31 March 2014

Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
SYDNEY, NSW 2001

Email: fsi@fsi.gov.au

Dear Mr Murray,

AFA Submission – Financial System Inquiry

The Association of Financial Advisers Limited ("**AFA**") has served the financial advice industry for over 65 years. Our aim is to achieve *Great Advice for More* Australians and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are required to be practising financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians' reach their potential through building, managing and protecting wealth.

Thank you for the opportunity to provide feedback on the Financial System Inquiry (FSI). It is now twelve years since the FSRA changes to the Corporations Act became law and ten years since they were fully operational. In the meantime there has been significant change in the legislative framework and the marketplace. Thus we believe that there is the potential for significant value to arise as a result of this review.

We believe that it is essential that the FSI give consideration to the productivity and efficiency of the Australian financial system. The Australian financial system needs to have the right balance between efficiency, consumer protection and the willingness of businesses to investment in the financial services industry. The objective should be to seek to protect against systemic failure and not business failure.

Whilst the terms of reference are very broad, we will limit our comments to the issues relevant to financial advice and the clients of financial advisers. There are a range of other important issues such as taxation, preservation arrangements and lump sum access to superannuation which we have not addressed in this submission, however we would be happy to provide further comment at a later stage.

In the section below we have set out the key issues that we would like this Inquiry to examine:

1. Public Perception of Financial Services and Financial Advice

Research undertaken by the AFA in 2010 demonstrated that consumers with financial advisers understood the role of their adviser, trusted them, highly valued the advice they were given and were happy to pay for it. These consumers were happier with their investments and had greater peace of mind than those who were trying to navigate the complex world of investment and insurance without the help of a financial adviser. The research clearly demonstrated that there is great value in financial advice.

Financial advice is also very beneficial for the country as a whole as an increased level of preparation for retirement will lead to a reduction in the level of dependence upon the public pension. The major complication is that only approximately one in five people are getting financial advice, and the remaining 4 out of 5 people have a very different, but misinformed view of financial advice. Australians approaching retirement need to take adequate steps to seek financial advice. Consideration should be given as to viable policy options to incentivise Australians approaching retirement to obtain financial advice. This could, for example include tax deductibility for retirement advice for people over the age of 50.

We have watched with dismay and alarm as the debate over the Future of Financial Advice (FoFA) Amendments have played out in the media over the last few months. One side of this argument, being the Industry fund movement, has been able to make a range of claims that have been predominantly inaccurate. Despite this they have been able to get a huge level of coverage in the media, with even detailed discussion about a single clause in the Corporations Act. In particular they have repeatedly made the claim that the Amendments would remove the Best Interests Duty which is completely and absolutely wrong. The coverage has reached a point, for example where an ABC comedy program (Mad as Hell) has even run a section where they made fun of the alleged removal of the Best Interests Duty. They also included a scene with an actor playing a financial adviser, where the outcome was very clearly intended to question the integrity of financial advisers.

We are particularly concerned about how this campaign of misinformation has led to what can only be described as a significant impact upon consumer confidence in financial advice. Increasing the level of financial literacy and increasing the utilisation of financial advice are important policy initiatives that will have long term benefits in terms of a population that is better prepared for retirement and better protected for the risks in life. This will directly flow through in terms of reduced pressure on the pension system. There needs to be controls and means to ensure that these policy objectives are not undermined by misleading advertising and media activity.

We note that Section 1(2)(b) of the ASIC Act includes an objective for ASIC to promote the confident and informed participation of investors and consumers in the financial system. We would like to believe that this objective should have caused ASIC to have stepped in to address the misleading information that has been pushed out to the Australian community. We think it appropriate for the FSI to consider how ASIC should respond to such misinformation.

2. External Dispute Resolution and Professional Indemnity Insurance

The AFA supports the existence of the external dispute resolution (EDR) framework, however has some specific concerns about how this framework seems to have moved away from its original design. At the outset it is worth understanding the critical interdependency between EDR and professional indemnity insurance. AFSL's are required to have professional indemnity insurance, however the capacity to get insurance, and on a cost effective basis, is highly dependent upon the insurers views of the conduct of EDR schemes. Where there is increased scale of potential payouts in the EDR system and reduced predictability in the outcomes, then PI insurers are much less likely to provide insurance at an acceptable pricing level. This is exacerbated by the lack of an appeals process. We have seen a significant reduction in the number of PI insurers in the Australian market and lack of competition is becoming a concern.

