COMMONWEALTH OF AUSTRALIA

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Financial products and services in Australia

FRIDAY, 28 AUGUST 2009

CANBERRA

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 28 August 2009

Members: Mr Ripoll *(Chairman)*, Senator Mason *(Deputy Chair)*, Senators Boyce, Farrell, McLucas and Williams and Ms Grierson, Ms Owens, Mr Pearce and Mr Robert

Members in attendance: Senators Farrell, Mason, McLucas and Williams and Ms Owens and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on:

Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
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;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
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;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

WITNESSES

ANNING, Mr John Melville, General Manager Policy Regulation, Insurance Council of Australia **72**

BATTISTELLA, Mr Julian, Certified Financial Planner and Member, Financial Planning Association **26**

BLOCH, Ms Jo-Anne, Chief Executive Officer, Financial Planning Association **26**

BROGDEN, Mr John, Chief Executive Officer, Investment and Financial Services Association Ltd **49**

CHONG, Mr Seng Wing, Member and Chair, Regulations Committee, Financial Planning Association; and Member, Board Professionalism Committee, Financial Planning Association **26**

CLARK, Mr Douglas, Policy Executive, Securities and Derivatives Industry Association **60**

CODINA, Mr Martin, Senior Policy Manager, Investment and Financial Services Association Ltd **49**

COOK, Mr Anthony, Chairman, Wealth Management Committee, Institute of Actuaries of Australia **80**

HORSFIELD, Mr David, Managing Director and Chief Executive Officer, Securities and Derivatives Industry Association **60**

LIM, Mr Michael, Analyst, Investor Protection Unit, Corporations and Financial Services Division, Treasury **1**

MILLER, Mr Geoffrey, General Manager, Corporations and Financial Services Division, Treasury **1**

O'REILLY, Mr David, Policy Director, Investment and Financial Services Association Ltd **49**

PARKER, Ms Cherie Rebecca, Analyst, Investor Protection Unit, Corporations and Financial Services Division, Treasury **1**

RAFE, Mr Barry Edwin, Vice President, Institute of Actuaries of Australia **80**

SANDERS, Mr Deen, Deputy Chief Executive Officer and Head of Professionalism, Financial Planning Association **26**

SELLARS, Mr Andrew, Senior Adviser, Corporations and Financial Services Division, Treasury **1**

SEWELL, Mr Mark Francis, Manager, Corporations and Financial Services Division, Treasury **1**

THOMPSON, Ms Catherine Louise, Member Professional Indemnity Insurance Committee, Insurance Council of Australia **72**

Committee met at 8.31 am

LIM, Mr Michael, Analyst, Investor Protection Unit, Corporations and Financial Services Division, Treasury

MILLER, Mr Geoffrey, General Manager, Corporations and Financial Services Division, Treasury

PARKER, Ms Cherie Rebecca, Analyst, Investor Protection Unit, Corporations and Financial Services Division, Treasury

SELLARS, Mr Andrew, Senior Adviser, Corporations and Financial Services Division, Treasury

SEWELL, Mr Mark Francis, Manager, Corporations and Financial Services Division, Treasury

CHAIRMAN (Mr Ripoll)—I declare open this public hearing of the Joint Committee on Corporations and Financial Services, part of a series of public hearings the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with the recent collapses of financial product and service providers such as Storm Financial, Opes Prime and other similar providers. In conducting its inquiry, the committee has made a decision to focus specifically on non-superannuation products and services.

Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false or misleading evidence to a committee. The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult the witnesses before doing this.

I welcome the witnesses from Treasury to the table. Mr Miller, if you could make some opening remarks in relation to your submission, that would be great.

Mr Miller—Certainly. Firstly, thank you very much for allowing us to come here and help the committee with their deliberations. I just wanted to put a bit of context around our submission, particularly as I think our submission has been put in the wrong light by some newspapers. Our submission does not make recommendations; it puts forward context and options, and the pros and cons of many of those options. We are not suggesting a particular outcome for the committee; we are trying to ensure that you have the fullest amount of information available for your deliberations.

In a very general sense, apart from the submission, what we are saying is that we do not believe that the regulatory system around financial services is fundamentally flawed. Certainly we have been through a global financial crisis, and, if there is any silver lining to such a crisis, it is that it puts your regulatory system through a type of stress testing and allows regulators and policymakers to see where there might be flaws in that system.

Certainly there is no question that a few stress cracks have appeared. But nothing has broken fundamentally, in our view. To that end, the government has been doing quite a bit to fix those stress cracks. As you know, there is a bill in parliament at the moment dealing with the margin lending, which is putting in place a licensing system, putting in place responsibility around margin lending and also making very clear the responsibilities of the various parties in relation to who should tell who about the calls when they are coming up. There are also in that same bill provisions around debentures and promissory notes. While there was a regulatory system around those debentures and promissory notes, it was a split system. Ones over $50,000 had one system of regulation and ones under $50,000 had another system of regulation. This bill brings them together into a single harmonious system so there is no confusion of which system applies for bills and promissory notes. On top of that, the government has in place an organisation called the Financial Services Working Group, which is looking at improving financial product disclosure documents to assist investors in understanding what the products are, and the risks and fees and everything around those products.

So there are a number of things going on to fix those cracks. No-one is saying that there are no issues that have come up. The global financial crisis has really put some of those issues into stark relief. It is our fundamental proposition in our submission that the system is not fundamentally flawed. Economically we have held up well through the GFC. There have been some devastating collapses. Obviously it is terrible for those people who have lost money in those crashes. But to some degree they have been minimal compared to what we are seeing overseas. I think that is a tribute to how robust the system still is. Other than that, I was just going to ask if the committee has any questions.

CHAIRMAN—Thank you very much. Yes, we do have some questions. It is an extensive submission, and we thank you for that. You have raised a whole range of issues. I do note that you are not making specific recommendations, but you do, if I understand it right, make some judgements or have views about specific areas, particularly in relation to other submissions and views that others might have put forward in terms of what might be solutions to existing problems. I also note that there seems to be a general view that fundamentally our system is operational, that it does function, but there are obviously some inadequacies, some gaps and perhaps some inefficiencies in that as well. With that in mind can I get your view. I have picked up in a range of submissions that the focus of FSR seems to be more on compliance than disclosure, that really the intent or the direction—I will put it in those broad terms—focuses on ensuring that people just comply, whether it is for licensing or any other obligations rather than clients or outcomes. Is that correct? Do you have a view on that in particular?

Mr Miller—Certainly in the whole of the Corporations Act—not just around these financial services aspects—there is a fundamental tenet of disclosure and transparency. When we went through the review process 10 years ago, when we pretty much revamped the whole of the Corporations Act, one of the primary tenets was a concept of disclosure and transparency. So, yes, every aspect of the Corporations Act has that woven into its psyche. Yes, as soon as you impose a licensing system, as we have with the Australian financial services licensing system, there then becomes conduct requirements and other compliance requirements that get attached to that licensing. So there is compliance, but I think it is more just a natural consequence of having a licensing system.

CHAIRMAN—Could you expand a bit further on the concept of ticking the box on compliance, meeting obligations or licensing where, as long as you have met the minimum requirements for an application—which are not high bars; they have minimal requirements—that opens up the way? There are no further real mechanisms in place? We have enough evidence from ASIC and others that, apart from some small cases of auditing—window-shopping exercises, shadow-shopping exercises and so forth—there really is not much checking afterwards.

Mr Miller—I will pass to my colleague in a second. Many of the provisions are principles based. They are fairly high level and really give the intent of what parliament wanted to achieve. Quite a bit of that, then, goes down to the regulator to determine how much checking they do on that. In my view, if ASIC is saying that it is too low a bar or just a tick in a box—

CHAIRMAN—I am not saying that ASIC is saying that; I am saying that, as are others in submissions.

Mr Miller—The question is: are those principles that we have set out and the powers that we have given to ASIC insufficient for them to go deeper than that? I am not sure. I will pass to my colleague.

Mr Lim—I do not think your first question—about whether FSR is not outcomes based—is quite correct. For example, the licensing system is designed to ensure that licensees are adequately resourced and adequately trained; therefore, as part of the licensing exercise there are training requirements that licensees, particularly those who offer advice, are required to satisfy. The outcome of that is intended to be that licensees have the knowledge and understanding to offer proper advice to their clients. That is the policy underlying the law. So I think that in that sense FSR is really outcomes based. The purpose of the disclosure regime is to ensure that consumers are adequately informed about the products they are looking at, based on the belief that it is ultimately the consumers themselves who are in the best position to make a decision on whether to purchase or sell a particular financial product. I think the underlying policy of FSR is outcomes based and tries to achieve that through means such as licensing and disclosure requirements.

On your second, more detailed question—about the licensing system and whether it represents too low a bar—I think we would very strongly support what Geoff has just said. The law and the policy in no way intend for the licensing system to represent too low a bar. We have given the means to ASIC, the regulator, to implement a system that is appropriate and strikes a balance between the needs of the various stakeholders. For example, I can tell you that we get constant complaints from certain stakeholders that the licensing requirements are too onerous, particularly in—

CHAIRMAN—Which parts?

Mr Lim—Training, probably.

CHAIRMAN—For the individual licensee?

Mr Lim—The standards that are imposed on licensees offering advice.

CHAIRMAN—Can you describe that? It does not seem to be what I read in the regulation. Which bit of it is too hard?

Mr Lim—This relates to the particular financial service of offering advice.

CHAIRMAN—Which part of the training is too difficult to get an AFSL?

Mr Lim—The law says that you must be adequately trained to offer advice.

CHAIRMAN—But it is a very low training bar.

Mr Lim—The law itself does not say what the details of that mean. ASIC, in implementing that prescription in the law, has issued a very detailed regulatory guide that specifies in detail what training courses you have to attend in order to offer advice on a particular financial product. It is broken down.

CHAIRMAN—I want to get this right. That has nothing to do with the attainment of an AFSL. To get an AFSL you just need the minimum. It is a compliance requirement. From my understanding—please explain to me if I am wrong—if you have made application, as long as you are not of unsuitable character and as long as you have met the minimum requirement to get in, which is a very low educational bar, you cannot be refused a licence. What you are consequently licensed to do in terms of different streams requires further training in different parts, but you still have the licence. There is only one licence. There are not different categories of licence. Am I right?

Ms Parker—That is true, but the licence will set conditions. Your sole service provided might be in execution of the platform, and therefore there are differences. But there are a whole set of licence conditions that kick in once you have a licence. They vary according to what you do—for example, for retail clients there are requirements for membership in external dispute resolution and compensation arrangements. As Michael has been talking about, if you provide personal advice there is a series of obligations in terms of training. There are various obligations that attach according to the different types of licensing. Yes, in a very basic sense you can get a licence, but that licence operates in various different ways according to the types of services that you offer and also according to whether it is purely a wholesale licence. The reason that we license wholesale participants is that we are concerned about market integrity issues. It is true that, first of all, there is a licensing process making sure you have applied properly, have good fame and character and will comply with your obligations. But once you actually have your licence there are conditions that ASIC can set, plus there is a framework that says you have to have adequate financial resources, you have to comply with training standards, you have to act ethically and responsibly—those types of things. Those are principles based. You have to have organisational competence.

CHAIRMAN—They are really self-regulating, though. The nature of the system is self-regulating.

Mr Miller—No. There are regulatory guides that ASIC has issued on all these matters, and they enforce that.

Ms Parker—It is ASIC's job to enforce that.

Senator WILLIAMS—On the issue of licensing, is it possible to get a licence by doing a six-week internet course?

Mr Miller—You would have to ask ASIC. I am not intimately detailed in their guidelines. Assuming you could and that it would give you a certain training to a certain level, that is all you would be licensed to do. The requirement is that you be adequately trained to whatever service that you are going to provide. If a six-week internet course gave you enough training to do a very small part of financial services, that is what you would be licensed to do. You would not be licensed to do the whole suite of things.

CHAIRMAN—The point of my questions was that regardless of having a licence, whether it is to provide a certain amount of services or a full licence, the majority of people will work under a dealer group. It is the dealer who holds the licence. It is the principal who holds the licence. Everyone who works under that person, be they in their dozens, hundreds or whatever number that might be, does not have that same level of competency or qualification. It is up to the licensee to manage, monitor and regulate that internally.

Ms Parker—Yes, but those people would still have to be trained to a certain standard to provide personal advice.

CHAIRMAN—I know that is the intent, but what we are finding in practice is that that is not the case.

Ms Parker—In its submission ASIC has talked about some reforms that have already happened in the credit context. The government would have to have a serious look at those. We note that it has already happened in a similar piece of legislation which allows them to further control and ban the individuals concerned in the industry. We have certainly noted ASIC's concern in that regard.

If you are talking about a system where you have a huge amount of people being individually licensed, you are essentially moving away from the benefits of where a principal runs its business and is responsible for the conduct of its agents and employees. That is why the law prescribes that the individual licensee is responsible for the conduct of its agents. If you move away from the benefits of that type of system you essentially would be imposing quite large costs on a number of people who would have to get their own individual licences. So I think the question is whether it can be resolved by ASIC having some additional powers in relation to making sure that they can ban individuals in an appropriate context, or whether we want to be imposing, at the initial stages, something that would require a lot of resourcing from ASIC.

CHAIRMAN—Does ASIC not have that power now?

Ms Parker—ASIC can ban people but, in their submission, they have raised some tweaks around the framework. They have experienced some particular issues with the use of the words 'will not comply with its obligations'. The AAT has interpreted that as a fairly high standard. There have been some remedial tweaks, for example in the Credit Bill, that talk about 'not likely

to comply with its obligations', so it sets a slightly lower standard. It is just a tweak to the power to make it a little bit easier for access to get down.

CHAIRMAN—My concern with the licensing revolves around the example of Storm, and I am very interested in what Treasury think about this issue. You had a principal who was fully licensed and operated a particular system which was completely compliant, from what I understand at this point—in fact, it had been audited by ASIC not long before the collapse, had had every boxed ticked and had met every compliance requirement; there were no compliance issues that I could see—yet ran an operation that is acknowledged by many in the financial services world to have been dangerous, aggressive, double-geared, one-size-fits-all, undiversified, risky—the list goes on in terms of describing where they were at. And yet it was fully compliant. This is why I raised the issue of whether FSR, or regulation generally speaking, is more focused on just compliance—regardless of what you do in reality, you just comply; therefore you are then free to place everybody into the same basket to do the same thing and take the same risks.

Mr Miller—The case with margin lending is exactly where there was a hole, and that is why the government has moved to close that hole. Yes, they might be licensed for their AFSL, but there were no licensing requirements over margin lending—it was not part of the Australian financial services regime. So now the government has moved in. Fundamentally, margin lending is a strange creature. It is not quite a financial product.

CHAIRMAN—So, would the proposal for new requirements in terms of margin lending have meant that Storm would not have happened? That is almost what you are saying.

Mr Lim—You cannot guarantee that—

CHAIRMAN—No, I know that. I am not asking for a guarantee. I am saying that you are almost saying to me now: 'Margin lending was the problem; margin lending was not covered—it now will be.'

