A SUBMISSION TO

THE INQUIRY INTO FINANCIAL PRODUCTS AND SERVICES IN AUSTRALIA

PRINCIPLE CONCLUSIONS

The fact that all the failures that are part of this Inquiry are second tier is a sign not of systemic failure but of success of the system.

- All recent product failures were reliant on credit availability.
- Other than reliance on credit the products failures had nothing in common;
    - Not all failed products paid high commissions.
    - Not all failed products advertised misleadingly.
    - None of the failed products failed due to poor regulations
- Commissions align the interests of Planners and clients – to say otherwise demonstrates a lack of understanding of economic incentives.

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"Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone."

John Maynard Keynes [1]

[1] As quoted in Moving Forward: Programme for a Participatory Economy (2000) by Michael Albert, p. 128 via http://www.economicshelp.org/blog/economics/quotes-by-john-maynard-keynes/ accessed 6th June 5.15 pm

1.0 EXECUTIVE SUMMARY

The Australian financial services industry in general and the advisory industry in particular had helped a business culture emerge that protected Australians from the worse outcomes of the recent economic downturn.

In the immediate past some product manufacturers designed products that were reliant on the constant flow of credit; some financial advisers undeniably recommended investment strategies rooted in hubris. Overall, however, most of the investing public in Australia were invested in well constructed, diversified investments rooted firmly in key elements of the Australian economy.

Like any crisis, the current downturn in market activity brings opportunity to review how things are done to see if there is a better way to provide Australians with wealth management advice.

The principal conclusions of this submission are;

1. That all the recent product failures were those reliant on continuing credit availability.
2. Other than the above point the failures had nothing in common
    - Not all failures paid high commissions; indeed some failed products did not pay any commissions to financial advisers.
    - Not all failures used advertising misleadingly, indeed some failed products did not advertise direct to the public.
    - None of the failures were due to regulatory failure.
3. Commissions do not present a conflict of interest;
    - As all mainstream products pay the same commission or allow the financial adviser to select the commission. Commission is not a part of the decision making process in choosing products.
    - Ongoing commissions align the interests of clients and advisers – the adviser only does well if the clients succeed.

4. That some regulatory changes would be welcome;

    - The mandated standard of care in the legislation should be reviewed.

5. The licensing regime should be reviewed to increase the number of licensed financial advisers.

6. In most cases it is difficult to know if the failed products were appropriate to the clients as we were not privy to the conversations.

2.0 INTRODUCTION

I would like to begin with a caveat – the views expressed in this submission are mine alone. They do not represent the views of my principal employer; nor of any of my clients past or present. And an apology – it is difficult to capture the full nuance of a fully developed opinion set without neglecting all other obligations and commitments; therefore I have deliberately chosen to present only one stream.

I believe that there has been a societal trend, (I would suggest among all the so-called "Anglo-sphere", but certainly) in Australia of increasing levels of responsibility being given to individuals for their own well-being including their wealth management, including particularly retirement funding. Implicit with the passing on of this responsibility has been the transference of the risks involved with managing these issues; without any consideration by the parties transferring the responsibility (i.e. employers and governments), of the public's capacity to understand financial risks or their ability to manage these risks.

Growth in the community occurs by observing what others do both in a positive and negative manner. Positively – people learn what they should do and negatively - people learn what they should not do. So a natural consequence of a populace learning to manage any skill is some individual people will make mistakes. These individual's mistakes teach the whole populace what not to do. In the specific situation that is the subject of the Inquiry, this skill acquisition will come at a cost of some individual's wealth. A very "Lamarckian" view of the world, I agree but a necessary one. Metaphorically, driven by greed, certain individuals have found the places the wealth accumulating populace should not go. These mistakes, individually, are a tragedy, but paradoxically as a collective, they are normal and beneficial to the populace. If you will, their mistakes point to the places the "investing tribe" should avoid. They are a sign of progress in the Australian population in understanding the financial world. They are like a hot iron to a toddler – by incurring the minor burn to the toddler learns the concept of "hot"; financial failures teach the whole investing community about "harm avoidance".

In addition, my submission makes the case that the economy is a complex and evolving neural network that will naturally experience failures and successes and therefore are to be expected. As with any evolved neural network the failure of a few connections doesn't lead to a complete failure of the system. Therefore, the failures that are part of the Term's of Reference for this Inquiry, (and others) does not indicate that a problem exists but rather the system is working.

I would like to address the Inquiry's points via dividing my submission into three sections;

1. The Regulator.
2. The Industry.
3. Consumers.

Before beginning, I would like to set the tone of my submission.

1. I have not annotated each fact stated. However, I have, referenced the direct quotes in the form of endnotes.
2. I hope that my sincere belief that wealth creation should be available to all sectors of society – and that technology does allow this to occur becomes apparent. Financial Services is the only industry where the best costs less than the worst; and this fact should be used to help all Australians maximise their wealth.

