26 August 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), including responding to the issues raised in the FSI Interim Report. We recognise that the FSI is a great opportunity to identify what is working well and what can be improved in the Australian Financial System. We note that the interim report did not address some of the key issues that were identified in our earlier submissions such as payroll tax for financial advisers, however we will take this opportunity to restate the importance of these points. Whilst we primarily focus upon the issues most directly related to financial advice, we have also put our views forward on other key issues relevant to financial services in Australia. 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 attractiveness for businesses to investment in the financial services industry. The goal should be to seek to protect against systemic failure and not business failure. The public debate during 2014 with respect to the FoFA Amendments clearly lost the focus on this goal.

In our submission we have addressed the following issue that were raised in the Interim Report:

- Superannuation
    - Market Competition
    - Default Superannuation Arrangements
    - Three-Day Portability Rule
    - Product Design Issues
    - Leverage in Superannuation
    - Stability of Superannuation Policy Settings
- Disclosure
- Financial Advice
    - Education and Experience Standards for Financial Advisers
    - Professional Standards and Codes of Conduct
    - General Advice
- Underinsurance With Life Insurance
- Retirement Incomes
    - Alternative Options
    - Retirement Income Product Development

In addition we have addressed the following issues that were not addressed in the interim report:

- Payroll Tax for Financial Advisers/Licensees
- External Dispute Resolution and Professional Indemnity Insurance
- Mandatory Transfers to MySuper
- Corporate Superannuation Advice

Part 1 – Response to Interim Report

1. Superannuation

Market Competition

The AFA cautions that a focus on fees in isolation will lead to poor consumer outcomes from superannuation products.

We note the comments in the report about fee levels in superannuation. Whilst achieving the best possible outcome on fees is important, a singular focus upon fees without reference to the level of choice available in the Australian market opens up the risk of the Australian superannuation system being inappropriately judged. There have been a number of groups who have expressed opinions on

the value of this analysis. We would simply suggest that there needs to be caution in any high level international comparisons. The evidence shows that fees have come down over time and can be expected to continue to decline. A focus upon ensuring the highest level of competition in a genuinely competitive marketplace is the best vehicle to achieve the desired outcome for consumers.

Whilst it was expected that MySuper would drive a reduction in fees, the trade-off that has taken place to achieve this is a reduction in functionality of the products, including a high level of investment focus upon indexed funds, rather than active funds. The judgement on whether this is good for consumers is still open, however we are aware that there are a range of cost increases that have arisen. There are also many examples of where the implementation costs of creating MySuper options are being passed on to consumers.

Default Superannuation Arrangements

We believe that the criteria for the selection of an employer superannuation fund should be based upon whether the MySuper fund has been approved by APRA. All APRA approved MySuper fund should be eligible for selection by every employer.

A market works most effectively where competition is encouraged and consumers have full visibility of the choices available. The default superannuation fund market is very different from this.

The state of the current arrangements in modern awards is unquestionably biased in favour of industry funds. The way MySuper has transpired in terms of the old industry funds being so easily rebadged MySuper funds also allowed these industry funds to convert to a MySuper product in a low cost manner and be able to refer to historical investment performance. With the retail fund providers, the products are new products and therefore it is more difficult to state historical investment performance. It is our suggestion that the marketing of MySuper products be closely scrutinised to ensure any comparisons are reasonable and accurate such that employers and their staff are not misled.

The AFA view is that the default fund superannuation market should once again be based upon a level playing field where the primary objective is the achievement of the best possible outcome for consumers, including a range of choices.

We do not see any merit in a process that is based upon auctioning for default fund status. This places an excessive focus upon cost at the expense of all other key features including compromising investment approaches that may otherwise deliver a better net return over time.

Three Day Portability Rule

Retain the three-day portability rule and strengthen the compliance measures to avoid the risk of significant account holder detriment.

The Interim Report has asked for feedback on the possibility of replacing the three day portability rule. This appears to be based upon concerns that this requirement is contributing to a need to maintain higher levels of liquidity within superannuation funds which might be reducing after-fee returns to members.

