Building a better working world

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Summary of analysis - Compensation Scheme of Last Resort

Report to the Financial Services Council

13 August 2021

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NOTICE

Ernst & Young was engaged on the instructions of the Financial Services Council ("Client", "FSC") to provide an assessment of the potential costs of a compensation scheme of last resort ("CSLR"), including a range of alternative scheme designs (the "Services"), in accordance with the engagement agreement dated 14 July 2021.

The results of Ernst & Young's work, including the assumptions and qualifications made in preparing the report, are set out in Ernst & Young's report dated 13 August 2021 ("Report"). The Report should be read in its entirety including the transmittal letter, the applicable scope of the work and any limitations. A reference to the Report includes any part of the Report.

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In preparing this Report we have considered and relied upon information from a range of sources believed to be reliable and accurate. We have not been informed that any information supplied to us, or obtained from public sources, was false or that any material information has been withheld from us.

We do not imply and it should not be construed that we have verified any of the information provided to us, or that our enquiries could have identified any matter that a more extensive examination might disclose.

The work performed as part of our scope considers information provided to us and a combination of input assumptions relating to future conditions, which may not necessarily represent actual or most likely future conditions. Additionally, modelling work performed as part of our scope inherently requires assumptions about future behaviours and market interactions, which may result in forecasts that deviate from future conditions. There will usually be differences between estimated and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We take no responsibility that the projected outcomes will be achieved, if any.

Our conclusions are based, in part, on the assumptions stated and on information provided by the FSC and other information sources used during the course of the engagement. The modelled outcomes are contingent on the collection of assumptions as agreed with the FSC and no consideration of other market events, announcements or other changing circumstances are reflected in this Report. Neither Ernst & Young nor any member or employee thereof undertakes responsibility in any way whatsoever to any person in respect of errors in this Report arising from incorrect information provided by the FSC or other information sources used.

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Summary of analysis

- Based on a recommendation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the Australian Government has committed to establishing a Compensation Scheme of Last Resort (CSLR) to ensure consumers of financial services are compensated for losses where a finding is made in their favour and other compensation mechanisms are exhausted.
    - Draft legislation to establish the scheme is currently open for public consultation.
- To support considerations on design of the CSLR, EY has been engaged by the FSC to examine the potential cost of historical unpaid determinations, the average costs of the scheme under alternative design specifications, and the impact of insurance and capital adequacy requirements on the scheme.
- This note summarises the results of analysis provided to the FSC in our report "Economic analysis – Compensation Scheme of Last Resort", dated 13 August 2021.

Estimating future costs of the CSLR

- We estimate a level of historical unpaid determinations[1] required to be met in the first year of the scheme to be approximately $7.8 million.
- The costs of a CSLR will depend on the scheme's coverage, compensation caps and insurance requirements.
    - **The breadth of the scheme** — Restricting the scope of the scheme to advice failures only reduces the anticipated cost.
    - **Compensation caps** — Imposing a cap of $150,000 per determination on compensation payable through the CSLR reduces the costs of the scheme while balancing the provision of compensation to claimants.
    - **Improved governance with respect to insurances** — Increased requirements for businesses to hold appropriate insurances and capital adequacy along with effective monitoring of each improves the potential for claims to be settled before they reach the CSLR, or for payments to be funded through insurance policies instead of industry levies.
- Reflecting these key cost drivers, the potential average annual cost of the CSLR varies widely across different scenarios, with annual costs for a CSLR covering advice failure only ranging between $12.8 million and $105.7 million.
    - The lower cost estimate of $12.8 million per annum encompasses a $150,000 cap on compensation per determination, and insurance and capital requirements for businesses covered by the CSLR assumed to result in 100% of determination value recovered through insurance. This increases to $38.8 million per annum if only 50% of total determination value is able to be recovered through insurance.
    - The higher cost estimate of $105.7 million per annum does not include any compensation caps or insurance and capital requirements. A compensation cap of $150,000 reduces this to $59.2 million per annum.

[1] Unpaid determinations where a complaint was made to AFCA from 1 November 2018 to 13 August 2021

- We find that controls to limit the incidence of 'phoenixing' of financial advice firms places downward pressure on the annual average cost of the CSLR. Based on the UK experience the potential reduction in cost is $5 million per annum.

Comparison to the Treasury estimates

- Notably, cost estimates included in this report are higher than those from the Commonwealth Treasury which estimate scheme costs of approximately $8 million per annum.

    - The Treasury estimates are based only on business-as-usual conditions, while our estimates incorporate the potential for low probability, high consequence events such as recession or coordinated financial crisis.

    - Allowance for the additional cost of recessions, a financial crisis, or similar events is made by the proposed scheme design, which incorporates (for example) a mechanism for special levy collection by Ministerial determination in the case of 'black swan' events.

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