Institute of Actuaries of Australia

31 July 2009

Dr Shona Batge
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
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Dear Dr Batge

Inquiry into Financial Products and Services

This submission is made for and on behalf of The Institute of Actuaries of Australia (the Institute). The Institute is the sole professional body for actuaries in Australia.

Many actuaries work in the financial services sector where they produce practical solutions to problems involving risk and finance and the impact of uncertain future events on assets, liabilities and cash flows.

The Institute commends the committee for conducting the present Inquiry and thanks it for the invitation to provide views on issues raised by the terms of reference.

We have focused our submission on those areas where we believe we have most to contribute, in particular points 3, 6 and 7 of the Inquiry's terms of reference. Our submission makes four recommendations, namely:

1) A well structured 'Personal Stress Test' be required as an integral part of the purchase of financial products when certain threshold circumstances arise. This Personal Stress Test would measure the possible consequences on a person's whole financial arrangements, both balance sheet and income, of realistic adverse events.

2) Recognising that consumers can suffer a catastrophic loss when a structured product fails, we recommend that specific structured products be sold on a restrictive basis only. In particular, we believe they should be restricted to certain classes of sophisticated investor, through advisers with special qualifications and after some form of prudential scrutiny of the issuer.

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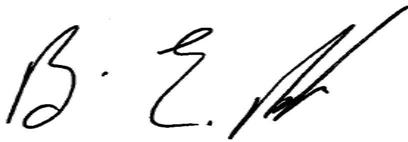
3) We recommend the use of the word "Guarantee" be limited where it may cause significant misunderstanding. As a minimum, disclosure should be required as to the nature and extent of the guarantee and by whom it is provided.

4) The remuneration the financial planner receives for providing advice should be separate to remuneration for selling products and remuneration for providing advice should not have a commission component.

The Institute would be pleased to discuss the views and recommendations expressed below. Please do not hesitate to contact Barry Rafe Vice President of the institute of Actuaries of Australia on email at julia.purves@actuaries.asn.au or telephone (02) 9233 3466.

Yours sincerely



Barry Rafe

Vice President

1. Executive Summary

The terms of reference for the Inquiry cover a wide spectrum of activities. We have chosen to focus our submission on improvements that could be made to the standards of disclosure of risk and financial planner remuneration. Most of our submission addresses points 3, 6 and 7 of the Inquiry's terms of reference.

Effectively communicating how much financial risk an investment strategy involves can be challenging. It is particularly important to do so, however, when recommended financial strategies have the potential for significant adverse outcomes for customers.

Our view is that the significant adverse outcomes experienced by customers of some financial products and strategies can be attributed to two causes:-

- Failure to appreciate the significant adverse outcomes to which they were exposed, either because they were not advised, were unable to appreciate the significance of the risk, or chose to ignore the downside and focus on the potential upside,
- Absence of a standard minimum practice with regard to the provision of advice covering potential adverse outcomes, which in turn has limited the ability of regulators to effectively identify and police practices where advice requirements are not adequately fulfilled.

The main recommendation is that a well structured 'Personal Stress Test' (PST) be required as an integral part of the purchase of financial products when certain threshold circumstances arise. The test would reflect the consumer's personal financial position and present the financial outcome arising from the proposed financial strategy under certain realistic historically based adverse events. The test only makes sense when looking at all the circumstances of a client. As such it is applicable to the advice, not the product disclosure process.

Financial planners play an important role in Australia advising customers on financial strategies and needs. Arguably not enough Australians receive the advice they need, so it is important that any changes made to the regime are practical and do not place an undue extra burden of compliance cost on advisers. Many advisers already do a very good job communicating risk to customers. The PST proposal is intended to be practical to apply. The PST would use information an adviser should already have and would be required only when certain threshold circumstances arose.