Ms Parker—I think it is an element of it. It is very difficult for us to comment with an ongoing ASIC investigation. I would theoretically—

CHAIRMAN—Are you part of the ASIC investigation?

Ms Parker—No, Treasury—

CHAIRMAN—Then you would not know anything about their investigation, so you don't need to—

Ms Parker—Only what is reported in the media. Occasionally, we do get—

CHAIRMAN—That is fine. That is all I am saying. I am not asking you to comment on their investigation.

Ms Parker—Okay. There is a regime that talks about 'appropriate advice'. That advice would have been covered to the extent that we are not talking about margin lending, so we have to

exclude that from the picture. But, when they are giving financial product advice otherwise, that advice has to be appropriate. If you are talking about a one-size-fits-all approach that is just a strategy that is handed out, I would have serious questions about whether or not that advice was actually appropriate.

CHAIRMAN—But it was completely compliant with the regulations.

Ms Parker—That is really a question that ASIC has to answer.

Mr Miller—But it could not have been compliant—

CHAIRMAN—But ASIC said it was, because it did an audit just before the collapse.

Mr Miller—Yes, it was fully compliant for the sort of advice that the AFSL system covered. There was no question of compliance with regards to margin lending, because the system does not cover margin lending.

CHAIRMAN—So, with the system now covering margin lending, that will not happen again?

Mr Miller—It will significantly reduce the probability of that happening, yes.

CHAIRMAN—It is an interesting conundrum, though, isn't it?

Mr Miller—One of the issues here is that—and you have talked about double-gearing and all of those aspects that were reasonably evident after the event of what the problem was—the legislation we have put in place for margin lending has tried to fix each one of those aspects.

CHAIRMAN—I accept that.

Mr Miller—I was going to say before that margin lending is a bit of a strange creature in that it is partially a lending product and partially an investment product. It does not fit well. If we had just brought it into the AFSL system and done nothing else then that would not have worked properly because if it has features of lending as well as features of investment. What we have done by putting a modified arrangement for it into the AFSL system is to say, 'We will take all those benefits we get from AFSL but we will add to that a lot of benefits, for example, that we are getting from our new credit arrangements.' So we sort of have two systems now overlapping to cover this one area because it is a different sort of product from most other investment products. Certainly I think the system will cover it, if passed by parliament. It is going to be very comprehensive and should significantly reduce the risks that were evident before this system goes into place.

Ms Parker—I would like to add, just very briefly, that ASIC is still investigating Storm Financial. Obviously once ASIC publishes its findings we will engage with it if there is any sort of tweaking that we need to do. So we do need to keep in mind that ASIC has not fully completed it in inquiries. I just wanted to have that on the record.

Senator MASON—I would like to just draw your attention to some evidence we heard in Melbourne. It relates to the education and the duties of financial planners. Both MLC, the ANZ

Bank and others spoke about restructuring both the legal duties and the educational requirements for financial planners. In your submission you draw on the UK professional standards board and their approach—a bifurcated approach to financial planning. What is happening there and do you think that is a useful model for Australia to adopt?

Ms Parker—They are trying to create a clearer landscape for consumers to understand the types of services on offer. I would just preface my comments by saying that the UK did initially consider separating out professional from general advisers and having different structures attached to that. They decided not to pursue the path.

Senator MASON—Why?

Ms Parker—It seems that they received strong opposition. It was not entirely clear in their paper about the concise angles it was coming from. The FSA did note that they thought maybe essentially you would have a whole series of requirements on professional advisers and it would raise the bar so high that people just would not be interested in providing those services—in particular, it would end up being only for the more affluent clients and not for less affluent people.

Senator MASON—So, in giving independent advice, the educational qualifications would be higher and the legal duties would be higher?

Ms Parker—Looking across the market it would be higher. So the independence requirements would be higher—there were issues around legal duties, professional qualifications and whether or not you accept commissions. The UK instead decided to focus on separating out independent advice and restricted advice. Independent advice means that you have to look completely across the market. So it is very broad. You have to give unrestricted advice. You have to basically have knowledge of all of the products that might provide suitable outcomes for your clients. The restricted advice model is where you are clearly stating that you are offering a lesser range of products, and you have to clearly articulate that upfront to the consumer.

Senator MASON—I think MLC described that as 'affiliated'.

Ms Parker—There have been various suggestions put forward in submissions about how you could create a two-tier structure. Various people have suggested different ways in which you could achieve that outcome. Looking at the UK model, you cannot adapt it straight across to the Australian model because, for example, in the appropriate advice regime we do not require that every single product in the market be considered. So there is not an exact or straight translation. Certainly there have been proposals in the past—like the sales proposal in 2006—which talked about separating out sales and advice functions. Perhaps Mr Sellars can talk a bit more about that. That in itself was also designed to create a clearer landscape for consumers and increase access to advice.

Senator MASON—We need some successful precedents, Ms Parker. That is what the committee needs.

Ms Parker—The UK is in the process of implementing so it is difficult for us to say what its experience will be.

Senator MASON—It is early days.

Ms Parker—Yes, it is early days. Certainly I can say that they did not decide to distinguish. They were sort of concerned about the cost of that and there was some fairly clear opposition coming from submitters in the UK. Certainly what they have tried to do is to create a clearer landscape for consumers.

Senator MASON—Does the Treasury have a view on the payment of commissions? Should the industry be moving to a fee-for-service model?

Mr Miller—We note that the industry already, both IFSA and FPA, have put out their own views on moving away from commission based payments, and we actually think that is a good idea. I suppose the question is: in that move away what is the best way of achieving that? You have had various submitters talking about an outright ban. There are others who say that we should not move away from that model at all. I suppose in a regulatory sense there is a spectrum of regulation—there is one end where the government comes in very heavy-handed and just bans something, there is the other end of the spectrum where you have a voluntary system which is an industry based system and a self-regulating system, and then there is a range in between where you might have an industry based self-regulatory system that you put some legislative powers around. For example, to the extent that that system does not cover everybody in the industry, the government might extend that industry system to everybody in the system or give some extra powers. So there is a whole range. It will depend on the degree of possible market failure, the degree of people who might get hurt and that sort of thing. We would tend to move towards that self-regulatory side rather than the heavy-handed side. But that does not mean that we will not—

Senator MASON—Philosophically I would too. That would be my philosophical position.

Mr Miller—So, on the question of getting rid of commissions, yes, we are certainly in favour of moving away from that area. But the question is: what is the best way of doing it? We are quite encouraged by the fact that the industry has already started to do that in its own right. But I note that, for example, what the FPA and IFSA are doing is not quite exactly the same. Obviously you would need a single system for that to work. Then the question would be: if they cannot cover the whole of the industry, and I think it would be necessary to cover the whole of the industry, what can the government do to assist to ensure that that is across the whole industry? If the government makes an assessment that the industry based system will not be effective then you have to move further down that regulatory line to make it more effective.

Senator MASON—Sure, and we have heard evidence that if we get rid of commissions totally then that might preclude certain people from obtaining financial advice, particularly less well-off people.

Mr Miller—Yes, that is a possible consequence.

Senator MASON—Indeed, and you recognise that. But you say in your submission that the Financial Services Working Group is looking to improve disclosure documentation.

Mr Miller—Yes.

Senator MASON—We have heard evidence that disclosure is not working well, and some people have described it as a failure. That is fairly profound statement to make in the context of this legislation—to talk about failure. So if we can get disclosure right and that working group can get that right then in a sense perhaps commissions can be maintained in certain contexts. Is that how you see it?

Mr Miller—Certainly, as I said, the whole fundamental tenet around the Corporations Law is this disclosure and transparency. We believe that an investor is going to be—

Senator MASON—But the disclosure has not led to transparency. That is the problem.

Mr Miller—Yes, exactly.

Ms Parker—And that has been acknowledged.

Mr Miller—And that is what the Financial Services Working Group is trying to do—to ensure that an investor who goes into these products knows what the fees and commissions are, knows what the other costs are, and has at least some degree of knowledge about the risks of what they are getting into and all those sorts of matters. That is obviously going to assist them.

I do not really need to go through all the issues that brought about the Financial Services Working Group, but such large product disclosure statements—they might be 80 or 120 pages long and no-one reads even the first page because they are too big—clearly were not achieving that disclosure and transparency. Maybe they had disclosure but they did not have any transparency because nobody read them.

Senator MASON—We might have to take evidence in London, Chairman, about how the British are going to do it.

CHAIRMAN—I do not know how we are going to fit it all in.

Senator FARRELL—You mentioned some concerns about training. Is it that they are required to do the wrong sort of training? Is it the length of the training that they are concerned about? Could you expand a little more on that?

Mr Lim—The way it is represented to us is that it is largely a cost issue. This relates only to financial advice not to other types of financial services. The training requirements are the largest, most significant cost in the licensing system. The way ASIC have done it is that they have basically separated two types of product categories: one type being relatively basic, simple products such as a straightforward bank account—tier 2 products, as they call them; the other are the more complex products, the tier 1 products, which are things like managed investment schemes. Each of those have different training requirements prescribed. ASIC publish a list of courses accepted by ASIC as complying with training requirements. ASIC are constantly getting complaints about the system not being quite right and needing to be adjusted. I think the last major review of that regulatory guide occurred about three years ago. Is training being reviewed again?

Ms Parker—ASIC have said in its submission that it is looking at training standards with a view to their improvement. They have also noted that they are conscious of industry concerns that talk about compliance costs and therefore increasing the cost of advice, which industry continue to reiterate. In particular it relates to the compliance documents and those types of things which must be done—the PDSs and the SOAs. They continue to say that they impose a higher compliance burden on them and that ASIC, in that context, have noted that they need to weigh those concerns in looking at where the bar correctly sits for training standards.

Senator FARRELL—Are the people who are complaining saying that there is a mismatch between what is being required for the training and what product is being sold? Is that the fundamental issue?

Mr Lim—For the detailed issues, you might need to talk to ASIC. Fundamentally, as Cherie said, our main concern is around the cost of advice. On the other side, we are hearing complaints that advice is too expensive, particularly for the mum and dad type investor with smaller amounts to invest and that for them it is too expensive getting access to advice. On the other hand, of course, we want to ensure that advisers are properly trained and know what they are talking about. That is the fundamental bind we, the policy and the law, are caught in here: striking that balance between making advice affordable and on the other hand ensuring that the advice is competent.

Ms OWENS—We have been through 15 years of boom. It is as if all of our roads suddenly went downhill and even bad car manufacturers would have looked pretty good under those circumstances. In terms of advice and quality of advice, to what extent are we looking at a period of time when a more normal market would have weeded out those less good at what they do and shown up problems earlier because there were more ups and downs? To what extent are we looking at the product of 15 years of boom and to what extent are we looking at flaws which would still show in a more normal environment?

Mr Miller—As I said in my opening address, I think the stress that the global financial crisis has put on the system has allowed those cracks to come to the surface. They would have come to the surface in due course but it may have taken a much longer time to do so.

Ms OWENS—In the boom time, did they talk about quality advice and qualifications, or is that something that has only happened since—

Ms Parker—People do not complain when they are making money.

Ms OWENS—I know—to some extent that is the point I am making.

Mr Miller—But even in that period there was a lot of concern around availability of advice. There were not enough advisors around and/or not enough advisors at a reasonable price around. When things were booming, there was a big demand for advice. People were doing a lot of investing. In fact, the supply was not meeting the demand. That was a big issue pre-GFC.

CHAIRMAN—To follow up on that general concept, you and others refer to the cost of advice and say that it will become more expensive, but isn't that what you would expect from an industry? 'It is always going to be too expensive so make it as cheap as possible for us'—isn't

that really just code for, 'We need to make bigger margins or have a larger market share'? Surely if a competitive market exists—and there are perhaps 45,000 people, generally speaking, in finance advice and somewhere along the lines of 18,000 that work under a licensed group—they can set any price they like, they can provide any level of service at any price, any entry. Three out of 10 Australians pay for financial advice—what is happening to the others? Isn't there an opening here for somebody to provide a low-cost, efficient service? What is stopping people doing this?

Mr Miller—Yes, and you preface it by saying 'if you had an efficient system'. If the system was working correctly, that pricing mechanism would work, to provide the services at the price at which the people needed it at the time. In some ways, you cannot say it is overpriced if people are paying for it, if the system is working efficiently.

CHAIRMAN—You cannot say it is overpriced if people are paying for it; yet, at the same time, we are collectively saying it is too expensive and that is why people do not get advice.

Mr Miller—Correct.

Mr Lim—We do have objective evidence that, for example, probably only one in five active investors is actually getting advice. We are not saying that everybody should get advice; clearly there are people who are sophisticated enough to do it off their own bats, but, still, one in five seems low.

CHAIRMAN—I agree with you—I think it is a very low number. I have asked the industry: why is this the case? Is it just too expensive? Do they see value in paying for advice?

Mr Lim—Cost is certainly one factor, and we are trying to do things around that. Our recent intrafund superannuation exemptions that we and ASIC provided through the working group, allowing superannuation trustees in certain situations to provide limited advice, should be a significant move forward in that respect. On the other hand, there are also elements that are less tangible at play here. We have clear evidence that consumers are generally overconfident in relation to their financial know-how and ability to make financial decisions. There is clear evidence that consumers are not realistic about their objective ability to decide on the financial—

CHAIRMAN—Would that view carry across to finance advisors as well?

Mr Lim—I do not think that that is what is being said.

CHAIRMAN—I know it would not be being said. Given what Ms Owens just raised, after 15 years of buoyant markets, most people I spoke to today said, 'Jeez, we only saw the upside.' There was no risk any more.

Ms OWENS—My question would be: have the number of people seeking advice or the optimism changed over the last 15 years?

Mr Lim—We do not have numbers that are differentiated enough to allow us to track that sort of development. It would be extremely interesting to know those answers.

Senator McLUCAS—Ms Parker, just going back to licensing and Mr Ripoll's question about individual licensing, you said there would be quite large costs associated with that. Can you talk to me about the quantum of those? Your submission talks about the cost on the industry, which would be transferred to consumers. But I do not have an understanding of the quantum of the costs that the submission talks about.

Ms Parker—We have not done any detailed costings. It is a basic comparison between what the system does now and what would have to happen. You would have to license not a small number but a very large number of individuals, and obviously a whole lot of resourcing goes into ASIC's background checks. When I talk about looking at business models, I do not mean evaluating the merit of those models; I mean evaluating the actual systems and procedures that sit around that. Essentially it is more of a general comparison than a detailed financial costing. ASIC may be able to give you a more specific view.

Senator McLUCAS—Your submission goes to the question of financial literacy. It talks about what ASIC does in terms of school based training around financial literacy. When you are 16, you do not tend to have a lot of money. You tend to have money and to want to become part of the financial investment area when you are closer to 60. Is it Treasury's view that we do a good job in assisting Australians to be financially literate?

