INSURANCE COUNCIL OF AUSTRALIA

12 February 2020

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

Dear Sir/Madam

COMPENSATION SCHEME OF LAST RESORT

The Insurance Council of Australia[1] (Insurance Council) appreciates the opportunity to comment on the Compensation Scheme of Last Resort (CSLR) Discussion Paper which is examining the establishment of the CSLR and seeks input on coverage of the scheme, funding arrangements, compensation to be paid and managing its evolution. The Insurance Council also appreciates the opportunities provided to attend the industry roundtable discussions held by Treasury on this issue.

Coverage of the scheme

Establishment of the CSLR is part of the Government response to the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (FSRC) recommendation 7.1. Recommendation 7.1 was that the Government should establish a CSLR consistent with the Review of the Financial System External Dispute Resolution Framework (Ramsay Review) which supported a CSLR 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.

It is significant that the Government has committed to a CSLR extending beyond personal financial advice failures as recommended by the Ramsay Review. The Insurance Council submits that in deciding on the coverage of the scheme, careful consideration be given to the analysis within the Ramsay Review which recognises that the majority of disputes giving rise to uncompensated consumer losses stem from financial planning advice or managed investment schemes.

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent about 95 per cent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. September 2019 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of $49.5 billion per annum and has total assets of $128.3 billion. The industry employs about 60,000 people and on average pays out about $155.1 million in claims each working day. Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

The Discussion Paper outlines two possible approaches to coverage - a 'mid-coverage approach' to include financial services that are not solely provided by prudentially regulated financial firms or a 'broad-coverage approach' to apply to all activities that require a financial firm to hold AFCA membership.

The Insurance Council supports a 'mid-coverage' approach as a more targeted means of resolving the identified problem of unpaid compensation in the provision of particular services. As noted in the Discussion Paper, the 'mid-coverage' approach also acknowledges that services provided by prudentially regulated entities are at a low risk of leaving a consumer or small business with unpaid determinations. In particular, there is no evidence of unpaid compensation awarded in respect of a prudentially regulated general insurers.[2]

The Discussion Paper cites that there is evidence of prudentially regulated firms failing in Australia, referencing the HIH Insurance Group collapse from nearly two decades ago which is suggested as support for broad-based coverage. However, the Insurance Council submits that the regulatory and industry landscape is now radically different to 2001. There are no current circumstances within the general insurance industry which might lead to the collapse of an insurer and so result in unpaid compensation determinations. Given additional reforms stemming from the Royal Commission to enhance prudential requirements, bolster oversight of prudentially regulated entities and improve consumer protections, the risk of prudentially regulated insurance firms failing is even further reduced.

The need for a CSLR and its feasibility has been examined several times including the 2012 Report by Richard St John (St John Report), the 2017 Report following the Ramsay Review and most recently by the FSRC. As in its previous submissions to the Government on this issue, the Insurance Council considers that the potential need for a CSLR stems from issues of poor quality financial advice and financial advisers failing to maintain adequate compensation arrangements. Several reforms have been undertaken to address this specific problem since the St John Report and the Ramsay Review with further extensive reforms proposed by the Australian Government in response to the FSRC.

The Financial Claims Scheme (FCS) already exists in order to provide consumers with compensation in the event that an Australian bank or insurer fails. If the FCS is activated by the Australian Government, most claims made against a failed general insurer by their policyholders or people with valid claims against the insurer, are covered up to $5,000. Claims above $5,000 are also covered under the FCS for eligible policyholders and certain third parties.

While the Discussion Paper states that the FCS would not compensate consumers who had been missold an insurance product, the key point is that prudentially regulated general insurers have the financial capacity to pay compensation awarded through any external body or tribunal. We submit that CSLR with broad coverage in anticipation of a hypothetical and highly unlikely failure by a prudentially regulated general insurer would impose costs on the insurance industry with minimal benefit to consumers.

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[2] The Insurance Council also notes that MIGA, the medical defence organisation and medical/professional indemnity insurer, has made a submission on the CSLR advocating for the exclusion of medical indemnity insurance (MII) from CSLR given that, among other things, it is a highly regulated product and there is no evidence of uncompensated MII losses or unpaid determinations.

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The Discussion Paper suggests that a broad-based approach with wider membership would result in enhanced sustainability, as large and unexpected claims costs could be met by a wider range of members. It was suggested at the Treasury Roundtable that a broad-based approach would also be simpler in design, easier to explain, and provide greater clarity to consumers. The Insurance Council strongly submits that these reasons are not sufficient justification for a scheme that would involve cross-subsidisation of compensation costs by industry sectors, such as general insurance, where they have not contributed to the consumer loss.

