

# Submission to Treasury Discussion Paper - Establishing a Compensation Scheme of Last Resort

Australian Financial Complaints Authority

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# Contents

- Overview..... 1**
- 1 CSLR coverage..... 3**
  - What is the appropriate coverage for the CSLR, beyond the coverage of personal advice?..... 3
- 2 Funding arrangements..... 6**
  - To what extent should the funding model be based on risk? ..... 6
  - To what extent should the funding model be based on a firm’s ability to pay? ..... 8
  - How should the funding model address unexpected costs? ..... 8
  - How should the funding model promote sustainability and affordability? ..... 9
- 3 Compensation payments..... 9**
  - How should the CSLR balance the interests of consumers and financial firms? ..... 9
  - How should the CSLR manage claims associated with large unexpected failures? ..... 9
  - How should compensation for legal and professional costs be limited? ..... 10
  - To what extent should the operation of the CSLR be responsive to experience? ..... 10
- 4 Commencement of the CSLR ..... 11**
- Appendix 1 - About AFCA ..... 12**
- Appendix 2 - AFCA sizing metrics..... 13**
  - Annual levy assessment ..... 13
  - All business activity types ..... 13
  - Business activity type dependent..... 13
- Appendix 3 - AFCA activity groups ..... 15**



## Overview

The Australian Financial Complaints Authority<sup>1</sup> (AFCA) is the independent external dispute resolution (EDR) scheme for the financial sector.

We welcome the opportunity to respond to the Discussion Paper *Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort* released by Treasury on 20 December 2019.

For many years, our predecessor ombudsman schemes<sup>2</sup> and more recently AFCA, have advocated and supported the establishment of a compensation scheme of last resort (CSLR) to fill a major gap in protection for consumers of financial services.<sup>3</sup> Our strong support for a CSLR has been influenced by the experience of over 400 people who, since 2010, have suffered financial loss through no fault of their own and, been awarded compensation by the Financial Ombudsman Service (FOS), the Credit Investments Ombudsman (CIO) or AFCA, but have not received any payment because of a financial firm's inability to pay them. This amounts to over \$30 million in unpaid compensation.

The Government has recognised this injustice, and in the May 2019 Federal budget announced its intention to compensate these individuals. We warmly support the Government's grants program for unpaid FOS and CIO determinations which is processing payments to these individuals and will provide them with redress.

The CSLR proposals that are the subject of this consultation should provide the same protection to consumers who have gone through the AFCA process from 1 November 2018, and to consumers who will do so in the future. Without this measure there is a significant gap that will cause considerable hardship to consumers who have done nothing wrong, who have suffered financial loss, and taken appropriate action through AFCA only to have those EDR awards not honoured.

The road to the development of this policy has taken a long time but we commend the leadership shown by the current Government on this important issue.

Consumer confidence in the financial services industry has been badly impacted by unfair treatment, misconduct and uncompensated loss. As was evidenced by both the Ramsay Review<sup>4</sup> and the Financial Services Royal Commission, consumers need to have confidence that if things go wrong, they will be compensated when a decision is made in their favour. Establishing a broad based CSLR that holistically covers the financial services industry without carve outs is an important part of restoring

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<sup>1</sup> Appendix 1 provides a brief overview of AFCA. For comprehensive information about AFCA, see our website [www.afca.org.au](http://www.afca.org.au).

<sup>2</sup> Financial Ombudsman Service (FOS) and Credit and Investments Ombudsman (CIO).

<sup>3</sup> <http://www.fos.org.au/public/download/?id=53753> & <http://www.fos.org.au/custom/files/docs/fos-response-to-supplementary-issues-paper.pdf>

<sup>4</sup> Review into dispute resolution and complaints framework chaired by Professor Ian Ramsay. See [Supplementary Final Report](#) of the review, released on 21 December 2017.

consumer trust and confidence in the financial services industry following the Royal Commission. This re-building of trust is in the interests of all financial services firms and all Australians.

As we saw through the case studies presented at the Financial Services Royal Commission, the impact of a financial firm's actions can be devastating on an individual consumer and their family. There is often a big power imbalance between the parties and achieving a fair and just resolution through the Courts is out of the reach of most people. It is for this very reason that the Government established AFCA on 1 November 2018 to provide a one stop shop EDR scheme with a significantly enhanced jurisdiction and increased compensation limits. Over 91,000<sup>5</sup> consumers have now used this service; 81% of their complaints have already been resolved and \$245 million has been obtained in compensation. There is a significant injustice and disillusionment though if a consumer successfully exercises their rights through dispute resolution, but the compensation awarded is not paid. This also significantly undermines the EDR framework.