1. I believe that the majority of financial services industry participants have allowed "the few" to dominate the debate on the future of financial services industry. These corporations, associations, and individuals have directed the debate away from what matters and perhaps away from their role in the financial services industry. (I am not, of course, insinuating a conspiracy or some sort of industry complex- merely a coinciding of various group's and corporations' interests. One could say there is "Baptists and bootleggers[2] " alignment of large organisations – institutional and industrial. This has allowed the debate to be skewed towards discussing only the "evil nature of commissions"; without discussing other more important things. Issues like progressing the nature of the advice; raising the national consciousness of people taking personal responsibility for their own wealth creation and protection; the futility of investing for taxation (why spend $1 of capital to save 50c of taxation due?).

[2] It is a light-hearted expression that suggests both bootleggers of alcohol and Baptists would have a similar aim –the prohibition of alcohol. Obviously their motivations were different and there certainly was not any formal associations and certainly without a conspiracy.

3.0 THE REGULATORS

The financial advisory industry has one formal regulator – the Australian Investments & Securities Commission (“ASIC”) and two informal regulators. The two informal regulators are;

1. The Financial Planning Association (“FPA”) - for those industry participants who choose to be member the FPA provides codes of conduct and ethical standards. I do not intend to make any comments about the FPA, as membership is voluntary. Therefore, any strictures or guidance they provide is adhered to voluntarily; and its actions are outside the Government’s ambit.

2. Financial Ombudsman Service (“FOS”) - perhaps little understood is the impact of the external disputes resolution body as a provider of a view of how the industry should behave. I will make no further comments on FOS as it would be outside the terms of reference of this Inquiry

It is not my intention to damn ASIC with faint praise but this section is the briefest in the submission. ASIC are caught too often between;

- Acting in a way that can be described as “too vigilant” and accused of stifling competition in economic boom times.

- Acting in a way that can be described as “not vigilant enough” and accused of not protecting the consumer when products or markets provide unexpected or even unfavourable outcomes when the economic boom times are over.

As a long term industry participant I can say from personal experience, ASIC as an organisation:

- Does occasionally act as if it has a vindictive streak.

- Often are petty in their requirements.

- Are always “box tickers” and,

- They are completed fixated on their own processes.

However on the whole the organisation, and individuals within the organisation, completes a difficult and under appreciated job as well as any interested party should expect. ASIC has done an admirable job in a difficult operating environment. It is my belief more important than ASIC's functions that, the business culture in the Australian financial advisory industry, the industry structures in place provided the investors and the economy as whole a degree of resilience not seen in other countries. This, I think, without any scientific proof, due to three reasons;

1. Our financial industry culture, generally, is less about innovation and more about adaptation of larger economy's developments. So, for example, the mortgage backed securities developed in Australia were made up of the originating institution's best assets not their worst. The higher returns from the higher risk mortgages were not sought by "securitising" merchant banks.

2. The broader financial services industry had the shocks of the "commercial property crisis" at the end of the last century – this did bring home the fact that risky property lending is, well, risky.

3. The participants of the financial advising part of the financial advisory industry are, on the whole, very conservative. Therefore, relatively little of the more innovative product was recommended to clients. Hence the reason some of the high risk investments used a direct to the public distribution model.

3.1 ROLE

ASIC has been tasked with the role of regulating the financial services[3] within a regulatory framework that has not been designed by accident. I do not need to remind this Committee of the history of financial services regulatory inquiries. The Commonwealth went from 1937 until relatively recently without a major inquiry into financial services but since the 1980's there have been three inquiries:

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[3] To quote from their web page. The Australian Securities and Investments Commission Act 2001 requires ASIC to:

Maintain, facilitate, and improve the performance of the financial system and entities in it
Promote confident and informed participation by investors and consumers in the financial system
Administer the law effectively and with minimal procedural requirements
Enforce and give effect to the law
Receive, process and store, efficiently and quickly, information that is given to us
Make information about companies and other bodies available to the public as soon as practicable

1. The Australian Financial System Inquiry, chaired by Sir Keith Campbell handed their report to the Liberal/Country Party government in November 1981.

2. In May 1983, Mr Vic Martin headed a committee to examine the proposals of the Campbell Committee in the light of the Labor government's economic and social objectives.

3. Mr Stan Wallis and his committee held the Financial System Inquiry. The so-called Wallis Committee's report was handed to the then government in March 1997. This latter inquiry was the primary informational support to the current regulatory structure.

None of these inquiries foresaw a prudential regulatory role for ASIC and indeed ASIC has not attempted to provide a prudential oversight. It is not possible to contend with fairness the current structure is ill considered or poorly executed. Yet at every corporate failure, there is am attempt to blame ASIC for poor oversight.

