



Australian Government  
The Treasury

**TSY/AU**

# Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort

Discussion Paper  
December 2019



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# Submission Process

Request for feedback and comments

Closing date for submissions: 07 February 2020

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The matters outlined in this paper are not yet law.

# Introduction

The Government is committed to ensuring the financial system works for all Australians and is one they can trust. To achieve this, the Government has already moved to strengthen Australia's external dispute resolution (EDR) framework to ensure that it delivers effective outcomes for consumers and small businesses.

The Government will establish a compensation scheme of last resort (CLSR) to ensure that consumers and small businesses receive compensation where a financial service provider is found to have engaged in misconduct and the provider is unable to pay.

On 21 December 2017, the Supplementary Final Report of the *Review into dispute resolution and complaints framework* (Ramsay Review) provided detailed recommendations to the Government on the key design features of a CSLR. The Ramsay Review accepted that existing arrangements are not adequate to ensure that all consumers and small businesses are compensated for losses where an EDR scheme, tribunal or court finds that there has been misconduct by a financial service provider and makes an award in their favour.

The Final Report of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Royal Commission) recommendation 7.1 stated that the Government should establish a CSLR consistent with the Ramsay Review.

In its response to the Royal Commission, the Government committed to establishing a forward looking CSLR by December 2020. The CSLR will also compensate consumers and small businesses that have an unpaid determination from Australian Financial Complaints Authority (AFCA) (made under AFCA's rules) after 1 November 2018.

The CSLR will be industry-funded, operated by AFCA, extend beyond personal advice failures and have design features consistent with the recommendations of the Ramsay Review.

The purpose of this discussion paper and consultation process is to further explore and seek views on four aspects of the CSLR. These four aspects are:

- coverage, beyond personal advice;
- funding arrangements;
- compensation to be paid; and
- managing scheme evolution.

Matters outside of the scope of this consultation process include the decision to establish a CSLR and alternatives, including changes to professional indemnity insurance and the adequacy of financial resources obligations of Australian financial services licensees.

Submissions in response to this discussion paper should be provided by close of business 7 February 2020.

Consultation will be undertaken in mid-2020 on Exposure Draft legislation to establish the CSLR by December 2020.

# Background

This section briefly recaps the background to establishing a CSLR and outlines the relevant aspects of the Ramsay Review and the Government's response to the Royal Commission that will inform the discussion in the remainder of the paper.

## Ramsay Review

### Overview

In line with Terms of Reference amended on 2 February 2019, the Ramsay Review made recommendations on the establishment, merits and potential design of a CSLR. The Ramsay Review Supplementary Final Report was finalised on 6 September 2017 and presented to the Government.

### Key principles

The key principles guiding the Ramsay Review, underpinning the review's recommendations for the design of the CSLR, are:

- **Efficiency:** Any framework should provide outcomes in an efficient manner. This requires ensuring the framework possesses adequate coverage, powers, remedies, resources (that is, funding and skilled staff) to enable issues to be resolved quickly and with a minimum of resources.
- **Equity:** Individuals should be treated fairly and be able to easily access any framework.
- **Complexity:** Any framework should have minimal complexity. It must be easy to navigate and use, with a focus on informality.
- **Transparency:** Any framework should be transparent and open. Users should have access to appropriately tailored information, including about what outcomes they can reasonably expect from the process.
- **Accountability:** Relevant information should be made publicly available. There should also be scope for periodic independent reviews and responses to these reviews.
- **Comparability of outcomes:** Any framework should ensure that individuals receive comparable outcomes, both procedurally and substantively.
- **Regulatory costs:** The regulatory settings should, as appropriate, utilise market forces and avoid creating moral hazards. The framework should impose the minimum amount of regulatory costs necessary to ensure effective user outcomes. These costs should, where appropriate, be borne by those who create the requirement for regulation, with incentives for costs to be minimised.

### Key recommendations

The Ramsay Review made three recommendations on the establishment of a CSLR, which can be found at Appendix 1. Relevant recommendations relating to this consultation process and the design of a CSLR are the following:

1. A CSLR should be funded by financial firms engaged in the types of financial services covered by a CSLR (initially, specified types of financial advice).
2. A CSLR should be ex-ante funded; that is, financial firms should be required to contribute to a CSLR from its outset. This ensures that those financial firms whose actions give rise to uncompensated losses are required to contribute to a CSLR.

3. The Government should work with industry to develop an appropriate mechanism, such as a levy, to fund a CSLR.
4. Comprehensive modelling should be undertaken to estimate the likely costs associated with a CSLR and the funding mechanism should reflect the outcome of this modelling exercise.
5. The funding mechanism should be designed to minimise the volatility in funding requirements; that is, it should be designed to minimise the need for a CSLR to raise additional ad-hoc funding to meet its obligations.
6. The funding mechanism should be designed in a manner that does not result in a substantial lessening of competition amongst financial firms, while ensuring that all firms providing the types of financial services covered by a CSLR make an appropriate level of contribution to a CSLR.
7. A CSLR should be provided with sufficient funding to allow it to raise community awareness about its existence.
8. A compensation cap, aligned to AFCA's, should apply. The CSLR should set limits on the level and types of legal costs that are recoverable.

