

Inquiry into Financial Products and Services in Australia

By Paul Resnik, July 31, 2009.

Summary

This is my personal view having worked in all parts of financial services supply chain in a number of senior and entrepreneurial roles for almost 40 years.

The Storm case gives a snapshot of the weaknesses in both the Australian financial services regulatory and self regulatory regime. In addition it clearly suggests that clients of planners will forever be victims of their own insecurities if they continue to have low levels of financial literacy.

What the Storm case specifically reveals is:

- That the 'know your client' obligations were ignored by Storm. All clients received virtually the same advice. No attempt was made to assess their personal financial risk tolerance or take into account their individual needs and circumstances. While this was visible to all who cared to look this did not result in action from anyone in the industry; the ASIC, the FPA or even the internal and external compliance managers.
- That conflicts of interest while arguably disclosed were neither well managed by Storm nor understood by clients. Storm's self-interest was so high that its fiduciary obligations to clients were not met.
- That after 20 years of increasing disclosure there is little evidence many read or understand the consequences. Storm ticked all the compliance boxes in terms of current disclosure but did not tell clients the single most important piece of information; that they could lose their home if the plan went awry. Very few would have been taken in by Storm if the obligation was both full disclosure of risk and properly informed commitment.
- That thousands of ordinary Australians were unable to see they were buying into an unachievable dream and willingly suspended critical disbelief. This shows that a considerable commitment to effective financial education is needed.

To all intents and purposes, Storm avoided any form of personalisation of advice. All clients received the same advice; liquidate whatever you can and invest in an index fund. To do so client's money was withdrawn from superannuation and investment properties sold. If the client had any capacity to borrow money, they were encouraged to do so. The net result was that investors were at the least 100% exposed to what would be considered a volatile asset class, the Australian stock market, through an index fund that was almost 50% more expensive than any mainstream alternative. Those that borrowed clearly had an even higher exposure.

Storm, and other disasters such as Great Southern and Westpoint, leave the financial services industry generally and financial planners in particular struggling to retain community confidence. This is not an isolated problem. Lack of confidence in the integrity of the financial system invariably leads to individuals saving less, investing less efficiently and underinsuring their lives and earning capacity. This leaves the community to pick up the inevitable shortfalls through social security payments.

Recommendations

The regulatory response is likely to be heavily weighted towards more disclosure. While better disclosure will assist in reducing the likelihood of Storm like cases occurring again, there are six other strategies, five requiring a long term commitment and the last capable of being adopted almost immediately, that also need to be taken up.

1. Stronger enforcement from ASIC on planners of the requirement to have a reasonable basis for advice.
2. Encouragement by the regulators for planners to move towards intent based regulation such as the UKs 'Treating Customers Fairly' in addition to prescriptive regulation.
3. A greater commitment to financial literacy with a particular emphasis on understanding the risks in gearing through independent education of planners, clients and the wider community. This should be paid for by those that benefit; the banks, life companies and super funds via a small percentage annual levy on assets or revenue.
4. Commitment to move towards investors making a 'properly informed commitment' to their financial plan.
5. True to label licensing. The public should be easily able to tell whether they are dealing with an agent for product manufacturers or a fiduciary representing only their interests.
6. Changes to gearing...please read my joint submission 'What went wrong at Storm and how we can fix it' prepared with Peter Worcester.

The Australian community has much to gain when consumers are confident of the integrity of the financial system, particularly the behaviour of financial advisers.

- More money will be saved and invested.
- Individuals and families will be more independent of government and community support.
- Planners and fund managers will have more money to manage and can therefore charge less.
- There will be a larger pool of investment moneys in Australia reducing the need for borrowings and investments from offshore.

The Parliamentary enquiry is a good opportunity to put the real issues on the table. We can but hope that there is sufficient will to make the difficult decisions.

Detailed below are responses to the specific issues raised in the terms of reference of the enquiry.

1. The role of financial advisers;

Personal financial issues are so complex that most Australians will need access to professional advice at a point of time in their life. While some advice is transactional in nature, such as rolling from superannuation accumulation to pension, other advice requires regular review to keep on track. This is particularly the case with longer term planning questions such as the amount of money drawn down from a pension account in the light of an individual's prospective longevity. This in turn needs to take into account the performance expectations for the different asset allocations available to the client. It's critical that the money lasts as long as the individual who spends it or an alternative strategy put in place such as taking equity from the family home.