We are particularly surprised by this view as the report equally refers to the low level of movement between funds. This low level of movement along with the preserved nature of superannuation funds limits the flows for any particular fund. In a practical sense, the amount of additional funds held in liquid assets and the relative differential in performance would at best mean a very small difference in the investment return of the fund.

Our members report that non-compliance with the three day portability rule is a regular problem, particularly with respect to Industry Funds. We suspect that this is not attributable to liquidity reasons but rather to do with fund retention strategies and administrative inefficiencies. We would not like to see this relaxed on the grounds of an impact upon net returns when the core underlying reason is

something completely different. Superannuation funds need to manage liquidity requirements and three days is particularly reasonable.

We would also argue that it is too early to determine whether the three-day portability rule is causing significantly higher allocations to liquid assets, as the new rollover standards only came into full effect from 1 January 2014. We would like to see the compliance regime with respect to this requirement enhanced and the availability of improved data to understand the reasons for the failures to comply with this requirement.

We would also like to ensure that this debate considers the interests of account holders where they wish to move their superannuation funds for whatever reason. It is absolutely reasonable for them to expect to be able to transfer their funds in this timeframe.

Superannuation is now a key vehicle for insurance, and as a country it is critical that we address the issue of under-insurance. There are a number of superannuation insurance products that have been recently developed where the premium can be paid based upon a roll-over of funds from one superannuation fund to another. This is a good outcome for consumers as it allows them flexibility and increased choice around their insurance arrangements and greater control of the funding of their insurance. With these products there is invariably a reliance upon the roll-over being processed in a timely manner so that the funds are available when the premium is due. Any deterioration in the timeframe for processing these roll-overs will mean that members will need to move this money sooner than it would otherwise be required and therefore it will be out of the market for longer than would be necessary.

In the context of superannuation insurance products where funding is based upon roll-over arrangements, any relaxation of the portability rule is likely to increase the risk that insurance premiums are not met when due and that members will suffer reduced investment returns when the funds are held outside the market for longer. Most importantly, a failure to comply with the three day portability rule could result in the premium not being paid on time and the insurance being cancelled. There can be significantly negative consequences for clients in this context.

Product Design Issues

We support the opportunity for consumers to choose the product that best suits them rather than pursuit of product design based upon a singular view of what is perceived to be best for consumers.

Leverage in Superannuation

Require SMSF trustees to attain licensed financial advice before they can enter into a limited recourse borrowing arrangement within the fund.

The ability to use debt leverage within Self Managed Superannuation Funds (SMSF's) has raised some concerns within the market place. Whilst we are generally supportive of this concept there is mounting evidence that poor practices are emerging creating issues of liquidity, over-gearing and poor trustee decision making.

Of greatest concern are examples where uninformed consumers are taking on the role of trustee of a SMSF for the purpose of gearing into property without sufficient understanding of their obligations and the risks associated.

It is our suggestion that SMSF's should need to obtain advice from an appropriately licensed financial adviser before they can enter into a limited recourse borrowing arrangement within the fund. This advice would need to clearly explain the risks of the strategy and also model the outcome of the investment strategy including sensitivity to a change in interest rates.

Whilst we recognise that this is a cost imposition on the SMSF, given that the asset values being considered would in most cases be well in excess of $300,000, the cost of the advice is likely to be

relatively insignificant. By requiring advice from a licensed financial adviser backed by the Best Interests Duty requirement, we can have greater confidence that only appropriate gearing strategies will proceed.

Stability of Superannuation Policy Settings

We seek stability in the superannuation system so as to increase confidence and participation by more Australians.

A lack of stability in Superannuation policy settings over a number of years has significantly impacted upon consumer confidence in the overall superannuation system. The feedback that we received from our members in the lead up to the announcement by the former government in April 2013, where there had been a high level of speculation about further superannuation changes, revealed deep implications for the willingness of their clients to voluntarily participate.

Superannuation by its very nature is a long term investment. Any level of uncertainty in the minds of consumers about future rule changes reduces confidence and thus the willingness to voluntarily participate and this has particularly poor outcomes for the many self-employed small business owners in Australia.