## Royal Commission

The Final Report of the Royal Commission agreed with the recommendations of the Ramsay Review, including those made about the design of a CSLR, and stated that the approach proposed by the review panel should be followed.

## Government Response

In its response to the Royal Commission, the Government committed to improving consumer and small business access to redress, including by implementing a CSLR.

Specifically, the Government's response to the Royal Commission, and Government's Implementation Roadmap committed to:

- Establishment of an industry-funded forward looking CSLR for consumer and small business complaints to be operated by the Australian Financial Complaints Authority (AFCA);
- Extending the scheme beyond personal advice failure; and
- Establishing the scheme by no later than December 2020, but covering unpaid determinations made under AFCA's Rules from 1 November 2018.

## Unpaid determinations

The Ramsay Review found the activity contributing the largest share of unpaid determinations was financial advice.<sup>1</sup> Recent data provided by AFCA also indicated the highest contributor to unpaid determinations was financial advice (based on value of determinations), with a significant portion arising from investments (such as managed investment schemes) and a lower portion arising from the provision of credit.

The Ramsay Review referenced modelling done by Grant Thornton and the Financial Services Council (FSC) which attempted to forecast the cost of establishing a CSLR. The modelling conducted by Grant Thornton estimated modest costs with levies decreasing after the initial establishment of the scheme. The modelling provided by the FSC predicted much higher costs based on different event scenarios. These included, normal operating events, a major loss such as a recession or large firm

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<sup>1</sup> Ramsay Review para 2.44 and 2.45.

failure and a catastrophe reflecting a major industry failure. Contrary to the modelling conducted by Grant Thornton, the FSC predicted the costs of the CSLR would increase over 20 years.<sup>2</sup>

As highlighted by the FSC, it is acknowledged that in the future the CSLR could be impacted by large losses and thus the CSLR needs to be designed to manage such losses.

The Ramsay Review also found that the past practices of AFCA's predecessor schemes, the Financial Ombudsman Scheme (FOS) and the Credit and Investments Ombudsman (CIO), would have meant that a number of determinations would not have been made where the firm was insolvent at the time. This is a result of the predecessor schemes terms of reference which did not address any disputes relating to firms that were insolvent.<sup>3</sup> As a result, the level of unpaid determinations in the future may be higher than the level experienced in past and current schemes.

The Ramsay Review recommended that eligible court and tribunal decisions should be captured under the CSLR.<sup>4</sup> There is currently no collated data on the number and amounts of court and tribunal determinations that remain unpaid. This inhibits the ability to estimate the number and quantum of unpaid court and tribunal determinations that could impact the CSLR.

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<sup>2</sup> Ramsay Review para 4.223 and 4.224.

<sup>3</sup> Ramsay Review para 2.41.

<sup>4</sup> Ramsay Review para 4.76.

# Coverage, beyond personal advice

## Issue

The Government has committed to establishing a CSLR that provides coverage in circumstances that goes beyond the provision of personal advice. That is, that goes beyond the recommendation of the Ramsay Review that the CSLR initially cover financial advice failures where a financial adviser has provided personal and/or general advice on relevant financial products to a consumer or small business. This section seeks views on the appropriate coverage of the CSLR.

## Considerations

Determining the appropriate coverage of the CSLR will need to balance a number of considerations, including:

- **Evidence of uncompensated losses:** a history of unpaid determinations in a particular market segment is evidence the CSLR should cover that segment.
- **Impact of existing regulation:** CSLR coverage should take account of the impact of existing regulation on the likelihood that claims will be unpaid.
- **Market distortion:** CSLR coverage should avoid market distortion to the extent feasible.
- **Clarity for consumers:** CSLR coverage should provide clarity for consumers.

## UK experience

As a point of comparison, the Financial Services Compensation Scheme (FSCS) is the United Kingdom's statutory compensation scheme of last resort for customers of financial services firms. It is an independent body established under the *Financial Services and Markets Act 2000* (UK). Individuals and small business are eligible to make claims to the FSCS. The FSCS will pay compensation when it is satisfied that a firm is unable, or likely to be unable, to pay claims against it and therefore deemed to be 'in default'.

The UK FSCS covers claims for the following activities:

- Deposits – banks, building societies and credit unions
- Investments – financial advisers and investment firms
- Insurance mediation – general insurance intermediaries (for example, brokers, car dealerships)
- General insurance – non-compulsory (home, motor) and compulsory (CTP)
- Life insurance and pensions
- Home finance – covers claims against authorised mortgage firms
- Debt management – covers claims against a specialised debt management firm

The UK FSCS differs significantly in scope to the proposed CSLR, as the UK scheme encompasses all compensation schemes that pay eligible claims for both insolvency as well as misconduct. For example, the UK FSCS compensates for the same risks addressed by Australia's Financial Claims Scheme (FCS). The FCS provides compensation for retail clients of authorised deposit-taking institutions (ADIs) and policy holders of general insurance companies (which are regulated by Australian Prudential Regulation Authority (APRA)) from certain losses due to the failure of these institutions.