Mr Miller—What was the financial literacy taskforce—I am not sure what it is called now—was transferred into ASIC. Before they transferred, and even after, they had the concept of ensuring that all life stages are covered in financial literacy. So the curriculum work they are doing is one stage, but I know they are very cognisant of ensuring financial literacy is lifted at all stages throughout life. Are we doing a good job? We are always trying to do better. I know that this government is particularly looking at things that can be done to increase both financial literacy and financial inclusion. This is why there still is—I am sorry; I do not know its current name—the financial literacy task force, which now has a whole ASIC team now behind it to help implement these things. I believe it is still very high on the agenda of the government.

Of course, we also have the Financial Services Working Group, whose whole focus is disclosure. It is not about education but, when you are looking at disclosure, if they can read it and understand it on the face of the document itself, you cut through some of this lack of knowledge that perhaps a lack of education might have caused. I think the government is attacking it from all different directions. It is looking at it from the financial literacy side, from the documents and disclosure side and from the financial inclusion side. There are quite a lot of different things happening all at once to try and improve the system. No system is perfect and no efforts are going to make it 100 per cent, but there are certainly plenty of efforts going into improving it.

Senator McLUCAS—How much do we spend in Australia on educating Australians around the question of financial literacy?

Mr Miller—Because it is now within ASIC, they would probably have some of those figures; I do not have them.

Senator McLUCAS—I know you are not the compliance unit, in terms of ensuring that licensing regulations are there, but can you tell me when Treasury became aware that there was a problem with Storm?

Mr Miller—If you want an exact date we will have to take that on notice because we do not have the information with us.

Senator McLUCAS—I understand that. Also, can you tell me about the nature of the information that you received at that time?

Mr Miller—We will take that on notice as well.

Senator WILLIAMS—In your opening address, Mr Miller, you referred to margin lending practices. Obvious, with Storm and Opus Prime many of the investors were geared too high and hence, with the crash of the market, they found themselves in serious trouble. Would you agree with that?

Mr Miller—There were certain practices that concerned us a lot, particularly what we refer to as 'double gearing', where people borrow to get their first level of money that went into the margin loan—

Senator WILLIAMS—A deposit, if you want to call it that.

Mr Miller—Yes. They were then lent moneys on top of the other lendings. Certainly, a lot of the measures we have put into the new margin lending provision are to try to avoid that problem ever happening again.

Senator WILLIAMS—Have you ever done any figures on those situations. I have never bought shares in my life for various reasons, the main one being I never had much money! But it just appears to me that if you geared yourself to 80 per cent to buy shares and you were looking at an eight per cent investment interest rate, the franked dividends coming back would to me not meet the financial commitment to the lender. Have you done any figures on the way that these people were leveraged so highly? In my opinion, if you go in that deep your return is not going to pay your interest. Perhaps I am wrong.

Mr Lim—I have something to say on that. I think you are perfectly right—if you take those levels of debt. You may be referring to a particular submission that I looked at, Worcester Consulting, who have done some number crunching in relation to margin loans. Certainly, in the case of Storm it is abundantly clear that too much debt was put on a substantial number of the clients. If, however, we look beyond Storm at the general margin investor population, the Reserve Bank has some very useful statistics on the population as a whole. What we see is that the average gearing level across all margin loans in Australia is extremely conservative. The average level of gearing is below 50 per cent.

Senator WILLIAMS—Which is conservative.

Mr Lim—Even a few months ago, at the height of the global financial crisis when share markets around the world had fallen by 50 per cent—

Senator WILLIAMS—If I could stop you there. Even if they fell by 60 per cent the top-up difference would not have been a great amount of money if you only geared to 50 per cent.

Mr Lim—That is correct. The evidence is that the vast majority of margin loan investors in Australia did not get a margin call and did not have a problem in surviving what we may almost call the worst of times in the stock market. So in that sense the Storm situation was unfortunately a very exceptional situation in terms of the margin lending industry as a whole in Australia. As Mr Miller said, we have particularly designed our legislation with a view to preventing that sort of development from occurring again.

Senator WILLIAMS—It is interesting that you say that because I was talking to a friend last night who has a margin loan and he said that rule No. 1 is that you never gear higher than 50 per cent. He is geared less than 50 per cent and has not had a problem. Now with the recovery in the market from the lows of 3,200 to 4,400, or whatever it is now, he has breezed through it without putting another cent in and the value of his assets is coming back. Obviously, in the case of Storm, in many cases not only did they gear heavily at first but they had gone in years ago and, as the market rose, borrowed against it to keep their level of gearing extremely high instead of soaking in that extra equity. As the value of their assets went up they just increased their debt by borrowing more.

Mr Lim—I think that is exactly what happened in the case of Storm. Storm was indeed the perfect storm—when all of these factors came together. Sorry, that was entirely uncalled for! It had a terrible impact on a large number of individuals. It is an awful outcome.

Senator WILLIAMS—A chap in Melbourne told us that when he took out his Storm loan he borrowed the money but Storm actually paid his interest to the bank. He just received his dividend every month. That was the inference from what he told me.

Ms Parker—Yes, ASIC may have more detail for you on those arrangements. We would be very interested to know. The Storm model seemed to have a lot of unique features.

Senator WILLIAMS—On that point, ASIC were going to report on Storm at about the end of August. Is that still the date?

CHAIRMAN—I am not in a position to say at this moment.

Senator WILLIAMS—Obviously, with Storm, the clients were either gullible or stupid when it comes to gearing so heavily. Obviously they thought that the market was just going to keep going up and up forever. Hindsight proves that that is certainly not the case. I do question the lending practices because surely the lenders would have knowledge of the risk involved when you gear people as highly. If you have a glitch in the system and you have a 20 per cent fall in the market then people are out of equity.

Mr Lim—The main change that we have made in the legislation is that, regardless of what advice you get from your financial planner, at the end the responsible lending requirement rests on the bank or the lender. The lender has to make an independent assessment of whether this loan is not unsuitable for a particular client regardless of what the financial planner has said. So there is a second line of defence.

CHAIRMAN—That currently exists?

Mr Lim—No, it does not.

CHAIRMAN—Not even through the Australian banking code.

Mr Lim—The code of banking conduct has a general requirement to act as a prudent banker would act vis-a-vis the client, but it is on a very high level and a very general level.

Senator WILLIAMS—My apologies for my ignorance, but I have not seen the legislation that is being proposed as it has not been to the Senate yet. Could you give us a briefing in layman's terms of what you have proposed in this legislation as far as lending practices and margin lending are concerned?

Mr Lim—In relation to margin lending specifically, it is being defined as a 'financial product' in terms of the Corporations Act. So it will be included in chapter 7 of the law, which regulates financial services. That has all the requirements that Geoff and Cherie mentioned early on of having to be licensed and having to do things like, in particular, join an external dispute resolution scheme that is free for the consumer to go to and complain about a particular dispute they may have with their lender or their planner. But what we have specifically added in relation to margin lending is the responsible lending requirement that I just mentioned, and Mr Miller as well. It requires that, before granting a margin loan, the lender must make an assessment of whether the proposed loan is not unsuitable for the client. We are prescribing that certain important factors have to be taken into account.

Senator WILLIAMS—Sorry to interrupt. Are you implying that many of these lending practices before were not suitable for clients? Obviously, if you are going to put a regulation—

Mr Miller—We are not really implying anything. We just want to make sure it does not happen in future.

Ms Parker—The Commonwealth Bank has specifically come out and said that it has identified deficiencies in its lending practices, so there are admissions from some parts of the industry that those things were not working as well as they should have been.

Senator MASON—But this is to focus the mind that legislatively—

Ms Parker—That is right: it leaves them with a detailed requirement as opposed to a general requirement of prudent lending which largely leaves it to the banks as to how they implement it.

Mr Lim—It would also give borrowers very clear rights in these situations. The Storm borrower, once the new legislation came into force, would clearly have the right to go to the free dispute resolution service, make a complaint and ask for compensation for the damages and losses they had suffered, whereas today, although there is this requirement in the code of banking conduct, the code of banking conduct is very high level and does not cover all lenders, only those who have signed up to it.

CHAIRMAN—It would certainly cover the majors, though.

Mr Lim—It would cover the majors.

CHAIRMAN—To follow from what Senator Williams was asking you about: does the idea that a professional standards board might in some way add a level of integrity have merit, or do you see it as just an overlay, a complication to the current system?

Ms Parker—All ideas have merit. It allows you to have a dedicated body with particular focus. It may extend not just to setting standards but also to codes of ethics and discipline. I guess a major consideration we would have to take into account is how it would work in conjunction with the role of ASIC. You could see an overlay in roles; you could see confusion for industry and investors; and obviously it would occur additional costs. You also have to ask yourself: do you put it within ASIC or do you have it as a separate body, which means that ASIC and the body have to work closely together to try to avoid duplication? The fundamental question we raised in our submission was: are the additional costs of that warranted; will it particularly address the issues that are being raised?

CHAIRMAN—Is it your view that perhaps we should have something like that, given that there would be some complexities and you would have to work out some clear roles and distinctions between what ASIC did and what a professional standards board might do? Would you see it as providing some confidence to the market or raising the standards within the sector and providing a more accepted view by the community that this is a more professional sector, rather than where it is at? There seem to have been a lot of submissions saying: 'We want to professionalise. We need to find mechanisms to become more professional.' The inference is that by doing that you create greater confidence and more market but people have more confidence in the service and are probably more prepared to pay because they are more confident about the service they get.

Ms Parker—It is one element that you could consider. There are other types of things such as, through ASIC, increasing the training standards or considering whether in more areas they can be enhanced, or how in other areas, such as intra fund advice, we can provide exemptions to increase the access to simpler advice. There are various ways in which you can go about it, but most definitely we would agree with the principle that trying to raise the bar in community expectations would facilitate confidence.

Mr Miller—Of course, any new organisation will have to build that confidence. They will not necessarily have the confidence from day one, and there is always a question mark as to whether they will build it. It depends on whether the industry, consumers and investors actually accept what they come up with.

CHAIRMAN—Do you see that there would have to be mandatory membership or that they would have to have real power in exercising their oversight? Would it be by peer review?

Mr Miller—Again, how you would structure it would depend, as Ms Parker talked about, on how it is going to interact with ASIC. ASIC has powers already. Are you going to take those powers away from ASIC and give them to the board, are you going to leave the powers with ASIC and have the board have an advisory function or are you going to get the board to direct ASIC to do certain things but leave most of the powers with ASIC? There are a whole lot of

issues that you would have to sort through if you were going to impose what is essentially another level of regulation.

Senator WILLIAMS—Mr Lim, taking you back to the regulations proposed with the margin lending—I have not seen it and I apologise for that; I have not read it as yet—do you actually propose a limit to LVRs in certain situations, or do you leave that to the financiers?

Mr Lim—We do not prescribe specific levels of LVR—

Senator WILLIAMS—You don't?

Mr Lim—No, we do not. That is the unsuitability assessment—

Senator WILLIAMS—It would vary from client to client, yes.

Mr Miller—It might be useful to talk about the factors that are required in the unsuitability.

Senator WILLIAMS—Yes, that would be good. Could you explain those?

Mr Lim—Yes. We consulted quite intensively with stakeholders in developing these regulations, and when we discussed the idea of an unsuitability assessment it was generally voiced that we should provide more guidance on what exactly people should look at in making this assessment. Plus we had our own ideas coming out of the problems that have occurred in the recent past around margin loans. In regulations that will accompany the act itself, we are prescribing a number of factors that lenders must specifically look at when they are doing the unsuitability assessment. The main one is probably this double gearing situation which led to so many problems in Storm. What we are saying is: you the lender must ask the client, 'Are you double gearing to put in the equity into this loan? If so, how much?'

Senator WILLIAMS—Because they might have got the deposit from another bank, for example.

Mr Lim—That is right. We are also asking them to look at the overall assets and liabilities of the client and to consider how many liquid assets the borrower may have, in order to be able to assess whether, in the case of a margin call, the borrower would be able, in a worst case scenario, to put in a bit of extra money to adjust the LVR again. So they are required to look at that. In addition, we have given ASIC a general power to prescribe additional factors. Financial services are always changing, there are always new things coming up, so we want to have a mechanism where ASIC can quickly make additional requirements in this area if they are necessary.

Senator WILLIAMS—I think those ideas would be welcome. It is a pity we did not have them 10 years ago—but better late than never.

CHAIRMAN—With respect to the concept that you cannot regulate, you have certainly made comments in here about business models and individual products. No-one expects that ASIC would rule on each individual product. There are just too many; it would be impractical. It is the same with business models. It is not really up to ASIC or to us to decide what model fits. But there obviously are some problems particularly with the one-size-fits-all approach, where it is

the same advice for everyone, regardless of their circumstances—which is contrary to the regulations in terms of suitability. Could you give us some idea of what more could be done in that area in terms of personal advice or general advice to try to mitigate the problems that exist around a one-size-fits-all approach—particularly if it is an aggressive model such as Storm?

Mr Miller—As we had touched on a bit earlier in the discussion, and many of the submitters talked about this two-tier system, we in Treasury and the government at the time did look at a two-tier system and did some work on that. Perhaps I will ask Andrew Sellars to talk a little bit about what we did there and the problems that came out of it. If it had all worked, we would have had it in place now. But there were obviously problems with it.

Mr Sellars—I am going to talk a little bit about the work that was done a few years ago in connection with a proposal to split sales from advice. The idea of that was to try to deal with the conundrum or the bind that was mentioned earlier about the desirability of having access to advice for as many people as would like it, and the quality of advice issue.

What you are talking about, I think, are options for raising quality. You might be thinking of best interest type tests or adding things on to the personal advice area—maybe, but I do not know. The proposal that was floated was to have a sales stream which was not really considered advice and to label that very clearly so that consumers would know that what they were getting was a sales person who was going to sell them a product and that they would not expect that that person would necessarily give them the best product throughout the market for their needs. The other stream would be the genuine advice stream, and there may be higher requirements on the people offering that kind of service.

Mr Miller has asked me to talk a bit about what the reaction to that was. Generally, people were quite concerned about that kind of two-tier system, and there were a couple of issues. One was that consumers may not necessarily appreciate the difference between the advice stream and the sales stream, and you would need to have very, very clear warnings or some kind of communication tool so that everybody would know precisely what it was that they were doing. And there was not confidence that we could come up with that.

The second big issue was that, if that kind of structure were adopted, one outcome might be that the number of participants in the market going for the full advice model would decline significantly and that a lot would shift into the sales stream, because the sales stream would not be accompanied by the kinds of regulatory requirements in terms of training, competence and so forth. So there was a concern that an outcome that might occur is that there might be plenty of sales people out there but not many people who were offering the genuine advice. The concern that was mentioned earlier about real, genuine advice only being available to affluent clients was another issue. I suppose they were the main points that were being raised. After that, there was some other work done to come up with some kind of an alternative to address those points. But, as you are no doubt finding, it is not an easy one to crack.

CHAIRMAN—We have some obvious models—and there would be a number out there—where they really have only one product and one system and there is really just one business model and they have many clients. Obviously it just would not meet the requirements of the act that talks about personal advice. There just seems to be some sort of disconnection between what happens in terms of the regulation and licensing and what takes place in practice—not across the

whole sector but certainly in parts of it—where they have honed it own to one business model and then sold it to everybody.