There are significant economic and investment benefits for Australia driven by retirement adequacy outcomes and it is well documented that we are quite some way off achieving this for the majority of Australians. Attracting them to voluntarily participate in superannuation is thus a desirable outcome which is difficult to achieve whilst scepticism and mistrust exists over the willingness of successive governments to meddle in the rules to achieve short term budget/fiscal outcomes.

We applaud the current government's policy position to make no adverse changes to superannuation settings and encourage a bi-partisan approach be taken to ensuring this is maintained following any recommendations adopted from the FSI.

2. Disclosure

We advocate for a long term sustainable approach to raising financial literacy standards and simplifying disclosure.

We fully recognise the current problems with the disclosure system. Behind this issue are two key factors – complex disclosure documents and inadequate levels of financial literacy on the part of consumers relative to the complexity of the Australian financial system.

We support a solution based around reduced complexity, increased relevance of the disclosures, and a shared responsibility to improve financial literacy. We emphasise there are no simple or short term solutions to this issue. It is invariably a balancing act and improvement can only be achieved by ensuring changes are subject to an appropriate level of consumer testing and industry consultation.

The introduction of the Best Interests Duty (BID) on 1 July 2013 has placed additional legal responsibility on licensed providers of financial advice to ensure the advice is indeed in the client's best interests and it is therefore possible to argue that this duty reduces the need for many of the usual disclosures contained within documents provided to clients such as Statements of Advice. At the end of the day, the BID is a significant obligation and will be the one most relied upon by clients. It would be useful for the regulator to work with industry to ascertain what are the essential disclosures required in light of the BID being in effect. We nonetheless appreciate that products are acquired in some cases without advice and this reliance on the financial adviser is not an option.

We applaud the recent strategy document released by the Australian Financial Literacy Board. We believe a focus on financial literacy within the school curriculum will create meaningful and sustainable behaviour change to improve individual financial outcomes in Australia. The AFA has a strong focus

to shoulder our share of responsibility to support this and other initiatives and encourage the FSI to place emphasis on financial literacy initiatives focused on younger Australians.

3. Financial Advice

Trust in financial advice is absolutely critical. The events of 2014, including the level of media coverage related to the FoFA Amendments and the release of the Senate report into ASIC, have had a significantly negative impact upon the public perception of financial advice. This is a poor outcome for consumers, the country and for financial advisers. It appears the impact has been greatest on those who don't have a financial adviser relationship. They have no context within which to assess the media driven information. They are more likely to take what the media has said (be it accurate or inaccurate) about the industry, or about specific advisers, and assume that this is typical across all advisers and 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 beneficial for the nation as a whole as an increased level of preparation for retirement will lead to a reduction in the level of dependence upon the public (age) pension, and holding appropriate levels of personal insurance similarly relieves the public burden that results from either serious injury or illness, or premature death.

The research did indicate that only approximately one in five people are getting ongoing financial advice, and that the remaining 4 out of 5 people struggle to understand what financial advice is, what the experience of getting advice will be like, what it should cost and therefore what value might it deliver.

Our goal is to achieve Great Advice for More Australians and inherent in that is raising the public perceptions of advice through engaging and educating them, whilst at the same time, continuing to provide leadership to advisers on the standards and behaviours required of them to earn the public's trust and support.

Education and Experience Standards for Financial Advisers

The AFA strongly supports an increase in education standards for financial advisers and we believe that the process behind the FSI and the current PJC Inquiry is a tremendous vehicle to get broad support for a new path forward.

There is broad recognition and support for the need to increase the education standards within the financial advice profession both at the entry and ongoing practitioner levels. There is a reasonably universal view that as a profession, the education standard should be a university degree. The AFA supports the goal of a relevant university degree as the entry criteria for new financial advisers entering the financial advice profession, however we do not believe that this goal can be achieved in the short term. The reasons for this are as follows:

- The education marketplace for financial advice degrees is currently immature. Some courses exist, however they are not well supported and typically the entry level is reasonably low. There simply isn't currently a high level of demand or throughput for financial advice degrees.
- Whilst life experience isn't mandatory for someone operating in the financial advice profession, it is often considered by clients to be desirable as it better enables an adviser to have the

empathy, understanding and emotional intelligence integral to helping clients develop new behaviours to improve their financial position.