Storm Financial Planning, Lift Capital and Opes Prime all failed due to bad business models that were poorly implemented not poor regulatory oversight. According to popular press reports at the time, ASIC had just completed a review of Storm Financial Planning and found them compliant with their obligations under the governing legislation and the applicable regulations. Having been involved with the purchase of a business that had recently had an ASIC surveillance visit I can assure the Committee that ASIC does not treat this process with scant regard. Indeed the phrase "nit picking" could be applied with much justification. If Storm Financial Planning was in some way not meeting its legal obligations I am very comfortable to assume ASIC would have found it.

ASIC, simply, performs its legislatively mandated tasks with all the effectiveness that the Government should expect. I would not like to say the industry fears ASIC, but certainly the industry is mindful of the consequences and the costs of ASIC becoming involved with your business. And that mindfulness is enough to motivate industry to generally follow ASIC's bidding. It is too distracting and expensive to do otherwise.

3.2 ADEQUACY

Much has been blamed on ASIC about the collapse of Storm Financial Planning, Opes Prime, Lift Capital, and MFS by linking these failures, (and other failures that have occurred since the terms of reference for this Committee's hearings were issued) as if there was some common cause . However, most of this blame has been driven by "fuzzy and misguided thinking" on numerous levels.

Firstly, the industry sectors these companies invested in were vastly different; and they failed for different reasons (but arguably with the same prime cause – faulty business models that were reliant on gearing to increase returns). Opes Prime and Lift Capital simply lied to their source of funds. They did this by allowing selected individuals to exceed a prudent loan to value ratio and hence left their lenders with no protection against falls in the underlying security's value. When Opes and Lift Capital's lenders found out that on aggregate Opes and Lift's loan to value ratio was over a reasonable level the lenders withdrew their credit. Compare this with the high profile financial planning failure - Storm Financial Planning. The reason for this failure was different; Storm's principals were infected with the hubris of believing if something had never happened; it never could. Not the same reason for failure as the two margin lenders.

Secondly, these firms' failure was not related to the regulator's actions or inactions – others actors with similar business models but different licensing regimes[4] also failed; actors with the same regulatory oversight but different business models succeeded. Whilst the failures were all high profile; surely at least in part this high profile was due to the small number of failures? If the regulatory oversight was at fault wouldn't the numbers of failures have been higher? If a regulatory shortfall existed, wouldn't have more people have taken advantage it?

I do not want to exhibit my inherent snobbery – but is a financial planner based in Townsville "going broke" really a symptom of regulatory failure? Are two small non-ADI lenders failing a symptom of regulatory failure? [5]

3.3 SUGGESTIONS

ASIC overall, in my view, fulfils its roles and obligations within any reasonable expectations from the actors impacted by ASIC. The small caveat I place on any comments I make here are, of course, limited by my personal experience and those I acquire second hand. My interaction with ASIC has been via consultative meetings & liaison sessions and via professional interactions with ASIC for routine licensee issues.

ASIC needs to engage more positively with the parties they regulate. I have heard ASIC describe people like myself as "the industry." Whilst I am sure that is a term of endearment, I would like a regulator who is not afraid to be seen as part of the industry and to engage with the industry it oversees. The regulator's officers could visit licensees (with a "how's things?" agenda) and provide guidance as to ASIC's thinking on contentious topics; I would like a regulator with a "key account" structure - with the aim to engage more with the industry. I am not advocating the style of

[4] As well as Storm, the author is aware of a number of Authorised Representatives with the same views. Macquarie Bank gave up their margin lending business; although they had clearly a different model and regulatory structure than the two failed lenders.
[5] I am not ignoring the large personal suffering of their clients in this flippant comment. Their real difficulties are acknowledged.

relationship that existed between HIH and its regulator with the inherent problems and consequences of that style of regulation. Simply a relationship that acknowledges most participants in the industry are prepared to obey the law and are looking for effective and efficient methods of doing just that..

4.0 THE INDUSTRY

Undoubtedly, Australians have a misguided belief that financial businesses "should not collapse" - but they do and they have in the past. A somewhat freakish combination of policy settings and world wide conditions has led to a period that might be called "the great moderation"[6] . This led many industry participants to grossly underestimate the risks inherent in their business model – to the point where they felt confident to use borrowings to increase the returns (and hence the risk) in their business models. Whilst superficially it is easy to link the failures in reality they are mostly unrelated.

The common elements in these failures are;

1. The presence of gearing in the product – either at the level of the investor borrowing money; or where the product design itself involved borrowing money; or worst of all (from a risk point of view) both.