Ms Parker—I think ASIC in its submission has also talked about it going out there right now and recognising some of the issues around quality of advice. I do note that ASIC overall has said it is largely adequate but we do have some instances of poor quality advice. ASIC is going out to benchmark and measure and look at how it can work appropriately with industry so that industry really understand the sorts of obligations that attach to suitable personal advice. So I think that is a welcome initiative. It is important that we—

CHAIRMAN—I am just wondering what we might do in practical terms in relation to compliance. While we all acknowledge and recognise problems exist, and they may not necessarily truly be compliant with the regulations, it still meets the tick box compliance.

Ms Parker—I just do not see how it does.

CHAIRMAN—But it does, because they not only continue to be able to gain a licence but also continue to hold a licence even under audit.

Ms Parker—But it would be breach of the financial services law. So what you are looking at there is: how do ASIC get out there more? ASIC do not check every single statement of advice.

CHAIRMAN—I acknowledge that.

Ms Parker—That is the problem. If you were providing—

CHAIRMAN—There just seems to be a gap there.

Ms Parker—It is an enforcement issue. It goes to the work that ASIC can do with the industry to really raise the issue to the forefront so that it is really in people's minds—for example, benchmarking and measuring the sorts of stuff they were talking about in their submission. That is important work that needs to be done, because there needs to be a focus on promoting that there is this regime that requires that advice be appropriate—that you know your product, that you know your client and that, in the circumstances, the advice is reasonable in that context.

Senator MASON—We heard evidence the other day in Melbourne that most financial planners are linked in some way to certain products, banks or industries. So they are not giving truly independent advice. One of the witnesses said, 'The fact is that people are being misled. They go to get financial advice but in fact they are being sold a product.' You have not given the committee a lot of comfort this morning that we are capable of somehow drawing advice away from sales. If we cannot do that—and the British are struggling with it as well, obviously—that is a pity, but make not mistake: that is one of the central issues of this inquiry. Some evidence is that people are commonly misled. They go to get financial advice and they have been flogged a product. If we cannot draw that apart, the problems will remain. I think the Chairman is dead right: this is a central issue.

Ms OWENS—I would like to ask a few questions on that. That troubled me when I read the report. There are a few elements that trouble me. I assume that you looked initially at separating

the sales from the advice because consumers currently do not understand the difference. So at the moment there is already confusion, but what I think was said was that any system that you came up with would still have confusion. Is there less confusion—

Mr Miller—The systems that we came up with at the time still would have led to confusion, yes.

Ms OWENS—As much confusion, confusion across the range, or confusion amongst moderately educated investors?

Mr Miller—It would depend on which version of the system, but none of them was perfect. And I suppose we were not looking for perfect, but we were looking for something that was significantly better—and none of them was getting us 'significantly better'. That is one of the reasons that we turned to the concept of the Financial Services Working Group looking at the actual disclosure documents. It is taking it from a different direction. First, we were trying to separate them and then we said, 'If we can't separate, let's make sure the consumer understands what they are getting into and understands what this is.' If the documents are easy for them to read and they understand that a person is getting all these commissions and they will only offer you products of this sort and they understand exactly what they are getting into, at least we are one step closer to where we are trying to get to.

Ms OWENS—The second thing—which you came back to several times in your submission—was the increase in price and the pricing out of that sort of clear, quality advice from the low end of the spectrum. That is of course an issue but so is it also an issue if people can only get inadequate advice.

Ms Parker—As Mr Miller pointed out, there is a very fine balance that we are trying to strike.

Ms OWENS—But it would be hard just to accept that a person looking at investing even $100,000 could not afford to pay. They might be unwilling to pay for various reasons, including perception, education and understanding. Those things can be altered, but the question really is: is the quality of advice that is being given to people entering for the first time adequate, even if they are getting it for free?

Mr Miller—I still think it is the case that there is not sufficient advice around for those who even want it—and at a price that they can afford.

Ms OWENS—Or will afford.

Mr Miller—So a lot of people are going into investments without any advice. But you are quite correct: there has to be a bottom line. There has to be a line over which there must be a certain level of quality; otherwise it should not even be in the market. That is the line we are trying to draw. We are trying to draw a line of: what is that lowest quality? But once you get to there, the question is: how do you open supply; how do you make sure there is as much advice out there at least that quality to as many as people at an affordable rate?

Ms OWENS—And how do you make people prepared to pay as well?

Mr Miller—That is harder.

Ms OWENS—That is not your problem as much. Australia seem to be unique because we have such large superannuation funds, people coming into their first investments very late in life when they get their funds, lots of mum-and-dad investors. Are we unusual in terms of the number of more educated investors in this country?

Mr Lim—I do not think we have specific numbers on that but certainly the size of Australia's superannuation industry relative to the population is pretty much unique in the world.

Ms OWENS—So we are facing a situation which has developed over the last 20 years or so which we are really the first to have to deal with.

Mr Lim—Yes. That is why that move we made to allow superannuation trustees to offer limited advice is specifically designed to target those kinds of investors who are often also older investors. Suddenly at age 55 they find themselves with a lump of money which they need to invest somehow, and they may not be well equipped to make the relevant decisions. So through the working group we have given that relief to superannuation trustees to provide certain categories of advice easily and cheaply to these investors.

CHAIRMAN—Can I draw you on a point of risk. Obviously risk is a big issue. At some point, we all acknowledge, people forgot risk existed and everything just seemed to point one way. How do we improve that in disclosure? How do we require in disclosure that people fully understand? To use just one example, if you are getting some sort of a debt facility or a gearing facility, there is a potential to lose your home. Perhaps we could, just in simple plain English, write that on a document when you sign. As we have heard, people ask the question, 'Is there any chance I'll lose my home?' The answer was invariably: 'No, we've been doing this for years. We know what we're doing. You're completely safe with us.' But the reality is, no matter how remote, you could lose your home. That needs to be made crystal clear. What can we do to improve that?

Mr Miller—It is a little difficult because the government—within, I believe, weeks—will be releasing regulations and details of the margin lending disclosure documents, including a copy of an example document. Without giving too much away, there is an exact statement in the risk example that says in quite bold print, 'You may lose your home.' It is actually in the document that we are putting forward. You will probably see it fairly soon.

CHAIRMAN—That is good. Not all investments mean you could lose your home, but there are some where you could.

Mr Miller—To explain how the working group is thinking about that—and I do chair the working group as well—we have moved to this concept of stark language. It is not just a matter of summarising everything that was in the 120-page document; it is about the message that you are trying to get through. Sometimes you have to make stark statements. There will be a section that talks about the benefits, but there is also a section that talks about the risks. In the section that talks about the risks, it says, 'If you are borrowing against your home for this, you may lose your home.'

Senator MASON—It is like a warning on a cigarette pack, is it?

Mr Miller—Not quite as big as that. But this is the sort of stark statement that is needed for this to get through. These documents are very short, sharp and informative.

Senator WILLIAMS—We had this debate in Melbourne where I requested it in shearers language, perhaps without the swearwords, whereas my learned friend here used solicitors language, and you do not understand that language.

CHAIRMAN—Maybe it is just the rest of us, then.

Senator WILLIAMS—Exactly. Could I just make the point that I know of one Storm investor who had sold their cane farm and their house—they were renting. They had a little bit of land left and they put their cash in. So it is not only that you may lose your house but, if you have sold your house and you have it in cash, you may lose everything you have. That is something you might consider as well. You refer back to the Aussie dream of having a family home.

Mr Miller—One principle that the working group abides by is this. The working group was set up originally by Ministers Sherry and Tanner. Minister Sherry asked us to apply what he called the 'Burnie pub test'—

CHAIRMAN—That is no reference to me, of course!

Mr Miller—no, no—that is, he should be able to show these documents to somebody in the Burnie pub and they should be able to read them and understand them. That is one of the guiding factors that the working group has used to think about how we deliver these messages. We were talking about the shearers.

Senator WILLIAMS—Us laypeople.

Mr Miller—It is a very valid point.

Senator WILLIAMS—It is a very valid point. When you look at many documents drawn up by solicitors, you almost need a translator for sections of them. If it can be in layman's language, that is great.

CHAIRMAN—We will go to compensation.

Senator MASON—Mr Miller, there was evidence given in Melbourne by Ms Maynard from the Financial Ombudsman Service and I think a couple of others, who touched on a statutory compensation scheme. I think it was to compensate investors where financial planners had breached their statutory duties and gone out of business. There are all sorts of moral and other hazards here. Ms Maynard, I thought this approach may not be a bad one. It would be funded, no doubt, by a levy on the industry and perhaps from government as well. It probably has financial and budgetary implications as well. What do you think about that?

Mr Miller—Essentially, there are many different options. The questions are these. Is the existing professional indemnity insurance working? Is it too expensive? Is it available? At present, all the evidence says, 'Yes, all that is there,' but it does not cover everything. It is like any insurance. If you actually wanted to cover everything, the insurance premium would go through the roof and you could not afford it anyway so you would not take out insurance. On the concept of a national compensation scheme, there are obviously clear benefits for the consumer-investor. The question is: how expensive would that be? How expensive would it be to the industry? Therefore, how much extra cost would go onto the person receiving the advice? Therefore, would that cut back on the amount of advice that could be received? Again, it is a very major balancing decision. Treasury cannot say which way you should go on all this.

Senator MASON—Sure.

Mr Miller—But again—

Senator MASON—But you have given it some thought.

Mr Miller—We certainly have given that thought, yes.

Senator MASON—Thank you.

Senator McLUCAS—We have talked about improving the readability of the documentation. We have talked about improving financial literacy. We have talked about an increase in regulation around margin lending. Given all that and given what you know about how Storm Financial operated, if all of those things had been in place, would we have stopped what happened at Storm Financial?

Mr Miller—The first thing is that I will not know everything about what happened with Storm until the ASIC report comes out.

Senator McLUCAS—Sure.

Mr Miller—In the financial world, there is never a guarantee that you can stop anything with regulation. But, as I mentioned before, I think all the measures that are being put in place would significantly reduce that risk.

Senator McLUCAS—I am not sure. I do not know. I think the model that was operated by that company was almost unregulatable.

Mr Lim—That is possible. What we have done would also give those investors that suffered losses and damages much clearer rights as to how they could get compensation in that situation.

Mr Miller—Plus it would pass some more responsibility back to the lenders and out of the hands of—for example—Storm.

Senator McLUCAS—Yes, to the banks. That was a tragedy. Thank you.

CHAIRMAN—Can I summarise all of this for you and ask you this question. Have we potentially made the system too easy? Is it too easy in the sense of that one-stop shop approach where somebody can to a particular organisation and receive sales and/or advice, speak to someone about insurance and get some further advice on something else, and make use of the lending facility that they might need? Everything is there right through from start to finish. By having this simplicity, which I am sure a lot of people would appreciate and enjoy—that you can just go to one place and get it all—in a way masks integrity or removes the intent of regulation to provide some separation in the market. Do you see that potentially becoming a problem? I am specifically thinking of Storm as one example—that it might have been all too easy. Once they had you in the door, once you were convinced that it was where you needed to be, however you got there, it was all done for you. You were directed down a road that you really did not understand right through to the end.

Mr Miller—I actually do not think it is as simple as you are putting it and I suspect some of the speakers after us may tell you how complex it is. In regard to Storm, the particular area that was of concern was margin lending and that was not regulated at all. That was a particular issue with Storm. It is about regulatory balance. It is about where you get that balance. I know that in the days leading up to the GFC, because there had not been any market failures, because the system looked like it was running quite well, Treasury had been constantly looking at how to lift regulation off. We do not need regulation unless there is potential for any sort of market failure. I do not mean big lifting off, but tweaking to make it slightly simpler and to make sure that businesses can operate as freely as possible.

When you get market failure or the potential for market failure, all of a sudden the focus moves towards maybe needing a bit more regulation and maybe pushing the line further down because we can actually identify it. While it was here one day or one year, it might actually need to be moved slightly down further a bit down the track and be here at another point. At any one time, we are trying to find that line for that regulatory balance. To say that the system we have now or the one that we are going to have when these other pieces of legislation go through is an easy system, I do not agree. I think it is an appropriate system. It is trying to find that regulatory balance. The committee might come out with some other things that will help that regulatory balance, but it is close to where it should be. That is our primary submission.

CHAIRMAN—Thanks. There are no further questions, so we thank you for your submission and thank you for appearing before us today

Proceedings suspended from 10.02 am to 10.24 am

BATTISTELLA, Mr Julian, Certified Financial Planner and Member, Financial Planning Association

BLOCH, Ms Jo-Anne, Chief Executive Officer, Financial Planning Association

CHONG, Mr Seng Wing, Member and Chair, Regulations Committee, Financial Planning Association; and Member, Board Professionalism Committee, Financial Planning Association

SANDERS, Mr Deen, Deputy Chief Executive Officer and Head of Professionalism, Financial Planning Association

CHAIRMAN—I welcome representatives from the Financial Planning Association to the table. I invite you to make an opening statement.

Ms Bloch—We thank you for the opportunity to appear before the parliamentary joint inquiry today to represent members of the Financial Planning Association. For the record, the Financial Planning Association represents nearly 12,000 members, of which 550 are Australian financial services licensees and 9,000 are individual financial planners. Of those 9,000, 5,800 are certified financial planners such as Julian.

In my brief opening comments I would like to address the FPA's role in relation to Storm Financial, which was a member of the FPA. I would like to respond to some of the points that have been made in other submissions over the last few weeks. I would like to talk at a high level, although I welcome questions on the detail later, around our recommendations for improving the delivery of professional advice in Australia.

It is our view overall that the various collapses that have occurred as a result of very different issues—ranging from poor advice, high fee structures, inadequate business models, badly managed products and in some cases even alleged fraud or criminal behaviour—require a specific and individualised perspective, not a one-size, over-regulatory response. In order to reach rational outcomes that achieve the balance—and Treasury talked about this balance previously—between robust consumer protections and a vibrant competitive industry we need to bear all factors in mind and not just point the finger at financial planners.

In fact, the point that we want to make this morning is that not all financial planners in the Australian market are indeed equal. Being a member of the Financial Planning Association does make you different, because FPA members sign up to much higher professional obligations than the general population. In fact, we have just conducted research on this. We can tell you from comparison with ASIC publicly available data about their actions against financial planners that if you are a member of the FPA you are 19 times less likely to face an ASIC investigation for breaching obligations. If you are a certified financial planner, you are 32 times less likely to face an investigation for a breach of ASIC obligations. These statistics illustrates the effectiveness of professional membership and the effects of professional obligation in addition to the minimum requirements of the law.

Moving on to Storm, as an association we certainly accept responsibility for the fact that Storm Financial was a member of the FPA and we certainly wish that we could have acted early and we wish that we could have prevented some of the losses that have occurred. We acted very swiftly when we became aware of the issues in October last year through a complaint that we made against Storm as a result of a letter that they had sent to their clients. We can talk in much more detail about Storm if you wish. Deen Sanders is the head of our professionalism area and is intimately involved with and has detailed knowledge of Storm. In summary, Storm promoted a very aggressive investment strategy which carried significant risk.