We also make recommendations on two further matters:-

- Product specific risks and what could be done about these (relating to point 5 of the Inquiry's terms of reference). We are referring here to structured products and products that claim a "Guarantee"

- Inappropriate remuneration structures of financial planners (relating to point 3 of the Inquiry's terms of reference)

The introduction of the PST requirement cannot stop inappropriate advice nor can it stop customers ignoring, or failing to act upon, appropriate advice. It can, however, provide a minimum standard for disclosure of financial risk and enhance financial risk understanding. Further, adoption of such a test would assist regulators in policing inappropriate advice, by equipping them with a disclosure tool to identify if an adviser systematically advises customers to use higher risk strategies.

Part 3 and Appendix 2 illustrate important components of a PST framework. The framework would need to be defined further before it could be implemented in practice. The Institute would welcome the opportunity to discuss this submission with the Inquiry and how we could help to implement this framework in practice.

2. Background to the Issue

It is human nature to focus on the potential for positive financial outcomes and to give insufficient weight to the likelihood of things going wrong. While this fact is recognised in the current regulatory framework, risks can still be hard to describe, which makes quality advice important.

It is the Institute's view that a number of the recent collapses of financial products and services providers, and the associated losses to consumers, have common themes, including:-

i) the financial strategies followed had the potential to have significant adverse outcomes for consumers;

ii) significant potential adverse outcomes were not consistently well communicated or understood by consumers; and

iii) the most significant adverse outcomes resulted from financial strategies that often had similar risks.

During our research for this submission we found a disturbing recurrence of the types of risks that get customers into trouble. In particular, high levels of gearing or leverage in the strategy, too much invested in single assets (concentration), and investments in products which require further (sometimes ongoing) cash flow for their continuing survival. (Refer to Appendix 1 for a discussion on gearing and concentration and section 4 for a response to products requiring further cash flow.)

Therefore, we seek to improve the effective communication and understanding of downside risk, particularly where higher risk financial strategies are used.

Many, if not most, financial advisers already do this well. However, as recent events such as the collapse of Storm Financial have shown, a proportion of clients still end up adopting a financial strategy that, on any objective test, is inappropriate and involves an excessive level of risk, given their circumstances.

While many of the problems that occurred relate to particular product offerings, it must be recognised that the same problems could have occurred by the use of two or more products in combination e.g. a managed fund investment funded by a mortgage on a customer's primary residence. Any response must therefore consider the customer's complete circumstance which can only be addressed via the advice process.

It is already a mandatory regulatory requirement that financial advisers take into account their client's personal circumstances and provide advice on the risks associated with the financial plan they recommend. The current legislation specifies when additional consideration is required and the factors that need to be taken into account. However, it does not specify how the risks are to be communicated. For example, the ASIC Regulatory Guide 175, Licensing: Financial product advisers – Conduct and disclosure - Appendix F, states that:

"More extensive client inquiries are likely to be necessary where the potential negative impact on the client is likely to be relatively serious if the advice is inappropriate (and the client acts on the advice)".

Effectively communicating how much risk an activity involves can be challenging even for professional risk managers. Witness the fallout in many financial services institutions across the globe during the Global Financial Crisis (GFC) ie institutions in which understanding and mitigating financial risk were supposed to be core parts of their business. In that context, the lack of any prescriptive standards for disclosure either in legislation or in financial planning associations' own professional standards mean that standards of risk advice must, inevitably, vary substantially across the advice industry.

The lack of such standards also makes it difficult for regulators to police whether or not current requirements are being met.

Therefore we would seek a minimum prescribed mandatory standard disclosure in circumstances where financial strategies may lead to significant risk

3. Recommendation 1 – Introduce a Mandatory Personal Stress Test Disclosure

Stress testing is an accepted and proven risk management communication tool. It works by presenting the outcomes for a business after assuming a set of potential (often adverse) events have occurred. It can equally be applied to personal financial arrangements. Many financial planners already adopt a process of scenario analysis or stress testing when advising individual clients. The Institute's proposal is that this current "best practice" be required as mandatory practice for all financial planners.

A prescribed Personal Stress Test would provide customers with a simple objective measure of adverse outcomes as relevant to their individual circumstances. The adoption of standard assumptions and trigger events will ensure that the test will not be onerous for advisers.

