

Submission to the Australian Financial Services Inquiry

Thank you for the opportunity to provide a submission to the Inquiry.

Idea: A simple Rating System for Financial Products using Recommended Financial Literacy Competence Levels

I encourage the Inquiry to consider the following idea to achieve better financial outcomes for customers. The idea is to apply a simple rating system to financial products recognising that different levels of financial literacy (usage competence) are required to understand how to use different types of products to create the best outcome for the customer. Similar systems are already an established part of many other industries wishing to optimise customer outcomes. These systems are often catalysed to minimise downside risks from sub-optimal usage, but often quickly evolve to ensure users capture potential upside as well. Examples include ability to use machinery from motor bikes to boats, medical treatments, recreational sports such as scuba diving, and teaching from kindergarten to post doctoral students.

I am very pleased that the Inquiry is using the term customer outcomes (or an outcomes orientation for the financial services industry) as I believe the industry is yet to fully evolve from a product push and short term customer experience optimisation model to one focused on actual customer outcomes as measured in a libertarian but appropriately paternalistic way. I believe customer outcomes can best be achieved by both optimising and measuring around the following formula: Right Products multiplied by Right Usage = Right Outcomes

The industry has comprehensively embraced the idea that it needs to be more customer centric. The evidence to support this includes heavy investment in more segment focused business models, more customer choice of products and what is commonly referred to as a solution focus (which, when operationalised, spans the spectrum from blunt cross selling to sophisticated needs analysis and tailored solution provision). I believe that the industry should be congratulated for increasingly striving to put the right permutation of products in the hands of customers, so my focus in this submission is on the second lever, which is to apply more effort on getting product usage right to produce the best customer outcomes.

A self-certified Driver's Licence Approach to Raising Financial Competence

I observe that for any given financial product a randomly selected customer cohort may produce a range of outcomes from that product (interest earned, interests paid, pay down period and the like). I believe that the distribution of these outcomes (if translated into a single price per kg style measure) is largely driven by two fundamental factors. Firstly the product's design and secondly by a combination of customer usage factors, such as engagement levels, education, response to choice architecture, the financial literacy of the customer and others. Of these, one factor that I believe can be improved through a virtuous reinforcing loop is financial competence. I believe that if customers are made aware of the recommended financial competence level of the products they wish to use then they (or people around them, parents, advisers, and educational institutions) will seek to ultimately ensure they are closer to having the necessary 'drivers licence' level for that product type. If this idea were progressed to implementation, then regulators would seek proof from manufacturers and their distributors and their prospective customers that efforts were made to ensure the customer had a 'drivers licence' for that product or at least certified that they had completed the requisite driving lesson(s). This idea is complementary to umbrella financial literacy programmes like Money Smart Week, but is much more targeted and timely, so therefore better aligned with the principles of just in time training and the growing literature on 'learning moments'. Ultimately, I would expect that product outcomes through

better usage could become a more accepted part of the competitive positioning for a product in much the same way that heavy machinery is sold on a total lifetime cost rather than the upfront cost (headline rate) basis that is so common in financial services.

Using online learning tools for just in time (product usage competence) driver training as an adjunct or alternative to Product Disclosure Statements (PDS)

To illustrate, I observe that most customers have a general sense that a margin loan is a potentially hazardous product in the wrong hands. However I don't believe that many customers would recognise that a line of equity mortgage can produce similarly hazardous outcomes if it is treated like a large revolving credit card for most of its life. I believe that such a distinction can be made with involvement of industry to help customers understand how much financial competence they should acquire themselves or through an outside adviser who has the required competence. The model would work as a simple grading system – perhaps as few as 5 levels – our industry already recognises the notion of advised and unadvised products so we already have two. We would then categorise products into each layer and ensure that customers are required to self-certify to distributors and product manufacturers that they have completed the necessary online 'driving lesson', or product usage tutorial. This would work in much the same way as corporate anti-discrimination training is completed – online video and simple online testing of comprehension. I see little hardship to such a process, just modest additional variable cost and time, which I hope would be seen by both customers, manufacturers, and regulators as much higher value adding than the current product disclosure statement (PDS) or product contract signing process. Distributors and some manufacturers may argue that this additional 'process tax' and risk of losing their customer sale through just in time competency training may be detrimental to their business. These stakeholders will need to be reminded of the many positive reinforcing loops and long term economic and societal benefits from having a more financial literate population and a financial services industry which over time is better aligned with the objective of creating positive customer outcomes as measured by long term impact rather than short term experience (Net Promoter Score is a commonly applied measure) or sales volume. In a practical sense this is inherent in the simple statistic that the proportion of an economy that is made up by the financial services industry grows with GDP. The more quickly an economy evolves its financial services supply base from transacting (exchange), to lending (capital), to insurance (risk management) to wealth creation (GDP growth and longevity risk) the larger the available revenue and profit pools are for incumbents and new entrants.