Consumers deserve more from their relationship with financial firms. Whilst most of the financial services industry is responsible and quickly pays compensation when ordered to do so, this issue, caused by a few participants in the industry, must be addressed urgently. We are pleased to see the Government implement this recommendation of the Royal Commission. This is good policy and will improve the operation of the financial services industry sector as a whole. It will improve trust and confidence which underpins all dealings. This in turn is good for the whole economy.

As stakeholders work through the details required to implement a CSLR we do not underestimate the task and work ahead. However, when things get difficult the key focus should be on the impact of unpaid compensation on consumers and the broader implication this has on trust and confidence in the financial sector.

A CSLR will also enhance the reputation of relevant markets and consumer confidence in EDR, the regulatory system and financial services sector more broadly. We consider that it will also maintain existing incentives for both retail clients and licensees to recognise and manage their risks.

Our submission<sup>6</sup> draws on the experience of AFCA and its predecessor ombudsman schemes – organisations that have handled financial services complaints for more than 25 years.

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<sup>5</sup> Figures are for period from 1 November 2018 to 31 January 2020.

<sup>6</sup> This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.

# 1 CSLR coverage

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

AFCA strongly supports the 'broad-coverage approach' outlined in the Discussion Paper.

The CSLR should cover unpaid compensation arising from the provision of any financial service and product that comes within AFCA's jurisdiction, in the same way as the Government's grants program for FOS and CIO determinations did so.

In our view, it is essential that the CSLR covers financial firms of all forms of regulated financial services, financial advice or financial products.

If a consumer has been awarded compensation and this has not been paid by the firm due to insolvency, the type of financial service or product it concerns should not be a determining factor as to whether or not the consumer is compensated for their loss. It would raise significant issues of fairness and cause confusion for consumers if certain types of financial services are excluded from the scheme.

While many of the unpaid determinations have arisen from the provision of financial advice that has caused financial loss, the evidence indicates non-compliance with determinations is not limited to financial advice firms. The types of firms who have unpaid determinations extends past financial advisers who provide personal and general financial advice to include; credit providers; managed investment scheme operators; finance brokers; mortgage brokers; securities dealers and derivatives dealers. In our view, all firms are responsible for restoring trust in financial services and ensuring that their EDR obligations are met.

In our view, it is important that the CSLR also covers managed investment schemes (MIS). This is due to:

- the potential for unpaid determinations and consumer detriment to flow from this group;
- the involvement of other financial firms or their subsidiaries in the funding, distribution or other arrangements with MIS, and
- funding contributions to a scheme across the whole 'value chain' would support increased accountability of all participants, including MIS operators.

In our view including MIS and other financial products in the CSLR coverage should also be considered in the context of other relevant regulatory reform that has been implemented, including the recent introduction of ASIC's product intervention powers and unfair contracts legislation which apply to this group.

As outlined in a range of submissions previously made on establishing a CSLR<sup>7</sup>, the need for a CSLR is separate to considerations of professional indemnity (PI) insurance-coverage and reform. PI covers business risk and is not a consumer compensation mechanism. Notwithstanding any need for further PI reform in relation to how firms meet their legal obligation to have adequate compensation arrangements in place, there is a need for a CSLR to cover loss where PI will not respond. These circumstances include fraud, amounts above PI limits and other situations where PI does not provide coverage or is not available.

We also consider that a broad-based scheme would assist in spreading the funding load across sectors, while including appropriate mechanisms in its funding model to minimise cross subsidisation. The CSLR is of benefit to all the financial services sector as it will help re-build trust in the industry as a whole. Without a broad funding base, the cost could fall heavily on parts of the sector that are least able to fund it. AFCA believes there is significant advantage in keeping the scheme and its administration as simple as possible.

### **Coverage should include all AFCA determinations**

We believe the proposed CSLR should cover all unpaid determinations made by AFCA from 1 November 2018 onwards. This is to ensure there is no gap between the Government's unpaid determinations program (which covers AFCA's predecessor scheme unpaid determinations) and AFCA determinations.