2. The obstruction from plain view of the *real* business model – either deliberately or by the legal structure. Lift Capital and Opes Prime for example allowed (only) certain (favoured high profile or large) borrowers to exceed prudent loan value ratios and to not be subject to margin calls when their holdings fell in value. Facetiously, I make the point that these unique features were not disclosed in the product's PDS. Westpoint allowed monies to be mixed and transferred between projects despite what their offer document stated. As well it could be argued that Westpoint directors had poor project management skills a feature not found in the other failures[7].

3. The acceptance on the "face value" of the product offering by either the consumer or the financial adviser or both. It is true that both investors and financial advisers

The Chairman of ASIC, Mr Tony D'Aloisio, in his speech to the Securities & Derivatives Industry Association said:

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[6] Many markets over the last twenty years have exhibited much reduced volatility when compared with other time periods in history – this has led many to think that the business cycle had been conquered.

[7] 1. Why else did it the financial hardships of falling behind on the underlying projects occur?

"*a significant feature of the collapses which have been part of this wealth destruction has been flawed business models. Flawed in the sense that they could not withstand the downturn.*[8]

It is not true that the common elements in the failures are;

1. The presence of financial advisers in the product distribution;

    a. Some were distributed directly to consumers who purchased products based on the headline rate. (e.g. ACR or Elderslie)

    b. Some of the customers in some of the failures were repeat customers – they had enjoyed the high returns from these promoters or their products for many years[9] .(again ACR, Elderslie or Westpoint)

    c. Some were distributed via unlicensed unqualified persons[10] .(e.g. Elderslie or Westpoint)

    d. Some were distributed via financial advisers for minimal or "acceptable" commission rates. (E.g. Lift Capital). Undoubtedly some were sold on the basis of high commissions. (Storm Financial Planning was an expensive firm & Westpoint paid 10% initial commission.)[11]

2. The use of advertising – whilst there is no doubt many consumers were attracted to the headline interest rate of the products where promoters used newspapers; some of the failures did not use this manner of growing their business. (Lift Capital for example.)

3. Abusing poor regulation. All of these failures were due to poorly executed business models; not to the licensing regimes they operated under. Some were due to the particular market niche of the financial advisory industry they operated within (eg Storm Financial). All were

[8] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/sdia-speech-chairman-May-09.pdf/$file/sdia-speech-chairman-May-09.pdf Accessed 6th June 2009 6.20pm
[9] The author was involved in a consumer complaint about a failed Westpoint product who had invested in 4 previous Westpoint products. The author is unsure why the fifth one was not a reasonable investment when the above market outcomes previously offered were satisfactory
[10] A lot of Westpoint product was sold by under educated mortgage brokers in NSW.
[11] Whilst 10% initial commission is high by financial planning industry standards; it has been suggested to me that it is not that much higher than the total setup costs of mezzanine finance supplied by an investment bank.

brought down by what could be seen as an old fashioned “credit crunch” as they all incorporated some degree of gearing. When funds became unavailable, the businesses could not continue.

4.1 STANDARDS

Whilst on the whole I argue no changes are required, I accept the Committee has a need to be seen to “do something” by the public In that context I ask the Committee to consider making a recommendation to the Government in an area that I believe where the community could reasonably expect improvement without excessive costs. I believe that the standard of care enshrined in the Corporations Act [12] of “reasonable basis” could easily be upgraded to a higher standard than currently applying. This might lead all those involved with giving advice to consider applicable alternative strategies and the choices product providers offer.

There are a number of standard levels being touted and it does seem that this does seem to be a discussion for the lawyers. I would propose a “most reasonable” level of advice may be one wording the Committee may consider recommending. I would suggest that the UK experience where “best advice” created more problems than it solved for the industry without any real benefit to the consumer should be considered.

Financial services are one of the only industries where the best costs <u>less</u> than the inferior does[13]. Still the inferior products get used by the investing public. I don’t believe that there are *systemic* faults in our industry. I would be foolish and a liar if I did not explicitly state that I agree that the quality of advice and products selected in some recent circumstances has not been of a quality that I would wish to be associated with. For

[12] Corporations Act Section 851 says:
An adviser must have reasonable basis for recommendation
(1) A securities adviser who:
(a) makes a securities recommendation to a person who may reasonably be expected to rely on it; and
(b) does not have a reasonable basis for making the recommendation to the person;
contravenes this section.
(2)For the purposes of subsection (1), a securities adviser does not have a reasonable basis for making a securities recommendation to a person unless:
(a) in order to ascertain that the recommendation is appropriate having regard to the information the securities adviser has about the person's investment objectives, financial situation and particular needs, the securities adviser has given such consideration to, and conducted such investigation of, the subject matter of the recommendation as is reasonable in all the circumstances; and
(b) the recommendation is based on that consideration and investigation.