In recent years we have seen the caps on EDR payouts increased significantly to $280,000. It should also be noted that claims can be split across partners within a client relationship and years and different pieces of advice so that the payout can in fact be multiples of the cap per family-unit advice relationship. Importantly, there is no fee for the submission of a complaint, and all costs are picked-up by the financial service provider even if found not to be at fault.

Given the limitations of the EDR process in that it is not bound by legal principles and is not subject to appeal, there needs to be a genuine consideration as to what level of compensation should be considered by an EDR scheme and at what point it should need to be heard in court. The initial positioning of a small claims type tribunal is no longer the case. We advocate for the consideration of a small charge for submitting a complaint that could be reimbursed by the financial services provider on successful conclusion of the matter. This is likely to ensure that there are less frivolous and vexatious claims which can have significant detrimental outcomes for advisers, their businesses and their licensees in terms of costs, distraction to servicing other satisfied clients, and reputation and brand damage.

We are also increasingly concerned that legal practitioners are seeking to get involved in insurance claims. Whilst we do not oppose the involvement of lawyers in the circumstances where a claim involves a complex legal matter or it has already been rejected by the life company, we do not believe that it is appropriate where a client or their beneficiary is submitting a standard claim. Financial advisers will typically provide these services on an included basis for existing clients or on very reasonable commercial terms for new clients. Plaintive lawyers can take a significant percentage share of claims, when in many cases a lawyer is not required. We believe that this is an issue that needs to be addressed so that consumers have a better understanding of the infrequent need for legal advice relating to an insurance claim and as a result consumers retain a greater share of the claim money for the original purpose for which it was intended.

In addition we have recently had an online advertisement by a large legal firm brought to our attention which states "We'll check your super for free." It is unclear what reason these advertisement are being placed, and what the nature of the service that might be provided, however we question the appropriateness of such an advertisement. We recommend that the FSI review advertising of this nature by parties who do not have an AFSL, in the interests of consumer protection.

3. Regulation of Financial Advice

Financial advice has been subject to the primary regulatory oversight of ASIC. This is not to ignore the other regulators who have some interest in the financial services space, including APRA, Austrac and the ATO, however ASIC through licensing and oversight is the key regulator. With the passing of

the Tax Agent Services Act (TASA) amendments in June 2013, financial advisers now have an additional regulator in the Tax Practitioners Board (TPB).

The application of TASA for financial advisers is due to commence on 1 July 2014, however there are a number of important issues that are not yet resolved. The AFSL regime is based upon licensees and financial advisers operating as authorised representatives or representatives of the licensee. Licensees are responsible for the conduct of their advisers and have significant obligations in this respect. One of the major complications with the TASA legislation is that it does not recognise the existence of the Licensee. We believe that this needs to be addressed to create an efficient supervisory outcome.

Further, on the issue of EDR, we believe that there needs to be sensible consideration of how taxation related complaints will be considered. It seems that the TPB is positioning to be the point of contact for taxation complaints, however in the AFSL regime the primary focus is via the licensee to the EDR scheme. There needs to be a pragmatic solution implemented to ensure that complaints are dealt with in a way that adequately protects consumers and results in only one process where both taxation and other financial planning issues are combined in the context of the complaint. Often the issue of taxation is wrapped up in the overall assessment of the appropriateness of the advice and it is not so simple to say it is just a financial advice complaint or just a tax advice complaint. Dual complaint processes represent complication and inefficiency for the consumer, the AFSL and adviser.

Further it will be important that ASIC and the TPB can establish a sensible model of supervision, where there is clarity as to what is done by each, considering that the divide of financial advice and tax advice is in essence an artificial distinction.

There is much that is still to be finalised for the commencement of TASA by 1 July 2014. We are still awaiting regulations from Treasury. We are now of the belief that this deadline is no longer possible, given the important unresolved issues and the very short timeframe in order to facilitate implementation of Treasury's requirements once it is received. We believe that there are issues relevant to TASA that should be considered by the Financial System Inquiry and would recommend that the commencement of TASA awaits this outcome.