## Discussion items

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

#### Ramsay Review

The Ramsay Review considered that coverage by the CSLR should be based on the financial services provided by a financial firm rather than the type of financial firm providing the service.<sup>5</sup>

In terms of coverage, the Ramsay Review recommended that the CSLR initially be restricted to financial advice failures where a financial adviser (that is, a 'relevant provider') has provided personal and/or general advice on 'relevant financial products' to a consumer or small business.<sup>6</sup> The Ramsay Review also recommended that the CSLR be scalable so that it could be expanded to cover other financial and credit services should evidence of significant uncompensated losses emerge.<sup>7</sup> For the purposes of this paper, the Ramsay Review recommendation is considered to be a 'narrow-coverage approach'.

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<sup>5</sup> Ramsay Review para 4.60.

<sup>6</sup> Ramsay Review para 4.59.

<sup>7</sup> Ramsay Review para 4.63.

## Experience

As noted earlier, the highest contributor to the historical value of unpaid determinations has been those associated with financial advice. Although lower than the portion attributable to financial advice, a significant portion of historical unpaid determinations has arisen from investments and a lower portion from the provision of credit.

Over recent years, there is no evidence of unpaid determinations in Australia relating to the provision of prudentially regulated banking, insurance and superannuation services to consumers and small businesses. There is, however, evidence of prudentially regulated firms failing in Australia, such as the collapses of HIH Insurance Group in 2001, and globally, such as the failure of HBOS plc in the UK.

## Existing compensation schemes

In Australia:

- the FCS operates to provide consumers with compensation in the event that a bank or insurer fails;
- the National Guarantee Fund (NGF) operates to provide consumers with compensation for certain losses incurred by investors who trade in shares on the ASX; and
- Part 23 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) allows for financial assistance to be granted in the event that the fund has suffered an eligible loss as a result of fraud or theft.

The type of compensation covered under these schemes differs from that of the CSLR. For example, in the event that a large insurer were to fail, policyholders would be compensated under the FCS for the value of their policy, but consumers who had been misold an insurance product would not be eligible for compensation under the FCS for the insurer's misconduct.

It is unlikely that there will be many circumstances where the CSLR interacts with these schemes. If a determination were to relate to claims covered by these schemes, the CSLR would not pay any awarded amounts that are covered by the jurisdiction of these schemes. That is, the CSLR would exclude this part of the determination and only pay the residual part of the determination that is solely within AFCA's jurisdiction. The CSLR will need to develop rules and guidance on the process that will be followed in the cases where jurisdictions may overlap.

## Potential approaches to coverage

A 'mid-coverage approach' to CSLR coverage could be to include financial services that are not solely provided by prudentially regulated financial firms, such as distribution services (including the provision of financial advice and brokerage services), investment services (including services relating to investment in securities, managed investment schemes and derivatives) or credit provided to consumers and small businesses. This approach would mean that all firms engaged in the provision of these services, regardless of whether the firm itself was prudentially regulated or not, would be captured by the CSLR in respect of eligible services. For example, an ADI would be included in the CSLR's scope to the extent that it engaged in non-prudentially regulated activities covered by the scheme (such as the provision of credit). In contrast, determinations in relation to an ADI's deposit-taking activities (which are prudentially regulated) would not fall within CSLR's scope.

The mid-coverage approach acknowledges that there is evidence of unpaid compensation in the provision of covered services and also acknowledges that services provided by prudentially regulated entities are at low risk of leaving a consumer or small business with unpaid determinations. A potential criticism of the mid-coverage approach is that consumers may be unclear as to whether the services they are receiving are covered by the CSLR or not.

A ‘broad-coverage approach’ would be for CSLR coverage to apply to all activities that require a financial firm to hold AFCA membership. This broad based approach is similar to the broad based approach used by the UK FSCS.

A benefit of the broad-coverage approach is that there would be greater protection and clarity for consumers who would be covered under the CSLR in respect of all activities requiring a financial firm to hold AFCA membership, including for prudentially regulated activities. An additional benefit of a broader membership base is enhanced sustainability, as large and unexpected claims costs can be met by a wider range of members. Criticisms of the broad-coverage approach could include that it requires prudentially regulated financial firms to contribute to the CSLR when the risk of a determination relating to these services being unpaid is low.