Financial planner's remuneration is in many cases based on a percentage of the amount invested. This does not necessarily match either the quality or value of the advice. Often the guidance is much

broader than simply an investment. A financial plan will regularly engage a wider range of other issues such as insurance adequacy, social security entitlements, tax planning, budgeting and estate planning. In addition, financial planners often fulfil a critical role in providing a professional overview of the state of an individual's affairs reassuring them that the plan they have for their financial lives is achievable and on track.

Planners provide significant benefit by framing and helping clients set limits on their behaviour. Many individuals are tempted to invest in inappropriate investments or move between investments at the wrong time in the investment cycle. It is well recognised that individuals regularly buy at the top of the market when all around them seem to be making money and sell near the bottom when the media is full of tales of doom and gloom. Having someone with a calm voice reassuring them and help them avoid injudicious decisions is one of the benefits gained from an ongoing relationship with a good financial adviser.

Perhaps the most valuable insight that a planner can share with a client, particularly those with smaller amounts of money invested, is the counter intuitive fact that more long term financial benefit is gained by spending less, minimising fees and taxes and working longer than chasing investment performance.

Currently regulation puts the entire responsibility for advice on the planner. There would be much better outcomes if the client took some responsibility after full disclosure of the risks and rewards. It's the client who has to live with the outcome of taking on too much risk. The planning goal should be the client's properly informed commitment to the financial risks they accept in the pursuit of their plan.

For clients to make informed decisions they must understand both their risk capacity [how much they could lose without messing up their lives] and risk tolerance [an enduring personal trait]. Both are relatively easily understood. The client is only responsible to the extent that the adviser has:

- properly informed the client about strategic alternatives and allowed the client to make a free choice between alternatives;
- recommended/selected only products/services that are fit for the alternative's purpose; and
- properly implemented the recommendation/selection.

2. The general regulatory environment for these products and services;

One of the most obvious failures in the Storm collapse is the non adherence to the obligations in relation to the 'know your client' rules that are generally associated with S945A of the Corporations Law.

I must note here that the Government has chosen to diminish this same responsibility for super funds which are now exempt from this obligation for advice to their members in particular circumstances. This might lead us to believe that enforcement of the obligations will be more rigorously enforced from now on.

An alternative approach which has been embraced in other jurisdictions is ISO 22222 – Personal Financial Planning. "Personal financial planning is a process designed to enable consumers to achieve their personal financial goals. The service of personal financial planning is provided by a personal financial planner to assist clients with their personal financial planning." By starting from this definition, which asserts a consumer focus, it is possible deal effectively with many difficult financial

planning issues, particularly misunderstandings concerning risk, and ultimately client accountability for their financial plan.

The process of personal financial planning invariably involves helping clients manage one or more conflicting alternatives through trade-off decisions that best meet their present and future wants and needs in their current and anticipated circumstances. This is echoed in ISO 22222 – Personal Financial Planning. “The personal financial planner shall produce and provide to the client, in a clear and reasonable manner, an evaluation of the client’s status that identifies areas of strengths and vulnerability, comparing them against the client’s goals, plans, restrictions and assessment of financial risk tolerance.” Later in the Standard at Developing and Presenting the Financial Plan it states “Personal financial planners shall be able to compare the client’s tolerance for financial risks and the financial risks that may be involved in achieving his or her goals and assist the client in resolving any differences.”

Effective trade-off decisions can only be made when the elements of the trade-off have been separated, and can be clearly understood and compared.

In the UK a less prescriptive regime called treating customers fairly has proven to be reasonably successful in making planners personally more conscious of their obligations.[see 9 below]

3. The role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;

Ironically, Storm, from the information I could find, were just as likely to charge a fee against borrowings and rebate commissions as they were to take the higher than normal commission from their preferred investment fund. Rebating commissions against fees charged is no guarantee of greater integrity. A planner wishing to look good simply selects investments with high commissions and rebates them against fees. High fees generally reflect how difficult it is to sell some thing in the first place because it is inherently risky.

Consumers need to know who they are dealing with; is their planner an agent for a super fund/bank or are they a Fiduciary, representing just them? We need differential ‘true to label’ licensing so consumers can make up their own mind who they want to deal with. Agents for product houses can be remunerated any way they like. Fiduciaries on the other hand would do best to distance themselves from the past and not accept commissions or any other form of kickback.

