Submission to Senate Committee Inquiry

Into Financial Products and Services in Australia

Personal Background

I have been involved in personal financial services and advice for over 20 years in various capacities, including as:

- a chartered accountant in public practice
- a policy adviser to a major Public Sector Superannuation Scheme
- a salaried financial adviser for an industry superannuation scheme
- a Compliance Manager and General Manager for an independently owned financial services licensee supervising around 15-20 authorised representatives
- for the past 6 years, as principal and owner of my own fee based financial planning practice licensed by an institutionally owned licensee.

I believe this experience, developed through varied roles across the spectrum of the financial services sector, provides me with a broad perspective to bring to this submission.

Outline of this submission

Whilst the terms of reference of the Committee are very broad, I believe they all generally pertain to investigating how the provision of financial products, services and advice can be improved in the wake of recent high profile product and service provider collapses. This submission seeks to provide some thoughts around this core goal.

I have attempted to group my thoughts under some of the particular areas listed in the terms of reference being:

- The role of financial advisors and the general regulatory environment
- The Role played by commission arrangements ….and remuneration models for financial advisors
- the appropriateness of information and advice provided to consumers considering investing in these products
- the adequacy of licensing arrangements for those who sold the products and services

At the end of this submission I have described some potential solutions to the issues I have raised covering:

- minimum standards for quality advice and risk management to be applied to all licensed advisors.
- licensed advisers who are paid primarily (directly or indirectly) by products they should be forced to refer to themselves as product agents – not financial advisors.
- efforts continue to be made to remove inconsistencies in regulations applying to different areas involved in delivering financial products and advice to Consumers.

<u>1. The role of financial advisors and the general regulatory environment</u>

I agree with The Media Release from Bernie Ripoll on 26 February 2009 that "it is important that we learn from recent events and company collapses…". I would add to that statement that it is most important that we learn the right lessons.

The first lesson I would focus on is how many elements of Australia's Financial regulatory system have performed well during the extraordinarily volatile markets that contributed to most of these collapses:

- of the thousands of financial products available in Australia - how few have collapsed?
- of the hundreds of thousands of clients of financial advisers, how many have been well looked after with their investments remaining sound and poised to eventually recover?
- of the many of the people who lost money due to product failures, how many did so after being sold these products directly or through unlicensed advisers rather than through licensed financial advisers?

The overwhelmingly successful navigation of such an extraordinary period by the majority of products and investors would give me pause to think very carefully about any changes proposed to be made to such a generally robust model.

As a personal comment in this respect, I know scores of licensed financial advisers and my personal experience is that the vast, vast majority work hard everyday to provide their clients with the best advice they can in an uncertain world. My experience is that most licensed advisers have by and large done a good job of steering clients away from many of the high profile failures referred to in the terms of reference.

I believe it is vital that this context be recognized and that this review be undertaken with this understanding in mind. I am confident that if the role of licensed financial advisors is considered objectively and dispassionately there will be much more to commend than condemn. On the other hand, I am concerned that if licensed financial advisers are unduly scapegoated, it will drive more people towards direct or unlicensed sources of advice which has proven (and will continue) to be much more damaging to investors.

2. The Role played by commission arrangements ….and remuneration models for financial advisors

Before outlining my views in this area I would like to declare that my business, has since inception, operated on a fee for service basis with all clients in relation to all investment products. We do not take any commissions in respect of investment products (though we do for insurances for a host of reasons that mean this approach delivers the best outcome for clients).

However, whilst we operate on a fee for service basis, my view is that commissions have received much of the attention, yet played a minor role in the problems addressed by this committee. I believe the prominence of commissions in this debate is driven more by various vested interests than by its actual importance to the outcomes received by clients.

2.1 What is a fee and what is a commission

Before discussing this issue it is important to define what we mean by fee versus commission. There are different views on this in the community. My view is that:

- a commission is a payment where the amount is determined by the product provider and where the client has no choice in whether it is paid.
- A fee is an amount that is agreed between the client and the adviser and the client can choose to terminate the fee arrangement if at any time they are not satisfied with the services they are receiving. Fees can be paid directly from the client to the adviser or be collected from the client's investments – as agreed by them.

Some argue that to be a fee, an amount must be determined based on an hourly rate or flat dollar amount. Whereas many fee for service advisers (us included) have as part of their fee structure a % of funds under advice. Whilst we think all are legitimate options, we use % fees for a number of reasons which I will not expand on here. Suffice to say that unlike many who oppose % fees, we have actually asked our clients, if they had the choice, would they prefer us to charge hourly rate, flat dollar or % fees. 100% of respondents opted for % fees.

