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MEDIA RELEASE: Last resort compensation scheme creates risk of big new levy

The economic impact and cost to consumers of a financial services compensation scheme of last resort is being perilously under-estimated by policy makers.

Conservative modelling by Cadence Economics estimates a scheme covering financial advice only would cost more than $100 million annually. This equates to an annual cost of $4,549 per financial planner, or $28,354 per AFSL authorised to provide advice to retail clients (advice licensees). Scheme costs rise to $310 million if the scheme is extended to cover product failures.

Further the modelling also shows that additional deadweight losses to the economy will accrue to the tune of 47 cents for every $1 paid in compensation. These additional losses would shrink investment and jobs in the economy. The Henry Review of 2008 found that taxes and levies on financial services are one of the least efficient forms of taxation available to government.

Cadence Economics was engaged by the Financial Services Council to model potential costs of a statutory compensation scheme of last resort to compensate retail clients who suffer losses due to insolvency of Australian Financial Services' licensees in the event of inappropriate advice, negligence, fraud or other actions.

The modelling tests numerous potential designs of such a long term scheme with different compensation limits applied under a range of real world conditions including recessions and GFC-style events.

The cost-benefit analysis strengthens the FSC's view that the most important step to protecting consumers, and reducing the risk that advice licensees are unable to meet their consumer compensation obligations arising from licensee misconduct, is to improve standards of licensee behaviour, as was recommended by Richard St John in 2012.

This would include licensees having greater responsibility for their own conduct. Improved professional indemnity insurance and capital adequacy requirements on licensees could also improve outcomes for consumers. Richard St John's recommendations have not been reviewed or implemented to date.

<u>Key conclusions of the St John Report to Government in 2012</u>

- recommended against establishing a CSLR concluding such a scheme would be 'inappropriate and possibly counterproductive'

- retail consumers are generally able to recoup losses attributable to misconduct by licensees that they have dealt with
- inappropriate to require more responsible and financially secure licensees to underwrite the ability of other licensees to meet their compensation claims against them
- cautioned against introducing a CSLR to underpin compensation arrangements 'as a shortcut' of remedying deficiencies in the current regime as it would not address the underlying problems
- recommended that the regulatory framework for advisers and licensees should be 'made more robust and stable before a safety net, funded by all licensees, is suspended beneath it'
- recommended more rigorous approach to insurance and capital reserve arrangements on financial services providers

FSC Director of Policy and Global Markets Allan Hansell said: "We consider the introduction of a compensation scheme of last resort as an incredibly costly short cut which won't address the underlying issues to better place advice licensees in a position where they can themselves meet their consumer compensation obligations.

"We are keen to work with policy makers, regulators and the rest of the industry to ensure financial advice licensees can be appropriately equipped to meet their obligations to customers should things go wrong.

"Strengthening the licensing framework would also go a long way to mitigating the need for a compensation scheme, while protecting consumers. It's better to fix the leaky bucket rather than simply place a safety net under it."

<u>Background</u>

The merits of a compensation scheme of last resort, including options for retrospective compensation, are currently being considered by the Review of the Financial System External Dispute Resolution Framework.

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