There are a number of reasons why we believe that Storm failed and there are a number of actions that are under way, including margin lending and credit regulation, which will address some of those issues. We as an association have made some changes and are moving to make some more changes to improve the nature of our audit process and to introduce a whistleblower policy so that staff, clients and financial planners in the community feel that they can blow the whistle in a safer environment—and there are reasons why that did not occur earlier. We believe that we all have a lot to learn as a result of Storm.

Storm provides an example of where financial planners necessarily provided poor advice about a particular strategy and product set. But there are many more examples where financial planners prevent clients from going into poor strategies and prevent clients from being recommended products that may not suit them and guide clients through an educative and literacy process in addition to the advice process. We believe that some time and attention should be placed on that role as well.

I will now move along quickly to where the FPA sees that the regulatory regime can be improved—and I stress 'improved', because as a result of the global financial crisis financial services reform has been stress tested like you would never believe and it has withstood the tests of a very significant set of events. We believe therefore that financial services reform and its application to financial planning is robust. It works, but there are clearly gaps and issues of cultural, ethics and integrity that need to be addressed. Those issues could be best addressed outside of the framework of legislation. That is our first point.

We would like the committee to consider seriously the role of professional obligation over and above the requirements of the law, complementary to the law and as an additional safeguard. We would like the committee to consider professional obligation and its role with ASIC's role, for example. The term 'coregulation' is often thrown out. I caution on the use of that term, because it has different meanings to different people. But we strongly believe that professional obligation and professional associations can play a significant role in the areas of behaviour, ethics and integrity—the culture that we are talking about.

We also believe that the term 'financial planner' needs to be better defined. I heard the committee ask questions of Treasury around the role of product and advice. There is a very large population of financial product advisers out there—possibly 200,000 or more. I am not sure if you are aware how many people have the role of giving financial product advice. We believe that there are around 45,000 representatives and we believe that there are something around 18,000—and ASIC has quoted this figure—financial planners. We have 9,000 financial planners who are genuine financial planners working through the six-step financial planning process, which involves a lot more than regulating a product.

Let us not forget that financial services reform is targeted at product recommendations. Therein, we believe, are some of the issues. We are happy to talk about the role of the financial planner, their fiduciary responsibility and how we can have higher standards of competency than are currently available and how planners have a professional commitment and an obligation to be able to effect fiduciary ethical responsibilities.

We have suggested in our submission that licensing, monitoring and supervision should be improved. We addressed remuneration and we would like to talk about asset based fees verus hourly based fees. We have addressed disclosure and the role of product providers. We certainly believe that there is a strong need for a review of external dispute resolution mechanisms and in particular professional indemnity insurance. On that note, I can stop. Hopefully, you will ask us questions about the detail involved in some of the issues that we have raised and about a lot of the other issues that have emerged along the way.

CHAIRMAN—We certainly appreciate the submission from the Financial Planning Association and your introductory remarks. Broadly speaking, everyone agrees that we have a robust system and that the regulations and FSR are robust and has withstood a massive shock in the market. We have all come out of it reasonably well, barring the people who have lost everything. Can you make some comments in terms of the system? Is FSR focused purely on compliance? Is it a system designed around product focus, rather than clients and professionalism and advice? Could you give us some idea of what the FPA thinks about those issues.

Ms Bloch—I will make some initial comments, and then maybe Deen will speak to that a little bit further. There is no doubt that financial services reform has introduced a regime of disclosure, conduct and so forth to regulate the role of financial product advice. There is not doubt that that has played a significant role and is in fact seen to be a leading regulating regime around the world in terms of regulating advice. Having said that, it has increased the cost of advice and it has necessarily focused advice on compliance and product recommendations alone.

That is not uncommon around the world. As we speak, as this inquiry is looking into these issues, the rest of the world is saying, 'Is a regime targeted purely at a product appropriate and are there other ways of perhaps capturing the role that financial planners play in contrast to the role that others play?' Hence the term 'fiduciary responsibility' is being talked about in the UK, the US, South Africa and various other jurisdictions.

Overall we believe FSR has worked to a point, but it has necessarily also increased the cost. It has increased and focused everything around tick-box compliance. It has necessarily enabled the role in terms of culture, integrity and ethics to be subsumed in the compliance context. Do you want to add anything to that?

Mr Sanders—Only very briefly, to support Jo-Anne's comments that both the Treasury and ASIC submission identify the emphasis of the disclosure regime that currently exists in financial services as a primary mechanism for regulation in this particular space. I think that is exactly what we are emphasising. Disclosure is an after the fact exercise, arguably in the process of advice, and the emphasis occurs in our marketplace in the statement of advice—the document that is produced at the end of that dialogue. Professions are focused on other activities—on the piece of work that goes into the relationship with the client, on the activity that pre-exists the

production of the documents. That is what our emphasis as a professional regulator focuses on. Our key premise, as discussed in our submission, is a better relationship between those two environments—between the professional regulation and the government regulation—to enable a more rounded approach to what professional advice is about. The final disclosure documents and the SOAs and other sorts of issues which we do think are insufficient are in fact a consequence at the end and should not be the entire focus of any good regulation.

CHAIRMAN—The reason I ask that question—and I particularly asked Treasury about this issue of compliance versus client focus—is to see whether the system has evolved since its introduction, since FSR. As Ms Bloch said, it is more focused around the tick-the-box type approach to compliance. In the Storm example, it was supposedly completely compliant with regulation and in fact I read that it had strong legal compliance systems in place, yet that did not translate to anything in practice in terms of knowing the client, appropriate advice and appropriate products for clients. It seemed to be a one product, one model, one-size-fits-all type approach. Could I get some comments on that, particularly in relation to regulation? Has regulation evolved into being more focused just on, 'As long as people tick the box, what they do after that in practice is a separate issue.'

Mr Sanders—I think that essentially is correct, although I have to admit that I think it is largely transitional. With the adoption of any new regulatory regime there is a mechanism by which people need to comply with that regime, so they seek the fastest, easiest mechanisms to do so. Certainly the evidence shows in the case of Storm that it is possible to comply with the law, but they certainly failed in their obligations to what the professional expectations are or what the community expectations more largely are. I think that is a gap in the process and certainly something that we are anxious to make sure we respond to as part of our work as a profession. What we would certainly encourage, however, is that there is a genuine commitment from the vast bulk of the industry and from the vast bulk of professional participants to comply with not just the letter of the law but in fact with the spirit of the law. We have seen that evidenced I think in the last couple of years. We have seen that growth and change. This is perhaps one of the arguments that Treasury was getting at—that this is an evolutionary exercise. The first phase is always about how we quickly comply with their obligations. How do we do it cheaply and streamlinedly? Over time we can grow that into a more robust and appropriate system. The consequence of Storm is unfortunate and frankly a disturbing example of that environment right in the middle.

CHAIRMAN—Now I have got to you to sort of agree that they complied—maybe. There seems to be this view that perhaps they did comply, and certainly ASIC did not audit, as we understand it, just prior to their collapse, and everything seemed to tick the box. Yet, at the same time, how can that be so? How can that compliance exist? If we look at the 'know your client' rule—the client's objective financial situation and needs need to be reasonably considered—how can it have meant that the adviser has considered and investigated the subject matter of the advice 'know your product'? Is this product suitable for that person or is it appropriate advice for the client? How can those two co-exist in the same space? How can they be compliant, even if it is a tick-box type system, when at the same time they are providing the same advice and what everyone agrees to be dangerous, aggressive, highly double geared et cetera for all the same people, who all happen to be elderly and in their twilight years? It does not seem to me to sit right that the two can co-exist.

Mr Sanders—It needs to be noted firstly, as a caveat, that our investigations and professional prosecutions are continuing in relation to Storm Financial. They have not yet concluded. So it is important for us to identify what we have learnt through the exercise to date. I have to qualify that because there were what we have would term some very unusual circumstances that occurred in relation to Storm. One of them was a practice which is very uncommon, the concept of prequalifying clients. In specific answer to your question, clients were asked to qualify themselves as being suitable for the strategy—'If you want to achieve these goals and these outcomes then this is the sort of client you need to be. So are you in fact that client?' Clients themselves consented to be identified in that particular way. Whether that was a misunderstanding on their part or a mis-selling on the part of Storm is yet to emerge in our investigations and prosecutions. It was that essence, that clients themselves were part of this dialogue, perhaps inappropriately. That satisfies the prequalification example of knowing your client. To contemporise this if you like, the argument from Storm Financial was the idea, 'We can work with you to achieve great wealth in an extraordinary journey to capitalism, if you are prepared to be on this particular journey.' So clients were invited to qualify themselves into the relationship.

CHAIRMAN—Is a good point. How does that comply with the regulation, with FSR?

Mr Sanders—It does in fact comply with the law because the client is then required to satisfy how they—the advice is provided relevant to the client.

Senator MASON—This is a breach of professional expertise.

Mr Sanders—That is absolutely the point, Senator. In fact, we do not believe it complies with our expectations. That is an important distinction in this process.

Senator MASON—This is a professionalised industry. You cannot let people prequalify and determine what they think they are.

Mr Sanders—That certainly is a significant issue that arises in Storm. Again, we are pre-judging prosecution out comes but certainly our investigations had determined that it does not satisfy professional obligations and we have laid charges to this effect. It may have satisfied the law. That remains yet to be proven in relation to ASIC. In the current circumstances those two assumptions are correct.

Ms OWENS—In other areas, like tax law for example, it is quite common for a company to find a way to work within the letter of the law but technically outside the spirit of it. The tax office can go for those companies for spirit, so to speak. Storm we know about because it crashed spectacularly but are there other examples you know of where companies of financial planners find ways to work within the letter of the law but still outside the spirit of it?

Mr Sanders—I think it is entirely feasible that that is possible. Joanna has identified that in terms of FPA membership we have 550 licensees and 900 practitioners, which is less than 50 per cent of the population in that marketplace. There is no doubt in our mind that there are participants who will choose to the sail very closely to the edge, complying with the law but not seeking to truly take on its obligations. Believe it or not, we tend not to see those people as professional. I think it is of benefit to the committee to know that when we are called to an

investigation we often find that the people we are called to investigate have withdrawn at some point in the past from the professional obligations. They are no longer a member of the FPA, which is an interesting correlation. At some point they chose to step aside from professional obligations. We often see that. If you have chosen to relinquish your professional obligations but to continue to practise in the marketplace we see that obviously as something to be concerned about. You would not consider those participants to be a majority; we would assume then to be a significant but small minority.

Ms OWENS—Again, we focus on Storm because it was so spectacular. I am trying to get a sense of whether there is a larger—thank you.

Senator MASON—I return to an issue raised by the chairman before. I congratulate you for your candour this morning and for seeking to professionalise the industry. I think that is terrific. I am sure the committee welcomes that, but do you see the efforts to professionalise the industry with ethical overtones and regulatory bodies as compatible with financial planners continuing to receive commissions based on product sales? Are those two things consistent, do you think? There seems to be a tension between the two.

Ms Bloch—There is a tension. There has been a tension and it is the very reason why the FPA in May this year recommended we move away from commission based advice. That was driven largely because of perceptions but also because we believe that payment for advice must come from the client, not from the product to the adviser, which is what a commission is. A commission is a payment by the product provided to the financial planner through their licensing arrangements. The FPA put out a paper to our membership. Two thirds of our membership have supported our proposals and we well no doubt move forward. The debate of course is how long and how quickly and clearly. This committee will have an enormous impact on our own deliberations but we very clearly believe that payment for advice should come from the client and that that is the most important thing you could possibly do and not only that payment must come from the client that it must be aligned with a service and you should be able to switch that payment of if you are no longer getting that service. We have moved the debate to direct negotiation between client and adviser, which is where all our efforts are focused.

Senator MASON—In the same way that solicitors and accountants are paid. It is a fee for service rather than receipt of a commission. Can I play devil's advocate. What happens if you argue two points: firstly, if that happens, many people who are less well off may not be able to receive financial advice and, secondly, surely you can still be a profession so long as there is sufficient disclosure and transparency. They are the two principal arguments. What do you say to that?

Ms Bloch—I will start with the premise that when we talk about a fee based service, we talk about a client directed service, an hourly rate—$200 an hour, $450 an hour, $5,000 for a service—a fixed cost, and we also refer to an asset based fee, which is the subject of much debate and discussion and has been over the last couple of weeks. The reason we wish to preserve the role of an asset based fee, so long as it meets the premise that the client pays for it, the client negotiates, it is fully transparent and so forth, is that we are very concerned that middle Australia, the large bulk of the population who could very well do with advice or want advice, will not be able to afford advice if it is purely delivered on an hourly basis. So we are very concerned. We talk to a lot about people with assets, we talk to people with products, but

frankly—and Julian can speak to this in a lot more detail—we see clients who simply want a budget, a strategy, and they want their position to be put in place. They do not necessarily have assets; in fact, in many cases they have debts. We need some flexibility for people to choose how they pay for the advice and to choose how they can access that advice and therefore be able to afford advice.

If you want to talk specifically in terms of client discussions, Julian is a certified financial planner who talks to clients all day every day and can speak more about how that would work. The point we make is that, if we are forced into an hourly basis, as in the legal and accounting professions, which are different from financial planning in terms of the work transacted, then indeed we will find it very difficult to deliver that advice to a vast number of Australians who will be priced entirely out of the market.

Senator MASON—So you would not argue that transparency and disclosure would be a sufficient mechanism to overcome any issues with the professionalisation in the industry? That is what some people have argued.

Ms Bloch—We have argued beyond that. On the fee issue, for example, transparency and disclosure are important, but it is important that the client and the adviser negotiate and understand that fee. It is important that a service is delivered. There are applications other than disclosure and transparency; and, by the way, we can talk at length around disclosure and why disclosure itself has in fact been one of the unfortunate areas of financial services reform or regulation that has increased costs and has not necessarily delivered the outcomes.

Senator MASON—It has not delivered the transparency. The committee has heard evidence over the last couple of days about that. That is fine. I think we have heard enough on that for the moment.

With regard to products, I think you suggest that more should be done to conduct oversight of product before issuance rather than leaving this task to financial planners. I think you assert that, 'to this end, more should be done by government to establish a comprehensive risk rating system.' Tell us about that. How would that work? Is this a new idea, Mr Sanders?

Mr Sanders—It is based on a very careful consideration of what is happening globally. I think the Treasury submission also makes the point that Australia has a financial services product marketplace. I think the term they use is 'coloured by innovation', which we think is a great statement, because it does clearly communicate the breadth, size and complexity of that marketplace. One of the conversations that has emerged globally is the relationship between qualifying the nature of products in the marketplace at the point of products being developed versus qualifying the participants who can access products, in terms of investors and who should be excluded from it. Treasury in their submission also make the point that there are obviously tensions in either of those environments. Our suggestion comes about from a recognition of what has actually gone on in the credit regulation, quite recently—a recognition that there is a relationship between product provider and their obligation in terms of the risks attached to their product, how well those risks are communicated and the impacts that those products may have on clients. That is also mediated via the professional intermediary that will connect that client to that particular product. But it is the idea that these are multiple parts of the system and that we need to find a better way, at the product manufacture level, of qualifying the nature of these risks

and qualifying the impacts of those risks for particular clients. The role of a professional intermediary is then to fit the right products to the right clients and their risk appetites and capacities.

