Insurance Council of Australia

17 August 2021

Mr Chris Lyon
Director, Redress Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submitted via email: CSLR@treasury.gov.au

Dear Mr Lyon

COMPENSATION SCHEME OF LAST RESORT: PROPOSAL PAPER

The Insurance Council of Australia (ICA) welcomes the opportunity to comment on the Treasury consultation on the Compensation Scheme of Last Resort (CSLR) comprising the Proposal Paper, the draft bills to establish the scheme and the explanatory materials.[1]

The ICA is the representative body of the general insurance industry in Australia and represents approximately 95 per cent of private sector general insurers. A foundational component of the Australian economy, the general insurance industry employs approximately 60,000 people, generates gross written premium of $53.9 billion per annum and on average pays out $166.2 million in claims each working day ($41.5 billion per year).

The ICA notes that insurance product providers have been designated as **out-of-scope** (at least for the purposes of the primary funding mechanism). We support this element of the proposal. However, insurance product providers remain potentially **in-scope** in other important aspects, such as initial establishment fees and ongoing liability for special levies. Indeed, when considered as a whole, the funding mechanisms outlined in the proposal paper rely heavily on out-of-scope entities for key elements of the scheme. For example, despite not contributing to the accumulated unpaid determinations, general insurers could contribute approximately 20 per cent of the one-off levy that is proposed to fund those claims.

The ICA reiterates our views outlined in previous submissions regarding the challenges associated with cross-subsidisation.[2] Cross-subsidisation raises a moral hazard risk as it essentially requires firms which meet expected ethical and prudential standards to underwrite those who do not and cannot afford to pay compensation.

Additionally, requiring insurers to fund unpaid compensation claims from unrelated sectors will inevitably impact insurance affordability as costs are passed onto consumers. Such an outcome would be incongruous with recent policy initiatives of the Australian Government that seek to improve insurance

---

[1] Treasury, (July 2021), Financial Services Royal Commission – Compensation Scheme of Last Resort
[2] Insurance Council of Australia, (Feb 2020), Submission to the Treasury Consultation on the Compensation Scheme of Last Resort

affordability, such as the north Australian reinsurance pool. The simplest and most effective solution to minimise both moral hazard and affordability concerns is simply to remove insurers from funding liability.

In addition to those core points, this submission raises some suggested changes related to scope and funding arrangements.

Scope

While the proposals paper does not include insurance product providers within scope, insurers may be included in some circumstances. For example:

- Insurers who offer lenders' mortgage insurance (LMI) products are within scope, by virtue of being credit providers; and
- Distributors that hold an Australian Financial Services Licence but are not an APRA licensed general insurer are within scope. For example, if they distribute insurance products in a white label arrangement or on behalf of an APRA licensed parent/related company.

The ICA suggests that LMI insurers who form part of the insurance product providers sub-sector be excluded from the scope of credit providers. This would ensure that LMI insurers are treated in line with other insurers – noting that insurance product distributors who are also insurance product providers are already contemplated to be out of scope. The rationale for excluding LMI insurers from this category is that they are qualitatively different to other covered credit providers. They do not issue credit, and their Australian Credit Licence is limited to credit activities associated with debt recovery activities only.

Additionally, the ICA suggests the need for a more granular distinction between distributors that are related entities of APRA-regulated firms, and those that are not. We understand and support the policy rationale for not including within scope APRA licensed general insurers, given the role of prudential regulation in minimising the risk of insolvency. However, this rationale also extends to a number of entities which will be caught as insurance distributors by virtue of the fact that they are not an APRA licensed general insurer. However, such entities *are* subject to APRA regulation because of their relationship with an APRA licensed general insurer. In particular, we note that APRA's prudential requirements (including capital, risk management and governance) apply to insurance groups, which extends APRA's regulation beyond the licensed general insurer to include its "controlled" and "related" entities. Therefore, it would be inappropriate to capture these entities within the scheme given their relationship to a general insurer and financial strength.