Limited data exists relating to unpaid AFCA determinations given that AFCA only started receiving complaints from 1 November 2018. However, we have already seen several financial firms have their licences cancelled; cease business or enter into insolvency since 2018. Since our commencement there have been more than 40 AFCA determinations awarding compensation to consumers that have not been paid due to the insolvency of the financial firms involved. For this reason, we consider it is critical that CSLR cover any unpaid determinations issued by AFCA from 1 November 2018.

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<sup>7</sup> See previous submissions made by FOS to the 2017 Ramsay Review - <http://www.fos.org.au/custom/files/docs/fos-response-to-supplementary-issues-paper.pdf> & <http://www.fos.org.au/public/download/?id=53753>

## Coverage of voluntary AFCA members

There are only a small number of financial firms that are voluntary members of AFCA and we note that these firms are not currently subject to licensing or EDR requirements.

It is important to avoid any change that may discourage voluntary AFCA membership and prevent consumers from accessing no-cost, efficient EDR for redress.

We do consider that there should be further regulatory and licensing reform in a number of sectors that do not currently require an Australian Financial Services License or an Australian Credit License to operate, which is also relevant to whether a firm is a voluntary member of AFCA. This includes regulatory and licencing reform of debt management firms and buy now pay later providers. We acknowledge that in several of these sectors there are firms who currently voluntarily take out AFCA membership. In our view, licensing, IDR, and EDR requirements should be made mandatory in such sectors. Voluntary membership of EDR is not enough to protect consumers as the financial firm can choose to cease membership. Where this occurs, consumers would be excluded from accessing both AFCA and the CSLR and this could cause consumer detriment.

## Inclusion of court and tribunal decisions should be considered later

To ensure equity to consumers irrespective of the forum from which they received compensation, AFCA believes the CSLR should eventually cover court and tribunal decisions as well as AFCA determinations. The compensation should be aligned with AFCA's compensation limits. It would be an unnecessary regulatory burden on the CSLR if the compensation limits were different to AFCA's. We see no benefit in having a different limit operating for the CSLR and there is a potential for consumer confusion as to their rights to access the CSLR if different limits existed.

We acknowledge that information about the extent to which court and tribunal decisions involving financial services are unpaid, needs to be gathered and analysed before they are included in the CSLR scheme.

Funding modelling of the impact of including court and tribunal decisions should be undertaken as part of this further work, and consideration needs to be given to how class actions would be dealt with by the CSLR. AFCA does not support the use of CSLR funds being made available to litigation funders.

As this further work is likely to take some time, a decision whether to include court and tribunal decisions should occur after the CSLR is established, so that it does not delay the commencement of the scheme for EDR determinations. We agree with the phased approach of considering this inclusion in the CSLR's first post-implementation review after three years.

## 2 Funding arrangements

AFCA considers that the CSLR should have an equitable broad-based funding model across financial firms, with an activity type (risk based component) and an ability to pay (sizing) component. Complexity in the CSLR funding model should be avoided and there should be appropriate flexibility built into the funding model to enable the CSLR to adjust and adapt funding arrangements to reflect any changing profile in unpaid compensation claims. It is important to keep the regulatory costs to a minimum.

AFCA's predecessor scheme FOS has previously provided high level modelling on how an industry funded model could operate. The modelling showed that if a broad coverage CSLR was implemented, when spread across all providers, both the establishment costs and annual contributions to the scheme's pool of funds and its administration could be kept quite low.<sup>8</sup>

Administrative and cost efficiencies could also be achieved by using existing AFCA systems and administrative infrastructure through a service agreement between the CSLR and AFCA.

Funding arrangements of the CSLR should cover:

- compensation paid by the CSLR;
- the CSLR's administration costs;
- capital costs (for establishing and maintaining an appropriate level of capital funds for future claims payments); and
- AFCA's claim handling costs arising from unpaid determinations against insolvent firms that are referred to the CSLR. Investigating and issuing Determinations on complaints against insolvent firms by AFCA is a CSLR related cost that requires coverage within the overall CSLR funding model.

Initial CSLR funding arrangements will also need to cover the once-off expense of establishing the scheme and covering eligible unpaid determinations issued by AFCA from 1 November 2018 onwards.

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

AFCA considers that the funding model should reflect risk and the type of activity firms are engaged in. This appears to be the most simple and equitable option and would reduce any potential industry cross subsidisation and keep the regulatory costs to a minimum. Obligations to collect and analyse data indicating risk should be kept to a minimum.

