Submission to the
Parliamentary Joint Committee on Corporations and Financial Services'
Inquiry into Financial Products and Services

July 2009

Key points

- The way the financial products and services sector is currently regulated in Australia can be likened to running a stock market without a ban on insider trading.

- There is overwhelming anecdotal evidence that the financial product and services sector is in many cases unable or unwilling to manage the conflicts of interest that may arise if a financial adviser acts as a planner and broker, or as a planner, broker and marketeer.

- This evidence extends across the spectrum of financial advice and products, and includes advice and products provided by superannuation funds.

- An effective and efficient financial products and services sector is of vital importance not only to retirees but also the wider community, who stands to pay for any failings of the sector through increased taxpayer-funded subsidies of the pension-, health and aged care systems if retirement incomes fall short.

- A review of the financial services industry and regulation should be conducted to find ways of separating the planning, brokering and marketing functions to ensure conflicts of interests do not occur or are resolved in an open and transparent way. This review should also look at the possibility of creating a publicly funded generic financial advice service.

- National Seniors is not a priori opposed to commission-based fees. The public debate about fees and charges for financial advice tends to centre on commissions, particularly trailing commissions. While this is understandable as the conflicts of interest arising from commissions are easy to imagine, in focusing so much on commissions, the debate is only about how the price of financial advice is paid, ignoring the far more important question: what is the right price?

- National Seniors suggests that a financial risk labeling system for financial products should be introduced and complemented by a requirement for financial advisers to inform consumers in the simplest of terms possible about the financial risk they are advised to contract into.

About National Seniors

National Seniors is the largest seniors' organisation in Australia with over 280,000 individual members in 175 branches across the country. We are a not-for-profit community organisation with the following objectives:

- to provide economic and social benefits for people 50 years and over;
- to represent our members' views to government at all levels; and
- to make donations and provide service and advice to charitable institutions assisting people 50 years and over.

Our members, who are from metropolitan, regional and rural areas across all states and territories, are broadly representative of the three key ageing cohorts: those aged 50-65; those aged 65-75; and those aged 75 +.

1. Introduction

1.1 Financial advice: state of play

National Seniors' interest in the Inquiry Into Financial Products and Services is a logical consequence of its consumer advocacy in respect of retirement income. The way financial products and services are provided and regulated has the potential to significantly influence the standard of living of retirees and their ability to access the necessities of life, including health- and aged care.

An effective and efficient financial products and services sector is therefore of vital importance not only to retirees but also the wider community, who stands to pay for any failings of the sector through increased taxpayer-funded subsidies of the pension-, health and aged care systems if retirement incomes fall short.

National Seniors understands that this inquiry was prompted by the collapse of Storm Financial, which followed a number of dramatic collapses and loss of retirement savings. However, National Seniors' concerns about the financial products and services sector pre-dates these collapses. It has always been clear that, from a governance perspective, the conflicts of interests in this sector were unresolved and that this was likely to be disadvantaging practically everyone engaged in saving for their retirement and those already retired.

The way the financial products and services sector is regulated in Australia can be likened to running a stock market without a ban on insider trading.

1.2 Financial advice: functional perspective

Financial advice can be divided into three categories:

- Planning -the development and maintenance of formal financial plans;
- Brokering - the implementation of financial plans, essentially a brokering role;
- Marketing - the marketing of financial products, which can only very loosely be described as advice.

There is overwhelming anecdotal evidence that the financial product and services sector is in many cases unable or unwilling to manage the conflicts of interest that may arise if a financial adviser acts as a planner and broker, or as a planner, broker and marketeer. This evidence extends across the spectrum of financial advice and products, and includes advice and products provided by superannuation funds.

In this submission, National Seniors argues for a review of the financial services industry and regulation to find ways of separating the planning, brokering and marketing functions to ensure conflicts of interests do not occur or are resolved in an open and transparent way. Such a review should not shrink from recommending that a financial services provider cannot exercise all three functions if it were considered that one or more conflicts of interest could not be satisfactorily resolved on a systemic basis.

National Seniors also argues that this review should look at the possibility of creating a publicly funded generic financial advice service, as has been done in the United Kingdom.

A review of the financial services industry and regulation would also need to address:

- the independence of financial planners;
- the way fees and charges are applied;
- the way financial planners communicate about financial risk with their clients.