4. Education Standards for Financial Advisers

There is broad recognition of the need to increase the education standards within the financial advice profession both at the entry and ongoing practitioner levels. Like all journeys of this nature, there needs to be sensible grandfathering for existing advisers and transition arrangements to allow the significant changes to be achieved without an unacceptable interruption to ongoing business. The AFA strongly supports an increase in education standards for financial advisers.

ASIC have issued a number of consultation papers over recent years including Consultation Paper (CP) 153 in 2011 and CP 212 and CP 215 in 2013. It is important that this transition is achieved in a sensible timeframe, which is likely to be longer rather than shorter, but also takes into account the requirements and implications for education providers.

The number of financial advisers in Australia is likely to come under pressure in the next five years as a number of factors play out:

- A significant number of older advisers retire
- The broad awareness and attractiveness of financial advice as a professional career is low
- The uncertainty surrounding the regulatory framework reduces the attractiveness for new entrants
- The demand for advice increasing as baby boomers seek advice as they approach and enter retirement

- The difficulty of becoming a successful adviser means many leave in the first two years
- An over-reliance on technical training at the expense of emotional intelligence training, or more simply the inability to build and maintain close relationships with clients

We raise this issue as it will be important to consider the ability to meet advice demand within the timeframe of any change to the professional development and/or entry level requirements.

We would also like to see an integrated set of education requirements that cover the obligations under both the AFSL regime and the TASA regime. It is inefficient and impractical to have separate education obligations under each of these regimes. We would like to see a consolidated set of education requirements that align with the education pathways available for financial advisers.

We believe it is essential for the Financial System Inquiry to examine the issue of financial adviser education.

5. Competitive Landscape for Financial Advice

The FoFA and MySuper changes have had a huge impact upon the entire financial services industry in general and particularly on the financial advice profession. The impact has been greatest however on corporate superannuation advisers and licensees that are not institutionally owned. Whilst not seeking to oppose the FoFA changes, it is necessary after such a program of reform to assess the extent of the impact and to determine if there are areas where the final impact has been greater than expected and where long term viability is at threat.

The AFA have been keeping a close eye on the position with Corporate Superannuation advisers, including working with the Corporate Super Specialist Alliance and having held discussions and made submissions to the current and former government on behalf of corporate super advisers. Our key concerns are as follows:

- Financial advice to employers for corporate superannuation funds is fundamentally challenged by the conflicted remuneration rules. Significant value is delivered to both employers and employees through the services that corporate superannuation advisers provide, however complications arise as a result of the financial advice relationship being with the employer. Employers arrange the selection of a default fund, however typically they do not pay for the ongoing services provided by a financial adviser. The provision of a recommendation to an employer about the selection of a corporate super plan results in the creation of a conflicted remuneration situation if ongoing income is received by the adviser as a result of their recommendation of a fund.
- The problems impacting corporate super advisers were identified in the 2012 PJC Inquiry into the FoFA legislation. In that Inquiry the committee recognised the benefits provided by corporate super advisers and the need for a solution to be found. It requested that Treasury work with the Corporate Super Specialist Alliance to provide a solution. The outcome of this was the suggestion that intra-fund advice was the solution and that the corporate super advisers could be paid intra-fund advise fees by the trustees of superannuation funds as compensation for the services provided. There was never any contemplation at that stage that these fees would be considered to be conflicted remuneration.
- The situation is further complicated by the restraints in the MySuper legislation, which means that an explicit plan service fee cannot be paid to a financial adviser for services to MySuper members. Once again the solution appeared to be the payment via intra-fund advice fees for the services to the superannuation fund.
- With reference to the above two points, it is now apparent that the payment of intra-fund

fees, even from the trustee, would still be conflicted remuneration as these payments might be expected to influence the selection of a fund.