- The recent avalanche of negative media coverage about financial advice will invariably impact upon the interest in pursuing a career in financial advice, or enrolling in a financial planning degree.
- The current business model is not based upon the existence of roles that enable new entrants to gain experience prior to being in front of clients. Whilst roles such as para-planners and client service associates do exist, they are not necessarily a direct pathway into financial advice.
- The current adviser market place is skewed with a number of older advisers who are expected to leave the profession over the next few years before a sufficient supply of University graduates will be qualified.

As baby boomers approach retirement in increasing numbers over the next few years, there is no question that we need to ensure that there is an adequate number of competent financial advisers to meet this demand for financial advice. It will be critical to ensure that we have an adequate volume of new advisers entering the profession as existing advisers depart. Thus any fundamental change to the education standards needs to be done in a manner where transition arrangements will ensure that clients can still access the financial advice that they so clearly need within the timeframe that is relevant to their life stage.

We strongly believe that financial advice education needs to contain a balance of technical training and also emotional intelligence training. Client relationship skills are essential in financial advice. Financial advisers who have strong technical skills, but poor client relationship skills struggle and don't succeed in providing the emotional outcomes that drive behaviour like peace of mind, confidence and security. These are things that clients really value in their relationship with a financial adviser and have been proven through client research. Ensuring these skills are incorporated in university based financial advice degrees is essential. It is important to remember that much of the benefit from financial advice comes from the client successfully adopting better money-related behaviours and it is the relationship and coaching element within an advice relationship that creates the environment for this to happen and be maintained. It takes unique skills to create behaviour change with clients.

The current entry-level requirement, known as RG 146 is basically at diploma level, although the existence of some less strenuous versions of this course has led to much media discussion about a qualification that can be gained in 8 days. This does not reflect the vast majority of the marketplace, however this emphasises the fact that the minimum level needs to be raised significantly and the delivery needs to gain a level of standardisation to ensure that they are equally applied. We believe that action on this front can be taken in the short term.

It is our experience that education standards on their own will not achieve the outcomes intended. Cultural change, as proven through behaviour, is the ultimate goal and professional association membership, peer-to-peer learning experiences and practical training and supervision are needed to be successful.

Entry Level Requirements

In the table below we have set out our view on how education/qualification and experience standards could be raised in the near term.

Period	Qualification Requirement	Experience Requirement	Other Requirements
Commencement – 30 June 2016	Diploma	Nil	Completion of National Competency Exam, and Ethics Module. Completion of an Advanced Diploma by 31 December 2017
1 July 2016 – 30 Dec 2019	Advanced Diploma or equivalent and Completion of all mandatory Knowledge Requirements	One year approved experience	Completion of National Competency Exam and Ethics Module
31 Dec 2019 onwards	Relevant Degree or Equivalent and Completion of all mandatory Knowledge Requirements	Two years approved experience	Completion of National Competency Exam and Ethics Module

In addition we are seeking steps to be taken to ensure that all current Diploma of Financial Planning courses have adequate course content and assessment criteria.

Education Requirement for Existing Advisers

We support an increase in the level of qualifications required for existing advisers however this needs to reflect their experience in the industry and an appropriate transition timeframe. One option that might be considered is the completion of a once-off national competency exam. We will undertake further review and consultation with respect to this requirement.

Ongoing Professional Development

- Minimum 30 hours per year to be achieved through a variety of learning situations to include workshops and on-line learning/assessment.
- Mandatory ethics component each year with time equivalent of 4 hours.

We believe that the key requirements addressed above should be incorporated into the law, although some of the specific course and experience approval requirements could be done through professional self-regulation.

There will be significant detail involved in implementing a change as fundamental as what is proposed, which will need to be done in a careful and considered manner. In this submission we are placing a focus upon the high level principles, rather than the detailed implementation considerations.

Professional Standards and Codes of Conduct

Consideration be given to the merits of mandatory professional association membership

Ensuring that trust and confidence returns to the financial advice profession is also dependent upon proof that financial advisers operate within boundaries of behaviour that would be expected of a professional. The vast majority of advisers operate with integrity and demonstrate the required ethics. Nonetheless we believe that the importance of integrity and ethics can be reinforced by the provision

of specific and focused training.