The use of terms such as ‘financial planner’, ‘broker’ and ‘independent’ should be regulated in such a way that the public is able to judge by an adviser’s job title how his advice is likely to stack up in terms of the conflicts of interest described earlier on.

The most effective reform in the area of pricing is a requirement for explicit and informed agreement between consumer and adviser with either full disclosure of payments to the adviser built into the financial product by the product provider or a ban on product provider payments to advisers.

National Seniors is not a priori opposed to commission-based fees. The public debate about fees and charges for financial advice tends to centre on commissions, particularly trailing commissions. While this is understandable as the conflicts of interest arising from commissions are easy to imagine, in focusing so much on commissions, the debate is only about how the price of financial advice is paid, ignoring the far more important question: what is the right price?

National Seniors suggests that a financial risk labeling system for financial products should be introduced and complemented by a requirement for financial advisers to inform consumers in the simplest of terms possible about the financial risk they are advised to contract into.

Finally, the superannuation industry is a dominant part of the financial products and services sector. It should be included in the review of the financial products and services review of industry and regulation.

Specifically, National Seniors suggests that, where super fund members decline to become involved in decision-making about their funds invested, generic investment choices should be made for them by the funds based on factors that commonly influence the composition of financial plans and investment portfolios.

2. Conflicts of interest

Conflicts of interest in the financial advice and services industry include:

- given the choice of investing a client’s money in a product that will generate a higher fee for the adviser or in a product that generates a higher return for the client or carries a more appropriate risk, an adviser may opt for the higher fee;
- an adviser may be limited to the range of products available through a product provider; financial advisers working for the Commonwealth Bank, for example, are unlikely to invest a client’s money in a product not provided by the Commonwealth Bank;
- an adviser may be inclined to expose their client to inappropriate risk by investing excessively in a certain product to maximize the adviser’s fee;
- investment product performance fees may prompt advisers to invest their clients’ money in high-risk investment products where low- or medium risk might be more appropriate.

In an ideal world, there would be a clear commercial separation of planning, brokering and marketing functions. However, separating the planning, brokering and marketing functions in the provision of financial advice is significantly constrained by cost, not only in terms of affordability but also in proportion to the value of equity and the complexity of the people's circumstances.In the less than ideal world we live in, the regulation and/or self-regulation of the financial advice industry must ensure that conflicts arising from incomplete or absent separation of the planning, brokering and marketing functions are managed in such a way that customers come away with positive investment outcomes.

National Seniors suggests that a review similar to the Retail Distribution Review by the UK regulator the Financial Services Authority be conducted in Australia to address the conflicts of interest that beset the financial advice and products industry to the detriment of its customers and the industry itself.

3. Regulatory framework

The financial advice industry needs a regulatory framework that ensures consumers receive clear information on products, services and charges and fees to enable them to make informed choices. The regulatory framework also needs to ensure that consumers can have confidence and trust in the professionalism of the financial advice industry. It is essential that these outcomes be delivered in an environment where fees and charges for all products and services are competitive without threatening the overall commercial viability of the industry.

Three types of advice can be distinguished:

- generic advice;
- specific advice;
- full advice.

National Seniors supports a regulatory model for the provision of financial advice that ensures both financial adviser and customer are aware of the type of advice required based on cost-effectiveness.

4. Generic advice

In Australia, generic, or elementary, non-personalized advice is published by ASIC (http://www.understandingmoney.gov.au/) and also the National Information Centre for Retirement Investment on behalf of the Commonwealth. There are also numerous other sources of such advice.

This type of advice is clearly restricted to the planning function of financial advice provision, although it does not directly result in the development of a plan, the need for a broker or the purchase of a product. Its main benefit is to give people an appreciation that they may need some professional assistance, particularly where the value of the equity to be invested is high or a person's financial circumstances are complex. Typically this type of advice can give people an indication of the level of financial advice they need and where to get it.

A potential problem with this type of advice is that it can be abused to steer consumers towards particular financial products or schemes. Macquarie Bank, for example, runs an information service at http://www.macquarie.com.au/insights/ , which main purpose is to market financial products designed by Macquarie Bank. The webpages for this service do carry a disclaimer, but in small print, and the disclaimer refers to the content presented as “general advice”, when clearly the content is advertising.