4. The role played by marketing and advertising campaigns.

Much of what passes for education in relation to gearing could better be described as marketing. While financial planners have a duty of care to their customers no such obligation exists between margin lenders and their customers, financial planners and investors. As part of their licensing,

financial planners should have to comply with a number of issues in relation to gearing. These are set out in my joint submission to this enquiry with Peter Worcester.¹

5. The adequacy of licensing arrangements for those who sold the products and services:

Clearly the current licensing is inadequate.

6. The appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served.

Please read my joint submission 'What went wrong at Storm and how we can fix it.' Prepared with Peter Worcester.

7. Consumer education and understanding of these financial products and services

If we are asking consumers to take [some] responsibility for their financial decisions, the community needs to invest in their financial literacy.

The health industry is an exemplar of education and transfer of responsibility built on highly focused educational campaigns in the general media. Who could forget Norm the couch hugger, the camera shot of a cancerous lung, the "slip, slop, slap" sunscreen promos etc. Twenty years ago we went to doctors for remedies now many of us take responsibility for our health through preventative maintenance.

This should be paid for by those that benefit; the banks, life companies and super funds via a small annual levy on assets or revenue.

8. The adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers;

As professional indemnity insurers have already excluded PI cover for most agriculture investments, the same may happen with margin lending, unless the recommendations in my joint submission to this enquiry with Peter Worcester are adopted.²

9. The need for any legislative or regulatory change.

¹ Worcester & Resnik Submission to Ripoll Committee 30 July 2009.

² ibid

Australian financial advisers work within a highly prescriptive regulatory environment. This can lead to an abrogation of personal responsibility in many cases. It becomes all too easy to work within the letter of the law without paying any significant attention to the intent of the law.

In the Storm case it looks as if the business model was largely consistent with the laws as most participants in it, internal and external compliance managers, accountants and auditors, the FPA and ASIC for example applied it. Yet the business was hardly an exemplar of integrity and client focus.

The challenge for regulators is to infuse some level of personal integrity into the exercise. There are two issues that should be reviewed.

The first can be seen in operation in the UK where the notion of treating customers fairly has created a sense of personal responsibility for the integrity of advice that this author has rarely seen in Australia.

TCF (Treating Customers Fairly) is about setting personal professional standards, not just ticking compliance boxes. Prescriptive regulation is never sufficient by itself. For a successful outcome there has to be a higher moral and professional obligation in play.

UK financial services firms including mortgage brokers and financial advisory firms are expected to be able to demonstrate that they are consistently treating their customers fairly. This means that 'a firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems'. The UK's Financial Services Authority details six TCF outcomes:

- Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
- Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and targeted accordingly
- Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
- Where consumers receive advice, the advice is suitable and takes account of their circumstances
- Consumers are provided with products that perform as firms have led them to expect and the associated service is both of an acceptable standard and as they have been led to expect
- Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

This somewhat innocuous set of obligations has been a key driver in fundamental improvements in the quality of advice in the UK.

The **second** lies in the practice of seeking the clients properly informed commitment to their financial plan and the risks inherent in it. The current regulatory environment assumes that the planner is solely responsible for advice having taken into account all of the client's relevant circumstances. This is not only unreasonable; it is asking too much of the adviser. The world is too complex for such simplification. It also discourages the investor from taking meaningful responsibility for the investment decision. When markets are rising this is not an issue. But after a severe market downturn, as we have recently experienced, investor satisfaction will express itself through both loss of confidence in planners generally and legal action against them specifically. We can expect many more Storms.

The easiest and fastest way to limit the risk of gearing is to move the risks from the borrower's balance sheet to the lenders. To do so would simply require the lending institution to agree in advance on the price the margin call would take place. See our joint submission.³

This could be done fairly simply by distinguishing sophisticated investors from ordinary investors.

Sophisticated investors would need threshold assets or income and be prepared to take on the full risks of gearing after being advised by an independent lawyer, public accountant or financial adviser with recognised expertise in gearing. Ordinary investors would gear with some confidence knowing that there was a fixed downside limit.

Paul Resnik is an industry commentator and investor.

³ *ibid*