Codes of conduct also play an essential role. This is a set of standards that members can hold themselves and their colleagues accountable to that sit above the minimum legal standards expected of a Practioner. Working as a profession, ensuring that everyone lives up to the standards expected of them, is something that financial advisers can take collective responsibility for through self-regulation via professional bodies.

There has been a lot of comment recently about the potential introduction of a requirement for mandatory membership of a professional association. A number of licensees have already headed down this path. We support this approach, however do believe that it is timely for the Government to consider whether mandatory membership should be considered.

General 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.

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. It may be that changing the legislated term "General Advice" to "Product Information" will assist clarify the difference to consumers. However, we need to be careful about considering that the solution to this issue is renaming general advice. Clients typically would not be aware of the distinction between personal advice and general advice and having received general advice would be unlikely to be able to confirm that that was what they received. This issue is bigger than just the label used to describe the type of advice. Improved financial literacy will play a big part here. We also think that there needs to be consideration of additional plain English disclosure documents provided to clients where any general advice involves the recommendation of a specific product.

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 and either revised legislation and/or improved guidance from ASIC on how scaled advice can be achieved in concert with the Best Interests Duty would be useful. The access and affordability of good financial advice remains a challenge unresolved by FoFA.

4. Underinsurance with Life Insurance

We recommend that consideration be given to the issue of consumers' risk and protection where complex insurance products are sold on the basis of general advice.

We also recommend consideration be given to the role of Corporate Superannuation Advisers in supporting workplace insurance arrangements.

Underinsurance with respect to life insurance remains a problem in Australia. Most people rely upon their superannuation fund for insurance and in many cases they have the default level of cover which is likely to be significantly less than they would need in the event of a health crisis or death. There is a low level of appreciation of the need for insurance.

Consumers often do not understand what they are insuring and what needs will be addressed through an insurance claim. People often don't appreciate that their future employment and income is an asset that should be insured. 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 understood.

The emergence of the direct sale of life insurance has become an increasing factor in the Australian market. TV advertising, inbound/outbound call centres and direct mail campaigns are increasingly common. Whilst we support the increased provision of life insurance in the Australian market, it is time to reflect on the disclosure and product regime that applies to some of these product sales solutions.

In many cases, the products developed for the direct insurance market are typically simpler products yet most consumers are unable to interpret this difference and risk losing substantial benefits when switching to simpler products.

We are also 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 significantly 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 by the insured. The image of a grieving widow and children not receiving the expected death benefit following the loss of their husband and father would be particularly damaging.

Life insurance contracts are complex and 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 ensures 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.

We believe that it is appropriate for the Government to consider options to address the issue of underinsurance, including through consumer education and also workplace mechanisms to ensure that members of superannuation funds fully leverage the opportunity to obtain the level of cover that they need through their employer fund. Access to Corporate Superannuation Advisers can make a real contribution in this area. Corporate Superannuation Advisers play a role in the workplace supporting the members of an employer fund either through the delivery of seminars or through one-on-one advice and service. A strategy that utilises Corporate Superannuation Advisers to help educate consumers with respect to the need for insurance would be particularly beneficial.

5. Retirement Incomes

We support options that encourage retirees in the retirement phase to access income stream products rather than withdraw lump sums from superannuation.

It is our view that the purpose of the Australian Superannuation system is to provide retirement incomes for Australians. In this sense we support mechanisms that encourage, but not mandate, retirees to take out income stream products, rather than to take lump sums.

Alternative Options

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 note that the Interim Report appears to be advocating for intervention to promote the use of annuities. This has been argued on the basis of a range of factors including longevity risk. Whilst we support annuity products that provide a guaranteed income, we do not necessarily believe that this should be as a direct preference over account based pensions. It is our view that the selection of a retirement income product should be on the basis of the client's needs and objectives, not a preconceived view of one product over another.

Risk adverse clients are much more likely to seek an annuity product. Health and individual likelihood of longevity are also key issues where someone with a family history and a medical record that suggests the likelihood of a shorter longevity may not be likely to benefit from acquiring a lifetime annuity.