[13] If costs of the market leading Macquarie’s administration service were compared to Australian Wealth Management’s similar product the Committee would be amazed at the difference.

example the advice given by Storm Financial Planning's planners was stupendously wrong. Their understanding of financial markets was woeful; their understanding of retail client's psychology no where near sufficient. Yet they managed to convince a relatively large number of people to pay their fee.

My strident view of the real issue in the industry; across all parts of the value chain is the standard of care owed to the final user of the financial services product needs to be raised. I would prefer that this be achieved by the gradual natural increase in awareness by financial advisers of the consequences of their actions but would accept a legislative change, in this instance, to provide a framework for future evolution. Just as we expect our family doctor to be our advocate and balance the profit motive of large pharma against our need for medicine; we expect our financial planner to be our advocate and balance the risk/return trade offs the investors require with the promises of product providers.

I believe this change would be easy for the industry to adapt to. I need to add the caveat that the professional indemnity insurers would need to agree that this does not prejudice the insurability of financial advisers.

4.2 VALUE FOR MONEY

The real benefit of this Inquiry is it will highlight the issue Australia's investing public needs to face; "is financial advice worth the cost?" The corollary question is: "Does the current industry structure deliver the financial advice required?" There is no benefit to the investor if they agree that financial advice is worth seeking if the quest will be inevitably futile. It is possible that individuals will face disappointment with the outcome of either their quest or the results of their dealings – such is life. The vast majority of investors, in my personal experience, will, however, be satisfied with their outcomes.

The Committee will note that whilst industry superannuation funds have spent vast sums of their member's money highlighting that they don't pay commissions, neither the retail funds nor providers of personal advice have responded in the same way. I can also vouch that it is rare for anyone in the industry to raise the issue of "commission payments" at any forum. I believe that this could be put down to a range of reasons. Among them may be (in the absence of a scientifically constructed study):

1. Most clients do not care about the method of remuneration their financial adviser uses. Most investors care only about the reasonableness of the advice and the demonstrated level of empathy shown by the financial planner to their circumstances.

2. There are many houses in the financial planning mansion. Most industry funds appeal to a different target market than the market segment that is appealing to financial planners. Investors not wanting to pay an ostensible fee can either use an industry based superannuation fund, or a salaried adviser from an institution.

3. Many investors have decided advice is worth paying for.

The current maze of regulations and legislation governing superannuation (for example) meant that financial planners are actually providing a service that is indispensable. Successive governments (of both political persuasions) have built a superannuation system and a Centrelink system that have a complexity that almost mandates the requirement to seek advice. Amongst the salaried technical support people in the industry there is a standard joke that each Federal Budget further cements their indispensability to the financial advising community as another layer of complexity is added to the system; another set of "grandfathering" is added to the rules governing superannuation and Centrelink pensions. I regret the bluntness but if the Government wanted to address the issue of financial planning costs they should simply reduce the difficulties of navigating the elephantine labyrinth that is the ***two*** Income Taxation Assessment Acts.

It is my personal belief that the method of remuneration is, generally, irrelevant – the two real issues that are never debated are the linked issues of the quantum of the fee charged and the subsequent value provided for the fee / commission paid. If the Committee reflects, rationally, at the end of the process whether a client pays by a fee or pays commission the effect on the client's wealth is exactly the same. I agree that some financial advisers (particularly in the past) treat(ed) the trail income as "passive income" and do/did not provide any value for the money they earn – but not the majority and not even the large minority.

If the fee is expressed as a dollar figure or as a percentage of the investments held it doesn't matter – the issue is, surely, simply is the quantum charged disclosed to the client openly and clearly in a manner that can be compared if the potential client wishes to seek alternative prices. If the two parties agree to enter into a contractual relationship and the cost of the advice needs is explicitly agreed upon by the two parties – then the calculation method is surely irrelevant.

I agree that if the two parties cannot agree or are not in a position to be involved with the decision making process then the investor should not pay any commission or fee nor any service should be rendered. (For example an account holder in an employer sponsored superannuation fund). If we agree that the primacy of individual's right to contract is important then the fact that the individual member has no influence on costs levied on their money should be a concern. Further, I agree that some investors prefer an adviser that is remunerated by a fee. For these clients there are plenty of advisers who charge a fee only or who are happy to work on occasion for a fee.

I would say to the Committee that the knowledge problem looms large over any decision to impose a regulated charging regime in the financial advisory industry. The Committee members would be acquainted with Mr F A Hayek's 1945 American Economic Review article.[14] Financial advisers are a fiercely competitive and independent group; product manufactures face a great number of competitors accordingly investors are able to choose from a vast range of options. As well if investors are inclined to there are a number of free, easily accessible web sites that provide competitive pricing and performance results.