### **Exclusions from coverage**

Irrespective of the approach to coverage, voluntary members of AFCA would be excluded from the CSLR so as to not discourage them from becoming AFCA members, even though they are not currently compelled to do so. The Australian financial service licensing (AFSL) and Australian credit licensing (ACL) regimes impose upon licensees an obligation to have arrangements for providing compensation to consumers where certain losses occur. This obligation creates for consumers a reasonable expectation that, when dealing with AFSL or ACL holders, they will receive that compensation. In contrast, where an unlicensed firm has voluntarily joined AFCA, there does not exist the same grounds for consumers to expect compensation for their losses. For example, small business lenders and debt management firms are not obliged to possess AFCA membership so would be considered voluntary AFCA members. In addition, due to the cost associated with CSLR membership, requiring voluntary members to contribute to the CSLR may result in some voluntary members of AFCA ceasing their membership, thus acting as a deterrent to others obtaining AFCA membership. This would result in fewer consumers having access to a credible and free EDR service.

In order to establish the scheme by December 2020, at commencement the CSLR would only pay compensation in relation to unpaid determinations made under AFCA’s Rules. Consideration of the inclusion of compensation awarded by courts and tribunal decisions on a forward-looking basis would be made three years after CSLR establishment, in the context of a post-implementation review.

The proposed delay in including court and tribunal decisions within the CSLR’s scope is to enable the Government to quantify the potential exposure on the CSLR by putting in place processes to obtain and analyse court and tribunal data.

### **Questions**

1. What is the appropriate coverage for the CSLR, beyond the provision of personal advice?
2. Would there be any unintended consequences from initially excluding court and tribunal decisions or from excluding voluntary members of AFCA from the CSLR?

# Funding arrangements

## Issue

The CSLR is intended to supplement existing arrangements for compensation that are provided for in the regulatory framework, that is, the requirement for firms to have arrangements for compensating consumers for breaches of relevant obligations. The Government has announced that the CSLR will be industry funded.

The funding model needs to be designed to provide funds to the CSLR on an ongoing basis to cover administrative costs and claims costs, including the costs that are associated with AFCA making the original determination which would otherwise not be recouped.

## Considerations

An appropriate funding model for the CSLR will need to balance a number of considerations, including:

- **Resilience:** the funding model for the CSLR must be able to withstand a range of circumstances including failures of multiple or potentially large entities.
- **Sustainability:** the CSLR should be sustainable in the long term, without the need for frequent government intervention.
- **Affordability:** the levy imposed by the CSLR on entities should not represent an undue cost burden or adversely affect competition or consumers' access to financial products.
- **Volatility:** entities should be able to anticipate their costs with respect to the scheme year to year.
- **Proportional:** the scale of funding required for the CSLR must reflect the costs of risks posed to the scheme.

## UK experience

The industry levies under the FSCS are designed to be sector dependent. Every firm authorised by the UK regulators is obliged to pay an annual levy and if required a supplementary levy, which goes towards the FSCS' running costs and the compensation payments made. The levies:

- a) *Take into account a firm's size and ability to pay*: Each firm contributes proportionately, with larger firms paying more than smaller ones. The Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) set industry sector limits in each year based on an assessment of the sector's ability to pay.
- b) *Rely on cross-subsidisation between industry sectors*: If a firm fails within a particular sector and payment from that sector's pool is exhausted, the excess is levied more widely on the other industry sectors from what is known as "the retail pool". All industry sectors benefit from and contribute to the retail pool (with the exception of deposit acceptors and insurance providers, which only contribute to the retail pool).

## Discussion items

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

The CSLR is intended to address the risk that EDR, court or tribunal determinations awarded in favour of consumers and small businesses are unpaid.

As noted by the Ramsay Review, a risk based funding model has the potential to benefit the CSLR because it would provide an incentive for those contributing to the CSLR to maintain an appropriate risk profile and ensure those undertaking higher risk services provided proportionately more funds.<sup>8</sup>

However, applying a risk based approach at an individual financial firm level would be complex and involve significant regulatory cost for the firm and the CSLR.<sup>9</sup> For example, there is uncertainty in accurately determining the risk of smaller financial firms being unable to pay determinations. Also, a risk based approach will likely show a correlation between risk and financial firm size.

The complexity and regulatory cost may be reduced if the funding model reflected risk at a financial service class level rather than at the financial firm level. That is, all financial firms authorised to provide a relatively higher risk financial service (for example, a class of all financial firms providing personal financial advice) would be ascribed the same higher risk weight in the funding model. In contrast, all financial firms authorised to provide a relatively lower risk financial services (for example, a class of all financial firms providing deposit taking services) could be ascribed a lower risk weight in the funding model.

A risk based approach may be particularly appropriate for CSLR claims costs because those costs would be reflective of changing risk. In contrast, CSLR administrative costs would generally not reflect changing risk. It may therefore be appropriate for the funding model to apply administrative costs evenly across financial firms contributing to the CSLR.

A risk based funding model would be expected to result in a higher levy being imposed on financial firms authorised to undertake higher risk financial services. It is possible that the levy imposed could be unaffordable for some smaller financial firms, given the likely correlation between risk and

<sup>8</sup> Ramsay Review para 4.230.

<sup>9</sup> Ramsay Review para 4.231.

financial firm size, leading to increased costs for consumers and potentially reduced competition for those financial services.