I would envisage online education tools for each product type being accessible through an ASIC website (or accredited versions being available directly from product manufacturers). In this way, if someone wants to access a personal loan, they need to certify that they have watched a short education video on how to drive a personal loan safely, in their own time or as part of an online application or indeed sitting next to the salesperson. The actual messages in the video will change over time, but might include items such as ensuring that the asset being funded is fully insured, that the depreciation curve for the asset is not aggressively steeper than the loan amortisation and others. Such resources will be available for other purposes such as school and workplace education programs and initiatives such as Money Smart Week. Presently none of these 'safe driving' lessons are routinely delivered by our industry before young people are allowed to purchase a personal loan. As our understanding of what causes the most deviation in usage outcomes evolves (or customer behaviour improves with more education) then these messages can be increasingly refined. In time they may even be tailored to the characteristics of the segment seeking certification (eg young people accessing a store card for the first time).

Creating an accurate but pragmatic product categorisation and grading model using an expert industry panel and actual customer outcomes deviation

The question of how to rate products is one that should be answered both through the judgement of an industry panel and empirically through the deviation of outcomes generated by a random cohort of unadvised customers. On the first, to answer the question of how many products should be rated (all, most common, most hazardous) and the rating for each product or product category, I would envisage a film and television style rating system using experts from the ACCC, ASIC, ABA, Financial Literacy learning experts and Behavioural Economists and other specialists who have responsibility for both developing and refining criteria and applying the criteria to new products). For the second, I propose that products be rated empirically by finding a statistically significant random sample of unadvised customers and measuring the outcomes that they have generated by themselves using longitudinal analysis of actual outcomes achieved (eg total interest earned, or total fees and interest charged, the selection of the measure will of course be open to some conjecture but in time can be refined). I would then use something like the standard deviation of outcomes as the major proxy for the required competence level, ie the higher the risk of outcome deviation, the higher the need for competence. Further investigation and help from statisticians and behavioural economists may well reveal better or additional variables that help us accurately assess the range of outcomes that could normally be expected to be created by a customer normally using the product. I would expect that low deviation products like a term deposit would rate as requiring low levels of financial competency (ie they are very safe to drive) – only customers who constantly stop and start and park funds temporarily in transaction accounts or customer who automatically roll over to non-head line rates could produce lower outcomes and even then the outcome deviation would be low. It should therefore be rated as a product requiring level 1 financial literacy in the same way that a basic driver's licence doesn't allow average drivers to drive a large truck, dangerously or not. Of course there will be products which show low standard deviation but are potentially hazardous to consumers, these products would rely on the rating's panel for a higher grading of required financial competence

A moderately more complex product such as a credit card will produce a wider range of outcomes as more sophisticated customers will avoid late payments, and use revolving credit more appropriately. Less sophisticated customers (or those in distress) will produce less satisfactory outcomes for themselves (using the price per kg analogy again – the cost of interest to value of goods purchased). Clearly, customers embarking on a life time of use of such a product would benefit from education on its usage in the same way they take a driving test for a car. Of course if they drive the credit card badly and go into default then as well as taking steps to repay or write off the card, the customer could also be asked to complete further or remedial educational courses relating to the product. Our intention here is not to restrict consumer access to brought forward consumption or protect them from the costs of this but to help them learn that poor driving of financial products early in their lifecycle can constrain both their access to and resulting outcomes from wealth creating products such as an owner occupied mortgage. Helping even a small fraction of customers make this transition who currently don't, or help some make it more quickly will ultimately have many positive well documented and researched consequences for the industry, economy and society as a whole. In a similar manner, even more complex and powerful products such as margin loans, self-managed superannuation, hedging tools and online trading services would produce even more spread across customer outcomes. These products would require an adviser or a customer that self-certified that they had completed the most advanced online learning courses available (perhaps level 5). Ultimately some

alignment might be achieved between customer accreditation and aspects of professional adviser training.