The Insurance Council considers that a CSLR should be sector specific within the financial services industry. That would mean that specific sectors fund any losses within that sector, e.g. superannuation, advice, life insurance, banking and general insurance. Even a sectoral approach to a CSLR creates moral hazard as firms without appropriate financial resources may seek to rely on those within the sector which do have appropriate resources. This potentially creates a poor consumer outcome. However, the moral hazard is amplified if the scheme requires cross-subsidisation across the sectors.

Further inequity arises if prudentially regulated entities are required to underwrite those that are non-prudentially regulated. Regulated capital has an associated cost. Consumers and shareholders of prudentially regulated firms should not be required to underwrite non-prudentially regulated entities which do not have the associated capital costs.

In summary, the Insurance Council is against a broad based CSLR because of the inequitable burden that it would place on customers and shareholders of sectors which are extremely unlikely to have unpaid AFCA or Court determinations. Should the Government put aside the concerns identified by the Insurance Council and institute broad-based coverage for the CSLR, we submit comments in the following sections on funding arrangements, compensation to be paid and managing the scheme's evolution.

Funding arrangements

The Insurance Council notes that the discussion on funding arrangements which took place at the Treasury hosted Roundtables provided some additional detail on factors impacting on levy design such as data sources; risk rating to apply to financial classes of activity; unexpected costs and large unexpected failures. We have taken account of this in commenting on the Discussion Paper.

The Insurance Council is concerned that while the Discussion Paper references the Ramsay Review's general findings around a CSLR, it does not provide any modelling which attempts to forecast the cost of establishing a CSLR nor the compensation awards that it may be called upon to pay. The Discussion Paper states that in the future the CSLR could be impacted by large losses and it should be designed to handle such losses but it does not provide any detail as to the potential quantum of those losses and how it is expected they may arise.

It was generally acknowledged at the Roundtable discussion that there was insufficient data from existing sources to fully inform how a levy could apply to industry. The Insurance Council submits that the Government risks creating an unsustainable scheme unless greater thought is given to the design of a levy which is intended to apply across the financial services industry.

Noting however that the Government decision is to proceed with the CSLR, we understand that funding is to be provided to the scheme on an ongoing basis to cover administrative costs (including initial establishment) and claims costs. While not explicit, the Discussion Paper appears to suggest that funding would have two components: administration and claims costs. Furthermore, the Discussion Paper proposes:

- for the CSLR's administrative costs, as they are generally not reflective of risk, that they be shared evenly across financial firms contributing to the CSLR; and
- two broad approaches to funding claims costs – risk and/or a firm's ability to pay.

If necessary, the Insurance Council would favour apportionment of administrative costs evenly across firms captured by the CSLR in the interests of simplicity and solidarity. We also support a financial contribution by the Australian Government to administrative costs as an incentive for cost-effective and efficient management of the CSLR.

While its members do not see a need for them to contribute to the funding of claims costs, the Insurance Council would prefer primarily a risk-based approach to funding claims costs, with risks assessed at the financial service class level. Any financial service class levels should group firms that provide a similar service and we support collection of data in defining the risk factor. This would go some way to address our concerns about less riskier parts of the financial services sector, such as general insurers, cross-subsidising the riskier elements such as those providing financial advice

The Insurance Council does not support a funding approach based on a firm's ability to pay and particularly not one where the levy would be proportionate to a firm's size without accounting for the risk posed by the firm's activities. On this point, we note that the Discussion Paper is very focussed on ensuring that the CSLR is designed to ensure that small firms can pay their share of contributions and does not have such a financial impact that it limits competition. If a firm cannot contribute to a CSLR we would question whether it has adequate resources to be licensed under section 912A of the Corporations Act 2001 (Cth).

The Insurance Council submits that the policy underpinning the CSLR should take account of the implications for consumers of allowing firms which meet expected ethical and prudential standards within a sector to essentially underwrite those who do not and cannot afford to pay compensation Additionally, given the moral hazard inherent in the CSLR, an ability to pay approach is likely to be counterproductive in that those companies that are financially stronger are less likely to give rise to calls upon have the CSLR called upon, but are required to contribute disproportionately. This could encourage smaller firms to strip capital out, which heightens their likelihood to call upon the CSLR.

Adequate internal compensation arrangements

The Insurance Council notes the Discussion Paper rules as out of scope consideration of the role of professional indemnity insurance (PII) and adequate capital requirements for all financial services providers. However, the Insurance Council notes these factors are inextricably linked to the successful design of a CSLR since they minimise the number of unpaid compensation determinations. The purpose of PII is to protect the financial well-being of the insured from liability for third party loss arising from a breach of professional duty. In fact, PII is the 'preferred' mechanism for ensuring compensation is available for consumers of Australian financial services licensees and is ASIC's mandated approach as set out in its Regulatory Guide 126.