The ICA recommends refining the proposed definition of insurance product distributor by the addition of (3) below:

An Australian financial service licensee that is, at any time in the financial year:

1. *authorised to deal in general insurance products, life risk insurance products or investment life insurance products in relation to retail clients;*
2. *the entity does not form part of the insurance product providers sub-sector; and*
3. *the entity does not form part of a 'Level 2 insurance group' as defined in APRA Prudential Standard GPS 001 Definitions.*

Insurance Council of Australia

Funding Arrangements

Below, the ICA has provided feedback on various elements of the proposed funding arrangements. Several of the concerns below relate to the broader issue of cross-subsidisation, which raise questions around moral hazard and affordability that were outlined in our introductory comments. While the ICA views that the most effective solution is to exempt insurers from the operation of the scheme, alternative proposals are outlined should this not be adopted.

Lack of Certainty for Firms

A general concern is lack of certainty for firms regarding payable levies. The proposed model does not provide firms with any real capacity to predict their likely levies, let alone to budget for these costs. This arises both from the prospective nature of the assessment process (involving project claims and operating costs and filtering smaller firms) and the prospect of any special levies.

The proposals paper notes that levies will be issued in January for payment in March (with penalties for late payments applying from April) to fund the financial year commencing in July. From the perspective of an insurer, the annual payment required by March would need to be part of a corporate budgeting process that typically begins early in the prior calendar year – a lag of almost twelve months.

Further, if the CSLR is intended to commence operation in mid-2022 the ICA seeks clarification as to whether this would entail issuing levy notices in January.

Upfront Levy on 10 Largest Financial Firms

The proposal paper indicates that a one-off "accumulated unpaid determinations" levy will be issued to the 10 largest financial firms or their holding companies to fund the payment of eligible CSLR claims for unpaid AFCA determinations and AFCA fees (accumulated between 1 November 2018 and a prescribed day in advance of the start of the CSLR) that relate to in-scope financial products and services. The consultation paper is unclear as to why the 10 largest firms was chosen rather than another number.

The ICA cannot see the justification for imposing this levy on prudentially regulated insurers (or their corporate groups) given that insurance product providers are proposed to be out of scope and have not, as far as we are aware, contributed to the unpaid determinations.

The ICA notes the Government's commitment in the May 2019 federal budget that it would provide $30 million to cover unpaid legacy determinations from the Financial Ombudsman Service and Credit and Investments Ombudsman. The ICA agrees with the rationale of this position – public funding of unpaid determinations allows the CSLR to operate on a prospective basis. We suggest that the simplest and most effective outcome is for a similar position to be adopted here.

In the alternative, the ICA suggests that the proposed measure to identify the largest firms (total income reported in the Australian Taxation Office *Report of Entity Tax Information*) could be improved. We suggest that a measure based on profitability rather than revenue be considered. This would provide a better view of a firm's ability to pay. However, we reiterate our preference for unpaid determinations to be funded out of consolidated revenue.

Insurance Council of Australia

Secondary Funding Mechanisms and Scheme Levy Cap

The proposals paper distinguishes between primary and secondary funding mechanisms. The primary funding mechanism is proposed to be the annual levy, payable by leviable financial firms.[3] This will cover ongoing costs and ordinary outlays within the leviable firm's relevant subsector. The secondary funding mechanism is proposed to be used where primary levies are not sufficient to fund outlays in a given year. The secondary funding mechanism can take the form of "draw-down of unutilised funding from a single pool, the capital reserve and/or a special levy". Alternatively, classes of CSLR claims that exceed the cap might be paid over multiple financial years.

Two related issues are notable:

- The special levy contemplated under the secondary funding mechanism would include a range of financial firms that are not otherwise in-scope. **Appendix D of the Proposal Paper** indicates that this would include insurance product providers.
- The proposed scheme would include a cap of $250 million as the maximum amount that may be levied from financial firms in any one year to support the operation of the CSLR (the cap applies across all funding streams). The proposals paper notes that the high cap is intended to cover "black swan" events. There is no liability cap for individual entities.

