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Submission to the Senate Standing Committee on Economics: Bills relating to the Compensation Scheme of Last Resort

December 2021

17 December 2021

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir/ Madam

Financial Accountability Regime Bill 2021, Financial Sector Reform (Hayne Royal Commission Response No. 3) Bill 2021, Financial Services Compensation Scheme of Last Resort Levy Bill 2021 and Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2021

The Institute of Public Accountants (IPA) welcomes the opportunity to comment on the above Bills. Our comments relate only to the proposed Compensation Scheme of Last Resort (CSLR).

The IPA is not opposed to a CSLR in principle. However, the IPA is opposed to the design of the CSLR as proposed in the Bills.

We have concerns that the proposed scheme:

- will become a go-to option rather than a scheme which is genuinely 'of last resort';
- has the potential to become a costly burden for a sector which is facing many challenges; and
- unfairly exempts some industry participants, such as product providers.

Our more detailed comments appear below under each of these concerns.

The IPA is one of the three professional accounting bodies in Australia, representing over 46,000 members and students in Australia and internationally. Three-quarters of the IPA's members work in or are advisers to small business and SMEs.

If you have any queries or require further information, please don't hesitate to contact Vicki Stylianou, Group Executive, Advocacy & Policy, either at vicki.stylianou@publicaccountants.org.au or mob. 0419 942 733.

Yours faithfully

Vicki Stylianou
Group Executive, Advocacy & Policy
Institute of Public Accountants

Introduction

The IPA is of the view that the CSLR should be considered in light of the outcomes from various reviews which will all have a bearing on the design, operation and cost of the CSLR. These include:

- Review of the Australian Financial Complaints Authority (AFCA) which was undertaken earlier this year. AFCA will have a major role and function as part of the CSLR.
- Ongoing consultation and an upcoming review of the ASIC industry funding model. This has a significant bearing on the cost of the CSLR.
- Review of ASIC (and APRA) by the Financial Regulator Assessment Authority (FRAA), with submissions due in January.
- Quality of Advice review in 2022.

Given how long it has been since a compensation scheme was first discussed and the negative impact of a flawed design, we see no compelling reason why the CSLR legislation should be rushed and why it can't wait for all of these other reviews to be completed. Changing the scheme once it has commenced would be sub-optimal.

'Last resort' should mean 'last resort'

The Financial Services Royal Commission recommended the establishment of a compensation scheme of last resort to compensate consumers once all other avenues had been exhausted. The IPA's view is that all avenues for payment must be exhausted, including engaging debt recovery services. Otherwise, there appears to be no incentive for the claimant to pursue payment if they can easily access the CSLR. We contend that this is not a genuine scheme of last resort. The proposal states that 'AFCA can conduct reasonable steps to secure payment'. The concept or idea of 'reasonable steps' does not equate to all other avenues being exhausted.

A claimant could become an unsecured creditor in an insolvency, and we believe this is preferable to abrogating the claimant's rights to the CSLR operator. This would avoid having the industry (or the taxpayer to some extent) funding the CSLR operator having to recover funds from a chapter 5 body corporate.

Otherwise, the scheme operates more like a 'reimbursement scheme' than a genuine scheme of 'last resort'.

If cost for consumers is an issue, then we point to the numerous debt recovery businesses which can be used by consumers on the basis of 'no recovery – no fee'. IPA members use these services for their own clients and employers.

In this regard a guiding principle should be taken from the Australian Government Cost Recovery Guidelines (RMG 304) which state that "Government activities should meet quantity, quality, and other targets, be undertaken at minimum cost…".

To operate effectively, a CSLR should be viewed holistically to ensure that everything is being done to reduce the reliance on such a scheme. This is simply part of the broader landscape of having efficient and well-functioning financial markets, with a regulator that can be relied upon for effective and efficient monitoring, supervision and enforcement activity. For this reason, the overall operation of

ASIC needs to be considered, which we anticipate will be examined during the upcoming FRAA review.

Part of this landscape of well-functioning markets is the role of professional indemnity (PI) insurance. We believe that government, Treasury and ASIC should consider the market for PI insurance and ensure that all licensees hold appropriate PI insurance as part of their obligations. Whilst the professional accounting bodies, including IPA, have this as a mandatory requirement which is monitored and enforced, we believe that it should be included in ASIC's supervision model. It may not solve all situations, and it is only one element, however, it is a critical one, also in the CSLR context.

Further, given that advisers cannot add insurers to a case by a claimant going through AFCA, then there is even more reason for the issues around PI insurance to be considered within the CSLR context. No regard seems to be given to the additional and significant costs incurred by advisers who may have to pursue indemnification from insurers through a costly court process. This includes instances where cases are decided in favour of advisers. The IPA proposes that this could be addressed by allowing advisers (not claimants) to join their insurer to a claim. To be clear, we do not support claimants being able to join insurers as PI insurance is not intended to provide compensation.

Cost

Overall, we do not support the proposed structure of the scheme which would enable AFCA to recover outstanding expenses in addition to failing to address the causes of unpaid consumer compensation. We contend this is a major and unwarranted departure from the Royal Commission's intent.