I chose the quote on the frontispiece deliberately to draw attention to the basis of western societies' success – it is the collective ability of individuals to freely contract on mutually beneficial terms. I would like to emphasise the sentiment by repeating the famous quote from Adam Smith:

> *….it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.*[15]

I notice that many people; Mr Roger Corbett[16] of Woolworths Ltd fame included, seems to have a view that commissions are a conflict of interest. ASIC insists that AFSL holders record the receipt of commissions as a conflict of interest. Alas, a misunderstanding of the issues causing unproductive work.

One of the pressing issues in finance / economics today is the so called "principal/agency problem". This is where the agent is not acting in the best interest of the principal due to conflicting objectives. I may be contrary or obtuse but I can not agree with Mr Corbett or ASIC – if anything commissions both solve the principal / agency problem and encourage proper behaviour from the financial adviser.

Most financial advisers are conservative caring people – not because they are all modern day St Francis of Assisi. Financial advisers have learnt when the product they have recommended collapses because of larceny by the product promoter or a poor business model they are the only party left to accept all the responsibility for the collapse! If we take the examples of Lift Capital, Westpoint et al – neither ASIC nor the investors have successfully sought recompense or retribution from the product issuers, from the directors or their insurers. None of the promoters of failed products have had to look a client in the eye and say their capital has "evaporated". Planners on the other hand have (rightly) been successfully held accountable and, generally, have expediently paid the penalty of the product failure by:

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[14] Edition XXXV, No. 4. September 1945 pp. 519-30.

[15] B.I, Ch.2, Of the Principle which gives Occasion to the Division of Labour from "An Inquiry into the Nature and Causes of the Wealth of Nations" Quoted from http://www.econlib.org/library/Smith/smWN.html accessed 17/5/2009

[16] Quoted in the Australian Financial Review on Friday 29th May 2009 Page 5 See article attached.

1. At least losing income ;

    a. Clients may leave following a loss of investment capital, immediately reducing an adviser's income.

    b. Following a loss of investment capital clients will cease referring other people in a similar financial situation to them, reducing adviser's potential income.

    c. Clients that lose some of the value of their wealth have a reduced need for financial planner's advice and hence reducing adviser's potential income.

    d. Following a loss of investment capital financial advisers will need to spend their time dealing with the paperwork associated with a client complaint reducing the time available for them to earn an income and hence indirectly reducing their potential income.

2. At worst, possibly, of facing the consequences of ASIC's involvement in an investigation into the product failure. The current situation has made it patently obvious that: ASIC can more expediently apply executive "law" by banning financial advisers from practicing *or* extracting an enforceable undertaking *or* prosecuting non licensed advisers than ASIC can bring judicial action to bear by trying to secure convictions for director's misfeasance.

3. Being directly out of pocket for the professional indemnity insurance excess in the case of a successful claim by the client through the external disputes resolution process or through the court process. The consumer protection offered by the external dispute resolution processes[17] is easier and quicker to access than the judicial system. Most investors who lost money through product failure and chose the external dispute process found a speedy cost effective outcome was achievable.

If a financial planner earns the opportunity to assist a client with their wealth management by either investing well, offering appropriate structural advice [18] or portfolio construction advice then it is in the best interests of the financial adviser to keep that client. If the client wants to be assured that

[17] I would draw the Inquiry's attention to the success and relative monies recovered by investors who lost monies in Westpoint who were able to access Financial Industry Complaints Service/Financial Ombudsman Service.

[18] The most useful and valuable advice a financial planner offers is often that part which relates to the most appropriate tax / legal structure for clients that enables them to arrange their affairs to either minimise their tax payable or to maximise their Centrelink entitlements. This is regretfully a consequence of timid regulatory frameworks and politically driven legislation following special interest group pressures to allow "special cases". If either of the main political parties would remove all the nonsense

the advice is appropriate then they should want the planner to only prosper if they do. The current commission based system delivers both these outcomes. There is no conflict of interest – the principal and the agent both do well.

In the current climate, most financial advisers have been affected twice. Like everyone else, the value of their wealth has fallen in line with markets; but more than their clients the adviser's income has fallen both in line with markets and as a result of the subsequent fall in investor sentiment.

In any sensible review of the methods of economic activity should not be seen to be acting in a vacuum of all the progress in economic theory, pricing theory, and dispersing of knowledge that the last century brought forth.

I would argue that, if the Committee feels the cost of financial advice is too high they can recommend a number of remedial changes;

1. Make recommendations that will act to increase the number of financial planners. For example;

    a. This may be achieved by making changes to the appropriate migrant visa conditions to encourage other country's financial advisers to come to Australia. A qualified resident of a jurisdiction with similar cultural values to Australia, with capital to invest, would be welcome to almost all Australian Financial Services Licence holders.

    b. This may be achieved by encouraging the TAFE institutions in each State to offer courses that meet the necessary standards set by ASIC hence providing an entry path for new financial planners to enter the industry

    c. Introduce a tiered licensing regime with the aim of allowing simple financial advice to be given by a less qualified (and hopefully cheaper) financial adviser. Differential professional designations could apply. Again the aim is to provide an entry pathway for new financial planners.

