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Comments and Observations on the ASIC Submission to the Financial System Inquiry

The Terms of Reference for the Financial System Inquiry include the need to -

“refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:

.....

2.3 assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users;

2.4 the role of Government; and

2.5 the role, objectives, funding and performance of financial regulators including an international comparison.”

It is very timely and appropriate that the Inquiry consider these matters. It is now over 10 years since the current approach to the regulation of financial advice and the financial markets has been in operation, and the Inquiry’s Terms of Reference provide the opportunity to seriously and critically review the operation and effectiveness of the Australian financial services regulatory regime.

Under the “twin peaks” model of financial services regulation, Australia has two regulators – APRA and ASIC. The NIBA submission to the Financial System Inquiry deals with the prudential regulation of insurance, and these comments do not take that matter further. The main interest of NIBA, and of insurance brokers, is the regulation of market conduct under the Corporations Act by ASIC.

ASIC has provided a comprehensive submission to the Inquiry, and the submissions acknowledges a number of critical challenges in the design and operation of financial services regulation. However, the ASIC submission presents a number of competing challenges and philosophies, and NIBA believes these challenges – and the overall regulatory objectives – need to be clarified and resolved before more detailed regulatory proposals are put forward.

What is financial services regulation intended to achieve?

The ASIC submission reaffirms (at para 35 and following) the “well accepted point that financial products and services require more intensive regulation than other products..., especially in retail markets”.

However, earlier in the submission (at para 28 and following), the submission argues that “ASIC’s regulatory role does not involve preventing the risk of all consumer losses or ensuring full compensation for consumers in all instances where losses arise. Removing risk from the financial system would be highly undesirable.”

Overall, the submission appears to assume the need for ongoing regulation in financial services, but in doing so NIBA believes it is important to clearly reaffirm – as required by the

Inquiry's Terms of Reference - the overall purpose of regulatory intervention, and the outcomes and objectives the regulation should be intending to achieve.

These core overriding objectives need to be stated clearly, in order to set the framework for resolving the inherent conflict between the "well accepted" need for regulation and the view that the regulator cannot possibly aim to prevent all consumer losses or provide full compensation in all circumstances. With respect, the discussion at para 256 and following of the ASIC submission does not resolve this dilemma.

Inherent in this question is one of the key items of the Inquiry's Terms of Reference: what is the role of government in this area? In other words, to what extent should government become involved in financial services markets?

What principles and objectives require government intervention via statute and regulatory activity, and – perhaps more importantly - in what areas should the purchaser be required to take responsibility for their purchasing decisions?

One area where this is relevant in the insurance context is the area of flood exposure and flood insurance. Expert reports have indicated that around 5% of properties are virtually uninsurable for exposure to flood, because of their exposure to regular and repeated flooding. There have been calls for the Federal Government to establish a community pooling mechanism, similar to that implemented when the private sector withdrew insurance cover for terrorism risks¹. To date, neither the former Federal Government nor the current Government has indicated any willingness to establish such an arrangement. This tends to indicate that the risks associated with high exposure to flood damage are not considered to be a matter for government intervention.

Before action is taken to develop more detailed levels of regulatory intervention, it would appear desirable to identify and articulate the goals, objectives and limits of regulatory intervention, and confirm the role of Government in this area, rather than simply assume that regulatory intervention (and as ASIC suggests, more regulatory intervention) is required on an ongoing basis. Once these goals and objectives are articulated and agreed, a regulatory regime can then be developed (or, more correctly, the current regulatory regime can then be modified) in a way that aims to achieve those goals and objectives.

Adviser Competence

The ASIC submission (at para 77) expresses strong concern in relation to the competence and training of financial advisers. The submission notes the statutory requirement for AFS licensees to ensure that their representatives are adequately trained and are competent, and also references ASIC's Regulatory Guide 146, which deals with this area.

The submission recommends a national examination model as the means to achieve minimum standards of competency among financial advisers.

On 24 June 2013 ASIC released Consultation Paper 212 *Licensing: Training of financial product advisers – Updates to RG 146*. NIBA provided a comprehensive submission to ASIC in response to the Consultation Paper. The NIBA submission expressed concern in relation to the inadequacies of the current RG 146 guidance, and also expressed strong reservations in relation to the proposals set out by ASIC in the Consultation Paper. ASIC has not yet published a response to the submissions it received following the release of CP 212.