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<sup>8</sup> <https://www.fos.org.au/public/download/?id=53753>



We favour an approach where funding is broad based across all licensees in which:

- some cost components, are covered by contributions based on both the size and the risk (determined by activity type) of the firm; and
- other cost components are covered by contributions based on the size of contributing financial firms.

CSLR levy calculations should be based on information for industry sectors or class rather than individual firms, which would also mean that work required and cost to collect and analyse information can be reduced. The CSLR would have an initial risk profile to apply to levy calculations which could change over time. In our view flexibility in funding future proofs to some extent the CSLR and reduces levy volatility.

### **AFCA metrics could be used to measure the size of financial firms**

AFCA uses sizing metrics to classify its financial firm members. Using these metrics, levy cost components based on firm size can be calculated for each of AFCA's five size classes. We consider that these metrics could be leveraged and applied by the CSLR in its levy calculations. AFCA members already provide this data to AFCA annually and using this data would also assist in reducing CSLR administration costs. Appendix 2 contains more information about AFCA sizing metrics.

While this data is self-certified data provided by financial firms to AFCA, targeted validation of data provided could be considered. If there are relatively broad sizing groups applied, this would also minimise any impact of inaccurate data being provided.

### **AFCA activity groups could be used for the CSLR risk measurement**

A key indicator of the risk presented by a financial firm is its activity type. This is an important factor that should be included in the CSLR's funding model and levy calculations.

AFCA currently collects and uses data relating to the business and activity type of each AFCA member. This information is used to calculate AFCA's membership levy.

We consider that these metrics could also be leveraged and applied by the CSLR in its levy calculations. AFCA members already provide this data to AFCA and using this data would also assist in reducing CSLR administration costs.

AFCA also has detailed information about determinations that have not been paid since 2010. Each of these determinations relates to particular financial services or activities.

When the CSLR is first established, levy cost components based on firm risk can be calculated using historical information about unpaid determinations. Over time, the calculations can use updated data on the number and amount of unpaid

determinations relating to particular activities to ensure levies appropriately reflect the risk.

Industry activity (risk rating) should be based on industry class/sector (type of financial services provided), rather than individual firm profile. The industry activity risk rating could be calculated based on historical unpaid determinations by each industry sector. This would enable progressive actuarial rating reviews over time, based on unpaid determination profiles, along with any other relevant factors. To adopt a group – rather than individual – approach to classifying financial firms by their activities, existing AFCA complaints activity groups can be used or aggregated into broader categories. Appendix 3 contains a list of the activity groups AFCA uses.

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

We consider that the CSLR funding model should take into account a firm's size and ability to pay. This will help ensure the CSLR is funded sustainably and will spread costs more broadly across financial services sectors. Cross subsidisation by industry sectors can be minimised by components of the CSLR levy taking into account a firm's risk and type of activity at a class level.

### **How should the funding model address unexpected costs?**

Unexpected costs need to be further defined and clarified. However, the Ramsay Review<sup>9</sup> noted a range of measures that could be used to deal with the potential problem of unexpected costs. They include:

- collecting extra levies;
- including an additional sum in annual levies, to cover any unexpected costs, until an adequate capital base is accumulated; and
- borrowing so that, even with unexpected costs, the scheme can make timely compensation payments.

We agree with the comments on these measures made in the Discussion Paper. We consider that the CSLR should have an appropriate minimum capital base to assist in reducing levy volatility and to provide an adequate buffer for unexpected costs. The CSLR should also have sufficient flexibility to be able to manage its financial risk through a number of means where appropriate and cost-effective, including: borrowing; insurance; payment of claims by instalments and the ability to apply additional levies where required.

Given the level of unpaid determinations in recent years, we consider a minimum capital base of between \$10-15 million should be established by the CSLR. Any additional capital base amount should be determined by the CSLR through regular actuarial modelling of claims. The amount of the minimum capital base required as

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<sup>9</sup> Review into dispute resolution and complaints framework chaired by Professor Ian Ramsay. See [Supplementary Final Report](#) of the review, released on 21 December 2017.

part of establishing CSLR should also take into account current unpaid determinations data from AFCA since 1 November 2018 up to the CSLR being established.

