SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE OF INQUIRY INTO FINANCIAL PRODUCTS AND SERVICES IN AUSTRALIA

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I am making this submission to the Committee as a person who has worked in the financial services industry for over thirty years as a superannuation consultant, financial planner and chartered accountant. I offer these views as an individual, not representing the position of any organisation or professional body of which I am a member.

My submission covers a number of the terms of reference, principally numbers 1,2, 3, and 9, although I have touched on others in the course of the submission.

RECOMMENDATION

The principal recommendation of my submission to the Committee is that the only way the Australian community can achieve permanent and meaningful consumer friendly reform in the financial planning industry is by removing the ability of advisers to receive remuneration that is based on the sale of products or the accumulation of funds under management.

I am not referring only to commission arrangements, which two industry bodies are now somewhat unenthusiastically proposing to partly phase out for their members over time. That is a start which should be supported; but it will not work unless accompanied by the removal of other forms of remuneration that act to replicate the poor behaviour caused by commissions.

That is, we must remove asset-based percentage fees for service, production bonuses and other similar models that operate to drive behaviour towards the sale of products and the accumulation of funds under management.

Unless this happens, the industry's product selling culture will not substantially change and the conflicts of interest that are embedded in the collapses into which the Committee is enquiring will continue. Basically, it will be 'business as usual'.

No doubt, submissions will be made to the Committee that the phasing out of commissions will be a big step in the evolution of the industry. Superficially, this is a compelling point, which will be attractive to many people who do not have a deep understanding of how the industry operates 'at the coal face'.

Unfortunately, the reality is that the phasing out of commissions, unless accompanied by wider reform of other similar remuneration arrangements, will simply lead to the replacement of one form of irreconcilable conflict of interest (commissions) with another form of irreconcilable conflict of interest (asset-based percentage fees for service, production bonuses etc).

The Committee will be told that reform of the industry is important in areas such as financial planner educational levels, licensing, disclosure, transparency and consumer financial literacy. All of these are important; but they will not solve the problem. They are not the answer to permanent and meaningful reform. If the Committee's recommendations for reform essentially involve these areas, very little will be achieved.

Similarly, if one of the Committee's recommendations is for the removal of commissions (voluntarily or by legislation), that will be an important change also worthy of support; but it will not solve the problem, because the industry will simply move to other forms of remuneration that drive the behaviour which the Committee is seeking to stop.

In other words, the danger here is that the Committee will be convinced to accept the propositions that the removal of commissions will either solve the problem, or will be a substantial step in the evolution towards solving it. My point is that without concurrent comprehensive reform of all forms of remuneration that drive poor behaviour, the removal of commissions alone will change very little about the way in which the industry operates on a 'day to day' basis.

In other words, the status quo will prevail and the industry will be greatly relieved that the Committee has not 'drilled down' to the core of the problem.

A failure to 'drill down' in order to properly understand the industry's poor behaviour explains why similarly well-intentioned committees of inquiry (in Australia and worldwide) have been unsuccessful in achieving lasting reform. In the end, it just seems 'too hard' (when in fact, it's a very simple problem to solve).

BACKGROUND

History shows that more regulation is unlikely to substantially improve the position of consumers of financial products and services. This does not mean to suggest that legislative reforms are unnecessary or undesirable; however, the community must recognize that regulation cannot force advisers to think ethically. It requires strong moral leadership within the financial services industry, especially by those who claim to offer financial advice to the public.

This involves the acceptance of some unpalatable 'home truths'. It is something that the financial services industry must do voluntarily, lead by individuals who are

concerned about the primacy of the public interest, rather than about protecting the vested interests of funds managers and dealer groups whose commercial imperatives lie in maintaining product distribution networks and the accumulation of funds under management.

Therefore, financial planners, whether they are arranging loans or assisting with clients' wider planning needs, must voluntarily minimise conflicts of interest, thereby putting themselves in a position of demonstrable and genuine trust (not just creating the appearance of it).