The data requirements to implement a risk based funding model could range from basic data about the proportion of unpaid claims relating to a particular financial service class through to details about each firm's likely risk of being unable to pay a determination. Data collection, especially at a firm level, would likely be a significant and intrusive data collection exercise. The costs of executing this data collection and modelling may outweigh the benefits of establishing a firm level risk based funding model. Additionally, any data collected would generally reflect historical uncompensated losses and would have limited value in predicting large loss events that may occur in the future.

## Questions

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

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

The Ramsay Review recommended that the funding model be designed so that it does not result in a substantial lessening of competition amongst financial firms, while ensuring that all firms providing the type of services covered by the CSLR make an appropriate level of contribution.<sup>10</sup>

The CSLR funding model could be designed to impose the costs of the scheme equally across all financial firms required to participate in the scheme. The benefit of this approach is that it would be a simple funding model and could be relatively resilient. The relative resilience of this approach would be higher if the coverage of the CSLR was broader.

A levy imposed equally across all financial firms could be unaffordable for some smaller firms and lead to reduced competition in the market containing those firms.

An alternative approach could be for the CSLR funding model to impose the costs of the scheme proportionately to a financial firms' ability to pay, similar to the approach in the UK. That is, financial firms with a proportionately smaller share of the market for a covered financial service would pay a proportionately smaller levy to the CSLR. In contrast, financial firms with a larger proportion of the market for a covered financial service would pay a proportionately larger levy to the CSLR.

The proportionate approach would increase the likelihood that CSLR was affordable for all financial firms required to participate. However, it would also be likely to reduce the extent to which the cost of the CSLR is borne by those financial firms most likely to be the source of risk.

A proportionate approach could be implemented at either an individual financial firm or financial service class level. The complexity and regulatory cost would likely be less at a financial service class level.

The data requirements to implement a funding model based on ability to pay would include having a common benchmark for firm size, for example, the annual gross revenue a financial firm gained from providing financial services covered by the CSLR. While it is expected that many financial firms would be able to calculate this figure, the data is not yet available in aggregate form and there would be a regulatory cost to both financial firms and the CSLR to obtain it. Furthermore, annual gross revenue

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<sup>10</sup> Ramsay Review para 4.239, 4.241.

may not be a suitable metric to assess ability to pay for some financial service classes, adding to the complexity of the model.

## Questions

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?

## How should the funding model address unexpected costs?

The Ramsay Review noted that there could be circumstances where the number and amount of claims made on a CSLR exceed its planned funding level. In this circumstance, the Ramsay Review suggested that the CSLR could address the issue by:

- collecting additional levies once the CSLR has become aware of unexpected increase in cost;
- including a buffer in levies as a means of protecting against future unexpected events; and
- borrowing so that compensation is paid in a timely way while recouping the unexpected cost over time through higher levies to repay any borrowings.<sup>11</sup>

Collecting additional levies after the CSLR has become aware of the unexpected increase in cost has the advantage that participating financial firms retain control of those funds until they are required. A disadvantage of such additional levies is that they introduce volatility to the scheme which some financial firms may not be able to easily manage. For example, if there is a large unexpected increase in costs, the levy financial firms may be required to pay could increase sharply and become potentially be unaffordable for some smaller financial firms. Another disadvantage is that consumers and small businesses may be required to wait an additional period to be compensated because of the need for the CSLR to maintain solvency and thus only make compensation payments once funds are available.

Including a buffer in an annual levy as a means of protecting against future unexpected events would involve the CSLR accumulating additional funds to establish a capital base for the scheme. The capital base would build over time until, for example, it met a target capital requirement, and would then only be used in circumstances in which the annual levy is unable to cover the annual schemes costs. The aim of a capital base would be to ensure the CSLR has sufficient funds to meet unexpected variations in claims costs in any year and to cover any components of operational risk. The CSLR can establish its capital base over a period of years or as a once off establishment cost upon inception of the scheme. If the CSLR adopts a capitalisation model, it is not envisaged the capital base would be sufficient to accommodate events that result in large uncompensated losses. Instead, in these circumstances, the scheme would raise additional levies. The average annual level of unpaid determinations has historically been lower than \$5 million. As such, the scheme could reasonably adopt a minimum capital level of \$10 million.

The advantage of establishing a capital base is that it would reduce the volatility of levies payable by financial firms providing financial services covered by the CSLR as there is a funding base that can be accessed if a variation in expected costs occur. This would smooth the levies imposed upon participating financial firms as the scheme will be able to draw from the capital base as opposed to raising additional funding from those firms. Additionally, the ability for the CSLR to access a pool of capital enables it to pay compensation in a timely manner rather than waiting for funds to be raised through additional levies.

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<sup>11</sup> Ramsay Review para 4.233.

The disadvantage of establishing a capital base is the funds provided by participating financial firms will be tied up in a capital fund that may not be used. This creates an opportunity cost that contributing financial firms would need to bear.

### Questions

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 be often 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?