The Institute believes that a Personal Stress Test would be a more effective means of communicating the risk associated with significant adverse outcomes. This Personal Stress Test would measure the possible consequences on a person's whole financial arrangements, both balance sheet and income, of realistic adverse events. The Personal Stress Test would have the following features:

i) ***Standard format*** – It should have an industry-wide standard format so that quality communication/disclosure can be provided on a consistent basis;

ii) ***Disclosure*** – Disclosure should be simple, prominent and acknowledged by customers;

iii) ***Output*** – Would show the potential impact on customer's wealth and income/outgo following the stress scenarios. This would finish with some key questions:- e.g. If this happened what would it mean for you? Could you recover? Lifestyle changes? – future savings needs? etc.

iv) ***Escalation and Second Opinion*** – Where the Personal Stress Test suggested a significant adverse outcome, a second opinion on the advice should be recommended to the consumer.

v) ***Prescription*** – Assumptions should be prescribed and linked to real events (e.g. stock market falls in 1987 and 2008/09;

vi) ***Minimum threshold and trigger events*** – It should only be required when certain levels or trigger conditions are reached which indicate the potential for high risk strategies, for example high gearing use or high asset concentration levels;

vii) ***Implementation means*** – it can be implemented either through ASIC regulation and / or financial planning associations. If it is implemented through financial planning associations, there is a need for these associations to establish minimum association rules, standards, and/or disciplinary procedures;

viii) ***Implementation vehicle*** – ASIC could have a standard Personal Stress Test program on its website that anyone could use. Alternatively or in addition, the Personal Stress Test should be able to be added as an additional module to the major financial planning projection programs:

ix) ***Be customer specific*** – The Personal Stress Test and trigger events must be considered for the customers as a whole and are therefore an advice requirement rather than a product PDS requirement. *For example, from the point of view of risk, there is no difference between bundled arrangements such as margin loans (where the borrowing and investments are usually arranged by the same adviser) and unbundled arrangements where a consumer takes out a loan and independently uses the money borrowed to invest in an unrelated asset. Both consumers are subject to the risks associated with gearing;*

Benefits of the Personal Stress Test

For the Customer:-

- Less likely to receive advice recommending inappropriate high risk strategies
- Alert them to what might go wrong that might previously have been avoided or not understood
- Fosters and promotes a discussion with the adviser about what outcomes the strategy may provide and whether the customer can handle that outcome
- Encourage the customer to obtain a second opinion if a financial strategy is going to be implemented that has a potential catastrophic outcome for the customer

For Advisers:-

- Provide financial advisers with an objective tool to demonstrate the potential catastrophic risks thereby improving the quality of their advice
- Further demonstrates to the client why advice is important as it provides highlights what could go wrong if they did not get advice ;
- Enhance the reputation of financial advisers as a whole by reducing instances of bad advice.
- Provide some legal/moral protection for advisers who will be able to demonstrate that they have disclosed and illustrated potential catastrophic risks to their clients.