The age pension in many ways is the ultimate lifetime annuity. The existence of the age pension invariably has a significant impact upon the decisions made by retirees. It is essential that the system encourages consumers to both save for retirement, but also to continue to manage for maximised ongoing income in retirement.

We question the inquiries conclusion that "the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees". We appreciate that the retirement income component of the superannuation system has not had the same level of focus as the accumulation stage since the introduction of the SGC. In our opinion the market has the capacity to meet the needs of consumers, although it is warranted to consider options that might encourage a stronger focus by consumers on retirement income solutions that counter longevity risk and further product development which may be beneficial.

In terms of the options that have been outlined in the Interim Report, we do not support any form of compulsion. Our preferred approach would be the introduction of further policy incentives to encourage people to acquire income stream products. In our view this is income stream products in general, rather than specifically products that help manage longevity risks. We would not support any form of default positions with respect to annuity products. We are also very concerned about solutions that might discourage consumers from getting advice at the time of retirement. Default solutions may work in a manner where people no longer feel they need advice. This would be particularly detrimental as the selection of an income stream product is only one part of retirement planning. Equally important are issues with respect to eligibility for social security benefits, cashflow planning, estate planning issues and aged care scenarios which come in to play for most Australians. It is a complex set of levers and advice is usually extremely beneficial.

Retirement Income Product Development

We support changes to the SIS Act to better enable the introduction of a deferred lifetime annuity into the Australian marketplace. We are less supportive of pooling based products as there could be a high variability in consumer outcomes and this would not be good for public confidence in the retirement incomes system.

We do not support any Government participation in the retirement income system. We believe that the government should focus on the policy settings and the age pension, rather than becoming a participant in the marketplace.

Whilst we believe that a principles-based approach to determining eligibility of retirement income products for tax concessions and their treatment by the age pension means-test would be an ideal outcome, we do anticipate that this might present a range of challenges. We do believe that a higher level of product control with respect to these products is appropriate given the importance of retirement income products to consumers and the overall Australian economy.

We question the proposal with respect to issuing longer dated government bonds, simply to provide support to the development of income stream products. Decisions made around Government funding should be based upon the right outcome for Government funding rather than to assist in the development of financial services products.

Income efficiency as a measure appears to disregard the fact that for some retirees, leaving an inheritance for their children is a primary objective. To exclude any residual benefit seems to result in a fundamental deficiency in this measure.

Reverse Mortgages have been in the Australian marketplace for some time however they appear to be unpopular. This might reflect traditional Australian views about the role of the family home and concerns with the reality that this is a loan product taken out at a time when their income is inadequate. It is our view that Reverse Mortgages are an important product option that is suitable for some client circumstances. It has a role to play, however we do not see any need to introduce any further measures to support greater use of the product. Appropriate financial advice would uncover this as one solution available to a client.

Part 2 – Other Issues

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

1. The Threat of Payroll Tax to Financial Advice Licensees

The application of Payroll tax for self employed advisers within the financial advice industry poses significant financial risk, particularly for the independent licensees.

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 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 (usually as a Pty Ltd entity) and provide services to their own clients. They have their own expenses in running their businesses including premises, insurance, accounting fees and so on. They are their own business and tax entity. The effective commercial arrangement between the adviser and the licensee is that the adviser will pay the licensee either a flat fee for licensee services, or a percentage of their revenue, or a combination of both.

Under FoFA, it is a fundamental requirement that clients are paying for the advice provided to them. The required business model where all advice fees being paid to the adviser must firstly be paid to 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 the revenue paid to them via the licensee will be exempt from payroll tax assessment. This however is subject to some uncertainty including how many employees and the nature of that employment or contracting arrangement.

Where the licensee was required to pay payroll tax on these self-employed advisers, it would be in addition to the GST which is paid for the services provided to clients. The addition of payroll tax on top of the GST is fundamentally inconsistent. It results in double taxation.

Previously in NSW there was an exemption for financial advisers, which was only removed from the state payroll tax legislation as part of cross-state payroll tax harmonisation. The public position at that time was that this change would have no impact upon financial advisers, which in practice appears to have been proven to be incorrect.