Perhaps the current crisis of confidence in the financial services sector might convince industry leaders that the critics may have a point. Here is an opportunity for the industry to comprehensively and dispassionately examine why financial planning as an occupation has failed (on a world wide basis) to achieve the professional recognition that it so strongly desires.

It's time for the industry to stop dismissing its critics as 'anti-advice', ignorant, or promoting vested interests. The truth is that most of the critics are very much pro-advice, so long as the advice is also (first and foremost) independent and pro-consumer.

Regrettably, the harsh reality is that financial planning is an integral part of the financial services industry and of its powerful product distribution networks. Therefore, planners cannot mitigate their personal involvement in the current crisis by suggesting that it was caused by a few 'rogues'. The financial planning industry is part of a seriously flawed system, and must take some responsibility for its reform (either voluntarily or by legislation).

The same fundamental forces that caused the problems in the USA were (and remain) at work in Australia. These forces influence the actions of most planners, to a greater or lesser extent. This point must not be minimized. It explains why the financial planning industry is not accepted as a profession, and never will be until these structurally embedded forces are removed.

Like it or not, the principal force that corrupts advice in the financial planning industry and constantly destroys any attempts by it to achieve lasting professional status, is the industry's predominant remuneration structure that relies on the sale of products and the accumulation of funds under management (be they commissions, percentage fees for service, trails or production bonuses).

The issue is not simply about commissions.

Until this impediment to professionalism is removed, the frustratingly poor image of the industry will remain. No doubt, useful reforms in areas such as disclosure and education will continue; but nothing will change fundamentally until the only issue that really counts is addressed, namely, remuneration.

Defenders of the industry's practices will typically offer the following responses to these criticisms:

a) Consumers should be given a choice about how they pay their advisers;

b) Asset-based percentage fees for service remove conflicts of interest;

c) Consumers should be encouraged to seek advice, and they won't do so if they have to pay hourly rates, retainers or task based fees for service;

d) It is offensive to suggest that financial planners could be improperly influenced by remuneration;

e) The alternative system (hourly rates) is just as bad as commissions and percentage fees for service because lawyers and accountants pad their time sheets;

and

f) Financial planners can't survive on hourly rates.

Putting aside (for the moment) the possibility that consumer-friendly reform might be resisted due to the financial services industry's commercial considerations, here is a brief response to each one of these criticisms:

a) Consumer choice is a superficially attractive point; but in practice, planners (who, after all, are human beings) will generally be conflicted into 'selling' the remuneration arrangement that commercially rewards them the most;

b) Asset-based percentage fees for service remove the temptation to sell high commission products, but they still require a planner to sell a product or accumulate funds under management (whether or not the client needs this). In addition, asset-based fees for service give the appearance of independence, without actually being so. Therefore, in some circumstances they can be more dangerous than commissions, and can even can lead to the derivation of higher levels of remuneration than would be possible via a commission model;

c) Many people don't seek advice, not because they don't want it, but because they don't trust it, and therefore, they don't value it. In addition, most people aren't attractive sales prospects for planners because they have very few assets on which commissions or percentage fees can be levied. Some planners have overcome this impediment to making money by heavily pushing margin loans;

d) Remuneration drives behaviour (an immutable law of business). If that were not so, this debate would not be happening;

e) Some accountants and lawyers do pad timesheets, proving that conflicts of interest exist in all commercial transactions. The trouble with conventional financial planning is that complex and confusing conflicts exist on several levels, not just one. While time-related charging has its problems, at least the client is assured that the adviser is selling advice, not products, and that a third party is not in the mix influencing the outcome; and

f) In order to avoid the possibility of going broke through charging hourly rates, financial planners can replace trails with an (indexed) annual retainer (the quantum of which is unrelated to funds under management). This is not a difficult 'sell' to clients, assuming that enough value-added work has ever been done in order to justify the trailing commissions/fees that are being replaced.

