Personal submission to

Financial System Inquiry 2014

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Introduction

The lengthy Interim Report issued in July 2014 has taken quite some time to read and digest; and the timeframe provided for comment has proven restrictive in terms of the number of items I have been able to address. Nevertheless it has been a privilege to submit this contribution for your consideration.

It is noted that the Inquiry panel has expressed the belief that the Australian Financial System should facilitate efficient allocation of resources and risks; and that it should be 'reliable and stable'; and 'fair and accessible'. These are sentiments with which I concur: and which influence my following comments.

Selected Topics Summary

In addressing the issues raised in the Interim Report to which I make any detailed comment, I make the points that:

- ***Financial literacy*** can and should be addressed so that within two decades, there is a sufficient knowledge about the financial system, financial documents/ instruments and investment products that financial advice can be delivered (to those who are likely to seek it) with the expectation of an underlying level of understanding – and only having to go into greater detail where that level of understanding hasn't been demonstrated;
- The ***superannuation*** system maturity has reached a stage where a dual/ multiple management system might be warranted, with the effect that the very substantial funds accumulated under the superannuation guarantee laws could be regulated under a separate set of provisions for the personal (self-funded) accumulations that include self-managed superannuation funds (SMSFs): the system of taxation of superannuation accounts should be stabilised – perhaps after a major review and re-positioning; and that SMSFs should not be further regulate in terms of minimum financial requirements, nor operating cost standards;
- The ***financial advice*** industry could be reformed, starting with a 'clean sheet of paper' approach, so that professional advisers could provide strategic advice but not investment product advice, whilst investment brokers could sell financial products for the implementation of the wealth management strategy recommended by the professional adviser; strategic advisers in this context to be appropriately educated and to operate under 'professional status' conditions; and
- ***Corporate governance*** principles should be rigorously retained, but the activities of directors regulated so as to ensure broader diversification of the talent pool accompanied by some practical constraints on the number of appointments accepted by directors, facilitating better risk management at the personal level (and greater commitment to the restricted boards to which service is given).

General Comment

Whilst I don't elaborate on the matter any further below, access to funds for small business in Australia is very much structured around the availability of equity in real property, with the consequence that there is an over-investment in residential property in this country. The consequences of this situation are that significant capital is tied up in that asset class, it is unproductive; and it is leads to unfair distribution of wealth, particularly with the Capital Gains Tax exempt status being applied to a Principal Place of Residence.

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1. Financial Literacy

In the Interim Report of the FSI, this subject is mentioned in the context of Corporate Governance issues and, more relevantly in terms of my comments, in relation to disclosure made in advice documentation from financial advisers.

The concern I detect from the Interim Report is that there appears to be some resignation to the fact of financial 'illiteracy' within the Australian community; and that little short-term benefit will arise from any level of attempt to raise the level of financial literacy amongst Australians.

This would be a disappointing outcome with significant cost consequences at the individual level; and one that should be given a high priority for attention – and redress. Whilst there will be a considerable period of time between the implementation of a policy/ program to raise financial literacy in this country, it will eventually facilitate more efficient and effective financial services segment of the financial system. In my view it should be possible to achieve a satisfactory improvement in financial literacy over a two-decade term to facilitate the efficiencies detailed further below.

Academics with greater experience in the broad-scale education of a population will be better positioned to comment on how an effective financial literacy program could be instituted, but at least the two-fold process of starting an in-school program for Primary School students, supported by a sustained financial literature distribution campaign to begin the process of educating the adult (post formal education) population. [This may need to be linked to some incentive process to have a substantially desired effect.]

With a greater level of understanding of financial terms and of the effects of various financial contract provisions, it should eventually be possible for –

a) more concise Product Disclosure Statements to be produced;
b) less verbose Statements of Advice to be issued; and
c) so-called 'scaled advice' to be provided effectively.

At an appropriate time in the future, a 'test' similar to the current investor risk profiling tools, might be developed to establish the level of financial literacy of an investor seeking advice and the documentation could then be tailored to speak to that level of understanding.

Superannuation engagement might also be enhanced as a consequence of such a program. There has been a series of reports about the superannuation system in Australia – highlighting the lack of participation and involvement by the vast majority of employee members of superannuation funds; and their apparent disinterest in pursuing 'better cover' through the exercise of Choice available to them since circa 2008.

2. Superannuation

Harking back to the belief that the financial system in Australia should be stable, reliable, fair and accessible, it is disappointing to note that Superannuation Policy stability may be at the one time: a benefit for the 'wealthy'; and a disadvantageous concern for lower-middle income people (who often make investment decisions outside of the superannuation arena) because of a perceived lack of stability of superannuation and retirement policies. The perception is often expressed that 'this is too big a pie for the politicians to keep their hands off it' and hence distrust leads to ineffective decisions.

The compulsory superannuation system has been the underpinning of the Australian Superannuation system since its introduction around thirty years ago: in essence the Superannuation Industry Supervision (SIS) legislation hasn't changed in its intent throughout its history: the bulk of the offending instability has been through the impact of the taxation system on this asset. In this suggestion I am advocating a 'clean sheet of paper' approach to Superannuation and Retirement Planning – and I will add Financial Planning Advice to this list later in my submission.

