



10 February 2020

Manager, Redress and Accountability Unit  
Financial Services Reform Taskforce  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [cslr@treasury.gov.au](mailto:cslr@treasury.gov.au)

Dear Sir/Madam,

#### SMSF ASSOCIATION SUBMISSION ON THE ESTABLISHMENT OF A COMPENSATION SCHEME OF LAST RESORT

The SMSF Association welcomes the opportunity to make a submission on the establishment and potential design of a compensation scheme of last resort (CSLR).

The SMSF Association's submission supports the creation of a CSLR and appreciates the key role it can play in protecting consumers and in providing confidence in the financial services industry. Overall, the introduction of a CSLR will install confidence and trust in the sector for consumers, especially when selecting a financial firm. It will also encourage consumers to seek financial advice which is crucial given the complexities regarding SMSFs.

We understand the Government's decision to implement a scheme of last resort as recommended by Commissioner Hayne and seek to engage constructively during the creation process. However, we also note that the SMSF Association is primarily concerned with the causes and consequences of unpaid determinations and insolvent firms. Treasury should consider how a financial firm has failed, why it has failed and who was in control. Any reforms must be framed to prevent financial firms from avoiding the consequences of complaints, including the risk of unpaid determinations.

It is also essential that reform deals with dishonest behavior and for a much clearer sharing of market intelligence among the CSLR, Australian Securities and Investment Commission (ASIC) and Australian Financial Complaints Authority (AFCA). An understanding of such behaviour should help effectively design any scheme of last resort and any access to redress.

In addition, noting the CSLR will likely be funded by industry, it is extremely important to recognise that the sustainability and affordability of the financial advice sector is paramount, especially as the cost to provide advice continues to rise from areas such as ASICs cost-recovery levy, AFCA, Tax Practitioners Board and extra fees associated with the new professional standards arrangements for financial advisers.

It is also important to recognise that the CSLR should only involve scenarios where all other redress avenues have been exhausted after a determination made by AFCA and the validated insolvency or wind up of the financial advice business involved.



We acknowledge that data relating to unpaid determinations is difficult to obtain. We appreciate the roundtable consultation conducted by Treasury which provided further insight to help build this submission. We would encourage the publishing of further data during the consultation period.

#### *Importance of a CSLR to the SMSF sector*

The SMSF sector forms over one quarter of the near \$3 trillion superannuation assets. There are approximately 1.1 million Australians in 596,000 SMSFs with an average fund balance of \$1.2 million and median fund balance of \$690,000. A high portion of SMSF trustees are advised by financial advisers and accountants in order to seek a secure and dignified retirement.

A CSLR will provide SMSF trustees with confidence that they have access to compensation on the provision of poor advice or failure of investment products. This is essential, given SMSFs are such an integral and successful part of the retirement income system.

The SMSF Association also represents the advisers and accountant professions that provide advice to this significant cohort of individuals. It is important that the CSLR is not only affordable but improves consumer confidence in advisers so that more Australians seek financial advice.

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

The SMSF Association believes a 'broad-coverage approach' would be most appropriate for the CSLR. It should apply coverage to all activities that require a financial firm to hold AFCA membership.

As highlighted by the Paper, a broad-coverage approach ensures that there is greater clarity and simplicity in determining if the service received is covered by the CSLR. In addition, a broader coverage also ensures that more consumers are protected.

*As stated by Commissioner Hayne, 'it is time to start reducing the number and the area of operation of special rules, exceptions and carve outs. Reducing their number and their area of operation is itself a large step towards simplification. Not only that it leaves less room for 'gaming' the system by forcing events or transactions into exceptional boxes not intended to contain them'.*

We believe that a broader coverage which enhances sustainability is of greater priority than the concern that some firms may be contributing to the CSLR when their likelihood of failure is low. However, we also believe certain funding arrangements relating to risk will mitigate this concern.

We believe arguments calling for exclusion from CSLR coverage because a firm's low likelihood of failure due to less risky product and service offerings, large capital adequacy or being prudential regulated are better considered in the determination of how much funding is required for the CSLR.

Fundamentally, if you are an entity supplying a financial product/service, your consumers should have remit to the proposed compensation scheme.

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

##### *Voluntary firms*



The SMSF Association understands the Paper's reasoning for exclusion of voluntary members of AFCA. However, in the interests of simplicity it is preferred that if a firm is a member of AFCA that it is aligned and included with the CSLR.

We believe there are potential options which AFCA may implement that will reduce the potential disincentives imposed on voluntary AFCA members.

One option is to reduce the funding required by voluntary AFCA members to recognise that they are voluntary members who are not obliged to possess AFCA membership and that their offerings are less likely to need the CSLR.

#### *Court and tribunal cases*

We have no reason to contend with Treasury's indication that the small proportion of eligible court and tribunal decisions would disproportionately increase the complexity of the implementation of the CSLR. Given this risk we support a staged inclusion of these decisions to the CSLR.