Senator MASON—Do you think government should do that rating?

Ms Bloch—I am not necessarily sure we are advocating that government should run with the rating; we are advocating a wider debate. A lot of the discussion has been around financial services regulation and its role with financial advisers. A lot of the work that is done at the compensation level is around financial advisers. A lot of what goes wrong is actually at the product end. Financial planners are there to advise on product, and I mentioned that they help pick and choose the right sorts of products, but they cannot guarantee that every product necessarily does what it said it would do throughout the journey. So—

Senator MASON—Neither can government, Ms Bloch.

Ms Bloch—No, absolutely. We also suggested that research houses could play a greater role in terms of ensuring how products are disclosed and the sorts of red lights and warning bells that go on. For example, I think you talked before about the cigarette pack warning. I am not sure we are talking about that per se. The FPA would not recommend—and I know this committee is looking at this issue—skewing products or determining which investors suit which sorts of products. We do not believe in regulating the industry to that extent; in fact, we would believe that that is the role of a financial planner, or, if you do not have a financial planner, the disclosure brochure that you should pick up should adequately set the warning bells off. So we have recommended the five things you must know about this particular product. That is a sort of rating system.

We have also recommended that where there are higher risk products there should be additional levels of disclosure. We really do support ASIC's role and some of the points they made in their submission around requiring more information that they can act on where the product is not necessarily delivering what it said it would do.

So there are a few things out there which would counteract the issue of saying: 'If you are over the age of 75 you really shouldn't be in that strategy,' or, 'If you've only got $5,000 you should be in cash.' We need to avoid that at all costs, because you cannot predict, based on income, age and circumstance, what people can and cannot do; it is their right to choose that. But there is an information asymmetry at the moment, so how do we, if people are not going to get a financial planner, get that information across? There are better ways of doing it at the moment. There are better ways of increasing the role of research houses which are being licensed. There are a lot of others things we can do without necessarily setting up a product regulator, which we do not advocate—hence our recommendation that we discuss this in a wider context.

Senator MASON—My friend Senator Williams, I know, is somewhat sceptical about some of the research houses. Standard and Poor's and Babcock and Brown got it wrong, didn't they, John?

Senator WILLIAMS—They certainly did.

Senator MASON—I am not trying to be difficult. I understand your point.

Senator FARRELL—I refer you to point 5.2 of your submission, where you talk about who can use the term 'financial planner'. Could you perhaps give us a bit more information about what you think the criteria ought to be for the use of that term and how you think that might be of assistance to us in solving some of the problems we now face.

Ms Bloch—This goes to the heart of what we believe is one of the problems with the regulation of financial services, which is that there are too many people out there holding themselves out to be financial planners when in fact they are not; they are doing a whole range of other things. We believe that the term 'financial planner' or 'financial adviser'—they are interchangeable—should be defined. There should be a fiduciary responsibility attached to that person. There should be a competency level that is higher than Regulatory Guide 146 attached to that person. And there should be a professional obligation attached to that person through membership of a professional body—in other words, they have to meet with requirements over and above the law. At the moment that is entirely voluntary. That would differentiate between the population of genuine financial planners and others who may be authorised representatives, financial product advisers, brokers or intermediaries. What they are doing, in essence, is delivering a product—not a strategy, not advice but a product. There might be limited advice attached to it but it is misleading to consumers and it is, we believe, a big issue.

ASIC has talked about attributing a fiduciary responsibility to the function of advice, and we think that that is going to be quite hard to monitor and manage. We would prefer that the role of fiduciary were attached to a person, not to a function or interaction. We believe the person should have that responsibility and that the criteria I have referred to should follow on from that. You would therefore find that a whole lot fewer people would be calling themselves financial planners and that consumers would find it a lot easier to differentiate. That is not, by the way, to regulate everyone out of the industry; it is simply to give much greater clarity to the distinction between what a financial planner does and what is done by others who call themselves financial planners or advisers when in fact they are not.

Senator FARRELL—We heard from Treasury today that there have been complaints that the training requirements are too rigorous and that too much time and money has to be spent on training. Do you have any remarks to make on that?

Ms Bloch—You heard complaints that they are too rigorous?

Senator FARRELL—Yes.

Ms Bloch—Goodness, gracious! We would say that the minimum requirements at the moment for financial planners are too low and that in fact as a member of the FPA you have to meet with much higher standards. We would argue to the chairman's point earlier that you have a compliance regime at the moment determining training and competence when in fact you should be looking at the role, the client and the depth and breadth that is involved. Julian, again, would blow the lights out in terms of competence, education and training, so I am quite surprised to hear—I think it is the first I have heard—that it is too high or too difficult.

Senator FARRELL—Treasury are not saying it is too high; they are saying that the complaint from industry is that ASIC's interpretation of the training requirements is too rigorous.

Mr Sanders—I wonder in fact if that is an issue of cost around the transition—

Senator FARRELL—They certainly indicated that.

Mr Sanders—As an example of FSR, acquiring the initial competence to satisfy the change of regime in 2004 involved several tens of millions of dollars in education. The question ultimately is whether that has led to behavioural change and, in our view, it has not sufficiently which is why our expectations are substantially higher than the law. I think that perhaps might be where they are referring to the transitionary cost of that. We certainly know that, in any compliance transition, at the point of any introduction of a change of regulation there are always misspent dollars and inappropriate costs. We think that can be done a lot better with a more appropriate union between professional regulation and government regulation and genuinely growing the professionalisation of the industry.

Senator FARRELL—I am not sure they were saying it was just a temporary cost. They seem to be suggesting it was an ongoing complaint.

Ms Bloch—If you are just simply an authorised representative and you are not giving financial advice, why should you meet with more than RG 146 requirements? We do not have an argument with that. Our concern is that it is the same low level for everyone. As you would expect from the Financial Planning Association, we are concerned about financial planners and others holding themselves out to be financial planners. I think perhaps what they are reflecting is industry concern that everyone across the entire financial services sector has had to expend money on training and so forth and if we are talking about raising the standards a whole lot more people would be involved. That is not what we are saying; we are saying financial planners have greater responsibilities and a higher duty of care, and therefore should have higher competency requirements, but there should be a recognition of that and that that should be captured through the term 'financial planner'. It could be that that is also what they are referring to.

Ms OWENS—In their evidence today and in their submission, whenever Treasury talked about improving the standards for various sectors of the industry or separating sales and product delivery from advice, they talked about the rise in cost and the concern that that would price the service out of the range of less affluent investors. What do you say to that?

Ms Bloch—There is a cost in any change you make, but there is a cost in keeping the system where it is at the moment. Let us go back to the balance. If we are really trying to differentiate between financial planning and financial advice and everything else to make it easier for consumers to understand the difference then that is something we are going to have to do. I think what they are referring to is potentially the increased cost of fiduciary commitment, training and competency requirements. From our point of view, our 9,000 practitioner members would probably meet all those requirements already. I am not sure that if you are talking about genuine financial planners you are asking them necessarily to increase their costs or commitments. I think what you are saying is that in recasting the shape or the framework there is inevitably some cost. You have to wear that cost. I do not disagree with that. At the end of the day, something has to change in terms of this vast body of people calling themselves a range of things other than what it is they are actually doing that necessitates some form of differentiation.

Mr Sanders—There is often a misunderstanding in legislative dialogue around the assumption that the more professional the participant the greater the regulation. This is one of the confusions that has emerged for us. We certainly strongly believe, as Jo-Anne has indicated, in the obligation that attaches to a professional financial planner. We also believe that in order to make that effective and ensure that more Australians get professional advice, you in fact need to incentivise that community rather than make their regulatory burden harder than the financial product sales environment, which is the current perversion. We think that seems to be the way legislative dialogue tends to go—that more professional participants often bear the higher regulatory obligation, which is inappropriate. The intention of enshrining terms like 'financial planner' and others is to encourage professional planners to be able to offer advice in a more appropriate, effective, streamlined and cost-effective way rather than having the highest cost and compliance and regulatory burden whilst sales people.

CHAIRMAN—But isn't that what keeps the less-professional people out? If they want to become more professional, they have to meet the highest standards. Isn't that the point?

Mr Sanders—There is government regulation and there is professional regulation. We will always have in place the highest professional obligations, and we also expect appropriate government obligations. But those things can be met through professional practice, not necessarily through satisfying the tick-box requirements with the law, which we think is sometimes detrimental to good advice.

Senator McLUCAS—How does the professional registration model that you are proposing sit with the licensing? How does that work? Is there a linkage between those two regulatory mechanisms?

Mr Chong—The current regime has a licensee and authorised representative framework. The licensee largely plays the role of a co-regulator together with ASIC and professional organisations like the FPA. The licensee's role is another level of assurance that the consumer gets through the supervision, monitoring and training that they are obliged to give advisers who are authorised under their licence.

Senator McLUCAS—But I do not think you are saying that there is a link.

Ms Bloch—There is a link. The licensee is a member of the FPA, and it has a professional obligation, and the authorised representative is by and large an individual member of the FPA. There are still issues around the number of individual financial planners who are members of a professional body, because there is no requirement for them to be a member. The role that we are talking about fits in with licensing obligation. We accept the licensing regime. It is a good strong regime, though it needs some tightening. Our interest is in assuring that the individual financial planner has a professional obligation. They are authorised by the licensee. There are rules and regulations. There are endless things they need to comply with. In terms of their professional obligation, it is they who sit in front of the client and the client expects them to adhere to professional requirements. That is where there is a lot more work to do. We are not questioning the role of the licensee and where it fits in. We are saying the individual financial planner, in addition to their obligations to the licensee and to the law, needs to undertake professional commitment. So we are taking it one step further.

Mr Chong—As a licensee who is a FPA principal member, we have to require that all our authorised representatives comply with the FPA professional requirements. At the moment, that is how it works.

Ms Bloch—But not all licensees are like that.

Senator McLUCAS—I understand that. Can I ask you a question that I asked of Treasury and will possibly ask of many others. We have heard that we are increasingly getting plain-English documentation, and we have a four-page product disclosure statement. If passed by the parliament, there will be some form of regulation around margin lending. Those changes have occurred since the events around Storm Financial. Would they have stopped an event like Storm Financial?

Mr Sanders—We are obviously party to that dialogue with Treasury. We sit with them on working groups around the development of those disclosure documents, and we welcome them. There are some substantial improvements in that material. The committee was earlier reflecting on 'stark language', which is a specific term for scaring the pants off consumers to appropriately inform them. There have been improvements in the way the disclosure documents are prepared. There have obviously been improvements that have emerged in the adoption of margin lending regulation into the Corporations Act and the credit regulations bill. As to whether all of those things would have stopped Storm, we can certainly attest to the increase in the responsible lending provisions that have emerged in terms of the way the institution works with the advice from a client. The way the disclosure documents work to improve education and information available to consumers would obviously have had an effect.

Ultimately, though, our continuously developing view about Storm Financial is that its behaviour was aberrant. There will always be participants who choose to step outside the obligations of the profession and, arguably, the law. In that circumstance, we cannot attest that it would have fixed everything, but we do believe it would have gone a long way towards improving the circumstances. We believe the most fundamental improvement that could have been made is if ASIC had been in the position of being able to inform themselves about our professional obligations and use that in their own surveillance conduct. That would have been significantly informative early in their own investigations, and they may well have been able to stop this process before it became an issue.

Senator McLUCAS—But ASIC cannot regulate a product and does not make a judgment about the suitability of a product. So what could ASIC have done?

Mr Sanders—Our professional standards speak to process and behaviour. We believe that, if they had used those as a lens through which they might have investigated particular actions, they would have formed a very different view about the behaviour that was evident in Storm that was not about the law but about professional behaviour. They may have been able to then advise us and we may have been able to respond early. A range of other cascading mechanisms may have worked, but where we think this fell through the gap was in the disconnect between professional regulations and ASIC's regulation. I think it has already been identified by the committee that, prior to this, margin lending was, frankly, an unregulated product. So we had an unregulated product and a Corporations Law that was not responding to professional obligation. We literally had a gap right down the middle into which this system fell.

Senator McLUCAS—You said it was almost like a self-generated complaint, once you had identified a particular letter that Storm had sent to its clients. Had you been advised prior to that that there were potentially problems with Storm?

Mr Sanders—No. In fact, we had not received any formal advice about Storm or anything to do with its advice models. We had been privy, as ASIC were, to their listing dialogue that had happened in the preceding year, and we had responded and required change. But we have never received any complaints or intelligence that Storm's advice model was inappropriate. That, I have to say, is to our embarrassment, and we are concerned about that. That is reflected in our whistleblowing strategy and our improved response to this in terms of market intelligence. But it was absolutely a gap. I was not advised of that particular process.

Ms Bloch—In case anyone thinks that this is a bizarre concept, I should just add that there were lots of rumours and innuendo, as there often is—and a lot of our members live in that community. There is a lot of competitive tension on the ground and there was a lot of finger pointing—'We think that's aggressive; we think it's going to fall over'. If we acted on every rumour or finger-pointing exercise in our industry, we would be flat out, all day long, running around in circles. ASIC has the same issue as us. We cannot just walk into an office and open the books. In fact, if we had, we probably would not have got to the bottom of it. We would have needed to talk to clients to get to the bottom of it, and we do not have those powers.

We need to improve our intelligence in terms of what is real, what is not real and what we can do to act, and step in much earlier. We are certainly talked to ASIC and others around that. We share the same anxiety and the same concern: when is the right time to move in, what powers do we have to go in, and on what basis do we do this? Let us not forget that there is a litigious environment out there as well. We are talking about reputations, incomes, livelihoods, earnings capacity and so forth. So it is a dilemma for us and it is a dilemma for ASIC as well. Hence a lot of this committee's focus is on what we can improve to act in a preventive sense rather than acting when it is too late.

Senator McLUCAS—I understand that those former members of yours who were associated with Storm Financial have relinquished their membership. Is that a nice way of putting it?

Mr Sanders—I think it would be quite informative for the committee to know that, of the 150 staff that Storm had, 34 were identified as advisers of one shape or another. Seventy-five per cent of those were not members of the FPA but nonetheless, one assumes, held themselves up to be financial advisers, which is the concern that Jo-Anne raised. As to the 11 we have been able to identify who had some relationship to the FPA in terms of membership, we have investigated 21 complaints as part of our investigated portfolio there. We have proceeded with charges against three of them and we will progress those through to our conduct review commission. They are, however, at the individual level. Storm Financial as a group—and Jo-Anne mentioned earlier the principal membership structure—initiated our investigation. We proceeded with that and we laid charges—professional prosecution began—but unfortunately their voluntary administration took them outside of our capacity to respond as a professional regulator. However, their membership has concluded, and we will proceed to the prosecution of the others, with an assumption of their expulsion from the profession.

Senator McLUCAS—How many members have you expelled from the FPA since its inception?

