<u>Financial System Inquiry</u>

Submission on Interim Report

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In the following paragraphs, I have made some comments and recommendations on the Interim Report to supplement my previous submission to the FSI (attached as Appendix A):

<u>Chapter 6-Consumer Outcomes</u>

<u>A) Conflicts of Interest</u>

I am encouraged by the Inquiry's acknowledgement in the Interim report of the consequences of conflicted remuneration on consumers' ability to access quality advice. Many years in practice as a licensed financial adviser and chartered accountant have demonstrated to me that 'all roads lead to conflicted remuneration'. This is so in both institutionally-owned advisory groups and so-called 'independents' (often called 'aligned' and 'non-aligned').

Unfortunately, the financial services industry spends a great deal of time, with considerable success, denying this conclusion or proposing ineffective solutions to deflect attention from it. The more popular deflection mechanisms used by the industry in recent times include reference to removing the 'bad apples' and the need for adviser higher education, both worthy causes in themselves, but not the solution to reforming the deeply flawed culture and structure that control the industry. This is sometimes referred to as 'structural corruption', a confronting but substantially correct characterisation.

The simple reality is that as soon as conflicted remuneration (and related product selling incentives, budgets, goals, expectations and requirements) are **removed** at all levels in the financial planning/advice industry and are replaced with un-conflicted forms of remuneration (hourly rates, flat/fixed fees), financial advice will become simple, affordable and trusted.

No amount of additional or new disclosures, regulatory restructuring or renaming, adviser higher education, compliance programs or consumer financial literacy courses will solve the problem. There is only one solution to winning the Australian community's trust and it requires acceptance of a conclusion that much of the industry does not want to hear.

In order to reform the industry effectively, my original submission to the FSI (Appendix A) proposed the adoption by all industry participants of a compulsory self/co-regulatory code (under RG183) as the solution to the problem of conflicted (and untrusted) financial advice. I continue to promote that proposal.

The important point here is that the code must be comprehensive. That is, it must not allow advisers to receive conflicted remuneration such as commissions paid by third parties, commissions paid by customers (aka 'asset fees' and misleadingly called 'fees for service'), life insurance commissions and other forms of conflicted payments, incentives and benefits. If the

code is not comprehensive, it will be meaningless. Worse, it will be misleading and damaging to consumers' best interests.

The lack of a comprehensive approach is also what concerns me about the industry's proposal to separate product selling from personal advice (accompanied by legislative reservation of the terms 'financial planner' and 'financial adviser'). This sounds fine in theory. Indeed, in some circumstances, it may have some merit. However, if such a structure were to allow legislatively endorsed financial planners/advisers to continue to receive conflicted payments, such as commissions paid by customers (aka asset fees/'fees for service') and life insurance commissions, it will achieve nothing.

We last saw this structure in action in Australia with the now repealed Insurance (Agents and Brokers) Act 1984. Under that legislation, agents were permitted to receive commissions from product manufacturers, whilst brokers, who were supposed to represent consumers, were not. It was not uncommon for industry participants to be both agents and brokers (different companies, same day), depending on commercial imperatives and customer expectations about 'independence'.

Most brokers charged a percentage-based 'brokerage' ('fee for service') on top of the insurance premium in much the same way as many of today's financial planners/advisers avoid the FOFA ban on commissions paid by third parties by charging a percentage-based asset fee on investments and misleadingly call it a 'fee for service'. This is simply a commission paid by a customer, structured in the same manner as a real estate agent's commission, with the conflicts masked as a professional fee.

The only way in which this approach may have some merit is if both product sellers and personal financial planners/advisers are precluded from receiving any forms of conflicted payments. Of course, if that were the case there may be little point in making the separation in the first place.

I note that various industry participants are currently promoting adviser higher **education** as the solution to the industry's problems. Education is fine in itself to assist in producing technically competent advisers; but we must never allow the industry to use education as a mechanism to divert attention from the real issue of conflicted remuneration. It's certainly desirable to have advisers in the industry with higher technical education and/or a university degree. However, unless this is accompanied by comprehensive remuneration reform, all that technical education will do is to create an industry of highly qualified product sellers.

We only need to look at the numerous examples of mis-selling involving the accounting profession to illustrate this point (e.g., commissions on agri-business funds, and commissions on real estate spruiking in self-managed superannuation funds). Naturally, I would support additional technical education of advisers, but not as a solution to the industry's lack of trust.