It is interesting to note that while many financial services industry leaders feel that they must be seen to support the public rhetoric, they also accept privately that the only way for financial planners to gain true professional acceptance is to adopt remuneration models that are 'product-free'. The question then is whether planners will ever do so, and whose decision it is to make (the industry's or the government's).

Some time ago, the then Minister for Superannuation and Corporate Law, Senator Nick Sherry, challenged the Australian financial planning industry to propose a structure that would both reduce fees to consumers and effectively deal with conflicts of interest caused by commissions. Initially, the industry's public response was to offer old lines about disclosure, transparency, education and choice, combined with surveys 'proving' that everyone loves their financial planner.

Subsequently, understanding the seriousness of its situation, the industry recommended the phasing out of commissions; however, as pointed out above, this will not work unless accompanied by concurrent comprehensive reform of all remuneration models that drive 'commission-like' behaviour.

THE (VOLUNTARY) SOLUTION TO THE PROBLEM

In order to achieve the position of trust, independence and professionalism that it desires (and the community deserves) the financial planning industry must genuinely accept that all remuneration models are not equal. This process has started with the industry's proposals around the part phasing out of commissions; however, this seems to be more of a defensive move than a genuine acceptance of a new approach to ethical principles.

The industry must adopt a genuinely held position that the only acceptable remuneration models are those that do not require product sales or accumulation of funds under management.

The industry's leadership should then promote that principle strongly and teach financial planners the practicalities of how to make the transition to professionalism.

This self-regulatory action requires no legislation.

This will lead to a position where financial planners are trusted by the public at large; resulting in a much lower level of intrusive regulation, thereby reducing the cost of advice, which will eventually provide many more Australians with access to affordable, independent and trustworthy advisory services.

Unless the financial planning industry is willing to take a proactive position of ethical leadership on this matter, government enquiries, intrusive legislation and uncooperative commentators will continue to fill the vacuum.

That would be a great pity, when the solution is so obvious, so simple, so achievable and so beneficial for consumers and financial planners alike. Consumers will get what they need and deserve; and financial planners will get the independence and professional recognition that they want, but hitherto have been unable to achieve.

If the financial planning industry won't accept the simple solution outlined in this submission (and government is not willing to force the issue), then eventually all the stakeholders will be forced to accept that true professionalism will never be achieved. As a result, the settled position may be some form of 'semi-professional' hybrid occupation, or an unwieldy and confusing two-tiered licensing regime, based on the selling of products combined with limited advice, prescriptive regulation and harsh penalties.

This would not be in the public interest, nor would it be in the long term interests of planners who aspire to professional recognition; but it would be in the commercial interests of fund managers and dealer groups that (directly or indirectly) control nearly all of the financial planning industry.

Most of all, it would be a very poor outcome for consumers.

CONCLUSION

The Committee has an historic opportunity to genuinely reform the financial planning industry, so that consumers know and trust that financial planners are acting in their interests. This will not be achieved by the usual 'workarounds', namely, education, disclosure, transparency licensing reform and consumer financial literacy programs. All of these are important, but they are not the solution.

The Committee must address the real problem outlined in this submission, namely conflicts of interest inherent in all remuneration models that rely on the sale of a product or the accumulation of funds under management.

If it does not, the industry will not change, and the conflict of interest-driven sales culture that controls the industry will simply continue to drive the poor behaviour that is behind the terms of reference of this Inquiry.

These reforms would substantially improve the image, behaviour and practices of financial planners and the institutions that manufacture the products distributed by them. As a result, the 'Armageddon scenarios' that drive much of the industry to aggressively protect the status quo would not come to pass.

In fact, consumers (and many more of them) would be far more inclined to deal with planners and institutions and they would do so with a much greater level of trust and openness. They would also do so at a reasonable cost because the complex compliance-based regulation that currently controls the industry would recede as trust increases.

I would hope that these reforms could be achieved voluntarily; but if the industry will not co-operate, the reforms should be legislated.

RMCB
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