** be introduced for the reasons set out in our February submission and the Hanrahan report. However, for completeness we make the following observation in respect of the questions posed-

(a) if there is to be a CSLR, it should be circumscribed and have clear parameters around it. A scheme which is restricted in its scope to compensation claims for misconduct rather than operating as a guarantee for investment loss is preferable for reasons of equity and economic impact. For example, it seems to us to be appropriate that such a scheme should be confined to advice-related failures rather than having a broader remit, given that the majority of unpaid determinations originate in that sector;
(b) a CSLR should be linked to EDR schemes and specifically to the proposed AFCA. Thus, the AFCA eligibility and compensation cap rules should apply in like fashion to the CSLR;
(c) the CSLR should have no further remit than unsatisfied orders or decisions of the AFCA-it should be seen as a final resort of the EDR system where for some reason an AFCA liability remains unmet. In this sense, it should operate in similar fashion to the National Guarantee Fund;

(d) the CSLR should be funded by an appropriately designed levy to ensure that the sectors where the major liabilities are being incurred meet the levy;
(e) consideration does need to be given to the role of litigation funders in any CSLR. It is possible that in the absence of such funding recovery could not be pursued. However, this could perhaps be addressed by making the CSLR process an administrative and less formal process;
(f) Access to the CSLR should be available only when it is clear for example because of insolvency of the FSP that recovery is impossible;
(g) The CSLR should be able to stand in the shoes of successful CSLR consumer and be subrogated to the consumer's rights against the FSP;
(h) consideration needs to be given to a specified percentage, say 70% of the lost amount being recoverable (as occurs in the superannuation context and, for some sectors in the United Kingdom, the Financial Services Compensation Scheme: **FSCS**).

Questions — Potential design of a compensation scheme of last resort
27.What actions should ASIC take against a firm that fails to pay an EDR determination or its directors or officers?
28.Should any compensation scheme of last resort be administered by government or industry? What other administrative arrangements should apply?
29.Should time limits apply to any compensation scheme of last resort?
30.How should any compensation scheme of last resort interact with other compensation schemes?
31.Are there any aspects of compensation schemes of last resort in other sectors and jurisdictions that should be considered in the design of any compensation scheme of last resort?

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42. A CSLR as we have indicated should be truly one of last resort. It should not be available to consumers if other compensation schemes provide them with a remedy;
43. There should be an appropriate time limit for pursuing a claim with the CSLR. This could be for example, no later than 24 months after the consumer became aware or reasonably ought to have been aware that the amount was not recoverable. As a safeguard

for unintended consequences, the CSLR could have a discretion to waive compliance with strict time limits in appropriate circumstances;

44. The CSLR itself should be an industry-run body with appropriate independent oversight. There would need to be legislative underpinning;

45. If there is to be a CSLR, appropriate models exist in Australia such as the National Guarantee Fund and various professional body fidelity schemes.

Questions — Legacy unpaid EDR determinations

32. What existing mechanisms are available for individuals who have legacy unpaid EDR determinations to receive compensation?

33. Is there a need for an additional mechanism for those with legacy unpaid EDR determinations to receive compensation? If so, who should fund the payment of the legacy unpaid EDR determinations?

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46. We confirm the comments in our February submission that legacy unpaid determinations should not be amenable to a CSLR for the reasons set out in our submission. As noted above however, there may be circumstances where a limited retrospective operation could be given to the scheme. This may be for example where a claim did not then meet FOS compensation limits but now does under AFCA limits. The preference however is to address this issue in the initial AFCA jurisdiction. Our starting point however is that retrospectivity of any kind should be avoided as a matter of good public policy.

Question — Circumstances which have prevented access to redress

34. Other than circumstances that may be covered by a compensation scheme of last resort (such as outstanding unpaid determinations), what kinds of circumstances have given rise to past disputes for which there has not been redress? Are there any other classes besides those identified by the Panel?

35. What evidence is there about the extent to which lack of access to redress for past disputes is a major problem?

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47. FSC members are not aware of any other circumstances preventing lack of redress. As the Hanrahan report alludes to, it is not clear that this is indeed a major problem.

Question — Approaches to providing access to redress for past matters

36. Which features of other approaches established to resolve past disputes outside of the courts (whether initiated by industry or government) might provide useful models when considering options for providing access to redress for past disputes in the financial system?

48. No comment.

Questions — Evaluation of providing access to redress for past disputes

37. What are the benefits and costs associated with providing access to redress for past disputes?

38. Are there any legal impediments to providing access to redress for past disputes?

39. What impact would providing access to redress for past disputes have on the operations of financial firms?

40. What impact would providing access to redress for past disputes have on the professional indemnity insurance of financial firms?

41. Would there be any flow on implications associated with providing access to redress for past disputes? How could these be addressed in order to ensure effective outcomes for users?

49. For the reasons previously given, in our view redress ought not to be provided in respect of past disputes in the sense outlined in the Paper.

Questions — Design issues for providing access to redress for past disputes

42. What are the strengths and weaknesses of the Westpac proposal?

43. What range of parties should be provided with access to redress for past disputes? Should all of the circumstances described in paragraphs 133-144 be included?

44. What mechanism should be used to resolve the dispute and what criteria should be used to determine which disputes can be brought forward?

45. What time limits should apply?

46. Should any mechanism for dealing with past disputes be integrated into the new Australian Financial Complaints Authority (once established) or should it be independent of that body?

47. Who should be responsible for funding redress for past disputes? Is there a role for an ex gratia payment scheme (that is, payment by the Government)?
48. Should there be any monetary limits? If so, should the monetary limits that apply be the EDR scheme monetary limits?
49. Should consumers and small businesses whose dispute falls within the new (higher) monetary limits of the proposed Australian Financial Complaints Authority but was outside the previous limits be able to apply to have their dispute considered? Should access to redress for past disputes be provided through a transition period whereby the higher monetary limits are applied for a defined period retrospectively? If so, what would be an appropriate transition period?
50. If it is not possible to fully compensate all claimants, should a 'rationing' mechanism be used to determine the amounts of compensation which are awarded? Should such mechanism be based on hardship or on some other measure?
51. Are there any other issues that would need to be considered in providing access to redress for past disputes?

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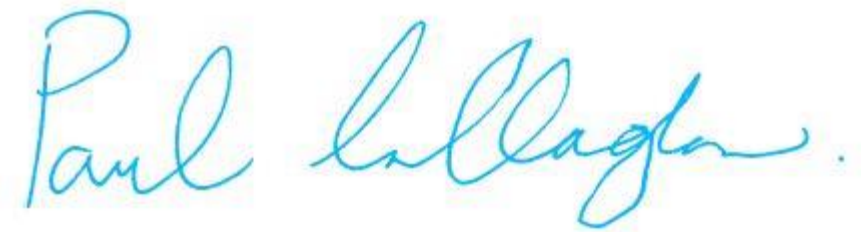
50. No comment as outlined in our response to the previous set of questions.

Should you have any questions, please contact the writer on 02-9299 3022.

Yours Faithfully

Paul Callaghan



General Counsel