Then there is the issue of advisers claiming to be 'independent' and free of conflict by not being owned by institutions. In many cases, these claims are disingenuous. Many of these so-called 'independents' have close commercial associations with platform providers, have their own 'white label' products, charge real estate agent-style commissions (asset fees/'fees for service') and/or receive life insurance commissions. The point here is that in the financial planning/advice industry, 'independent' does not necessarily mean 'independent'.

That is why deconstruction of the institutionally-owned vertically integrated distribution networks is not necessarily the 'silver bullet' that some claim it to be. Even if deconstruction could be done, unless it were done in conjunction with the removal of **all** remuneration conflicts throughout the industry, nothing would change. Arguably, consumers would be worse off through believing something about the industry that simply isn't so.

It follows that a proposal to distinguish institutionally-owned advisers from so-called 'independents' will not necessarily achieve positive outcomes for consumers unless the 'independents' are genuinely 'true to label' on conflicts of interest. This is certainly not so at present.

I have no doubt that the industry will say that what I'm proposing cannot be done (as they have always said before). They will say that it's impractical, idealistic, too expensive, unnecessary, 'the needs of consumer and advisers must be balanced', the problem will be solved with adviser and consumer education, we must endow ASIC with additional powers…..and so and so on. Some of these points have merit, but in the end, they are deflections from what the industry fears most, namely, the comprehensive removal of all forms of conflicted remuneration.

In fact, with commitment and a sincere desire to achieve genuine reform, what I am proposing can be done. There is a small, but growing group of financial planners/advisers who are doing it now. Not all of them are 'independents'. However, all of them are making a professional and commercial success of their trusted and affordable way of offering financial advice to the Australian community. These advisers understand that reforming the industry is not about access to 'affordable advice'. That is simply another deflection mechanism.

True reform lies in access to 'trusted advice'. These advisers understand that once advice is trusted, it immediately becomes affordable for a much greater number of people, simply because it is valued.

Furthermore, once the interests of advisers and consumers are aligned by comprehensively removing all the remuneration conflicts, the need for complex, costly, ineffective box-ticking compliance workarounds is removed. This will further lower the cost of advice, making it even more affordable.

It will also create a much happier, motivated and better qualified professional workforce in the financial planning/advice industry. Counterintuitively, it will lead to a greater flow of funds into product manufacturers through trusted advisers whose clients act willingly on their un-conflicted recommendations.

It will allow the regulator to concentrate on removing the 'bad apples' that remain, rather than spending limited resources on the thankless task of regulating a deeply structurally flawed industry. And it will result in many more consumers who don't currently trust the financial planning/advice industry to seek financial advice with a genuine assurance that the advice will be conflict-free and offered in their 'best interests', irrespective of what the law might say from time to time.

A common justification (perhaps better described as a rationalisation) for not acting as described in this submission is that we should allow the growth of various competing 'business models' in a free market. The point to make here is that the market is not 'free'. It is far from it. It is highly concentrated (and becoming more so) and it is highly regulated (and becoming more so). The solution I have proposed above will encourage free market competition, it will encourage the growth of independent advisers, it will encourage institutions to think carefully about why/whether they should own dealer networks, it will offer genuine choice to consumers based on judgments about the competence of advisers (as trust will be a 'given'), and it will lead to substantial reductions in costly, ineffective regulation of the industry.

B) Underinsurance

The so-called 'underinsurance problem' has been the subject of much industry attention since the GFC. There have been learned papers, media campaigns and conference sessions on the subject, all promoting it as a matter of urgent public importance.

It's no coincidence that 'underinsurance' was used successfully to justify the retention of third party commission payments in the FOFA legislation. The industry's argument has always been that people won't buy life insurance; it must be sold. Putting it another way, people won't pay a reasonable professional fee for life insurance advice. Therefore, given that customers don't know what's good for them, the only option is to embed commission payments into the premium in the hope that they don't notice the significantly inflated price of the product.

The problem with this logic is that third party commissions have been the industry's remuneration of choice for over one hundred years. So why is there an underinsurance problem? Surely, commissions must have worked by now. Could it be that the premiums (with embedded commissions of up to 65%) are too expensive in the first place, or that the public doesn't trust the industry to offer independent advice, or both?

In order to understand why the life insurance industry is structured in the way that it is today and why it staunchly defends the commission status quo, it's instructive to examine some recent history. Throughout the 1980s, an army of evangelical sales agents, often with scant regard for their prospects' circumstances, aggressively sold whole of life insurance policies with promises of healthy tax deductions and capital guaranteed returns. Sales were rewarded with large undisclosed commissions, sometimes as high as 250%.