- This has now resulted in the problematic situation where licensees are preventing their corporate super advisers from actually providing advice on super fund selection because of the conflicted remuneration problem.
- Neither is it possible for corporate super advisers to be paid commission on the selection and ongoing servicing of the insurance arrangements for a fund, despite their role in negotiating better premium rates, increased levels of cover and improved definitional terms.
- The existing client books of corporate superannuation advisers are also at significant threat as a result of the mandatory transfer of Accrued Default Amounts by 1 July 2017. As nearly 80% of corporate superannuation fund members are in default options, this is likely to significantly reduce their existing businesses. In this case there is no compensation being paid for the loss of this business. It is important to note also that many of the fund members will have purposefully chosen the default fund after seeking advice and understanding that it suits their risk appetite or investment goals.
- Employers need support in the selection of an employer fund. The changes around the default funds in modern awards arrangement, where the previously grandfathered plans are no longer grandfathered, will mean that a very large number of employers will need advice with the selection of an alternative fund. The current situation will mean that the only support that can be provided is by consulting firms who only provide fund selection services. These firms are typically much more expensive than financial advisers.
- Through a combination of all these factors, at present we face the prospect of a significant reduction in corporate superannuation advisers at exactly the same time that employers are most likely to need support and advice in the selection of alternative funds. Similarly, the advice needs of the members of the funds are being compromised.

We have equal concerns with respect to non-aligned or non-institutionally owned licensees. Over recent years we have seen a significant number of the independent licensees acquired by the larger groups. The FoFA reforms and the ban on volume based rebates have made the financials of running a licensee increasingly challenging. As the same financial pressures do not apply to institutionally owned, vertically integrated groups, there will be increasing pressure on the independent licensees. There are some elements of FoFA that are also supportive of these groups, including the grandfathering arrangements and the provision for a non-monetary benefit exemption for training and education. The impact of grandfathering will progressively reduce over time and the training and education exemption is ineffective as it is based upon the product partners paying the third-party suppliers directly rather than providing funding to licensees in support of training and education events more broadly. We believe that this is one area where further refinements can be made to level the playing field for independent licensees with the result of more competition at the licensee level.

We request that the Financial System Inquiry investigate these two cases where the impacts of FoFA have put the continuation of important sectors of the market at risk.

6. Consumer Literacy and Government Obligations to Inform Consumers

The former Government introduced some major legislation, with deep consumer implications in the MySuper or Stronger Super package. It is quite disturbing that there has been no consumer awareness program implemented in this regard.

It is important to be aware that from 1 January 2014 new Super Guarantee Charge (SGC) employer contributions for default fund members will go into a MySuper account. This means that from this

point, a default fund member will have two separate superannuation accounts and all without their knowledge. In addition, the former government has legislated that the existing "Accrued Default Amounts" for default members will be transferred to a MySuper account by 1 July 2017. Consumers will have the option to opt-out of this transfer, however in the absence of an adequate awareness campaign, there will be no knowledge for consumers of what will be done and what the implications are. It is important to be aware that there are some significant negative implications for consumers that can arise from this transfer:

- Members may be moved to a MySuper investment option that is different to their existing investment option and has a different asset allocation that may not be suitable for their risk profile.
- A potential increase in ongoing administration fees.
- In moving to a MySuper fund they may be required to take out insurance that is either at a reduced level of cover, at inferior terms or at a higher price.

We recommend that the Inquiry review these implications and make recommendation on whether the Government should reconsider the mandatory transfer of Accrued Default Amounts and also consider minimum requirements for consumer awareness campaigns when such significant changes are made to superannuation or other regulatory regimes.

7. The Corporations Act and the Implications for Payroll Tax

With the AFSL model, under the Corporations Act, the majority of self-employed financial advisers are authorised through a licensee. The implication of this is that whilst the financial adviser may recommend a range of products from different product providers and be paid adviser service fees by clients, the flow of payments either through commissions or adviser service fees to the adviser is directed through the licensee. This is predominantly a payment arrangement that reflects the licensing regime under the Corporations Act. These self-employed advisers are not employees and neither are they contractors. They run their own businesses and provide services to their own clients. They have their own expenses in running their businesses. The effective commercial arrangement with the licensee is that the adviser will pay the licensee either a flat fee for services or a percentage of their revenue or a combination of both. The business model of the fees being paid via the licensee is a consequence of the Corporations Act, rather than a reflection of the nature of the arrangement.

In recent years there have been a number of cases where state revenue offices have looked at financial advice licensees with a view to identifying payroll tax liabilities. Recent examples suggest that the key exemption available for financial advisers is one where if the financial adviser employs a minimum number of other staff then they will be exempt. This however is subject to some uncertainty including how many employees and the nature of that employment or contracting arrangement.

Where the licensee might be required to pay payroll tax on these self-employed advisers, then they may seek to recover this cost from the adviser's business. It should also be noted that GST is also being paid for the services provided to clients. The addition of payroll tax on top of the GST is fundamentally inconsistent.