In relation to a capital base we consider that an appropriate capital base would ensure that levy volatility as a result of any significant event is reduced for industry. This provides greater certainty for industry and means it would be simpler and more cost effective to administer the scheme. We would expect that a reduction in CSLR claims would result in reduced levies in future.

All of the above measures will, in our view, ensure that the CLSR operates efficiently.

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

AFCA notes the option of capping the annual levies that financial firms can be required to pay as described on page 14 of the Discussion Paper. AFCA does not oppose this option. However, input from industry on this and other funding components will be very important.

## **3 Compensation payments**

### **How should the CSLR balance the interests of consumers and financial firms?**

AFCA's claim limits and compensation caps were set in 2018. We support aligning the CSLR claim limits with compensation caps with AFCA's limits and caps.

Our claim limits and compensation caps are specified in the AFCA Rules<sup>10</sup>. The rules require these figures to be adjusted through indexation regularly and also allow additional increases to be made.

If the AFCA compensation caps are adopted, we suggest similar indexation requirements should also be adopted. The CSLR could provide for any additional increases to the AFCA compensation caps to apply either automatically or if the scheme decides they should apply.

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

On pages 16-17, the Discussion Paper describes measures to deal with events resulting in large uncompensated losses. We believe these measures are appropriate and could be put in place for cases where payments could exceed a clearly defined threshold.

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<sup>10</sup> See [AFCA Rules](#), especially Rule D.4.3.

The CSLR should be able to spread compensation payments over a reasonable period. We suggest up to three years would be a reasonable period. Where the CSLR decides to spread payments, consumers experiencing financial hardship or special circumstances such as terminal illness, should be able to apply for earlier payments and the CSLR should have discretion to make payments earlier in this situation. This should ensure that consumers are treated equitably in their access to the scheme.

We consider that a cap on total compensation payments resulting from a single significant event could be an option, to ensure the CSLR remains sustainable and its funding is appropriately scaled to such claims.

We do consider that further actuarial modelling should be conducted to consider any appropriate cap level, both as part of CSLR establishment and at regular intervals after establishment. If a cap was put in place, it should be set at a reasonable level, so it does not discount or reduce claim payments to consumers who have been awarded compensation and should receive payment of their claim.

Consideration should be given to providing the CSLR with discretion to determine any cap level between minimum and maximum amounts.

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

We suggest that compensation for legal and professional costs paid by the CSLR should be aligned with AFCA's professional cost limits. Under AFCA's Rules, unless there are special circumstances, a limit of \$5,000 on such costs applies per complaint – regardless of the number of claims or issues raised or the types of costs incurred.<sup>11</sup> In our experience we rarely award costs at that level.

The CSLR will pay compensation as awarded in the determination issued by AFCA. For this reason, there is no need to have a different approach to compensation for legal and professional costs. Again, we see no benefit in having a different limit operating for the CSLR and would be concerned about consumer confusion.

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

The Discussion Paper notes on page 18 that, as a new scheme, the CSLR will need flexibility and will need the capacity to respond quickly to experience and developments.

As an industry-based scheme, we consider that the CSLR should have legislative underpinning, but with appropriate flexibility pursuant to its governing constitution, Rules and any regulatory guidance to respond and adapt to changes. This would be more consistent with the AFCA regulatory model, including ASIC oversight.

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<sup>11</sup> See Operational Guidelines effective 1 October 2019, pages 187-189.

In our view the legislative framework should provide for:

- the coverage of the CSLR;
- obligations of financial firms to pay levies and cooperate with the scheme;
- the framework for the scheme's funding model;
- the authorisation of the scheme, including conditions of authorisation; and
- ASIC regulatory oversight of the scheme.

We consider that the structure of AFCA and the arrangements for its regulatory oversight provide a useful model for the CSLR. For example, the scheme's operations could be governed by a constitution and rules that could be altered readily to respond to experience. While we anticipate that legislation will set the broad parameters for funding, this would leave scope for the constitution and rules to impose more specific funding requirements.

### Independence

In our view, if AFCA is to administer the CSLR, it will be important to separate the CSLR from AFCA's dispute resolution service. This can be achieved through a separate entity and governance. AFCA is an EDR scheme that investigates and considers the merits of complaints, which is a different service to the function of a CSLR.

We believe that the operating model of the CSLR should be clearly separated from AFCA's decision making, with appropriate accountability and transparency measures to ensure the independence of the CSLR.