These were the days of low/no interest Agency Development Loans (ADLs), during which time tens of millions of dollars were loaned to so-called 'big producers' by conservative life insurance companies who were engaged in a commercial war over market share. In most cases, their mutual status and their lack of accountability to shareholders made it possible to engage in practices that would now be viewed as an irresponsible (if not illegal) use of shareholders' funds. The main qualification for an ADL was simple. Sell a lot of whole of life insurance (or even promise to do so); and be the recipient of millions of dollars in loans, many of which were written with such inadequate or no security.

The commercial frenzy ceased when financial markets' deregulation, the 1987 stock market crash, the recession of the early 1990s, the demise of death duties and life insurance tax breaks combined to ensure that whole of life insurance policies were no longer viable. Many of the policy premiums were funded through bank loans which could no longer be repaid. As a result, clients suffered termination penalties (but still owed the bank), agents suffered substantial commission write-backs and insurance companies wondered how to recover the ADLs and their tarnished reputations.

At much the same time, compulsory superannuation commenced, providing for most people a minimum amount of cover and an excuse for not buying any more. The fall of the life insurance agent coincided with the rise of the financial planner. Not wishing to be tainted by the poor image of insurance selling, many former agents reinvented themselves, finding new commercial opportunities in the world of managed investment funds. Life insurance selling was ignored as the disreputable activity of the 'white shoe brigade'.

Thus, the principal cause of any underinsurance in this country lies not so much in a failure by Australians to understand the need; but in inflated premiums and a lack of trust which continue to this day. Many people prefer to assume that their superannuation fund covers them adequately; however, many funds do not. They simply provide a minimum sum insured which is not tailored to a member's individual needs.

The solution to the 'underinsurance' problem lies in removing the embedded conflicted remuneration (commission). This will substantially reduce the cost of insurance while increasing trust in the industry. As a result, the issue will gradually recede. Much of the industry will strongly oppose this solution for the same reasons that it opposes the reform to which I have referred earlier in this submission.

<u>Chapter 4-Superannuation</u>

Contrary to predictions over many decades, the self-managed superannuation fund (SMSF) sector is thriving. So much so that it has almost become an industry in itself. It has spawned its own experts to establish, administer, advise and audit SMSFs.

The sector has even developed its own lobby groups for advisers, members and trustees, together with a cheer squad of spruikers and media promoters. At last count, there were at least six organisations claiming to represent the interests of SMSF advisers and members. Some of the sector's evangelical disciples have even suggested that the 'SMSF specialist' should be recognised as a discrete profession in its own right. This shows admirable enthusiasm, but the quarantining of a relatively small group of (mainly part-time) people whose livelihoods depend on the growth of one segment of a tax-protected industry is a touch over the top.

The danger here is that people will lose sight of the bigger picture and promote the establishment of an SMSF as the solution to every financial planning and wealth creation problem. I suspect that this is already the default position of some advisers, especially members of my own profession (accounting) for whom the prospect of a growing book of annuity income from administration/audit fees and commissions on investment and insurance products is too commercially tempting to ignore.

SMSFs have long been the target of criticism by funds managers, financial planners and industry superannuation funds. Their main concerns are that SMSFs are poorly run, far too conservatively invested and inherently risky. Therefore, the critics argue, it is in the public interest to bring SMSFs under the stringent compliance-based regulations imposed on other sectors of the superannuation industry.

This criticism has far less to do with the public interest, and rather more to do with uncomfortable commercial realities. The real problem for the critics is that the SMSF sector is too successful. Therefore, SMSFs must be brought to heel, preferably by their extinction (most unlikely) or by making them more complex and expensive to run. Recently, a more realistic approach has been offered by certain institutions offering 'if you can't beat them, join them' SMSF establishment, administration and advisory services. That seems to be far more sensible than seeking to extinguish a sector whose imminent demise has been predicted and even demanded since its inception in the 1970s.

The principal reason that consumers favour SMSFs is to get away from what they see as the control of the superannuation industry by the 'big end of town'. This desire by consumers to exercise personal control over their superannuation is a very powerful motive and based on my considerable experience as a practising chartered accountant, needs little encouragement from professional advisers.