The Federal Government made a commitment to reducing red tape to cut the cost of doing business and we point to the work of the Prime Minister's Deregulation Taskforce. Contrary to this work, the proposed scheme will add significant cost and complexity, which is at odds with this commitment.

The draft legislation establishes a CSLR operator as a subsidiary of AFCA. This adds unnecessary red tape by requiring ASIC to administer invoices and payments and significantly increases the Government's administration costs of the financial advice sector with little benefit to consumers. The costs to set up and administer the scheme (refer to this week's MYEFO) seem overly generous at a time when the sector is experiencing significant cost increases, which will have to be borne either by clients or absorbed by the business. Either way, the cost of advice will increase, and the accessibility of advice will decrease.

The proposal that ASIC can collect 'special levies' associated with the scheme leaves the door open for ASIC to increase the levy without proper consultation; and given the issues with the ASIC industry funding levy, we are concerned about the lack of appropriate accountability and transparency. These concerns have been well documented over a long period of time. Further, the proposal that the funding of CSLR Co as the scheme operator is funded by industry seems like another open door.

The proposal that CSLR Co will *estimate* levies and then request ASIC to levy a set amount is another open door for potentially increasing costs. The proposal that funds can be levied for unpaid AFCA fees, operational costs, and ASIC's administration costs under the CSLR is a major concern. Again, we point to the issues with the ASIC industry funding levy to describe the lack of accountability and transparency. Where are the incentives to keep costs contained and to consider the cumulative and increasing cost pressures on industry.

The proposal states that the CSLR is not 'fee for service' and is not 'cost recovery'. The inclusion of a possible secondary funding mechanism is a major red flag. The proposal states that the levy framework will align with the ASIC industry funding model but not form part of the framework. All of this presents an ambiguous model which can be used to increase the levy rather than having a model with built-in incentives to decrease the levy and ease the pressure on industry.

We believe this proposal will create a situation of moral hazard which will have implications for PI insurance, ASIC levies and licensee fees. Another implication is that the consumer bias indicated previously by AFCA decisions may return. We refer to our submission on the review of AFCA which describes the judicial criticism of this bias of AFCA acting as advocates for consumers. This was highlighted by Justice Stevenson in DH Flinders Pty Ltd -v- Australian Financial Complaints Authority Limited [2020] NSWC 1960. This judgment further highlighted that AFCA was acting outside its authority.

In terms of AFCA, a consequence of the no cost to complainant principle is that there is no disincentive to pursuing frivolous or vexatious claims. While consumer interests may be said to be appropriately weighted when the member is a large financial services provider, this weighting can operate unfairly when the member is a sole trader or small business in the following respects:

- The funding mechanism in place under the AFCA scheme incentivises financial firms to resolve disputes at the initial stages. If a frivolous or baseless claim is pursued, the mechanism penalises the member/ adviser unfairly.
- The impact of the time and resources required to respond to complaints impacts small advisers disproportionately where a complaint is frivolous or baseless.

ASIC fees for financial advisers have increased by more than 230 per cent over the past three years. Most financial advisers are sole traders or small businesses who cannot afford the rising costs. Small businesses, authorised representatives and smaller licensees may still ultimately bear some of the cost of the scheme as the costs are likely to be passed on by larger licensees. In addition, others are authorised representatives of groups who participate in other such schemes, which adds cost.

COVID impacts and Australia's ageing population mean the nation's advice needs are growing yet escalating regulatory costs have already caused a mass exodus of advisers from the industry. The total number of financial advisers has fallen below 20,000 and will not be enough to meet this increasing demand. We anticipate the proposed scheme will further reduce adviser numbers.

The IPA is of the view that excess funds should be 'pooled' and quarantined so that over time a pool of funds becomes available which may have the benefit of reducing costs for participants. The pool can be invested in the same way that a superannuation fund may operate. Otherwise, there appears to be no mechanism or incentive to contain or reduce costs over time, especially costs for industry participants who are being asked to fund the misdeeds of some.

We reiterate, that government should fund some of the operational costs from consolidated revenue since AFCA and the CSLR are public goods.

Shared responsibility

Policy design principles such as equity would dictate that responsibility for consumer losses and complaints should be shared evenly across the financial sector. However, the proposed scheme does not apply to some industry participants, such as product manufacturers.

This means that manufacturers whose products are poorly designed, and fail won't have to contribute to the compensation scheme. The industry needs advisers to act as distribution channels and advisers reasonably rely on manufacturers to ensure the products are fit for purpose. Having a shared responsibility reflects the integrated nature of the industry and ensures that product manufacturers are held responsible for their contribution rather than placing responsibility solely on the advisers who are only part of the equation. Otherwise, there is another potential moral hazard situation.

To overcome these concerns, we believe that product manufacturers and providers should be included in the CSLR.

Regulation Impact Statement (RIS)

As we have stated in other submissions related to the implementation of recommendations from the Hayne Royal Commission, the report should not serve the purpose of a RIS. A genuine RIS should be undertaken, especially with proposals such as the CSLR which are costly for industry, and which have the very real potential for cost blowouts due to design failure.