I believe that whilst discussions about the role of commissions versus fees in the current landscape is appropriate, I do not believe these debates should extend to what fee structure (hourly rate, percentage etc) a business should adopt. These decisions are best left between businesses and their clients.

2.2 Why commissions are not the main problem

Commissions are touted as a key issue because of the conflict of interest they supposedly represent. Specifically, it is argued by some that they lead to advisers recommending inappropriate products to investors in order to receive greater remuneration. These arguments (some summarized below) do not hold water in the real world:

- the vast majority of investment products available to retail investors have virtually identical levels of up-front and ongoing (trail) commissions. The same applies to most insurance products. This is the logical outcome of a competitive market for product manufacturers. The point is that where levels of commissions are the same for the vast majority of products – there is no incentive to use one over the other on the basis of commission levels.

- Industry superannuation funds argue that the fact that most financial advisers do not recommend these funds is evidence of a problem of conflict of interest caused by commissions. I do not agree. As a fee for service adviser, (and formerly a policy adviser to a major Public Sector Superannuation Scheme as well as a salaried financial adviser for an industry superannuation scheme) I rarely use industry funds. This is not because they do not pay commission. It is for numerous reasons including:
    - their service levels are generally sub-standard
    - their investment returns are manipulated and inflated using unlisted assets, smoothing reserves and other crediting rate policies
    - their fees are not transparent – many being deducted before final rates of return are declared
    - they do not support fee for service advice. That is if I wish to service one of their members they will not allow that member to agree to pay me from their fund on an agreed fee basis.
    - For the reasons above, it is virtually impossible for me, as a fee based adviser, to efficiently advise clients in industry funds. The solution to this problem is for industry funds to raise their service, transparency, and flexibility to allow members to seek advice should they wish to receive it.

- Many licensed advisers will have a small number of preferred investment vehicles through which they facilitate the majority of client's investments. Some point to this as evidence of commissions driving product choice. Again – this is rarely the cause. These arrangements are often run on a fee for service basis and do not generally exist because of the influence of commissions. They exist in the same way and for the same reason that a carpenter will generally source their nails and timber from the same small group of proven trusted suppliers, or a dentist will obtain their supplies from the same small group of trusted suppliers. For financial advisers, financial product providers are one of the suppliers they need to implement their advice. Most will stick with a small group of trusted reliable providers that offer the service, options and value they require in order to streamline

their business and enable them to spend more time on the provision of advice to clients. These preferred suppliers exist whether or not commissions are paid.

- There are many other areas of equal or greater conflict of interest in the Australian financial services landscape that have as much potential to lead to inappropriate product selection as commissions which for some reason attract significantly less attention. Consider:

    - The conflict of interest faced by accountants in recommending self managed superannuation funds over other options. If accountants recommend a self managed superannuation solution – they stand to earn fees for the administration work involved. If the client is encouraged to consider other solutions – the accountant will earn nothing. Yet several years ago accountants were granted a legislative carve out from the licensing requirements specifically to allow them to recommend the establishment of self managed funds without the need to hold a financial services license. In other words, legislation was actually altered to *encourage* a direct conflict of interest. Is it a coincidence this period has coincided with a dramatic growth in self managed superannuation funds?

    - Similarly, many large superannuation funds own and operate financial services licensees to provide advice to their members. These advisers' salaries are typically financed from revenue paid by the superannuation fund to the licensee to provide this service. In other words, these advisers are directly remunerated by these funds to recommend these products. What is the likelihood that alternative product solutions will be considered in this environment?

In my own career I can honestly say that:

- the time that my advice has been most constrained and conflicted was when I worked as a salaried adviser for an industry superannuation fund where we had no choice but to recommend the product that we were effectively employed by;
- the time I have been least constrained and conflicted is in my current business where I am licensed by an institutionally owned licensee who provides no monetary incentive for me to use the products of that institution over any other.

The point is that all professionals face conflicts of interest from time to time that need to be managed. In my experience, commissions do not in most cases represent a greater conflict than many others (some described above) to the point that they are a major contributor to the issues at the core of this review. I would contend that of those licensed financial advisers who do receive commissions, most would manage the limited conflicts involved and continue to provide quality advice as well as other professionals do.