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regulations and differentiations surrounding superannuation and personal taxation the Government would remove a need for many people to pay for financial planning advice.

2. I could suggest that licensing standards be relaxed – but I appreciate that this not an option the Committee would contemplate. The FPA recently lamented that 7 out of 10 Australians don't receive financial planning advice. This is to be expected given the rationing of expertise caused by licensing. In support of this point I provide a quote made in the context of the American environment[19]

> *Most of the evidence on this issue... suggests that licensing has, at best, a neutral effect on quality and may even harm consumers. By making entry more costly, licensing increases the price of services rendered in the occupations and decreases the number of people employed in them. The result is a "Cadillac effect," in which consumers either purchase the services of high-quality practitioners at a high price or purchase no services at all. Some consumers, therefore, resort to do-it-yourself methods,*

3. As an out of the box suggestion the Committee could recommend the Government simplifies the horrendous amount of regulations and guidelines surrounding superannuation and social security entitlements. This would have four benefits;

    a. Financial planning would undoubtedly be less expensive as less time would be need to be spent on professional development and less time spent on each client.

    b. Financial planning would undoubtedly be more accessible to the public.

    c. Financial planning would be demystified enabling a "DIY" inclined individual to use web based resources.

    d. The Federal Government could save costs in compliance and enforcement.

I would argue that, if the Committee feels the cost of financial advice is too high and they recommend mandated methods of charging;

1. The costs of financial advice would rise as the numbers of financial advisers fall. Not all financial advisers have developed their business skills in a fee-charging environment and those who could not adapt would leave the industry. This trend would be aggravated by the current demographics of the financial advisory industry. The average age of a financial planner is in their 50's and the motivation for change may be low.

2. The number of Australians able to access financial advice would fall for similar reasons.

[19] S. David Young, "Occupational Licensing." The Concise Encyclopaedia of Economics. 1993. Library of Economics and Liberty. Accessed 8 June 2009 http://www.econlib.org/library/Enc1/OccupationalLicensing.html.

4.3 CERTAINTY

At the end of the day the financial services industry is full of entrepreneurs and entrepreneurs want only three things:

1. A certainty of the current rules.
2. The appointed regulator overseeing the rules to act consistently.
3. To be allowed to get on and make money, honestly, within the current rules.

Whatever conclusions and recommendations this inquiry reaches; whatever forms the recent announced review of superannuation takes; even whatever the pre-eminent industry body decides is applicable for its members, will have no material impact on most industry participants' business life. They will adapt to the new rules, make the necessary changes to their business structure, and get on with their business activity. It would be more economically beneficial to every stakeholder if there was certainty. Clients could plan with more certainty, the regulator's task would be easier, and the Government's tax revenue would increase.

A very concrete example of the need for certainty is professional indemnity insurance. Uncertainty leads to the professional indemnity insurers deciding to exit the business of underwriting professional indemnity insurance. Without a healthy professional indemnity industry it is more difficult for financial advisers to get professional indemnity insurance and consequently stay in business[20]. A declining supply of financial advisers will not assist the cost or the availability of financial advice as the supply and demand equilibrium is shifted.

[20] I understand that one Australian underwriter has already stopped offering renewals on their professional indemnity line.

5.0 THE CLIENTS

At the end of the day, despite this Inquiry's lofty intentions, consumers will continue to lose money on investments. It is not possible to legislate or regulate people's greed or gullibility. Immanuel Kant said that it is not possible to make anything straight from the crooked timbers that make up Man (not a view I hold). The quote dramatically illustrates that there will always be someone falsely claiming they know more than everyone else; or are cheaper than everyone else; are cleverer than anyone else or even providing more opportunities to "the public" than anyone else.

There will be evil people always – Governments can not prevent their actions. The supply of people behaving in a gullible fashion does at times seem endless. Governments cannot help them make better decisions by limiting their choices. No central authority possesses all the required knowledge to regulate all transactions at all times.

5.1 NUMERACY

The English language has a word for degree of a person's understanding of numbers – numeracy. We don't need to use the phrase "financial literacy" to describe the understanding of numbers and the way they work. The English language has an appropriate word – numeracy. It is perhaps indicative of the reasons the previous government's campaign to promote "financial literacy" continues to be such a dismal failure; their command of our language was so limited that they were unaware of the right word to use.

At the "societal level", the level of numeracy is low. The decision by respective governments to insist individuals take responsibility for their financial security has collided with a lack of individual understanding of numbers. Regretfully, I would suggest that this applies generally as well as specifically to members of the financial advisory industry.