### How should the funding model promote sustainability and affordability?

The sustainability of the CSLR will be maximised if its ability to levy financial firms providing financial services covered by the scheme is unconstrained. However, this risks the CSLR imposing unaffordable levies on participating financial firms.

One way the funding model could promote sustainability and affordability is to impose a maximum cap on the levies that can be raised from any participating financial firm each year and thus effectively impose a maximum amount the CSLR could raise in levies each year.

The maximum cap could be set at such a level that it is not routinely reached but instead operates as a 'back stop' protection for financial firms in the event of an infrequent scenario where there are multiple large unexpected failures. For example, a cap could be expressed as a maximum proportion of annual gross revenue for covered services that can be levied by the CSLR. The advantage of this approach is that it would provide certainty for financial firms as to their maximum exposure to the CSLR. The disadvantage of this approach is that, in the case of large claims, it could require the compensation to be provided to consumers and small businesses to be reduced.

In addition, imposing a maximum cap on the levies that can be raised from any participating financial firm each year would introduce a level of complexity for the CSLR. For example, if the funding model has a risk based component, it is possible for financial firms providing higher risk financial services to reach the cap sooner than other participating financial firms. To meet compensation claims, and to avoid the fund going into deficit, the CSLR may be required to spread the residual cost relating to higher risk activities to participating financial firms that do not provide those services.

### Questions

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)?

# Compensation to be paid

## Issue

The amount, timing and type of compensation the CSLR can pay for losses suffered by consumers and small businesses are important design parameters for the scheme. For example, if the amount of compensation that may be claimed is too high, it may risk the financial sustainability of the scheme or impose undue costs on industry that impacts the viability of firms. Alternatively, if the amount is too low, it would unfairly disadvantage consumers.

## Considerations

Appropriate compensation amounts, timing and types for the CSLR need to balance the interests of the consumers and small businesses that have suffered loss with the interests of the financial firms required to fund the scheme. This requires the balancing of the following considerations:

- **Resilience:** compensation limits for the CSLR should enable it to withstand a range of events, including those that result in large losses.
- **Sustainability:** compensation limits should promote the CSLR's sustainability.
- **Fairness:** compensation limits should be fair to consumers to enhance confidence in the regulatory system.

### UK experience

The UK FSCS applies a range of compensation limits that depend on the type of business the responsible financial firm engages in. The compensation limits imposed by the FSCS are lower than the amount awarded by UK ombudsman services. The FSCS compensation limits have evolved since the scheme's establishment, but this has not been in line with that of the UK ombudsman service.

## Discussion items

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

The CSLR is intended to provide compensation for the loss experienced by a consumer or small business for financial firm misconduct, while ensuring the scheme remains affordable for those funding it.

The Ramsay Review recommended setting compensation limits as a way to reduce regulatory costs and ensure the sustainability of the CSLR. The Ramsay Review also recommended aligning the compensation limits of the CSLR with those imposed by AFCA.<sup>12</sup> An advantage of aligning the CSLR and AFCA's compensation limits is it would ensure the comparability of outcomes for consumers and

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<sup>12</sup> Ramsay Review para 4.170.

small businesses between an EDR framework, a court or a tribunal. Consumers would not be incentivised to pursue court and tribunal awards so as to pursue a larger claim against the CSLR.

An alternative to the Ramsay Review approach is for the CSLR to set compensation limits below that of AFCA claim limits, either as a percentage of the amount awarded or as a maximum dollar value. This is analogous to the approach adopted by the FSCS in the UK, in that the compensation amounts awarded through the scheme are lower than those of their financial ombudsman.

Establishing CSLR compensation limits equal to or lower than AFCA's claim limits would assist in ensuring the scheme remains sustainable in the face of a large number and wide variety of claims and thus affordable for those financial firms required to fund the scheme.

However, an excessively low CSLR compensation limit could undermine the intent of the scheme to build trust in the financial system if the compensation amounts are considered to be manifestly inadequate in a large proportion of cases.

## Questions

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?

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

The CSLR is intended to be a sustainable and resilient scheme that is able to provide compensation to consumers across a range of events. This includes unexpected circumstances in which the number and amount of claims eligible for compensation through CSLR in a given year exceeds the scheme's planned funding level for that year.

The Ramsay Review suggested the CSLR could have the ability to spread compensation payments over a period of time to manage losses associated with a large failure.<sup>13</sup> This mechanism allows the CSLR to pay determinations in instalments, so that the total amount awarded is accumulated by the consumer or small business over a period of years. The advantage of spreading compensation payments over time is that it increases the sustainability of the CSLR by allowing greater control over the rate at which scheme funds are depleted and by providing an opportunity for additional funds to be levied in an ordered way to meet claims. Additionally, this approach would assist to reduce the volatility of levies imposed upon financial firms required to fund the losses because the cost to those firms can be spread over time as opposed to be imposed at a single point in time.