For Regulators:-

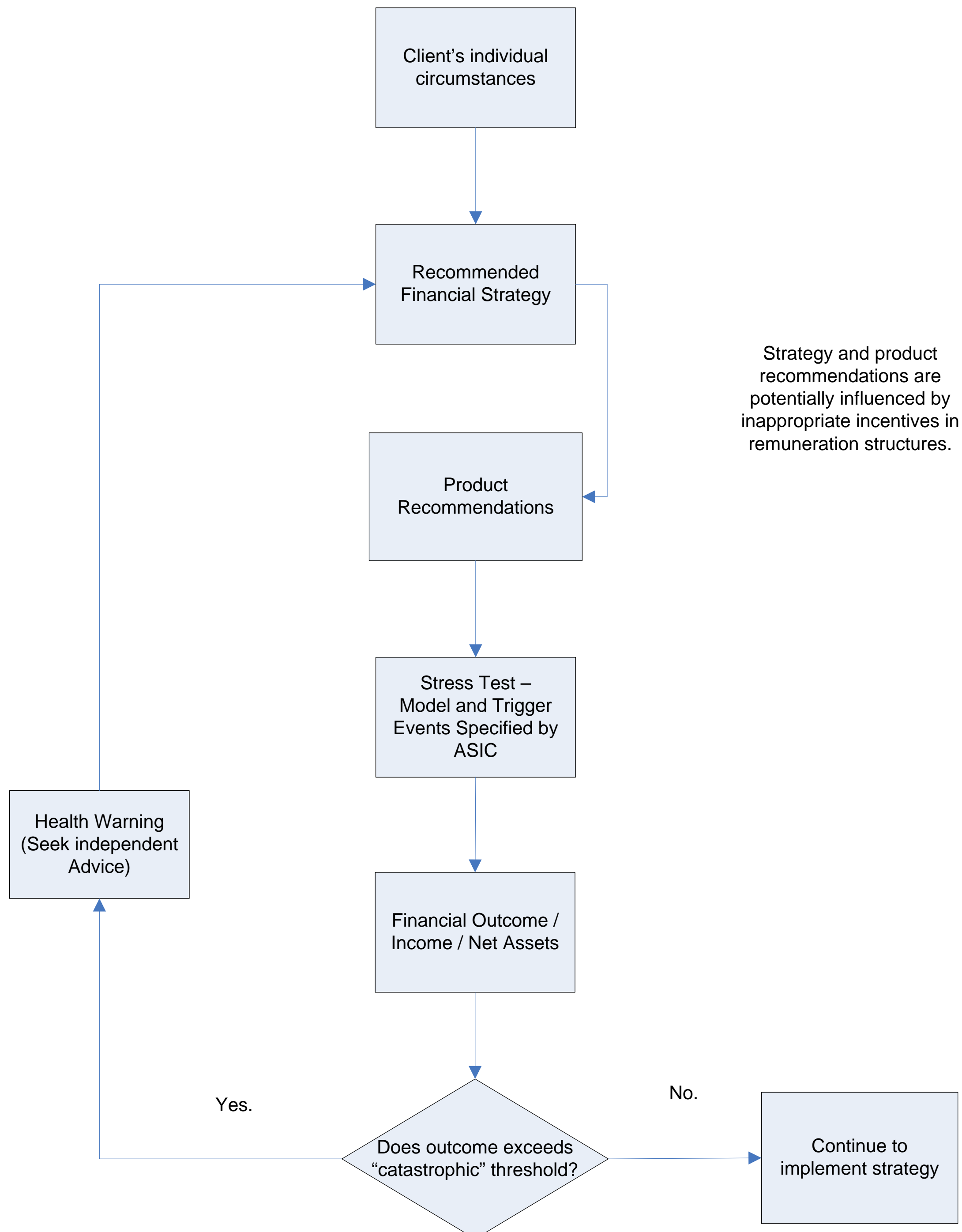
- Ensure a high level of compliance because it would be mandatory;
- Allow ASIC to vary parameters to suit the financial environment (e.g. require the test to assume a bigger fall in share prices if the market is believed to be

overheated or a larger rise in borrowing costs if interest rates are perceived to be significantly below the long term average);

- Enhance ASIC's ability to review compliance with the risk disclosure requirements;

Appendix 2 illustrates the form the Personal Stress Test could take.

The following schematic shows how this advice model would work:



It is our expectation that this process would lead to:-

(i) Less likelihood of higher risk strategies being recommended

(ii) More informed dialogue about potential adverse outcomes and whether the customer can handle it using the results of the stress test

(iii) Low number of cases requiring a second opinion.

Recommendation 1

We recommend that a Mandatory Personal Stress Test Disclosure be introduced.

4. Product Specific Issues

The main part of this submission (sections 2, 3 and 5) has focused on the need to address the issues through the advice process because they relate to the circumstances of the customer and the entire financial strategy. In this section we comment on a few issues which are specific to individual products.

Product Failure

Consumers can suffer a catastrophic loss when a structured product fails. Many structured products are effectively unsecured liabilities of the issuer exposing customers to counter party risk. Contrast this with managed funds where the assets are segregated from the issuer. The investor is therefore dependent on the solvency of the issuer which is often difficult for the investor or adviser to assess.