Previously in NSW there was an exemption for financial advisers, which was only removed from the state payroll tax legislation as part of state based harmonisation. We would like to see national action to ensure that self-employed financial advisers are exempt from the state based payroll tax regimes. The current situation has the potential to financially destroy some licensees, particularly those that are independent of institutional ownership.

8. Scalable Advice and General Advice

Within the financial advice landscape, there is a huge divide between general advice and personal advice. The obligations in the provision of personal advice are much higher, although many consumers would be unaware of the different standards that apply to the adviser in the respective situations. Where personal advice is provided, the financial adviser has the obligation to follow the full financial advice process, to comply with the Best Interests Duty and related obligations and to provide a statement of advice. The obligations are much less when general advice is provided. For this reason there is heightened risk and exposure for clients when businesses operate on the border of general and personal advice. The trigger, for personal advice rules to apply, is where the advice provider relies upon the client's personal circumstances in the provision of the advice.

We believe that there is a need to review the general advice option to ensure that the management of the boundary between high obligation personal advice and low obligation general advice is clearer. When it comes to call centres and internet based businesses that can facilitate financial transactions on behalf of clients through the use of general advice, there is a need to look very closely at this and to ask questions about whether this business model is in alignment with meeting the needs of the client. The important outcome here is that the client does not mistakenly act on general advice under an assumption that the advice purports to take their personal circumstances into account.

At the same time, we believe that it is necessary to examine further options for making it more cost effective to provide personal financial advice that is directed to a specific need of the client. This is known as scaled or scoped advice. The provision of scaled advice remains unnecessarily complex.

9. Direct Insurance and Consumer Implications

The direct sale of life insurance has become an increasing factor in the Australian market. TV advertising, outbound call centres and direct mail campaigns are increasingly common. We support the increased provision of like insurance in the Australian market, as this works to address the significant issue of underinsurance. The products developed for the direct insurance market are typically simpler products, although we are aware that some of these products are subject to underwriting at the time of the claim. This means that people will only know if they are effectively covered after they claim. This has the potential to reduce trust and public support of insurance generally where claims are denied due to pre-existing medical conditions that existed a number of years before the policy was purchased.

The Financial Services Council (FSC) has recently completed consumer research on life insurance consumers and discovered a low level of understanding of life insurance products and their features. Whilst the concept of a payout on death is reasonably clear, when it comes to TPD, trauma or income protection the clarity of the circumstances under which a benefit is payable is much less clear.

We note with caution that life insurance products are complex and that it is important that consumers understand what they are purchasing. In most cases access to financial advice adds significant value to ensure that the terms of the policy reflect the client's needs, and so that the client has a clear understanding of what is covered and what is not. We recommend that consideration be given to the issue of consumer risk and protection where complex products are sold on the basis of general advice. Where life insurance is sold via a direct channel, there should be additional obligations to address the circumstances where the product is replacing an existing product and the consumer has much greater need to understand the difference in terms of what the new product covers relative to the existing product. It is a poor outcome for a consumer to change policies and lose significant benefits without being aware of it.

10. FoFA – Grandfathering and Financial Advisers Changing Licensee

Whilst there appears to be a hold on the finalisation of the FoFA Amendments, we consider it worthwhile raising one FoFA legislative and regulation issue with the Financial System Inquiry. The former Government released a regulation on 28 June 2013 that came into effect on 1 July 2013 which indicated that where an adviser moved licensee after 1 July 2013, that existing client arrangements would no longer be grandfathered. There had been no proactive communication of this in advance of this release and it came as a huge surprise to the financial advice profession. Since this point, financial advisers have not been able to change licensees without this effect coming into play, which would have significant implications for the financial advice practice and also individual client situations. This has effectively caused a stall in movements and a major constraint on trade within the market. This is not an appropriate way to regulate an industry or marketplace.

Conclusion

We thank you for the opportunity to provide feedback on this enquiry. We are very supportive of this Inquiry and look forward to the outcomes being released. We recognise that Australia has a world leading financial system, and appreciate the need to remain at the leading edge.

We would welcome the opportunity to speak further to our views.

Should you have any questions, please do not hesitate to contact me on 02 - 9267 4003.

Yours sincerely,

Brad Fox

Chief Executive Officer