There is a strong case for the regulation of publication channels for elementary, non-personalized advice. In this regard, we refer to the Thoresen Review of Generic Financial Advice, March 2008 (http://www.hm-treasury.gov.uk/d/thoresenreview_final.pdf).

The Thoresen Review recommends the introduction into the UK of a free universal Money Guidance Service that is impartial from the Government and the financial services industry and is specifically not a product sales channel. The Review is of particular interest to Australia as the UK has introduced personal (pension) accounts, similar to superannuation accounts in Australia. Given the low complexity of retirement savings for probably the majority of people contributing to super, a service like the Money Guidance Service (which in Australia could build on the good work already being done by and through NICRI, ASIC and the Financial Literacy Board), would mean significant progress in empowering people to take charge of their superannuation savings and their retirement goals and would be likely to promote increased saving for retirement and self-sufficiency in retirement. Anecdotally, there seems to be a huge unsatisfied demand for financial advice, although it may often parade as a fatalistic indifference to financial matters.

National Seniors suggests that a review similar to the Thoresen Review of Generic Financial Advice be part of the wider review of financial advice and products it refers to in section 1 of this submission.

5. Specific advice

Specific advice is elementary advice tailored to people’s individual circumstances, but the level of analysis involved is likely to be almost standardised. It is one step up from generic advice, with a professional financial adviser tailoring generic advice to personal circumstances.

It currently involves the performance of at least the planning and brokering functions by a single financial adviser, but it is very common for all three financial advice functions, viz planning, brokering and marketing, to be performed by a single adviser. It is very likely that, if people were able to obtain cursory financial education through a generic advice vehicle such as a Money Guidance Service, their understanding of specific advice would improve significantly.

Specific advice is the most common form of personalized financial advice and is most commonly provided by organizations with extensive customer service networks nationally or at least at the state/territory level, i.e. banks, building societies and credit unions. Currently, the fees for specific advice tend to be obscured, i.e. incorporated in the price of the financial product people end up buying.

Storm, the organization whose failure prompted this Inquiry into Financial Products and Services, was a relatively small player in the specific advice market. It is very likely that if a service like the Money Guidance Service had been available and widely promoted, less people would have been duped into investing with Storm.

National Seniors suggests that, in relation to specific advice, a review of the financial services in Australia would need to find ways of separating the planning, brokering and marketing functions to ensure conflicts of interests do not occur or are resolved in an

open and transparent way. Such a review should not shrink from recommending that a financial services provider cannot exercise all three functions if it were considered that one or more conflicts of interest could not be satisfactorily be resolved on a systemic basis.

6. Full advice

Full advice is provided following exhaustive analysis and is uniquely tailored to a person's personal circumstances. If specific advice is 'off-the-peg', full advice is 'bespoke'. It is likely to be constantly reviewed. It may not be comprehensive in that it may be limited to a particular set of circumstances or a scenario. It is not clear to us what the current trends are in how this advice is provided (i.e. the extent of commercial separation of the advice functions of planning, brokering and marketing) or what the scale on which this advice is provided.

National Seniors considers that the provision of full advice should be subject to the same constraints regarding the performance of the planning, brokering and marketing functions as specific advice.

7. Focus of reform

We think that it is across all three areas of advice (generic, specific and full) that regulation is in need of review to ensure that the conflicts of interest that beset the financial advice industry in Australia today can be resolved. The least complex and least contentious part of reform would be the establishment of an impartial generic advice service and the regulation of the marketing of financial products not to be framed as 'general advice'. The areas of specific and full advice will be complex and contentious to reform as it will need to address:

- the independence of financial planners;
- the way fees and charges are applied;
- the way financial planners communicate about financial risk with their clients.

8. Independence of planners

The term 'financial planner' currently covers a range of advisers, from university-qualified professionals to salespeople with minimal training in the provision of financial advice. The term 'independent' is also frequently used in the public debate and means, roughly, a financial adviser who has no links to organizations marketing financial products.

We believe that the way in which financial advisers are designated is important.

National Seniors suggests that the use of terms such as 'financial planner', 'broker' and 'independent' should be regulated in such a way that the public is able to judge by an adviser's job title how his advice is likely to stack up in terms of the conflicts of interest described earlier on.

If the public had ready access to an impartial generic financial advice service, they would be able to become familiar with the various regulated job titles and choose their source of specific or full financial advice accordingly.