Although spreading compensation payments over a period of time increases the CSLR's sustainability and reduces the volatility of levies for industry, it would result in consumers experiencing a delay in receiving the full amount of their awarded compensation amounts. Where the delay in receiving the full award would lead to hardship for specific consumers (for example, it would result in the consumer having to default on mortgage repayments), the CSLR could have a discretion to pay compensation to that consumer in a single or smaller number of instalments. It is noted that the alternative to delayed payment could be no payment if the CSLR's funds were depleted because of a large unexpected loss event.

Another mechanism that could be used to manage large amounts and volumes of unexpected uncompensated losses is to impose an additional compensation limit for eligible claims associated with the specific loss event. This differs from the compensation limits discussed above as it would only apply in the case of large loss events. The advantage of this approach is that it would increase the CSLR's ability to provide compensation for a wider range of consumers with uncompensated

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<sup>13</sup> Ramsay Review para 4.233.

losses because the compensation limit can be set such that the schemes funding would not be exhausted after a single loss event. For example, compensation related to the specific loss event could be capped at \$50 million, with the result that claimants impacted by that loss event may receive less than the amount awarded if the aggregate value of claims exceeded \$50 million. This would increase resilience of the CSLR by increasing the likelihood that its funding pool remained available to respond to subsequent events. It is acknowledged that this approach would impact consumers by providing a lower level of compensation than originally awarded.

## Questions

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?
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?

## How should compensation for legal and professional costs be limited?

The Ramsay Review recommended that consumers and small businesses be allowed to recover their reasonable legal costs through the CSLR.<sup>14</sup> The Ramsay Review also considered that litigation funders should not be able to directly access the CSLR but that consumers and small businesses should be able to use compensation paid by the CSLR to meet obligations under a litigation funding agreement.<sup>15</sup>

An alternate approach is to limit compensation payable for legal and professional costs to the limit imposed by AFCA, which is currently \$5,000.

## Questions

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

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<sup>14</sup> Ramsay Review para 4.178.

<sup>15</sup> Ramsay Review paras 4.183 and 4.184.

# Managing scheme evolution

## Issue

The CSLR will be a new scheme in the context of the Australian financial system. In the earlier sections of this paper, it has been noted that while there is some historic data on unpaid determinations, this data is unlikely to be fully reflective of future experience. Given this, the actual experience of the CSLR will be better understood once the scheme is operationalised.

While legislation will be enacted to establish the scheme, there are options as to which aspects of the CSLR's operations are prescribed through legislation. In part, this decision follows from how responsive the CSLR should be to its claims experience and how sensitive the funding model should be to such experience.

## Considerations

The level of flexibility in the operation of the CSLR will need to balance a number of considerations including:

- **Adaptability:** the CSLR needs to be sufficiently adaptable to change its arrangements as appropriate.
- **Transparency and certainty:** the operation of the CSLR should be transparent and industry and consumers should have a high degree of certainty as to how the CSLR will operate.
- **Efficiency:** it is important that the CSLR is cost effective and able to make decisions in a timely fashion.

## Discussion items

### To what extent should the operation of the CSLR be responsive to experience?

The Ramsay Review noted the importance of establishing a CSLR that was independent but subject to regulatory oversight.<sup>16</sup>

One approach offering a high degree of flexibility to the CSLR to adapt its operations, including setting of levies, would be to follow the framework for AFCA. That is, while legislation would prescribe certain aspects of the CSLR's operations, a high degree of flexibility would be left to the scheme to determine other aspects of operations. For example, significant aspects of AFCA's operations are governed by its Rules but are not otherwise prescribed in legislation. Similarly, AFCA's approach to funding on a user pays system is not legislatively prescribed.

Adopting a similar approach in the case of the CSLR would enhance the CSLR's ability to efficiently evolve in response to market changes, changing stakeholder expectations and the recommendations of independent reviews. Government and regulatory oversight of the scheme would be designed to ensure that the CSLR's operations remain consistent with the key objectives of the scheme as detailed in legislation.

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<sup>16</sup> Ramsay Review para 4.273.

Alternatively, the legislation enabling the establishment of the CSLR could take a more prescriptive approach such as prescribing:

- the size and risk metrics used as the basis for annual levies for financial firms;
- the appropriate level of capital to be held by the CSLR in anticipation of potential unexpected events;
- a maximum cap applied by the CSLR in respect of annual levies for financial firms;
- a maximum amount of compensation to be paid to consumers; and/or
- a maximum amount of compensation to be paid where the determination relates to a large unexpected event.

Under this approach, changes to the operations of the scheme would require action by Government and would be expected to be less responsive to experience than if made by the CSLR itself.

### Questions

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?

# Appendix 1: Ramsay Review

## recommendations on the establishment of a CSLR

1. A CSLR should be established. A CSLR, if established, should be limited and carefully targeted at the areas of the financial sector with the greatest evidence of need.
2. A CSLR, if established, should initially be restricted to financial advice failures where a financial adviser (relevant provider) has provided personal and/or general advice on 'relevant financial products' to a consumer or small business. This means that only advice given by a 'relevant provider', as defined in section 910A of the Corporations Act, would be covered by a CSLR. Relevant financial products include, for example, financial advice on investments in managed investment schemes, superannuation and banking products that are not basic banking products.