The ICA has several concerns about the practical operation of these elements:

- It will be difficult, if not impossible, for out-of-scope firms to effectively budget for required outlays under the special levy. Insurers do not have visibility over consumer issues in unrelated sectors. They cannot realistically influence "black swan" events in those sectors. They do not have visibility over the financial strength (ability to pay) of firms in other sectors. Finally, there is only a global liability cap, with no liability cap at the level of individual entities. These factors create a significant practical challenge for insurers in assessing their potential liability – which, in any given year, may range from "zero" through to potentially millions.
- The proposals paper notes that, in deciding to use the secondary funding mechanism, the Minister will "balance the interests of claimants and scheme sustainability".[4] While this appears to envisage consideration of broader impacts, no further guidance is given as to the matters the Minister can take into account.
- The proposals paper notes that the statutory cap of $250 million can be raised by regulation, arguably creating additional uncertainty.

As suggested at the start of this submission, the ICA's preferred solution is that out-of-scope firms remain out-of-scope. The rationale for imposing a special levy on such entities is unclear given that those sectors will not have contributed to the unpaid determinations.

Should the Government proceed with the proposal to levy out-of-scope firms, the ICA suggests that a "post-funding" model based on the existing APRA Financial Claims Scheme may be more appropriate. Under this model, any revenue shortfall would be made up by Government in the first instance. Government would then consult with industry on an appropriate amount to recover and method to do so.

---

[3] For a list of leviable forms, see: Treasury, (July 2021) Compensation Scheme of Last Resort: Proposal Paper, **Appendix D**

[4] Treasury, (July 2021) Compensation Scheme of Last Resort: Proposal Paper, p24

As discussed above, a post-funding model would also provide industry with more certainty in predicting future outlays.

If the ICA's proposal for a post-funding model is not adopted, we suggest the following improvements to the current proposal:

- Greater clarity around the statutory cap, including removing the ability for it to be upwardly amendable by regulation, and/or specifying maximum levies at the level of an individual out-of-scope entity.
- Additional clarity around the exercise of Ministerial discretion in imposing special levies. This could include:
  - Requiring consultation with potentially impacted entities on (a) scheme sustainability, (b) which of the four actions (as listed on page 12 of the proposals paper) would be appropriate in the circumstances, (c) broader financial, economic or consumer impacts, and (d) any other relevant matters.
  - Clearly outlining the factors that a Minister must take into consideration.

Administration Costs

The consultation paper notes indicative annual running costs of $3.7 million and establishment costs of $6.3 million.[5] Table 2 provides estimated ongoing levies for the mature scheme of $8.0 million across all in-scope subsectors. This suggests relatively high running costs. The ICA understands that a previous independent report placed the administrative running costs of the scheme at approximately $400,000. The ICA suggests further examination of administration costs to ensure appropriate value for money.

Concluding Comments

Finally, the ICA would take the opportunity to reiterate points further raised in previous submissions. Namely, we view that key elements of a successful CSLR scheme include action to ensure that financial services entities hold appropriate levels of professional indemnity insurance (PII) and capital. While PII is designed to operate for the benefit of the insured (and cannot be transformed into a guarantee of compensation without rendering it commercially unviable) such actions will be important to minimising the number of unpaid compensation determinations and therefore minimise calls on the CSLR (including use of the secondary funding mechanism).

The ICA thanks Treasury for the opportunity to comment on the consultation paper. If you have any questions or comments in relation to our submission please contact Aparna Reddy, General Manager, Policy – Regulatory Affairs, on 02 9253 5176 or areddy@insurancecouncil.com.au.

Yours sincerely

Andrew Hall
CEO, Insurance Council of Australia

---

[5] Treasury, (July 2021) Compensation Scheme of Last Resort: Proposal Paper, p17-18