We acknowledge that such a measure would greatly affect important sections of the financial advice industry, notably banks, building societies and credit unions, which do not employ independent financial planners, as that term is understood in current parlance. National Seniors believes that these institutions can resolve the conflicts of interest that they and their planners currently have by separating the planning function from the brokering and marketing functions, where consumers are given a clear choice once they have seen a planner to go somewhere else for the brokering of the financial products they require to implement their financial plan. A similar functional separation appears to work in publishing, where media outlets are bound to separate their advertising and editorial functions.

Financial institutions would also have the choice not to separate the financial advice functions of planning, brokering and marketing, but they would be unable to refer to the staff providing financial advice as 'independent financial planners' or 'financial planners' if those terms became designations reserved by regulation for financial advisers working in environments where conflicts of interest had been resolved.

9. Fees and charges

The public debate about fees and charges for financial advice tends to centre on commissions, particularly trailing commissions. While this is understandable as the conflicts of interest arising from commissions are easy to imagine, in focusing so much on commissions the debate is only about how the price of financial advice is paid, ignoring the far more important question: what is the right price?

If adviser and planner can agree on a price, the manner in which that price is paid is of secondary importance. In complex transactions, there might be a need for contingency provisions to be built into the pricing agreement and it might well be appropriate for these provisions to make use of proportional fees, such as commissions.

We believe that payments to an adviser are always, directly or indirectly, payments by the consumer.

We would argue that a ban on product provider payments to advisers (rebates) would assist more in removing conflict of interest than a ban on commissions, including trailing commissions.

Full disclosure of product provider payments to the adviser in the context of a negotiated pricing agreement between the adviser and the consumer would put an end to agreements between providers and agreements about payments without any consumer involvement.

National Seniors suggests that the most effective reform in the area of pricing is a requirement for explicit and informed agreement between consumer and adviser with either full disclosure of payments to the adviser built into the financial product by the product provider or a ban on product provider payments to advisers.

10. Communicating financial risk

Anecdotal evidence suggests that the financial risk associated with the implementation of financial plans is poorly communicated to the consumer. It seems fair to assume that in the majority of cases financial advice is sought because consumers lack the financial and investment knowledge to determine their own strategies and draw up their own plans. It follows that, in explaining their advice to consumers, it is pointless for financial advisers to do so in-depth in the majority of cases.

We suggest that the two questions advisers should respond to in respect of each financial product or type of financial product that they recommend are:

- How much does the adviser expect the consumer to make by investing in a particular product or type of product?
- How much could the consumer lose in a worst case scenario?

Formal financial risk labeling for financial products could be introduced, tied in with generic advice services. This could probably cover a majority of, if not all financial products. However, where a package of financial products is proposed, additional explanations of financial risk may be required, particularly where packages containing products with different types of financial risk are concerned.

National Seniors suggests that a financial risk labeling system for financial products should be introduced and complemented by a requirement for financial advisers to inform consumers in the simplest of terms possible about the financial risk they are advised to contract into.

11. Superannuation and financial advice

National Seniors believes that financial planning for members of retail, public service and industry superannuation funds may be inadequate in many cases. Anecdotal evidence suggests that many people approaching retirement and even people already retired remain heavily invested in medium- to high-risk assets through their superannuation fund, when a low-risk emphasis may be more appropriate.

Working Australians can choose the fund in which their Superannuation Guarantee contributions are deposited. Most funds offer various asset mix options in which contributions can be deposited. However, the majority of working Australians allow their contributions to be deposited in default funds selected by their employer and, effectively, in a default asset mix option within the fund.

Given that superannuation is compulsory for working Australians on an almost universal basis and given that superannuation imposes a huge cost in tax expenditure on the community, it seems odd that the regulations governing superannuation do not address the financial advice aspect of what is for most people their most important investment after the owner-occupied home. There is no requirement for people to either elect a risk profile for their superannuation investments or, at least, for the funds to adopt generic risk profiles for their members based on factors that commonly influence the composition of financial plans and investment portfolios. There is also no requirement for members’ risk profiles to be periodically reviewed and adjustments to be made.

While the circumstances in which financial advice is, or should be provided, differs slightly from advice that is provided to consumers outside superannuation, the same principles, outlined above, should apply.

National Seniors suggests that, where super fund members decline to become involved in decision-making about their funds invested, generic investment choices should be made for them by the funds based on factors that commonly influence the composition of financial plans and investment portfolios.