Recommendation 2

We recommend that specific structured products be sold on a restrictive basis. The restrictions might involve:-

- **Only to investors who can demonstrate some financial qualifications (e.g. wholesale investors)**
- **Only through advisers with specialist qualifications**
- **Only following some form of prudential scrutiny of the issuer**

One particular risk present in the agribusiness investments is that the model requires further funds from existing or new investors to finance ongoing maintenance work on the properties. Failure to realise this funding ultimately leads to the destruction of value of the crop. This is one example of where prudential scrutiny could assist. These schemes should be required to demonstrate the impact on the business of a failure to secure further funding.

Restricted use of the term "Guarantee"

This term provides a level of comfort to investors which may be misleading.

Recommendation 3

We recommend the use of the word "Guarantee" be limited where it may cause significant misunderstanding. As a minimum, disclosure should be required as to the nature and extent of the guarantee and by whom it is provided.

5. Financial Planning

We support the view that commissions provide an incentive for financial planners to provide advice that is conflicted and not necessarily in the best interests of the client.

There have been some important recent developments relating to financial planner remuneration which we support. In particular, we support the notion that all advice fees should be negotiated with and paid by the clients, they should be clearly disclosed and they should be presented in a form that the client understands.

It should be recognised, however, that there is significant asymmetry of information between the financial planner and their client. Clients find it difficult to measure the value and quality of the advice, other than by seeking a second opinion which is often impractical and costly, and could in fact lead to further confusion where different strategies are proposed. The quality of the advice is also necessarily only realised and therefore measurable in the future.

Fee transparency alone does not, therefore, achieve the degree of customer protection that it would in an environment where the customer can easily compare value, quality of advice and fees. The financial planner leverages their authority in investment planning matters and this drives client decision making. The remuneration structure therefore needs to lead to outcomes that are demonstrably in the client's best interests. Our observation is that commissions can bias the adviser against the client. Whilst these commissions may be suitable from a tax or convenience basis, over the long term we believe that remuneration structures for investment and product advisers need to change so that clients directly remunerate the adviser for providing advice.

Further, any business model where financial advisers are rewarded by volume of sales or similar (whether through upfront commissions paid by the product providers, fees paid by the client based on total funds invested or otherwise) provide an incentive to give advice that may not be in the best interests of the customers. While upfront commissions are one form of remuneration that can provide an inappropriate incentive, there are others, such as fees charged on the total amount invested (which encourages borrowing and discourages what might otherwise be sensible actions such as paying off a mortgage), volume bonuses and entitlement to attend conferences in attractive locations.

Remuneration structures that provide financial advisers with an incentive to recommend one strategy over another or one product over another can lead to inappropriate advice on the choices of strategy or product. Note that any remuneration structure that generates fees or commissions for advisers based on gross assets (i.e. inflated by any borrowing) also provides inappropriate incentives.

There are a number of other observations on the financial planning industry that we would make.

It appears to us that there are two discrete functions involved in financial planning namely:

1. providing financial advice, and
2. promoting and selling various products or platforms.

As already discussed with remuneration we believe that it is currently unclear what role authorised representatives are performing. An option may be to limit the term 'financial planner' to those who are genuinely engaged in the provision of advice. In addition we believe that the professionalism of financial planners needs to be strengthened. It has been our experience that the law alone is often not enough to promote ethical behaviour. An option may be to require financial planners join a professional association and to have the need for fiduciary responsibility embedded in the term 'financial planner'.

Recommendation 4

Whilst there may be short term implementation issues we believe that, over the longer term, the remuneration the financial planner receives for providing advice should be separate to remuneration for selling products and remuneration for providing advice should not have a commission component.

APPENDICES

Appendix 1 - Strategies potentially giving rise to "catastrophe" risk

There are a number of investment strategies that potentially expose consumers to significant risk. The two such strategies which are included in the focus of this submission are described below:

i) Gearing Risk or Leverage

Gearing put simply, involves borrowing money to invest. Inappropriate levels of gearing appear to have been the main reason for the devastating financial losses suffered by many of the clients of Storm Financial. Both inappropriate levels of gearing and, in some cases, lack of adequate diversification appear to have been major issues in the case of Opes Prime's clients (although legal issue around title of the shares was also an issue).