A CSLR should be designed for the future and accordingly be scalable, which means it can be expanded over time to cover other types of financial and credit services should evidence of significant problems of uncompensated losses emerge.

3. If a CSLR is established, the following design features are recommended:

### *Prospective*

- A CSLR should only apply to unpaid EDR determinations, court judgments and tribunal awards which are made after a CSLR is established.

### *Eligibility*

- A CSLR should be restricted to consumers and small businesses (as defined by AFCA).

### *Types of claims*

- A CSLR should be limited to financial advice failures but scalable in the future subject to consultation and modelling.

### *Conditions for accessing a CSLR*

- Consumers and small businesses must have a decision from AFCA, a court or a tribunal which remains unpaid after reasonable steps, as defined by a CSLR, have been taken.
- To allow consumers and small businesses to satisfy this condition, AFCA should determine a dispute and make a determination in circumstances where a financial firm is insolvent or has been expelled from AFCA.
- A CSLR should only be able to receive a claim following a court judgment or tribunal award where the circumstances giving rise to that claim would have been eligible for consideration by AFCA.

### *Time limits for making a claim to a CSLR*

- Applications must be lodged with a CSLR by a consumer or small business within 12 months of the consumer or small business having completed specified reasonable steps to obtain compensation.

- Where an uncompensated loss arises from an unpaid EDR determination, AFCA should be required to provide certification that it has completed its processes to enforce the determination and that it does not consider that the determination will be paid, and then refer the consumer or small business to a CSLR.
- AFCA should ensure that consumers and small businesses are informed of their right to make a claim to a CSLR. This should be communicated as part of all key communications, such as when the initial determination is issued.

*Functions and powers of a CSLR*

- A CSLR should not independently reassess the merits of claims which it receives.
- Before paying a claim, a CSLR must be satisfied that the EDR determination, court judgment or tribunal award will not be paid by the financial firm to the consumer or small business.

*The amount and types of compensation that can be paid through a CSLR*

- A cap should apply to the level of compensation that a CSLR is able to provide. This compensation cap should be aligned with the compensation cap which AFCA applies.
- The compensation cap should be subject to review, from time to time, to ensure it remains fit for purpose and that a CSLR remains financially sustainable.
- A CSLR should set limits on the level and types of legal costs that are recoverable.
- A CSLR should consider issuing guidance on its treatment of compensation caps where litigation funding is involved, to ensure that access to a CSLR in matters involving private sector litigation funding does not undermine its financial sustainability.

*A CSLR's right to subrogation*

- A CSLR should have the ability to stand in the shoes of a consumer or small business and pursue the financial firm for the compensation amount, where the firm is still in existence and a CSLR considers that it has reasonable prospects of success.

*Funding of a CSLR*

- A CSLR should be funded by financial firms engaged in the types of financial services covered by a CSLR (initially, specified types of financial advice).
- A CSLR should be ex-ante funded; that is, financial firms should be required to contribute to a CSLR from its outset. This ensures that those financial firms whose actions give rise to uncompensated losses are required to contribute to a CSLR.
- The Government should work with industry to develop an appropriate mechanism, such as a levy, to fund a CSLR.
- Comprehensive modelling should be undertaken to estimate the likely costs associated with a CSLR and the funding mechanism should reflect the outcome of this modelling exercise.
- The funding mechanism should be designed to minimise the volatility in funding requirements, that is, it should be designed to minimise the need for a CSLR to raise additional ad-hoc funding to meet its obligations.
- The funding mechanism should be designed in a manner that does not result in a substantial lessening of competition amongst financial firms, while ensuring that all firms providing the types of financial services covered by a CSLR make an appropriate level of contribution to a CSLR.

- A CSLR should be provided with sufficient funding to allow it to raise community awareness about its existence.

*Administration of a CSLR*

- Financial firms providing the types of financial services covered by a CSLR should be required to be members and contribute to the funding of a CSLR as a condition of licensing.
- A CSLR should be governed by an independent board with an independent chair and equal numbers of directors with industry and consumer backgrounds, consistent with the model in the EDR framework.
- ASIC should have oversight of a CSLR to ensure it is fulfilling its objectives, similar to the role envisaged for ASIC in respect of AFCA. This will require ASIC to have a general directions power to allow it to compel a CSLR to meet its regulatory and legislative requirements.
- A CSLR should operate independently of AFCA; however, these bodies will need to work together.

## Appendix 2: Discussion questions

1. What is the appropriate coverage for the CSLR, beyond the provision of personal advice?
2. Would there be any unintended consequences from initially excluding court and tribunal decisions or from excluding voluntary members of AFCA from the CSLR?
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 service class level?
6. Should a risk based funding model apply to all CSLR costs?
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?
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 be often 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?
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)?
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?
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23. How should compensation for legal and professional costs be limited?
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?