In principle, we believe CSLR claims should also apply to unpaid court rulings. It would be unfair to exclude victims who went to the expense and risk of taking their cases to court from recovering their losses from advisors that the courts have found to be at fault but are insolvent and unable to pay damages as determined by a court.

The introduction of a cap on CSLR compensation would mitigate the risk of an uncapped compensation determination from a court or tribunal.

## Funding and compensation

The SMSF Association believes it would be beneficial for the CSLR to be designed as simply as possible. This would increase understanding for relevant stakeholders and also reduce the administration costs in operating the CSLR. However, this desire for simplicity must be balanced with considerations of equity, ensuring that AFCA members are not excessively funding the CSLR when they are unlikely to have an unfunded compensation determination.

We believe at a high level an equitable model would encompass:

- A split between administrative and claims costs separately.
  - Administrative costs should be funded equally regardless of risk and size.
- Levies which are raised from industry ex ante.
  - Based on previous year's data of unpaid compensation.
  - Allowing for a special levy in reasonable circumstances.
- Sectors which are assessed for risk based on claims costs.
- Subsectors in which firms are assessed based on their proportionate market share for claims costs.
- A single funding pool from which compensation can be paid.
  - In contrast to each sector forming their own pool of compensation for their sector's failures.
- A maximum cap applying to funding levies at the firm level.
- A compensation cap that is aligned to AFCA's compensation limits. (or to a percentage of those limits)



- Reassessed yearly.

It is extremely important any industry-based funding scheme takes into account the sustainability and affordability of the sector having regard to the introduction of more recent industry-based funding levies.

Therefore, sector analysis is extremely important in the funding model to determine estimated contributions to the CSLR.

For simplicity, a single pool of money would then be used to pay compensation. A single pooled fund is likely to have a lower cost and reduced compliance burden than multiple pools. It would allow better predictability of costs based on a combination of known costs, projections and the cost of a market professional indemnity insurance policy.

The balance between capital base, special levies and the spreading of costs is also important in the design of the CSLR.

To what extent should the funding model be based on risk? How should risk be assessed? Should the funding model assess risks at the individual financial firm level or at the financial service class level?

It is important that funding be based on a range of factors which determines an overall contribution to the CSLR. We support the premise that firms undertaking riskier services provide proportionately more funds than those with less riskier services. A levy imposed equally across all financial firms would be unsustainable and lead to reduced competition.

In principle, we believe a risk-based formula should consider:

- Riskier service offerings should invoke greater contribution than less riskier service offerings.
- Firms which have less likelihood of failure due to prudential capital requirements should invoke less contribution than firms which are not prudentially monitored.

We believe it is appropriate for the funding model to assess risks at a service class level. The previous history of unpaid determinations and failures should be the main input to determine these risk factors. This is because unpaid determinations are the problem the CSLR is intending to address which indirectly factors in service offerings and prudential requirements.

Depending on the level of administration required, it may be appropriate to consider subsectors within a sector for further risk assessment. For example, derivative product offerors could be expected to have a greater history of unpaid determinations than cash management product offerors.

Ideally, with perfect data collection assessing risk at the firm level would provide the most accurate funding model, however, this would be too costly to continually administer in the first iteration of the CSLR.



Guidance should be taken from ASIC's industry funding levies<sup>1</sup>. The financial industry is divided into appropriate sectors and subsectors each with a budgeted cost recovery amount.

Should a risk-based funding model apply to all CSLR costs?

We do not think risk-based funding should apply to all CSLR costs. We believe administration costs should be shared independently of the risk of each sector or firm. These costs should be seen as a 'ticket to play' in the financial services sector, to encourage buy in from all parties to improve the consumer confidence in the sector.

However, we note without further data it is hard to make any further assessment.

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

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 firm. A consideration of size is appropriate to reduce potential competition barriers. It would be inequitable to design a funding model where an adviser who services one client pays the same as an adviser who services 100.

Therefore, we support proportionate funding after risk is considered at the sector level. Firms which supply a large portion of the market would be responsible for supplying that same portion of the CSLR funding.

What are suitable universally available metrics to assess a firm's ability to pay?

We understand attaining an accurate dataset, especially for the determination of a firm's size is difficult. This is because the data is open to manipulation through self-reporting or may not be entirely reflective of a firm's actual size in the market.

Noting the issues highlighted, we are open to considering estimated revenue size and/or estimated number of clients as inputs to determining what portion of the market firms represent within a service class. Consideration should then be given to placing firms in 'classes' of size to reduce administrative costs regarding assessment at an individual level.

There may be an opportunity for AFCA to legally require regulated entities to provide accurate details and business activity metrics deemed appropriate for AFCA and the CSLR. This is currently the case for regulated entities who must lodge an industry funding return to ASIC.