¹ Cover for terrorism risks is now provided via the Australian Reinsurance Pool Corporation.

Australia has a strong national structure for vocational education and training, including in the financial services sector. Innovation & Business Skills Australia has published the Financial Services Training Package, a resource that sets out national standards for vocational education and training in Financial Services².

Neither the ASIC Consultation Paper 212 nor the ASIC submission to the Inquiry set out any issues, concerns or identified inadequacies in relation to the Financial Services Training Package. Indeed, RG 146 does not reference the Financial Services Training Package at all.

There is a widespread view that a national examination model will achieve one thing: it will demonstrate that people can pass an examination. There is also widespread concern that a national examination model will not improve the knowledge, skills and competencies of financial advisers, and will not lead to better advice or better purchasing decisions by clients.

NIBA has strong reservations regarding the proposed national examination model, and these reservations have been expressed to ASIC and to the Federal Government. NIBA respectfully suggests that ASIC develops and publishes a response to the issues and concerns raised with it following the publication of CP 212, before any further action is taken in relation to the proposed national examination model.

Managing Systemic Risk

The ASIC submission (at para 118 and following) argues “it would be useful to consider establishing a formal mechanism for monitoring for the future build-up of unacceptably high levels of systemic risk in entities, markets or sectors outside the boundary of prudential regulation and to respond if necessary”.

The submission does not mention, comment on or identify deficiencies in the operation of the Council of Financial Regulators, of which ASIC is a member.

The role of the Council is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. The Council has the capacity to advise Government on the adequacy of Australia’s financial regulatory arrangements³.

It is not clear from the ASIC submission why more formal mechanisms are required to monitor and manage unacceptably high levels of systemic risk.

The limitations of disclosure

The ASIC submission (at para 123 and following) discusses the requirements for mandatory disclosure of product information to customers and consumers. Most importantly, the submission acknowledges that mandatory disclosure of product information does not lead to better and more informed decision making and purchasing by consumers. ASIC seeks a broader toolkit of regulatory powers “to address market problems”.

The submission suggests, and NIBA supports, the need for ongoing financial literacy programs to ensure consumers have a good basic understanding of the main financial products they are likely to use in their daily life – basic banking (savings and loans), credit cards, basic consumer insurance products (home, contents, motor vehicle), and a broad overview of superannuation and saving for retirement.

² See: <https://www.ibsa.org.au/financial-services>

³ See: <http://www.cfr.gov.au/>

At the other end of the spectrum are a wide range of complex financial products (such as hybrid securities and CFD's), many of which are directly available to individuals. In this area there is an argument that those who invest in products of this nature should be personally responsible for the risks associated with that investment, and should not rely on regulator or government support if the investment outcome is not what they were expecting.

Between the basic and sophisticated financial products, there are a wide range of savings, loans, investments, insurance and other products that provide safety and security to the community, and have done so for many years.

ASIC appears to adopt the position that effective use of these products will only occur with a wide range of regulatory tools, and constant regulatory intervention in the financial services market place.

NIBA would like to suggest that before consideration is given to the "more flexible regulatory toolkit" advocated by ASIC, a careful examination needs to be undertaken of the preferred outcomes and objectives for regulatory intervention in relation to these products, and the development of a set of core principles which are designed to achieve these outcomes.

Importantly, those core principles should be consistent with the over-arching goals and objectives of financial services regulation discussed earlier in this paper.

One of the core principles is the need to ensure consumer have a good understanding of the range of financial products and services that will assist them with their lifestyle goals, and provide security and protection. But regulatory intervention is not necessarily the only approach that will achieve this outcome. Indeed, the ASIC submission (at para 712 and following) acknowledges the benefits to consumers and the community from good quality financial advice.

NIBA would like to see much greater recognition and emphasis being given by Government and regulators on the need customers and consumers to access and be guided by quality financial advice, by people who are trained, competent and qualified to give that advice. It has to be accepted that only a small proportion of the population will develop a reasonably competent level of knowledge and understanding of the nature, content and risks of the financial products they will most likely be using. They should be encouraged to seek assistance and advice in relation to those products and services. NIBA is very willing to work with ASIC and other areas of Government to overcome the barriers to accessing quality financial advice set out in para 720 of the ASIC submission.