As for the critics who disapprovingly point to a lack of government regulation of the SMSF sector, it should be remembered that the original thinking behind SMSFs (in the 1980s with the advent of the Occupational Superannuation Standards Act) was to allow small businesses and individuals to establish, control and invest their own superannuation funds with a minimum of legislative interference and regulation. The view of government at that time was that provided membership of SMSFs was restricted to 'Mum, Dad and the family', the risks of losses and political fallout were minimal.

That conclusion has remained valid until recently. However, with the advent of gearing in SMSFs, previously held positions may well change. Superannuation has always been viewed as a safe harbour in which aspiring retirees could accumulate money without the risk that would otherwise be created by borrowing against the assets in their SMSFs. In fact, this substantially risk-free approach to investment was legislatively codified many years ago. Borrowing (and lending) by SMSF trustees was a serious breach of the law, often leading to loss of tax concessions and substantial fines.

At least that was the case until a previous government decided to sell a major portion of Telstra ('Telstra 2'). Much of the selling activity took place in the form of warrants. All was well until it was suggested that the use of warrants was technically in breach of the law against borrowing by superannuation fund trustees. As a result, the government promptly introduced amendments to the Superannuation Industry (Supervision) Act to allow the use of warrants in these circumstances.

The new law went a lot further than expected, perhaps inadvertently. Surprisingly (and much to the joy of real estate promoters), it opened up the possibility of borrowing by SMSF trustees to purchase direct property investments. Even more surprisingly, the legislation contained no limit to borrowing by trustees, so that theoretically a loan of at least 100% was (and still is) possible; although anecdotal evidence suggests that most loans are limited to 80% of valuation.

Recently, I received an invitation to an industry seminar. In itself, that's not a particularly noteworthy event, except for the subject matter which strongly reminded me of the bad old days of SMSF abuse. The latter day promoters were promoting gearing in SMSFs (including negative gearing), the purchase of 'lifestyle farms' and the use of SMSFs to gain access to working capital for expansion of businesses. Ironically, much of this has become possible thanks to the 'warrant' (SMSF borrowing) legislation referred to above.

No doubt, claims will be made that all of these strategies will be undertaken responsibly and only after receiving carefully considered advice from expert lawyers, accountants and financial advisers. Regrettably, we've heard it all before. In truth, from the mid-1970s and throughout much of the 1980s, most SMSFs were little more than vehicles to achieve tax deductions for practically unlimited contributions which were loaned-back on the same day by a 'round-robin' of cheques between the superannuation fund and the sponsoring employer, thereby effectively creating tax-deductible working capital. Millions of dollars per fund was not uncommon.

All that was required was a 'superannuation fund' and a co-operative bank manager, neither of which were in short supply. Step by step, and in the face of considerable resistance, SMSFs were forced to evolve into legitimate ungeared funds for the accumulation of retirement savings. One piece of legislation and a few plausible spruikers is all it takes to go 'back to the future'.

Recent developments should cause warning bells to go off in the heads of experienced policy makers. Many years of experience have shown that complex arrangements involving SMSFs have great potential to fall apart due to technical incompetence, administrative errors or failures on the part of trustees (and sometimes their advisers) to understand exactly what they've done and the risks involved in those actions.

Should SMSFs once again develop a reputation for pushing the tax and risk boundaries, they will (and should) face a bleak future. That would be a sad result because a highly bureaucratic approach to the sector was never intended.

I accept that my comments on gearing will not be well received by some SMSF supporters and lobbyists, but it is important for the health and stability of the sector that SMSF trustees should avoid the temptation to borrow (as should APRA regulated superannuation funds). As a result, SMSFs will remain as they were intended to be, that is, tax-effective, un-geared, long-term and simple 'safe harbours' for retirement savings. In these circumstances, prospective legislation should be introduced to ban gearing in SMSFs.

25th August 2014

APPENDIX A
INITIAL SUBMISSION TO FINANCIAL SYSTEM INQUIRY

I am a chartered accountant, a financial educator and a former licensed financial adviser of some thirty years' experience. My submission does not attempt to cover all of the Inquiry's Terms of Reference. However, I have noted the following statement in the preamble to the Inquiry's website: **"Recommendations will be made that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users".**

My principal proposition in this submission is that for a significant number of users the system is inefficient, uncompetitive and inflexible. Furthermore, the system does not meet their needs due to its highly conflicted structure. This leads to low public confidence and a lack of trust. My submission includes a recommendation to overcome this shortcoming in the system.