Mr Sanders—I can certainly attest to the fact that, in the last quarter alone, we have expelled five members. We have somewhere between 21 and 50 investigations that have progressed over the quarter. We have a range of sanctions and penalties available, of which expulsion is obviously the ultimate impact. We have had terminations of a further eight members, as I recall—and I think that data it is in our submission. We have an active investigations portfolio now. It is perhaps one of the busier aspects of the FPA's activity.

Senator McLUCAS—I make no judgment on that. It is just interesting to note the quantum of membership closures.

Ms Bloch—We certainly provided those statistics in relation to Westpoint, and our investigation process there has been completed. For the last two years we have been publicly publishing information on our complaints and disciplinary process. I am happy to provide the committee with the results for the last quarter or the last year if that would be of interest.

Senator McLUCAS—The question I am really asking is: is it only after we have a collapse of some sort that an investigation is triggered and people are kicked out of the FPA? Are investigations happening outside of the 'collapse model' that result in people having their membership withdrawn?

Ms Bloch—Yes.

Senator McLUCAS—That is good.

Ms OWENS—I have a follow-up question. In any sector in the economy, the market is forgiving in good times, so you get fat inventories, sloppy cash-flow and all sorts of stuff and people still survive. I imagine it is the same in the financial planning sector. Over the last 15 years of the boom, what kinds of changes did you see in the sector? Were you looking at issues five years ago? What were you talking about then, when optimism grew and behaviour changed?

Mr Battistella—You have made an interesting point about being able to measure the differences. If we look at gearing in isolation, going back five or six years, gearing could have been totally appropriate for a lot of clients who met with a financial planner—on the basis that the portfolio may have been positively geared, so a client was not subjecting themselves to such a significant level of risk. But what has happened in the last three or four years—share prices increasing significantly, dividend yields contracting and interest rates being relatively high—could have been a warning bell for advisers that it may no longer be so appropriate to recommend gearing as a strategy for certain clients. Right now, more conservative clients could justify entering into a geared investment strategy on the premise that the portfolio would be positively geared so they are generating surplus cash-flow. I am not suggesting that gearing is necessarily appropriate for most people. But if we are looking at a changing landscape, this is purely looking at numbers that tell you that what was an appropriate strategy five years ago was not necessarily an appropriate strategy two years ago.

Ms OWENS—That is about the kinds of advice you are giving. What I am really asking is: was there an influx of less-experienced planners? Was there growth in the sales sector, relative to the good financial planning sector? Was there less diligence because of the good times? Did you identify changes in your sector? Were you arguing for things then and, if so, what were they?

Ms Bloch—Maybe I should answer that question. I thought that answer would be helpful to understand it from an individual client's point of view.

Ms OWENS—Yes, it was.

Ms Bloch—Financial services reform was a turning point. That was in 2001-04. Perhaps Seng Wing can answer it from an FPA licensee point of view, because he has been around a bit longer. But how far do you want to go back? FSR made some significant changes to the regulation of the industry. A lot of people exited the industry. We have had significant change in the aged population. In fact, it has taken quite a while to integrate financial services regulation into the business of financial planning. That was going on at the same time as the markets, if you like, so that was quite a significant regulatory intervention at that time.

I cannot really say the things we are talking about now are the same things we were talking about then. We had those debates then and we ended up with FSR. And now, down the track, we are seeing some issues that have emerged out of that, which in the last 18 months have been put on the table in terms of stress testing. Seng Wing, do you want to add anything to that?

Mr Chong—I agree with everything you have said, Jo-Anne. Five years ago, at the start of FSR, I think everyone was looking at FSR very positively as something that could actually improve standards. A lot of the focus was about understanding what FSR required, having dialogue with ASIC, working with the FPA and trying to comply with it. I think the focus has shifted slightly. It is not enough to just comply with the rules. Some of the rules work for the benefit of consumers, but some do not—they increase the costs but have no equivalent benefit. The FPA has been focused much more on looking at the substance of the rules, and understanding the need for developing the professionalism of its members is the key to driving the right change. But certainly those who choose to go down the path of being a financial planner and a member of the FPA have taken the view that they want to improve and want to comply with higher standards than those required in the law.

Ms OWENS—What are the things that increased the cost but did not bring a benefit?

Mr Chong—One example is the statement of advice regulation. There have been a number of iterations since FSR began about whether the SOA rules apply correctly to every situation. There have been a number of amending regulations and guidelines from ASIC as to how an SOA ought to apply. We now have the records of advice regime and the statements of additional advice regime. All these complexities just increase the cost of the delivery of advice to the client.

Ms Bloch—Another thing to add is that financial services reform scared the pants off the whole financial planning industry and has led everyone to over-comply, to over-advise and to over-disclose in order to protect the most critical thing a financial planner and their licensee have—that is, their reputation. As I was going to mention earlier, this has created a real fear factor. We are continuously debating rigorously with ASIC on the interaction between principles

based regulation, which we all support, and the black and white letter of the law, which is sometimes needed to try and understand what the principles are. So in an effort to deliver principles based regulation, which we continue to support, there have been grey areas: what is the difference between general and personal advice? What is limited personal advice? What is scalability of advice? What is the difference between a statement of advice, a record of advice and a statement of additional advice? These poor people sit there trying to deliberate while they service their clients. What they end up with is a one size fits all, highly costly, overregulated but very complying system.

I think we need to collectively pull back a little bit, without losing consumer protection and without losing some of the benefits of this into the behavioural/cultural/ethical approach. You have to say, 'There is a minimum requirement and it is principles based, so how do I interpret this without getting hit on the head because of some obligation somewhere or other?' Unfortunately we are still emerging from a climate of fear, of risk to reputation, of protecting yourself and your client from everything that could ever possibly happen. Yet we have still had collapses despite all of that. I guess the other view is that most people in our sector are trying to do the right thing. Most people are complying. Most people are spending a lot of time and effort, at a cost, in doing so. Yet we still have issues. So how do we achieve that balance between helping those people who are genuinely trying to do the right thing against stopping those who are out there, in the minority, who are unfortunately losing a lot of money for clients and causing all sorts of issues and concerns along the way?

CHAIRMAN—In that same vein, it would be fair to say that the big problems and collapses that we are talking about actually come from people who are fully licensed, fully qualified—in fact, they have probably reached the highest levels—have ticked all the boxes and are members of professional associations such as the Financial Planning Association. We all agree that we need to lift the standards. There obviously needs to be better ethical standards, better codes and principle based planning and advice. But there is no guarantee in that. Often the problem comes from people who use the system to maximum advantage to do whatever it is that they do.

Ms Bloch—That is a point. Whilst I do not want to demean the losses that have occurred, those cases are still a minority. If you look at the population, they are still a minority.

CHAIRMAN—Absolutely. I accept that. That is what we are trying to deal with. It is not about trying to say this to the whole sector; it is about dealing with problems where they exist and trying to clean that up. If you can do that, perhaps you can make it easier for everybody else.

Ms Bloch—Yes.

Senator WILLIAMS—If I am a mechanic and I become a member of the Motor Trades Association, I can hang a badge outside my shop and people will have confidence in me. That is similar to your association as well, I would imagination. How long was Storm a member of the association?

Ms Bloch—For 10 years.

Senator WILLIAMS—What does it cost to become a member of your association?

Ms Bloch—For a principal member of their size it would be around $7,500 a year.

Senator WILLIAMS—When they apply for membership, you obviously scrutinise their application. Did you have a close look at Storm's program and what they were doing?

Ms Bloch—Yes. Ten years ago they would have had to meet with entry requirements and they would have had to go through a due diligence process. Every year thereafter, we conducted a self-assessment questionnaire process in which they responded to a number of questions—and we have changed that significantly over the last couple of years.

Senator WILLIAMS—What sort of assessment have you changed to?

Ms Bloch—It is still self-assessment. What has changed is that we have risk-rated the system because visiting 550 licensees every year is an impossible task—and Deen can speak on this in more detail if you like. We have a system where we try and determine those that are potentially higher risk than others. We focus on the higher risk licensees, who may require a visit, a phone call, an office audit or other mechanisms that we have.

Senator WILLIAMS—Did Storm's publicity materials proudly have the FPA logo on them? Have you seen any of that material? Did they use their management of the FPA as a marketing tool?

Ms Bloch—I think they did. A number of the clients we met with certainly recognised the logo—principal member of the FPA—on the front of their office. One of the issues that has been raised with us is that there was a perception—and you cannot argue with this—that all financial planners working for Storm were members of the FPA and, therefore, there was confidence and trust in the brand.

Senator WILLIAMS—No doubt in the future you will be having a very close look at new members and people who wish to wear your label?

Ms Bloch—We do that anyway—bearing in mind that Storm entered 10 years ago. I guess the issue you are pointing to is: to what extent can you influence a business model? Can you influence the process by which they select their clients? Can you influence the way they deliver their advice? To that extent we have a code of professional practice that we will more rigorously enforce and look at in terms of the system of audit and compliance that we have.

CHAIRMAN—Just to follow that line of questioning, on the FPA logo, by sheer virtue of their being the principal member does that not imply to everybody else—and I would have assumed this until you just said that its members may not have been members—that because the principal is, the same as is on their licence, everyone else under them is also a type of member.

Ms Bloch—That is correct. I can understand your perception, and we are looking at that at the moment. Because having such low levels of individual membership should be a warning bell to us around individual professional commitment and obligation. I can say that having licensing obligations does automatically capture all authorised representatives, so we still do have some role and say in that, but that does not help the individual client sitting with the individual planner

who may have done something different, rather than simply accepting the Storm model. They may not. I am not sure.

Senator WILLIAMS—The evidence we have taken so far suggests that the Storm model was a one size fits all. Did your association never actually look at that model in recent years and stress test it? Did you pay attention to what Storm were marketing?

Ms Bloch—We did from the point of view of an initial public offer in about 2007. We certainly looked at some of the disclosure documents and the prospectus. But, again, our role is not necessarily step into the business model and to look at those sorts of things. We look at our code and rules and obligations with this. I do not know whether anyone wants to add anything.

Senator MASON—Are you satisfied that it was risk-rated? Senator Williams has asked and you have said that you are now involved in risk-rating because you cannot visit all of the firms operating under the FPA. Did you risk-rate Storm?

Mr Sanders—We did, and it is worth while giving some information here. As Jo-Anne reflected, our self-assessment questionnaire and annual compliance audit model for many years reflected ASIC's Corporations Act model. In fact it was a duplication of that environment, which was meaningful for members because they had been going through a FSR transition and so they were aware of those obligations.

In 2007 we took a decision to review that model because it was not, in our view, responding to our expectations of professional behaviour. We wanted to exactly example the discussion we are having here today, that there is a professional obligation as a licensee and a legal obligation. The first time we ran that audit model was last year. The results of that audit model came in November 2008, at which point we had risk-rated Storm and had identified that they would have been a member that we would have visited in response. It is a learning that came too late, but that is the evolution of any conduct and compliance model. We are quite proud that we got there much earlier than ASIC did in terms of reviewing that conduct model. Nonetheless, it is worth while noting to the committee that our audit model identified an audit risk there for us in November 2008. We had already begun investigations in October.

CHAIRMAN—So what was the risk?

Senator WILLIAMS—What was their risk-rating? Was it up in the red zone?

Mr Sanders—As Senator Williams said, it is the issue of concentration of business and the one-size-fits-all model that I think was reflected earlier. That is an area of risk, in our view. If you have a one-size-fits-all business model and you are only operating a particular domain of product and a particular domain of advice, that is something that would escalate you as a risk profile for the FPA to consider for a compliance review.

Senator WILLIAMS—Were you aware of the level of high gearing, the LVR ratios et cetera?

Mr Sanders—Only at the point that we received the email notification from them in October. We launched that investigation. We became very quickly aware, but we were not aware at that point.

Senator WILLIAMS—Did you get any complaints from the public or from Storm investors?

Mr Sanders—No. We initiated our own complaint on the basis of having received a copy of the email that was sent to all Storm clients.

Ms Bloch—That was only in October last year. Prior to that time we had received no complaints from clients or anyone else in relation to the Storm model.

Senator WILLIAMS—Thank you.

Senator MASON—If you are going to become a more professional organisation, clearly this risk-rating that Senator Williams has referred to becomes much more critical.

Senator WILLIAMS—If people are to have confidence in your label.

Senator MASON—You will have to gear up, as it were, that process, otherwise your body will not have the appropriate professional imprimatur required.

Ms Bloch—We have geared up, we are gearing up and we do not, fortunately, have a vast quantity of licensees that necessarily hit the red zone—to use your language. We are not talking about having to employ another 55 staff or anything like that.

The other issue is—and this is an interesting debate—how far can you step in and talk about business models and how far can you regulate these sorts of practices in an innovative and competitive market? We have some indicators that we can certainly look at, and we have a code and practice standards around that; but I do not want to leave the view that we are going to step in and determine which business models are good and which models are not. We will ask questions, we will investigate further, we will enter into that dialogue. But there has to be some degree of innovation and competitiveness left at the end of the day.

Ms OWENS—Following on from that, rule makers as we are, we all have to be aware that if a person wants to break the rules, a rule does not stop them. Rule breakers break rules. That is what they do. And sometimes they are very good at hiding the fact that they intend to do that. This is not a question specifically about Storm, because I do not know their motives, but no matter what your rules are and no matter what your processes are, from time to time businesses will come along that are con men, criminals, incompetent, careless or whatever. What kind of processes should we have had in place and could we have in place that would make those easier to spot? You have talked about your whistleblowing. I ask that question in terms of: what can we have in place without regulating everybody else out of business?

Ms Bloch—Wow. Where do we begin? I guess our starting point is that the law sets a minimum standard and sets the catch-all, if you like, around disclosure conduct and the various things we are talking about. Licensing sits at the heart of that, and the licensee has an obligation that is fairly detailed in terms of what it is required to do and how its authorised representatives are required to conduct themselves. We have made recommendations around improving, tightening and filtering those people who can get a licence and around the way authorised representatives are licensed. We have talked about a register of all people in the financial planning framework—that we should be able to get—that is publicly available, and that ASIC

manages, so that people can see who is in and who is out. That is the licensing side of things. That is the Corporations Law side of things. Then we talk about professional obligation and commitment, and it is our strong view—again only talking about financial planners, not the whole population—that financial planners should have that fiduciary responsibility, they should have higher levels of competency and education, and they should conduct themselves in such a way that they are focusing on the client and that they are conducting themselves according to what the client's interests and needs are. You are asking about a cultural approach as well as anything else, and you are asking a professional body who is close to their membership, who will, through improved processes, work on protecting the profession—having people say, 'That person is not meeting their professional obligation; what can we do about it?' There are a number of angles on both the professionalism side and the legislative side that we think could be improved and tightened.

I think you were asking about warning signals. I think everything we are trying to do is to try and raise the enforcement of some of what we have got in place at the moment and therefore, by exception, raise some of the situations that might alert you to the warning bells. We have not really talked about consumers, literacy and education, and that is another area. We have a long way to go in helping consumers become more capable in terms of their financial obligations, responsibilities, preparation, planning and all those sorts of issues. There is a whole body of work in there.