Given the broad lack of engagement by beneficiaries of the superannuation guarantee (s.g.) system, it may be that the superannuation industry is now sufficiently mature to allow for separate legislation to deal with retirement policies differentiating between the s.g. system and the personal contribution sector of the industry (as recorded in personal superannuation accounts through public offer; and in self-managed superannuation structures). Such a division of the superannuation system may remove the call for scaled advice in relation to s.g. superannuation; and could restrict the need for scaled advice for self-funding/ personal superannuants.

In the context of superannuation and the effects of taxation, the dilemmas indicated elsewhere in the Interim Report around the dividend imputation system could be resolved by removing corporate tax (at least on listed corporations), leaving dividend recipients to pay the tax on distributed earnings at the relevant marginal tax rate. There would be implications for statutory levels of distribution; and for taxation of capital gains realised within corporate entities.

Self-Managed Superannuation Funds (SMSFs):

- Are costs a concern;
- Should establishment be restricted?

In the context of the SIS legislation the costs of establishing and operating an SMSF should not be a concern to the government: however, consistent application of clearly-stated compliance obligations should ensure that such critical elements of the legislation as it currently stands (to satisfy the Sole Purpose Test for instance) should ensure that the members of the fund would be in an informed position to make a decision about entering such a structure – and the regulator should impose a fee that facilitates a substantive review of fund/ trustee compliance.

[By way of elaboration, during my period in professional accounting and financial planning practice, my firm has been involved in the closure and deregistration of more SMSFs than it has in opening them for 'suited' clients. The funds that have been closed on our review recommendation have served no purpose other than to meet some imagined flexibility with particular investment 'assets' or their strategic purpose has been accomplished (or superceded) by events or taxation legislative changes.]

However in the context of Retirement Policy, the cost of establishing and/ or operating a SMSF may well be a concern for policy-makers, particularly if the costs consistently result in fund underperformance against a reasonable benchmark in the process of wealth accumulation towards retirement.

The consideration as to whether as a Policy matter, the ability to establish a SMSF should be regulated so as to restrict acceptable circumstances for such activity would be advisable seems to tending towards an argument of ideologue: such restriction has only been by inference to date and I suspect that it should stay this way in the absence of compelling evidence that harm is being done to the financial system in the absence of such restriction.

3. Financial Advice

The approach to the system for delivering financial advice is concentrated on the existing system and seeking to 'tweak it at the margins' to improve what is proving to be a flawed system.

As referenced in the section above (Superannuation) it may be time to adopt the 'clean sheet of paper' and rewrite the system, allowing the financial advice industry to adopt a professional standard, based on minimum-requirement educational qualification, a set of self-regulated codes of practice and standards of professional behaviour, supported by an appropriate 'disciplinary' process. Advisers in this model would be restricted to the provision of *wealth management* advice: either holistic (comprehensive), or 'scaled' at the direction of the client. These advisers should not need to be subject to close regulation; and could develop acceptance in the community similar to that enjoyed by accountants and solicitors.

The distribution of financial products should then be left in the hands of heavily regulated brokers or agents who would select the products according to the strategic guidance of the professional financial planner/ wealth management adviser.

Separating these roles, strategic advice -v- product distribution, would remove the risk of conflicted remuneration as there would be no incentive for the (strategic) adviser to recommend any product – particular or otherwise.

The Interim Report also made reference to the fact that there is no generally accepted definition of 'wealth management', opting to define it as 'financial advice services and funds management'. Adopting these two segments of the industry in this way is not helpful under the current structure, a difficulty that could be ameliorated by adopting the above approach.

In the current model, 'financial advice services' includes the provision of financial advice including the implementation of recommendations about financial products (which include managed funds); and 'funds management' is broadly seen as being related to the role of managed funds, whether on behalf of institutions, high net worth individuals or publicly-offered managed investment trusts. 'Private wealth services' provide the broad range of services that might be accepted as 'wealth management', an area that includes the broader range of wealth issues including –

- Investment advice;
- Retirement planning;
- Asset protection;
- Estate and succession planning;
- Insurance portfolios;
- Philanthropy; and perhaps
- Family 'constitutions'; and
- Lifestyle 'concierge' roles.

4. Corporate Governance

The Interim Report raised the question as to whether boards of different organisations should have different duties; and to what extent regulators can continue to interpret the law so as to merge the responsibilities of management with that of directors in some instances.

For the integrity of the financial system it is important that competent, independent directors have the oversight of the strategic direction of corporations (of all description), that their duties be common – albeit that their responsibilities might vary according to the type of corporation and/ or industry involvement. This precludes undertaking management duties; it very specifically includes ensuring that management processes are implemented and monitored to meet the strategic goals of the company as approved by the board.

There exists opportunity under the current structure, for members of the management team to provide input to board committees; and for board members to familiarise themselves with operational activities of the corporations they serve, to satisfy themselves that their expectations of management in their key areas of responsibility are being met.

The role of the director should be tailored to the demands of each corporation's activities, conscious of risk management, financial accountability and regulatory compliance: to attend to these roles in a sound corporate governance environment adequate time should be required. This process could take into account the level of risk taken on board by each director personally, opening the door to roles for more independent directors (including some improvement in gender and skills diversification).