Is the system working effectively?

The global financial crisis resulted in major stress and ultimately very significant financial losses around the world, and in Australia.

Following the Wallis Inquiry, the Australian Government instituted a comprehensive financial sector regulatory regime, under the "twin peaks" model of prudential and market regulation. The regulation of financial services in Australia is widely regarded as one of the most comprehensive in the world.

With the experience of the HIH failure, prudential regulation was reviewed and reinforced, and no insurance company failed during or following the global financial crisis, despite the nature and cost of the insurance claims that arose out of the natural disasters in Australia in 2010 – 2012.

In relation to market conduct regulation, Table 24 of the ASIC submission presents a distressing list of very significant failures and losses, in many cases seeing individuals losing their entire wealth and retirement savings. These failures occurred well after the financial services regulatory regime had been introduced and entrenched in Australia.

The Parliamentary Joint Committee (the Ripoll Inquiry) undertook a review of some of these matters, and recommended a package of reforms which subsequently became known as the Future of Financial Advice (FOFA) reforms. There is ongoing debate as to the necessity for, and nature of, those reforms, with recent proposed changes to the FOFA legislation being referred to Parliamentary Committees for review.

In addition, the Senate has been reviewing the performance of ASIC in relation to the regulation of certain activities of financial services licensees.

NIBA believes it is very appropriate and timely that the Financial System Inquiry has been asked to review both the effectiveness of financial sector regulation (in other words, was the statutory and regulatory landscape adequate?), and the role and performance of financial services regulators (in other words, how effectively did APRA and ASIC exercise the legislative functions and powers that had been given to them by the Parliament).

One size fits all

Insurance brokers give financial advice, and must hold an Australian financial services licence.

Mortgage brokers, stock brokers, bank employees and a wide range of others also provide financial advice, and are similarly regulated under Chapter 7 of the Corporations Act.

The Wallis Inquiry gave almost no consideration to risk insurance (life and general) in Australia.

The Ripoll Inquiry examined issues associated with financial planning and investment advice, again with little or no reference to risk insurance products, services or advice.

The FOFA reforms were developed in relation to identified issues and concerns in relation to financial planning and investment advice. There were no identified issues or concerns in relation to insurance broking. Nevertheless, as initially drafted, the FOFA reforms applied to all areas of financial advice. Fortunately, changes were made during the development and passage of the FOFA legislation to limit the impact of the reforms in areas outside of financial planning and investment advice.

At a high level, the ASIC submission constantly refers to broad notions of financial advice. In reality, the submission is almost invariably talking about advice that is given by financial planners and investment advisers.

As stated in the NIBA submission to the Financial System Inquiry, different sectors of the Australian financial system perform very different functions, with very different products – which have very different purposes, providing very different outcomes, with differing levels of risk for the customer or consumer. Risk insurance – where a premium is paid to the insurer, and mostly nothing else happens (because the insured event does not occur) – is very different to savings, loans and the funding of retirement. Nevertheless, Chapter 7 of the Corporations Act applies a set of statutory obligations across all areas of financial services and advice.

As NIBA stated in the submission to the Inquiry:

The OECD, the Council of Australian Governments, the Productivity Commission and many others have identified, confirmed and agreed on the core principles that must be applied whenever consideration is being given to regulatory intervention in markets and the economy. They include:

- a clear statement of what actually is the issue being addressed
- is there a sound legal and empirical basis for this issue
- have all potential options for dealing with the issue been identified and assessed, including the option of no further action
- a clear statement of the proposed regulatory intervention, including the governing principles that will be used to guide the development of the regulatory intervention
- a sound legal and empirical basis for the proposed intervention, including a clear assessment of the nature and value of benefits to be derived, and the nature and level of costs (including compliance costs) that will be incurred as a result of the intervention
- a careful analysis and assessment that the proposed intervention will produce benefits that justify the costs, considering the distribution of effects across society, and taking into account economic, environmental and social impacts of the intervention
- assurance that the proposed intervention will minimise costs and market distortions
- strategies to ensure the regulation will promote innovation through market incentives and promote global approaches to strong and effective community outcomes
- be clear, simple and capable of practical adoption
- be consistent with other regulations and policies
- be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.

For further information in relation to these or related issues, please contact:

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