2.3 Conflicts of interest that do need to be reviewed

Having argued that most commissions alone are not the main problem behind the events leading to this review, I do believe there are particular practices within the financial services industry that do lead to unfavourable and unnecessary conflict of interest that can and should be reformed.

- Products with unusually large up-front commissions. Some products have been sold with unusually high (up to 10% or more) up-front commissions. These exceptional levels of commission do distort the market and encourage these products to be sold for the wrong reasons. I believe this issue can be dealt with effectively through some of the reforms the industry has already commenced (e.g. recent announcements from the FPA and IFSA) as well as some other proposals in this submission around standards of quality advice.

- Shelf space fees, product overrides, volume bonuses etc etc - there are a range of payments whereby financial advisers or their licensees are paid extra amounts by product manufacturers for increasing levels of clients' funds invested in these vehicles. This is a clear conflict and should be stopped. I see no problem with advisers operating with a suite of preferred products (for the reasons outlined above) – indeed I see this as a necessity to running an efficient business. But the selection of this preferred suite should never be influenced by extra payments from the product providers. Again I am hopeful that the industry is starting the reform process in this area.

- Situations where licensed advisers are remunerated by salaries financed largely from particular products (usually superannuation funds). This is a clear conflict where the licensed adviser's remuneration is ultimately driven first and foremost by their ability to encourage clients to add or retain funds to their effective employers' products.

3. the appropriateness of information and advice provided to consumers considering investing in these products

I believe that the Committee needs to objectively consider the degree of responsibility that Consumers themselves must accept for some of the events being examined.

In periods like this (when markets fall and people lose money) it is usual and useful to look for failures in the system and areas to improve. However, there is a danger in trying to protect consumers, of overlooking or discounting the role they themselves have in the past, and will continue in the future to play. Only by objectively assessing all the elements of the system can the best decisions be made.

I know from personal experience that there is a mountain of information we are required to provide clients about all elements of the strategies we put in place for them – especially with regards to investment risk. I also know that no matter how much information and education we provide, and how much clients confirm that they have understood this, – when markets fall – there is always a percentage of clients who will "re-write history" and advise that in fact they never understood the risk involved and had they done so – would have behaved differently. I do not say this with any bitterness or angst – it is part of human nature and part of life as a professional adviser.

I can also advise that through the years leading up to the collapse of Storm, we had discussions with Storm clients who were referred to us. On each occasion we warned them of the risk that we saw in their strategies and advised that were they to engage us as their adviser we would adopt more conservative strategies. Each one of these clients gave us the same response "thank you – but we will stick with what we are doing because we are making so much money from it".

This history is not provided to belittle the situation faced by many people who have suffered significant losses from the collapse of Storm – or to suggest that all of these investors were so inclined.

It is provided to illuminate the fact that, when it comes to investments, despite the best intentions, education, information and regulation there will always be an element of people who will do foolish things with their own money. To attempt to introduce measures designed to protect this minority from themselves will inevitably fail and will ultimately only lead to unnecessary constraints and restrictions on the remaining majority.

4. the adequacy of licensing arrangements for those who sold the products and services

Unlike commissions, this is the area where I believe the core of the problems (and solutions) stem from – in 2 main areas.

4.1 Quality advice and Risk Management

Virtually all of the damage arising to investors from the collapses referred to in the terms of reference arose from two things: Too Much Gearing and Too Little Diversification.

Whether or not you paid your adviser by fee or commission – too much leverage would have resulted in you losing money over the past 2 years. Similarly – whether you paid a fee or a commission – if you hade 50% of your wealth in a "collapsed mortgage fund" because you felt it was low risk – you would have suffered damaging losses (whereas if you had 5% in such a fund – the losses would have been manageable).

Any investment can fail (witness Lehman Brothers and General Motors recently as two examples that you are never too big to fail). What is more, despite all the research in the world it is impossible to predict and avoid every failure. Investment risk, therefore, can never be eliminated (without also eliminating any real return). But Risk can be managed. It can be managed by ensuring that you only have enough debt so that it is manageable even if markets plummet and income falls. It can be managed by ensuring that you never have so much wealth exposed to any single asset such that if it collapsed – it would cause a material damage to your long term financial security.

Unfortunately – these basic lessons were ignored by many investors in the lead up to the current bear market. They were ignored by many investors who invested directly. They were also, unfortunately, ignored by a minority of licensed advisors whose clients suffered as a result (though I refer back to my original comments that I am confident that many more clients of licensed advisors would have benefited from these sots of risk management practices over the past 2 years).