Creating a powerful reinforcing loop between financial competence and usage outcomes drives better individual, industry and economy wide outcomes

I expect that customers will increasingly recognise the need for financial competence and would respond to such a system by one of three changes in behaviour: 1. They will invest in building their own financial literacy competence (in the same way they upgrade their motor bike riding licence to bigger motorcycle engine capacities). Many will do this in a cursory or perfunctory way in order to access the utility that a new product provides them, a portion, will invest their time in how to drive the product well and some will share with those they interface with (friends, family and colleagues). 2. They recognise the need to get outside help and retain an adviser with the required level of competence. 3. They avoid the more sophisticated and powerful products. Of course the third outcome has some downside if it results in the client selecting a less sophisticated product that is less hazardous but is less effective in meeting their needs. This will need to be investigated more fully as part of further evaluation and detailed design.

I believe the concept of rating products (or product categories) by required financial literacy competence has merit at a number of levels:

- Helps manufacturers avoid future customer detriment regulation by genuinely attempting to align product design with intended usage and customer education
- Helps manufacturers refine their products to be safer to use (A form of crash test rating)
- Help customers understand (and access via online tools) the necessary educational materials so they can self-certify that they have the expertise to use the products to produce a better outcome
- Creates a complementary 'platform' to the PDS, full disclosure contract regulation that will lead to better customer outcomes
- Creates a common language for customers, their suppliers and those around them (educators, parents, employers) to reinforce increases in financial competence
- Ultimately the concept will include camouflaged outcomes benchmarking data, for example to help customers see what the bottom and top quartiles of customers generate from this product class so they can avoid downsides or use the product in a way that helps them achieve the same high outcomes as others (something akin to a realised AAPR)

The idea however has a number of obvious challenges, I am sure there are many others:

- Allocating products into competence buckets creates measurement challenges but will also incentivise manufacturers to bias design to just under the next hurdle – we may be able to learn here from other industries
- As mentioned, customers may self-select away from more complex but powerful products to simple products that are safer but less effective
- Customers may use self-certification as a substitute for accessing good advice
- Adds another compliance burden to the industry when past attempts (product disclosure statements have not been deemed to be always helpful at protecting downside risks)
- Adds some cost to regulators who need to play an active role developing and refining online education tools

- Adds costs to the sales process and creates a potentially annoying 'back to high school' requirement burden on customers wishing to access products (potentially individuals can have a financial competence passport attached to their open credit rating with expiry dates where needed or where products are significantly changed)

Outcomes benchmarking is ultimately a better locus of competition for an effective industry than product features and headline rates

Migration to a model which encourages a 'just in time' training element to build competence and help customer better understand how to use products correctly is of course just the start of a more robust approach to producing better outcomes in the financial services industry. For example, a higher rating product could be accompanied by warning messages of the outcomes generated by the poorest drivers of that product (ie the bottom quartile of revolving credit card users pay 18% interest for an average of 2.5 years on every \$100 applied to the card – illustration only). Similarly, an incentive could be provided for completing the training and understanding it fully because the competence level might also suggest that the top quartile of customers pay only 14% on every \$100 applied to the card (illustration only). This mix of benchmarking and product grading will reinforce education and encourage competition to migrate from product features and service quality to outcome effectiveness (through usage training and the like).

As more work is put into empirically understanding the actual outcomes customer produce with different products, more refinements can be made to product design (for example, to reduce hazardous usage, to improve choice architecture) and to product usage (for example through better competence building educational tools, through real time usage guidance such as 'safe to spend' and near limit messages). In time, my hope is that the locus of competition will migrate from product centricity and short term customer experience to outcomes benchmarking at the customer, competitor and nation building levels. If Australia's savings buffers, owner occupied housing, income protection and household budgeting products are not producing world leading outcomes benchmarks in 10 years then this Inquiry will not have realised its full potential. These products are used earlier in the customer lifecycle and are easier to fix than longevity risk, but as customer literacy levels increase so will their product outcomes and their ability to manage their own longevity risk – another key issue for this inquiry.

Balancing vision, ideals and a pragmatic implementation pathway

Such an idea would have been considered too ambitious just a decade ago. However advances in analytical techniques (Big Data), customer research, regulatory reform agility and online certification and learning systems means that 'stretch ideas' of this type which were once seen as conceptually appealing but difficult to implement can be considered in a more pragmatic light as Australia re-asserts its position as having one of the most progressive financial industries in the world.

About the Author:

David Moloney lives in Sydney. David is a consultant specialising in the financial services industry. David advises institutions, regulators, industry utilities, policy committees, financial literacy initiatives and other organisations around the world on how to optimise their role in this most critical of industries.