In making my submission and recommendation, I am concentrating on the vast majority of the Australian population who are generally referred to as 'retail' users of the system, rather than larger 'wholesale' users who (generally speaking) are capable of looking after their own financial affairs.

A key conclusion from an analysis of the global financial crisis is that the financial services system was (and still is) substantially driven by conflicts of interest which have embedded a strong culture of product sales. This is inconsistent with the expectations and needs of most users who are seeking advice, not a product. As a result, retail users of the system do not trust it and have little confidence in its ability to meet their needs and best interests.

A number of attempts have been made over the decades to address the problem of trust and confidence through inquiries and subsequent legislation. In recent years, an inquiry was held which resulted in parliament passing legislation in 2012 (Future of Financial Advice/FoFA) which was designed to curtail the excesses of licensed financial planners/advisers, particularly in the area of conflicted remuneration. This law is now subject to proposed amendments which have caused considerable and unprecedented public controversy. Regrettably, this publicity has led to a further lowering of trust and confidence in the financial services system, especially amongst its retail users.

Much of the recent discussion has been about the importance of creating a system which offers access to **affordable** advice. This is a commendable objective. There is no doubt that much cost is created by a system which is burdened with a great deal of complex and ineffective box-ticking regulation, although it must be recognised that much of this regulation has been self-inflicted by the industry's poor behaviour over recent decades. Nevertheless, anything that can sensibly be done to remove red tape and reduce the cost of advice should be supported.

However, users of the system must also be able to access advice that can be **trusted**. This is where existing legislation falls short because governments have never been willing to do what needs to be done to create an **affordable** and **trusted** financial system.

The **affordable** part is easy. There will always be enthusiastic support for that. The hard part is creating a **trusted** system. That's where the financial services industry always pushes back, usually claiming the need for 'balance' with respect to consumer protection. In this context, 'balance' is often code language for not doing anything that would substantially disturb the continuity of conflicted remuneration and the product distribution networks that are sustained by those forms of remuneration. For example, it's important from the industry's point of view that the FoFA definition of 'conflicted remuneration' is **not** comprehensive, so that one form of conflicted remuneration can simply be replaced by another.

As a result of this lack of legislative rigour, the consumer protection measures in the financial services laws are so compromised that the industry can (and does) easily avoid the laws' intentions. This game has been played for decades, resulting in a financial system that is heavily, **but ineffectively**, regulated and in which users have little confidence or trust that their needs will be met.

So the threshold questions in examining the financial system are:

1) Are we are serious about creating an **affordable** and **trusted** system? or
2) Do we just want the problem to go away to be dealt with by future generations?

If the answer to question 1) is "yes", I recommend a solution in which government offers to remove all (not just some) of the complex regulatory red tape in return for the industry adopting a comprehensive self-regulatory code of ethics and conduct in which all forms of conflicted remuneration would be removed (not just some of them). All participants in the financial system would be bound by this code.

Consumers would support this outcome because it would create both an **affordable** and **trusted** system. The regulator should support it because it could then concentrate on the 'rogues' with the assurance that the industry would no longer be structurally flawed.

But would the financial services industry participants support it? They should do so because a comprehensive self-regulation code would remove much of the costly and complex regulation about which the industry complains so loudly. However, many in the industry are likely to oppose a comprehensive self-regulatory code because it would work.

Sadly, much of the industry would prefer a complex, costly and ineffective legislative regime which can be avoided, rather than a cheaper, simpler and effective self-regulatory code; but, of course, they would not admit that publicly for obvious reasons.

Consequently, if the idea of a comprehensive self-regulatory code were to be raised, the industry's reaction is likely to be that it is 'impractical' and 'unworkable'. And if government insisted on such a course of action, the industry would spend much time trying to water down the code before it was adopted, in much the same way that they have lobbied political parties to water-down the FoFA consumer protection legislation in the name of reducing red tape, complexity and cost (when, in truth, that's not the genuine reason behind the lobbying).

I have watched the course of regulatory reform in financial services throughout my career and must sadly conclude that behaviour in the financial system has not substantially improved. There's been a lot of talk, a lot of complex legislation, but very little meaningful action. Successive governments have never had the courage to act comprehensively; such is the power and influence of the industry to resist change through lobbying and access to financial resources way beyond those of people who hold a contrary opinion.

I submit that unless we act comprehensively (preferably by self-regulation) nothing will change. Parliaments of the future will be faced with the same problem that generation after generation of politicians have failed to address and the lack of trust and public confidence in the Australian Financial system will continue.