## 4 Commencement of the CSLR

The Government has committed to establishing the CSLR by 31 December 2020, with the CSLR to then commence accepting claims from 1 July 2021. This commitment acknowledges that the CSLR establishment is a long-awaited and important reform.

AFCA welcomes the decision establish the CSLR promptly. We also note, however, that a substantial amount of work needs to be completed to establish the CSLR. Some establishment activities also cannot start until after any required legislative changes are passed. In addition, it is important that an appropriate period of time is provided for the CSLR to consult with industry on its funding model and levy components and to consult publicly on its Rules.

In our view, consideration should be given to adjusting the date that the CSLR commences accepting claims by six months to 1 January 2022 to ensure that the CSLR is established effectively.

## Appendix 1 - About AFCA

AFCA is the independent EDR scheme for the financial sector replacing the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.

AFCA sees its purpose as providing fair, independent and effective solutions for financial complaints. It does this not only by providing complaint resolution services free to consumers, but also by working with its members to improve their processes and drive up industry standards of service, thereby minimising complaints.

More broadly, AFCA plays a key role in restoring trust in the financial services sector. In addition to providing solutions for financial complaints, AFCA has responsibilities<sup>12</sup> to identify, resolve and report on systemic issues and to notify ASIC, and other regulators, of serious contraventions of the law.

AFCA's service is offered as an alternative to tribunals and courts to resolve complaints about financial firms made by individual and small business consumers. We consider complaints about:

- credit, finance and loans
- insurance
- banking deposits and payments
- investments and financial advice
- superannuation.

AFCA's role is to assist consumers to reach agreements with financial firms about how to resolve their complaints. We are impartial and independent.

If a complaint does not resolve between the parties, we will decide an appropriate outcome, including awarding compensation for losses suffered or substituting the trustee's decision in the case of a superannuation complaint.

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<sup>12</sup> See [ASIC's Regulatory Guide 267](#) *Oversight of the Australian Financial Complaints Authority*.

# Appendix 2 - AFCA sizing metrics

AFCA classifies members into five (5) categories that reflect their business. The categories are as follows:



In AFCA, these categories are taken into account when calculating the appropriate annual levy for a member based on the size and type of business.

## Annual levy assessment

AFCA members are required to complete an annual levy assessment and are asked different metrics based on their business activity. Financial firms are categorised on a curve based on the distribution of information provided to us for that assessment.

Nine business size data metrics are used, with members completing the metrics that are relevant to their business.

The diagram below is a high-level summary example of how these categories are calculated.



Further information about how AFCA determines the size of a financial firm is below:

## All business activity types

### Size

We ask for the total number of employees and/or representatives (individual and corporate) engaged in the selling, advising and distribution of the firm's products and/or services.

## Business activity type dependent

### Clients loans

The size of the loan portfolio as a result of direct lending to customers (e.g. banks, finance companies, micro lenders and leasing firms).

The total value of loans the firm has written in (e.g. mortgage broker), is managing (e.g. mortgage manager) or trying to collect (e.g. debt collection agency).

### **Client funds**

The amount of client funds held in deposits, under advice (e.g. financial planners) or under management by the firm.

### **Premiums**

The amount of premiums received for a contract of insurance (e.g. general and life insurers).



## Appendix 3 - AFCA activity groups

- Accountant
- Administration services provider
- Bank
- Building society
- Charity/community fund
- Clearing/settlement house
- Corporate advisor
- Cover holder
- Credit provider
- Credit repair or debt negotiation provider
- Credit reporting agency
- Credit union
- Custodial and depository service
- Debt collector or buyer
- Derivatives dealer
- Finance broker
- Financial advisor/planner
- Foreign exchange dealer
- Friendly society
- General insurance broker
- General insurer
- Life insurance broker
- Life insurer
- Make a market
- Managed discretionary account operator
- Managed investments scheme operator/fund manager
- Mortgage aggregator
- Mortgage broker
- Mortgage manager
- Mortgage originator
- Non-cash payment system provider
- Pooled superannuation trust
- Private health insurer
- Product distributor
- Product issuer
- Professional indemnity insurer
- Provider of lender of record services
- Reinsurer/reinsurance agent
- Research house
- Securities dealer
- Stockbroker
- Superannuation fund trustee/advisor
- Travellers cheques/foreign currency transfer provider
- Timeshare scheme operator
- Trustee
- Underwriting agency
- Warranty provider
- Other