This is an obvious area where improvements could and should be made. It is not reasonable for clients to expect that licensed advisers can remove investment risk – no-one can. It *is* reasonable for consumers to expect that licensed advisers will adopt reasonable risk management practices.

In order to learn from recent events it is just as beneficial to learn lessons from the practices and institutions that held up well as it is from those that failed. In this respect it is notable that those financial service licensees that had standards of quality advice, covering among other things, sound risk management and investment research have by and large been able to help their clients successfully navigate the recent markets. Had all investors adopted similar practices, many would have avoided the losses now under review.

4.2 Consistent Regulation: a level playing field

There are many inconsistencies in the regulation of financial services. The result of this is that it makes it difficult for Consumers to assess how reliable one source of advice is compared to another. Consider the following:

- Accountants can recommend a self managed superannuation fund without a financial services license
- Real estate agents can recommend clients borrow hundreds of thousands to invest in an investment property without a financials services license
- In a recent ASIC Class Order, Superannuation Trustees were given freedom from standard advice requirements when advising clients on matters such as whether to contribute more to superannuation or switch their investments from lower to higher risks
- Fees for accounting advice are tax-deductible, initial fees for licensed financial planning fees are not (yet if you charge by commissions – they may be – an incentive against operating on a fee for service basis!)

5 Potential Reforms and Solutions

I believe that a financial services system that consumers can feel confident in is vital if Australians as a whole are to successfully provide for their lifestyles over coming generations.

I also believe that the fundamental components of such are system are in place. Whilst some improvements can always be made, the quality of investment products and investment advice in Australia is already the envy of the world.

Given this background I believe reforms need to be carefully considered to ensure they improve confidence and outcomes for consumers without unnecessarily impacting those elements that are already working well.

I do not propose to offer detailed policy solutions as there are others with more time and expertise to devote to this task than me.

What I have done is list those areas where I believe reforms should focus (for the reasons previously outlined in this submission). It is my hope that if the Committee focuses on the right problems – they will be able to find the right solutions.

I believe reforms should focus on:

(i) Working within existing frameworks and institutions to develop minimum standards for quality advice and risk management to be adopted by all licensed advisors.
  - These would need to be clear enough to provide meaningful protection against the worst mistakes / abuses but be broad enough to allow individual advisers and clients to develop strategies that work best for them. The worst scenario would be to try to develop a detailed code of conduct of what is good advice and what is not. Everyone's situation is different and the world is too complicated for such an approach.
  - These standards would not be designed as an aspiration to a defined standard of "good" advice (this is too individual to define). They would be a minimum floor to protect against indisputably poor advice.
  - As well as standards of advice, these standards could also potentially cover increased minimum standards of education and experience for licensed advisers (though efforts by the FPA over recent years have already considerably raised these for much of the profession).
  - In the same way that licensees are required to be a member of a dispute resolution scheme, it may be possible that licensees are required to be members of some industry body charged with the responsibility of setting and reviewing these standards. Alternatively they could be developed through existing professional bodies like IFSA and the FPA.

(ii) Licensed advisers who are paid directly (via commissions) or indirectly (from salaries from superannuation funds or via volume bonuses or product overrides) by products they recommend should be forced to refer to themselves as product agents – not financial advisors. Only those advisors whose remuneration is primarily derived from fees agreed between them and their clients should be enabled to refer to themselves as licensed financial advisers.

- This approach recognizes that it may be impossible or undesirable to regulate to cover all the different forms by which products may wish to remunerate people to promote their products. However, it should be possible to clearly distinguish and educate the public to know when they are dealing with a product salesperson (whose job is to sell product and who may use advice to do that) versus when they are dealing with a professional adviser (whose job is to deliver advice and who simply uses products to implement it.)
- Care would need to be taken to define some materiality levels (e.g. many fee for service advisers may still receive a small amount of commissions from some clients on old products where commissions are automatically paid) and to consider life insurance as a special case. For reasons beyond the scope of this submission – I believe that at present and for the foreseeable future even as a fee for service adviser, remuneration by way of commission is preferable to the client when it comes to life insurance. This may be able to be addressed by adopting industry standard ranges of appropriate commissions for life insurance products – so that there is no material financial basis to choose one insurance product over another because it pays a higher commission.

(iii) Efforts continue to be made to remove inconsistencies in regulations applying to those people involved in delivering financial products and advice to Consumers. A level playing field is best for Consumers and the industry.

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