It is safe to say that most people do not understand the extent of their ignorance about financial matters;

1. The inability to equate risk and return. The ability to understand that volatility of returns is a precursor of returns. The implicit link is simply missed.

2. The inability to equate the high returns offered by fringe borrowers with those offered by mainstream institutions. Most investors believe that the major banks offer low deposit rates from a profit maximising motive. The source of bank's profits is not understood making the fringe operators marketing able to find fertile recipients.

3. The inability for investors to calculate the effect of the adviser's fees and the product charges on their investment portfolio.

4. The ability for investors to understand the consequence of the variability of investment returns on their portfolios.

5. Finally, for investors to understand the disclosures proscribed by the Corporations Act.

Financial advisers aren't immune from the problems associated with poor numeracy to the extent of their industry suffers from ignorance about financial matters it can lead to;

1. The inability to calculate the effect of their fee and the product charges on their client's investment portfolio. To speak of 1% as a service commission as if it is small shows that they are not aware of the fact that it 12.5% of their clients' return.

2. The inability to calculate the effect of 1% as a service commission as it represents 11% of their clients' annual superannuation guarantee contribution.

3. The inability to question the effect of large initial commissions on the performance of their clients' investments.

This is a difficult to remediate issue. This is the reason I am not in favour of changes to the current disclosure regime – not many client reads them let alone understands the impact of the charges; nor to be able to compare them with other charges.

I appreciate that educational authorities already feel that their syllabus is under pressure but simply the only way to address this issue, if the Committee feels that it should be addressed, is to ensure that the mathematics taught at schools incorporates financial mathematics.

5.2 EXPECTATIONS

It has been suggested, based on anecdotal evidence that part of the reason retail consumers were investing in high returning products was that they really didn't have enough capital to retire on; or had an unreasonable expectation of the returns possible. This can only ever be partly resolved as not all people are amenable to being reminded of reality. Nevertheless, what progress is available can only be made reinforcing and improving the level of numeracy of the population. I have heard anecdotally that part of the reason some people invested in these high yielding investments is without the promised return they would be unable to retire at the time they chose, or they had the "Australian morbid dislike "of banks.

Secondly, we need to make it clear that there is no societal guarantee for an individual's choice of investment. Not only will the Government stand behind them but nor will the professional indemnity insurance of the financial adviser in the absence of fraud or malfeasance or incompetence. Currently there seems to be a communal attitude that "I lost money – it someone's fault". If the cost of all failures was borne by the investors at all times a number of behavioural changes may emerge:

- More investors will learn that high return equals high risk.
- More investors will learn to take more care of the choice of their investment concern.
- The long suffering tax payer can stop funding other people's naivety or wishful thinking.
- More product promoters will learn to price risk correctly; investments are like any other product they need to be priced correctly.
- The cost of investment advice should fall as the cost of professional indemnity insurance should fall in price.

5.3 APPROPRIATENESS

The Committee specifically seeks Submissions about the appropriateness of the advice offered to the investors in failed products. The simple truth as we don't know – neither the Committee members nor the author were present when the financial process unfolded.

There is no doubt in hindsight they were not appropriate – they failed! The product structures were in some cases different from their competitors but none had a feature per se that made them inappropriate; so my experienced best guess is that they were appropriate products at the time of purchase. Particularly those product choices the clients made themselves.

Certainly the advice given by Storm Financial Planning to its clients was based on the hubris of the founders; but in hindsight if the margin lenders had not called in the loans the clients would have been less affected than they were.

Whilst I can find nothing professionally redeeming about the principals of Storm Financial Planning I stress that no party has acted with "clean hands". Surely, the clients need to take some responsibility for their actions. I understand that it was Storm's practice to have the client initial each page of their financial plan. I also stress that no party acted with malice – I don't think the principals of Storm really gained from their business plans being thwarted. If it is true that the product providers did act negligence, of course, that would change my opinion of the situation.

6.0 ABOUT THE AUTHOR

Daniel Parry has worked in financial services for 30 years. He has worked in product "manufacture"; product sales, advice delivery and product research. He has been a commissioned agent, a self employed consultant and a senior manager in large and small companies – both public and private.

Currently he runs a national independently owned Australian Financial Services Licence holder with planners on both sides of Australia; and is Responsible Manager at two other much smaller Australian Financial Services Licensees.

He has a Graduate Diploma of Applied Finance and Investments from FINSIA, a Bachelor of Business from Curtin University, a Diploma of Financial Planning & a Diploma of Life Insurance from Deakin University, and a Certificate of Superannuation Management from Macquarie University His favourite qualification is his Certificate of Theology from the Anglican Institute of Theology.