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<sup>1</sup> <http://download.asic.gov.au/media/4685852/summary-of-2017-18-indicative-levies-published-28-march-2018.pdf>



How should the funding model address unexpected costs? Is it better to avoid levy volatility or funds being tied up in a capital base that may not be often used? If a CSLR capital base is to be established, what is a suitable minimum capital requirement? If levies are to be collected after the CSLR becomes aware of unexpected additional costs, how will financial firms manage this?

Managing volatility is important. We are supportive of building a reasonable capital base rather than continual ad-hoc requests which may not be recoverable. If the capital base is a reasonable cost on top of initial funding, the opportunity cost should not be too large.

Without data, recommending a minimum capital requirement is hard to determine.

If the CLSR is able to borrow funds in order to pay claims while recouping unexpected costs over time through an additional year's capital base/claims contribution, this should be considered.

Another option is to spread payment to a consumer over multiple years because the capital base is unable to recover the determinations.

Should a maximum cap apply to the annual levies that can be imposed on participating financial firms?

We believe a form of cap is essential. This ensures that the affordability and sustainability of the sectors are not under risk of a detrimental funding determination in a financial year.

An uncapped levy on AFCA members, particularly advisers who have numerous regulatory costs could have significant effects on the advice profession. A CSLR will have reduced value if many advisers begin to exit the market. We believe any substantial levy costs would have a significant negative impact on individual advisers and accountants who provide ASIC regulated advice.

If the CSLR is unable to funded because some firms have reached their cap, we do not support the CSLR spreading residual costs to other participating firms through an additional levy. (The SMSFA's preferred design is a single pool which means there would be no ability to spread residual costs. Next year's levy would be reassessed to incur a greater cost to the sector which caused the unfunded determination)

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

The SMSFA would support the CSLR compensation limits aligning with AFCA's claim limits. This helps create a system that is easy to understand and is as simple as possible for consumers.

We would also support the CSLR compensation limits being set as a percentage of AFCA's claim limit. This ensures that the scheme has a greater chance of being sustainable. Given the compensation scheme is a last resort, after all options are exhausted, there is a justifiable reason that the limit does not need to be on par with AFCAs. The percentage set should not be lower than 50% as to not undermine the scheme.



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

As highlighted, we support the possibility for special levies based on reasonable grounds. A special levy should only be used when there is a large unexpected failure and not for smaller unexpected costs that the capital base is unable to recover. We do not support additional capital being held for significant one-off unexpected events.

It is reasonable to suggest that the special levy should be funded in majority by the sector that is responsible for the event. However, this is dependent on the unexpected event and failures that occurred which resulted in large unexpected determinations.

A special levy has the potential to place unaffordable costs on a sector and therefore the maximum cap should not be 'broken' to facilitate the levy. Therefore, we would support a model where special levy payments are spread over time.

The SMSFA also supports introduction of an additional compensation cap for large unexpected failures. In this instance, the special levy would be funded to recover a capped amount of compensation from a specific loss event. This ensures the sustainability and affordability of the CSLR, as uncapped specific losses could result in special levies that are extremely substantial, especially when they may be funded by specific sectors only.

How should compensation for legal and professional costs be limited?

The SMSFA agrees with the Ramsay Review that consumers and small businesses be allowed to recover reasonable legal and professional costs. We support limiting this amount to the AFCA limit of \$5,000.

### Managing scheme evolution

Given its impact on the financial services industry, a more prescriptive approach through legislation of agreed overarching principles should be taken in designing the CSLR. However, the CSLR should be flexible and responsive to any calls that its original establishment rules need improvement.

We recommend the CSLR consider the framework for the ASIC funding model as a workable industry funding model that uses a mixture of legislation and regulation.

The following list provides a proposed breakdown of areas which could be prescriptive through legislation and areas which could be made more flexible through regulations and AFCA/CSLR rules:

#### Prescriptive

- Who is required to be covered by the CSLR
- Distinction between administration costs, claims costs and capital base



- The principles/framework regarding size and risk metrics used as the basis for annual levies for financial firms.
  - The specific formula however may need to be flexible
- The 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
- The determinations which allow creation of a special levy

#### Flexible

- Ability to determine sectors, subsectors and size banding
- The appropriate level of capital to be held by the CSLR in anticipation of potential unexpected events.
- The maximum cap applied by the CSLR in respect of annual levies for financial firms.
- Discretion on when payments should be spread over years,

A post implementation review will be essential given the significance of the establishment of a CSLR.

If you have any questions about our submission, please do not hesitate in contacting us.

Yours sincerely,

A handwritten signature in black ink that reads 'John L. Maroney'. The signature is written in a cursive style with a large, looped 'J' and 'M'.

John Maroney  
CEO  
SMSF Association

#### **ABOUT THE SMSF ASSOCIATION**

The SMSF Association is the peak professional body representing the SMSF sector which is comprised of over 1.1 million SMSF members who have \$750 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.