Gearing increases the potential gain for a given level of investment if performance is favourable. However, it also leads to higher losses where investment performance is unfavourable.

EXAMPLE 1 - GEARING

A consumer who has $100,000 and invests it in the share market makes $20,000 if the market increases by 20% and loses $20,000 if the market falls by a similar percentage, leaving a portfolio value of $80,000.

If the consumer borrows another $200,000 and invests in the share market, the total portfolio of shares will initially be worth $300,000. The net value of the investment after deduction of the $200,000 loan will be $100,000 as above. In this geared example, the consumer will make $60,000 if the market increases by 20%. However, if the market falls by 20%, he or she stands to lose $60,000 (i.e. three times the ungeared example), leaving a portfolio value of $40,000. A fall in the share market of 33.3% would completely wipe-out the consumer's equity.

ii) Concentration

Diversification is often described as "not putting all your eggs in one basket". Numerous cases have been reported in the media recently of consumers who invested large portions of their savings in investment vehicles such as Timbercorp which subsequently failed.

Diversification is a powerful way of reducing downside risk. It protects consumers against the adverse effects of a single investment, or a single class of investments, significantly underperforming the broader market.

EXAMPLE 2 - CONCENTRATION

Diversification can be applicable at several levels.

For example, the consequences of the failure of an individual company are far greater if that is the only share an investor owns. The impact will be far less if the investor has a diversified portfolio of, say, 20 shares well spread across different sectors.

Some small superannuation funds are believed to have been wholly invested in listed property trusts that, as a sector, lost approximately 50% of their value over the 9 months to 31 March 2009. Had the investments of these superannuation funds been diversified across different sectors and different asset classes, the losses would have been much less. For example, if, instead, one-third of a fund had been invested in listed property trusts, one-third across the wider Australian share market (which lost 28% over the same period) and one-third in a typical diversified Australian fixed interest portfolio (which generated a positive return of 12% over that period), the fund as a whole would have limited its losses to 22% (compared with 50%).

Lack of diversification was a particular risk for those who invested a significant proportion of their net worth in Fincorp, Australian Capital Reserves, Westpoint and similar vehicles.

Appendix 2 – Illustrative Example of "Personal Stress Test"

The Personal Stress Test aims to illustrate the following financial impact to the consumers'

(i) Value of gross assets before and after the stress test;

(ii) Value of net assets before and after the stress test after taking into account gearing;

(iii) Net income/outgo before and after taking into account the stress test

The Personal Stress Test should consider the following events:

(i) 100% fall in the largest stock (where related stocks are aggregated for this purpose) held;

(ii) 50% fall in the second largest stock (where related stocks are aggregated for this purpose) held;

(iii) 25% fall in the rest of the stocks held;

(iv) Fall in Property Values

(v) Change in currency exchange rates

(vi) Real life events such as 1987 and 2008/09;

(vii) Loss of income and/or reduction in investment yields e.g. rental rates

(viii) Increase in interest rates on debt

(ix) Loss of liquidity from certain stocks or investments and its impact on cashflow for the customer.

The test would be mandatory when certain conditions occur. This could be setup in a range of ways but needs to be simple. Two ideas are:-

- Approach 1 (More Comprehensive Example)

  (i) The gross amount to be invested (including existing investments where relevant) exceeds $100,000 but not if less than a $50,000 increment to an existing investment;

  (ii) Loan to Value Ratio > 60% and the loan exceeds $50,000;

  (iii) The currency of any loan differs from the local currency;

  (iv) Etc;

- Approach 2 (Simpler Example)

  (i) Any plan over $100,000 and;

  (ii) Any plan with gearing;

If the outcome of the Test showed the potential for a catastrophic outcome for the customer, the test would report that a second opinion should be obtained. Whilst the customer's ability to handle outcomes will vary, for this purpose the trigger event would look at common measures of impact on net wealth and income/outgo. An example of a simple test is:-

(i) If the gross or net assets fall by more than 20% or

(ii) Net Income/Outgo falls by more than 10%.