While PII is designed for the benefit of the insured, it does operate in most cases to ensure that money is there is pay compensation to consumers. However, it cannot be transformed into a guarantee of compensation being paid in all cases without undermining its commercial viability. Consequently, as in previous submissions, the Insurance Council reiterates that in order to minimise the funding calls upon a CSLR, action needs to be taken to ensure that financial services entities hold appropriate levels of PII and capital. Indeed, having adequate capital is a key part of qualifying for an AFSL and a crucial requirement under section 912A of the Corporations Act. The Insurance Council would be pleased to provide more detail on the availability and strength of the PII market if it would be helpful to Treasury.

Unexpected costs

The Discussion Paper suggests two options to meet unexpected costs where claims made on a CSLR exceed its planned funding level – collecting additional levies as unexpected costs arise or establish a capital base as a buffer. The Ramsay Review also suggested a third option of borrowing so that compensation is paid in a timely way while recouping the unexpected cost over time through higher levies to repay the debt.

As explained above, the Insurance Council's strong preference is that, if general insurers are to participate in a CSLR, their contribution should be limited to a share of the administration costs. However, in commenting more broadly on scheme design, the Insurance Council would advocate, if unexpected costs have to be met, for the collection of additional levies or the Ramsay Review's third option of borrowing rather than an establishment of a significant capital base. While the Discussion Paper flags the potential for levy volatility if additional levies are collected after unexpected costs arise, there would be benefit in ensuring funds of firms contributing to the CSLR are not tied up in a capital base that is infrequently used.

Furthermore, if sufficient data were available, there might be interest by the re-insurance market to provide a stoploss to the CSLR.

Compensation to be paid

Compensation limits

The Insurance Council would support compensation limits for the CSLR and aligning them with AFCA's to ensure the comparability of outcomes for consumers and small businesses between an EDR framework, a court, or a tribunal.

Claims associated with large unexpected failures

The Discussion Paper seeks input on two alternative approaches – spreading compensation payments over time (if so, what should the max time period be?) or an additional compensation limit to unpaid determinations associated with a single specific large failure (if so, what would be an appropriate limit?). The Insurance Council reiterates that without credible modelling such questions cannot be addressed. It is not clear that "large, unexpected failures" require any different treatment to "unexpected costs" discussed above.

Compensation for legal and professional costs

The Insurance Council notes that the Ramsay Review recommended that consumers and small businesses be allowed to recover their reasonable costs through the CSLR. The

Insurance Council supports aligning compensation payable for legal and professional costs to the limits imposed by AFCA.

Administration
In the interests of administrative simplicity, the Insurance Council supports trialling AFCA administration of the CSLR with some strong safeguards to limit and prescribe its discretion such as clear rules setting out when a claim can be paid.

Evolution of scheme

Looking at the two alternative approaches to scheme evolution canvassed in the Discussion Paper, the Insurance Council supports a prescriptive approach in order to provide participants with more certainty. Prescriptive elements at a minimum should include:

- the size and risk metrics used as the basis for annual levies for 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 firms;
- a maximum amount of compensation to be paid to consumers; and
- a maximum amount of compensation to be paid where the determination relates to a large unexpected event.

Metrics for a levy

If the proposal for a broad based scheme is pursued, the question arises as to which metric should be used to allocate amongst general insurers any levy which is to be raised from the sector. The Insurance Council submits that gross premiums would be the most appropriate measure.

Application

The CSLR is to be established by December 2020, but liable to fund unpaid determinations back to November 2018. The Insurance Council queries how the cost of such payments will be allocated given that the entities that caused these losses will not be able to contribute.

Summary

The Insurance Council does not consider that a sufficient case has been made for the application of the CSLR to include financial services which are provided by prudentially regulated financial firms. Regardless of the Insurance Council's serious reservations about the application of the CLSR to the insurance industry, if a broad-based coverage is chosen, the Insurance Council suggests that the CSLR should be sector specific to avoid amplifying the inequity inherent in the CSLR where solvent, profitable and prudentially regulated firms are cross-subsidising firms that do not have appropriate financial resources nor are competitive. More generally, the Insurance Council submits that it is important that an appropriate period of time is provided for the implementation of the CSLR and also ensure that industry is appropriately consulted on its rules.

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If you have any questions or comments in relation to our submission please contact Mr John Anning, the Insurance Council's Head of Policy, Regulation Directorate, on telephone: 02 9253 5121 or email: janning@insurancecouncil.com.au

Yours sincerely

Robert Whelan
Executive Director & CEO