Existing examples of where state revenue offices have pursued licensees for payment have included backdating the assessment for up to seven years. Should this continue there will be many licensees where this would be likely to result in the financial collapse of the licensee. Most critically this impact will be the greatest for the non-aligned or independent licensees who do not have an institutional parent to pick up this significant unplanned and retrospective tax assessment. This would result in a further reduction in the independent section of the financial advice marketplace to the detriment of competition and confidence in financial advice.

We would like to see the Financial System Inquiry address this issue as it is likely to have a

fundamental impact upon the provision of financial advice to Australian consumers. We are seeking national action to ensure that self-employed financial advisers and their licensees are exempt from the state based payroll tax regimes and the resultant double taxation consequence.

2. External Dispute Resolution and Professional Indemnity Insurance

Refinements are required in the current compensation arrangements for financial advice to better balance consumer protection, legal liability and fair process.

We note the brief reference in the interim Report to the issue of Compensation Arrangements, External Dispute Resolution (EDR) and Professional Indemnity Insurance. We also note the reference to statistics provided by the Financial Ombudsman Service (FOS) on unpaid claims. We are also aware that the recent Senate Inquiry into ASIC made some recommendations with respect to EDR schemes.

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. Most recently Vero has decided to fully exit this market.

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. Importantly, there is no fee or cost 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. The potential quantum of a claim has now created a considerable imbalance in the EDR process further exacerbated by the complete inability to appeal an outcome.

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 and PI insurers 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, (reported to be in excess of 30%) 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.

3. Mandatory Transfers to MySuper

The Mandatory Transfers to MySuper should be changed from opt-out to opt-in to avoid the prospect of consumer detriment.

As a part of the MySuper legislation as introduced by the former Government in 2012, Trustees of superannuation funds are required to move "Accrued Default Amounts" to MySuper products by 1 July 2017. Accrued Default Amounts relate to members who are in the default investment option. This is likely to involve a very high percentage of members of employer superannuation schemes. There are some very important issues with this legislated requirement that need to be considered:

- Trustees have been given indemnity against action taken by members, which means that superannuation fund members are unprotected in the event of any loss that eventuates as a result of this mandated transfer.
- The transfer may result in members moving to a MySuper product that has a very different allocation to growth assets and therefore quite a different exposure to investment loss or gain.
- The transfer in many cases may result in a fundamental change in insurance arrangements. This could include a significant reduction in the level of cover or changes to terms or premiums. This could mean that a member who has specific insurance needs may lose the entire insurance benefit.
- Whilst members will have the opportunity to opt-out of these transfers, they are unlikely to have an understanding of what will happen or an appreciation of the consequences. There is no requirement to demonstrate the difference in outcome for the member in terms of costs nor benefits. Consumer responses to mail campaigns are invariably very low and inaction would see the transfer take place regardless of detriment to the fund member.

We firmly believe that this mandated requirement should be reviewed and the approach should be changed from an opt-out model to an opt-in model, particularly where members are left exposed by a change in investment profile or insurance arrangements or an increase in fees.

When clients subsequently lose money as a result of a changed investment option or a reduction in insurance cover and they have no capacity to seek compensation then this will have a hugely damaging impact upon consumer confidence in the Australian Superannuation system. No Australian Government should put Australians in a position where they are being exposed to additional risk without their specific consent and where they have no access to claim compensation should a loss result.

4. Corporate Superannuation Advice

Remuneration arrangements for Corporate Superannuation Advice must be reviewed in order to ensure that employers and members can benefit from the valuable services that they provide.

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. 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 advice 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.
- 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 the above factors, we now 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. Superannuation is a particularly important part of the Australian Financial System and employer superannuation is a critical part of this. Employers should have access to the advice they need to make a selection of an employer fund and corporate superannuation advisers should be able to be appropriately paid for the provision of these services.

Conclusion

We thank you for the opportunity to provide feedback on this enquiry. We believe that this review provides the opportunity for important improvements to be identified. We recognise that Australia has a world leading financial system, and appreciate the need to remain at the leading edge.

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

Yours sincerely,

Brad Fox

Chief Executive Officer