I think if you have a professional financial planner with a robust regulatory environment and an informed client, you are going to get the best outcome. To a certain extent that is the holy grail, but I do not necessarily believe it is out of the reach of any of us to achieve that.

Warning signals are difficult. We are talking about complex, deep issues, but I think what you want to strive for is the informed consumer, a professional financial planner and a regulatory underpin around products and all those sorts of things in the market that help—particularly where you are not necessarily talking about consumers who are always accessing advice. Your role is far beyond ours. You have got to think about everyone out there. Obviously we would love everyone to go and see a financial planner, but that is impossible. From your point of view, I think you are aiming for better-informed consumers with better disclosure documentation and a regulatory underpin that does not seek to capture everything, does not seek to regulate everything, because then you completely undermine competition, innovation and choice. People do actually want choice, and I think we are certainly heading down the track. In terms of warning bells, that is an ongoing and evolving process.

Senator McLUCAS—In your submission you also talk about regulating advertising. Are you proposing that there be some pre-approval mechanism? How do you propose to regulate advertising?

Ms Bloch—We would support ASIC's recommendations in this regard. You would ensure that there is a certain type of language included in some of the product disclosure statements and you would ensure that there is some form of true-to-label framework within the advertising, because there is not a week that goes by that I do not get one of our members sending us an advert—usually from a property provider, by the way, which is a whole new area we can talk about that still remains, by the way, outside of the regulatory environment and which is your next challenge—with some outrageous—

CHAIRMAN—Should we do that concurrently with this inquiry?

Ms Bloch—That is another state regulated area that has its own issues. If you want to look at collapse and investor losses, you will find a lot there. But I think true-to-label frameworks, truth in advertising and the ability to pull something if it is not appropriate are probably as far as you can go. I cannot imagine a situation where everything is vetted. I cannot imagine that sort of approach, but in our submission we certainly have talked about ensuring that the concept of 'this is what I say I'm going to do' is exactly what you do. I think that is important and that ASIC has touched on it adequately.

Ms OWENS—To talk about consumers, consumer perceptions, willingness to pay and need to pay, what was the effect after the crash? Did more people seek out professional planners? What was the consumer response?

Mr Battistella—I think it is fair to say that most financial planners would have been struggling with their existing clients, handling their inquiries and reassuring them. They would not have been very focused on trying to take on new clients at the time. Their obligation would have been to reassure their existing clients and to review their strategies to ensure that they remained appropriate. That being said, a lot of people think consumers chose to bury their heads in the sand and do nothing over that period, and that is why we have seen in the last few months, when it looks like markets have started to stabilise a little bit, that consumers are starting to come out to seek advice again. That is certainly what I am noticing as far as new clients are concerned. I think we had a period of about 12 months where a lot of people were just doing nothing, because they were too terrified to make any form of decision whatsoever.

Ms OWENS—To read their mail.

Mr Battistella—Absolutely.

Mr Chong—That was our experience as well. All advisers were busy reassuring their clients. The greatest value that they delivered to their clients was peace of mind. In a time when there is a lot of market impact, the clients expect them to be in contact and to give them reassurance.

Mr Battistella—I think that, too. Consider the issue of fees and appropriate means of charging and collecting fees from clients. Financial planners were operating solely on an hourly rate basis, which can be done very easily when you are providing initial advice or one-off advice. You can quite easily look at a client's circumstances, recommend an appropriate strategy, implement that strategy and do all of that on an hourly rate. I do not think there is a problem with that. The real problem comes down to the ongoing service that almost all clients that I see do require to ensure that they have the discipline to keep them on track. So many changes happen every year. It may not be legislative changes; it can be market volatility.

If we were dealing with all of our clients purely on an hourly-rate basis and all of a sudden the clients had not heard from us—because they will never hear from us proactively if we are not receiving revenue or charging our clients' revenue on an ongoing basis—we would end up having every single one of our clients booking in at the same time because the market had fallen and they suddenly needed a review conducted. We would have no choice but to turn them away, saying, 'Unfortunately, all of a sudden everybody wants to get advice, so you are going to have

to wait six months.' That is potentially a long enough time period to destroy people's lives and financial planning affairs. Instead, what we choose to do is charge our clients. We do not receive any commissions in the business that I work in. We instead levy a fee which is a percentage of funds under management. That means that we are able to have a very robust business that is going to be there in the good times and the bad times, because we have revenue coming through constantly that the client and the adviser negotiate.

If we do not deliver on our promises and provide the service we promised to our clients, they will turn that fee off. It takes a single phone call and that fee ceases being paid to the financial planner. So there is a very big vested interest for financial planners to make sure that their clients are being appropriately serviced at all points in time. Often in the bad times they are going to earn that money more than ever. If I look at the number of changes which have happened over the last two years alone, every one of those changes had an impact on our clients. If clients were required to come to us to determine whether this legislation is going to impact on them, many of them would not have because they would have feared an invoice arriving in the mail a week later to tell them that they do not need to make any changes because everything is okay. It is not a 15 minute consultation that you might experience with a doctor which costs $40. For us to conduct that type of review might take hours and hours. So it is conceivable, if we had not seen that particular client for 12 months, that we would have to conduct a complete analysis which could result in 10 or 15 hours of work, which has to be paid for because the business does not have any other revenue coming in. We do not want to be transactional focused or incentivised; we want to be advice focused and advice incentivised.

CHAIRMAN—Earlier you said a lot of what goes wrong happens at the product end. I am wondering what she meant by that specifically.

Ms Bloch—Again, a financial planner is there to provide advice and to necessarily recommend a product based on what they know and what they understand around that product at that time. Mostly those products fulfil their obligations. They fulfil what it is they said they were going to do, but there are instances, there are examples—we have had another inquiry on this—where the product promised has not been delivered, and the managed investment scheme examples are two good points. They were robust investments where the corporate entity made certain decisions which were not fully disclosed and were not fully understood. The financial planner was not privy to what was going on and the company itself ended up collapsing and taking everything with it. There are issues there which are really important. They flow through to accepting compensation or to making claims for compensation where it is very difficult to apportion responsibility between the planner and the product. We talk in our submission about improving that. There are issues around stress testing, around ratings, around the use of research houses.

CHAIRMAN—Yes, but given that the products are not regulated—we do not regulate specific products, we do not make any judgment of the value of the product, whether or not is going to be commercially viable—rather than it all goes wrong at the product end, it is the use of the product, the application of the product or the advice on the product that really is where it fails? That is where there is human interaction with the client. A product on its own is just a product. It may suit one person but it does not suit another. It may suit one person in a small quantity but not in a 100 per cent quantity. Is it more the use and application? Should we be diverting our attention? Should we look at individual products and models and say, 'Product in,

product out, obviously no'? Should we look more to the use, application and advice on those particular products?

Ms Bloch—We would say that by and large the use and the application are important but that is where there is a financial planner or a third party involved. That is also where there is full disclosure, where the product meets its commitments and where it does what it said it would do—I am talking about a product as an object. As we have seen, that is not always the case. So the question for us is not necessarily that we want a product regulator but what is it that we can do to improve disclosure, to improve understanding, to improve the environment in which products are out there and necessarily advised on. It starts, if you have a financial planner, with the advice process and an appropriate product and appropriate recommendations, based on what you know, based on the research. It does not always hold true to label. It does not always meet with what it says it would do. That is the gap, I guess, that we are talking about.

Mr Battistella—A good example of that is if we consider Westpoint as a product that failed everybody because you lost a 100 per cent of the moneys invested. Whereas, if we use the Storm business model, from what I understand, they were recommending an indexed fund. As a product, there was no problem with the fund they were recommending or the product they were recommending.

CHAIRMAN—It was its use, the application.

Mr Battistella—It was a strategy they overlaid over the top of the product. So there you have a situation where there are two products and two totally different outcomes.

CHAIRMAN—Thank you very much for your submission and for your appearance today. We appreciate your time.

[11.50 am]

BROGDEN, Mr John, Chief Executive Officer, Investment and Financial Services Association Ltd

CODINA, Mr Martin, Senior Policy Manager, Investment and Financial Services Association Ltd

O'REILLY, Mr David, Policy Director, Investment and Financial Services Association Ltd

CHAIRMAN—Welcome. If you want to make some opening remarks or add anything to your submission, that would be welcome.

Mr Brogden—Thank you. IFSA thanks the committee for the opportunity to present here today. It is now a well established policy of successive governments to encourage as many Australians as possible to provide for themselves in their retirement. This policy goal was most clearly expressed in the decision 17 years ago to mandate compulsory superannuation contributions by all working Australians. The opportunity individuals have to access financial advice impacts directly on this policy goal. Those that access financial advice are far more likely to be better prepared for their retirement. Maximising access to financial advice is therefore integral to increasing retirement incomes for all working Australians.

We strongly believe that good financial advice adds tremendous value to the financial wellbeing of individuals and their families in good and bad economic times. At the heart of the value of financial advice is its ability to help individuals and their families adopt a savings regime to allow them to reach their financial and retirement goals. Financial advice is also critically important to ensuring Australians have appropriate levels of insurance cover to safeguard their families' quality of life in the event of an accident, sickness or death.

Given the clear value and importance of financial advice, any reforms must ensure affordable access to financial advice for those Australians who most need it, particularly lower income earners and young people. IFSA believes that increasing access to financial advice is therefore a critical objective of this committee. Accessibility is primarily a function of cost and therefore an individual's ability to pay. In recognition of this, IFSA's members are streamlining the provision of advice and the cost of administration to generate efficiencies and increased returns to consumers. The measures they have adopted with respect to financial advice primarily relate to centralising certain functions to benefit from economies of scale.

IFSA fully acknowledges that we should strive to continuously improve the financial services regime to ensure it remains responsive to change. To this end, in June this year IFSA announced a super member charter that will, among other initiatives aimed at directly benefiting consumers, bind our members to move to a transparent fee based model for financial advice, starting from 1 July 2010.

We also believe that delivering continuous improvement requires that we raise the bar by improving regulatory standards in three areas. Firstly, we believe that there is a need to review

the financial services licensing process. Licensees and their authorised representatives must be appropriately resourced and sufficiently competent to offer the range of financial services and products for which they have or wish to obtain a licence. Secondly, we support improving the entry-level requirements, ongoing qualifications and professional development of financial advisers over time. Options in this area should be subject to a detailed cost-benefit analysis.

Finally, we believe ASIC must take a risk-weighted approach to monitoring and surveillance using its existing powers. More can be done to assist ASIC to be better prepared to respond pre-emptively to potential market misconduct. At the core of this approach is the development of a framework which allows ASIC to better assess the likelihood and risk of non-compliance presented by a licensee. Industry has an important role to play in this area by alerting and assisting the regulator to what is happening in the marketplace. We are in a good position to provide ASIC with practical insights into industry norms and best practice, which can assist them to develop the necessary risk-weighted view of licensees. Developing this view will naturally require an evaluation of a number of relevant risk factors, which we have outlined in our submission

The reality is that financial advice is already inaccessible to millions of Australians. Increased standards, which we support, will give rise to increased costs, which will most likely make financial advice more expensive and risk the exclusion of even more people from receiving advice—which, in many cases, they desperately need. As a result, IFSA believes that all financial advice should be tax deductible. Financial advice should be tax deductible irrespective of whether the advice relates to superannuation or other investments, to the creation of a financial plan or to an ongoing investment. Tax advice is tax deductible. We believe all financial advice should be too. Providing tax neutrality is essential to ensuring that investors are able to exercise choice effectively as to how to structure their payment for financial advice—be it an upfront or ongoing fee. We simply cannot afford to marginalise those who need financial advice the most.

Finally, and given the genesis of this inquiry, we feel it is important that we outline our view of the causes of the collapses which have been your focus here. The collapses are largely the result of participants operating outside, or on the fringes of, the current framework. This view is reflected in the recommendations we have made to the committee in our submission. We do not believe that raising the bar alone will deliver improved outcomes. It simply will not prevent market participants operating outside, or on the fringes of, any new framework that might be developed. That is why a key focus of our submission is on how we can improve ASIC's ability to respond pre-emptively in future. Thank you.

CHAIRMAN—Thank you, Mr Brogden. I might take you to the point that you made about the collapses really being at the fringe of the framework or were operating outside the framework—that sort of concept. I sort of accept that and I sort of do not. You would have heard from the previous submitters that people such as Storm and others were actually completely compliant, or they certainly got the ticks that they were compliant, had been audited and were found to be compliant, were members of the relevant professional organisation, probably had some of the highest standards and, I understand, might have had some very strong legal compliance frameworks in place. Yet they were actually diametrically opposed to the intent of FSR and compliance is supposed to be about. How do the two sit together?

Mr Brogden—Section 945A of the Corporations Act talks about the requirement for licensees 'to have a reasonable basis for advice' and says:

(1) The providing entity must only provide the advice to the client if:

(a) the providing entity:

(i) determines the relevant personal circumstances in relation to giving the advice; and

(ii) makes reasonable inquiries in relation to those personal circumstances; and

(b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and

(c) the advice is appropriate to the client, having regard to that consideration and investigation.

CHAIRMAN—So what you are saying is that they were not compliant?

Mr Brogden—That is the conclusion that is reasonable to draw.

CHAIRMAN—How is it then possible, if they were not compliant, that everyone who is charged with the responsibilities of making sure they are compliant actually say they are? There are audits, and they say they are and the professional organisation they belonged to did not seem to know that they were not compliant, either. So how can this be? Isn't this where the system has failed? Isn't this where the gap exists? How do we bridge that gap? How can that be possible?

Mr O'Reilly—What you have said is correct, but you are drawing a fairly broad blanket. There may have been some Storm clients for whom that advice in fact was appropriate. Obviously it is a matter for the courts at the end of the day whether the advice was appropriate, but if a person is on a pension and their sole asset is their family home, a reasonable person would probably say that it would be inappropriate to gear them up to 80 per cent or more.

CHAIRMAN—You are right. There is a very interesting figure here. They had something like 14,000 clients but really it was 3,000, because they were the ones who were so-called 'Stormified' or had been with them for a long period of time. The other 11,000 were coming through acquisitions and the buying of other businesses. But all of those 3,000 were into those gearing strategies—every single one of them. And they were all a particular type of person. Not all of them but most of them were aged. How does that fit?

Mr O'Reilly—Also, the Storm model was based on a rising market, which simply did not take into account the risks that were involved.

CHAIRMAN—So how do we deal with that in terms of regulation—compliance regulations, audits et cetera?

Mr Brogden—The law is pretty clear, and we would argue that ASIC needs to be more pre-emptive. We are not simply here to criticise ASIC. There are many people who may well have

missed the opportunity to proceed in the last couple of years on enforcement matters. We are very strongly of the view that ASIC has the ability to proceed to exercise its powers under this section of the act, and we would encourage ASIC to do so.

Mr O'Reilly—You will also see that section 912E of the Corporations Act specifically provides for surveillance of licensees.

CHAIRMAN—Where do you see that the problems exist? We all agree that generally it is a robust system and it is generally working well—all those things—but where there are collapses and failures we want to try to improve. Where there are failures, how do we make improvements?

Mr O'Reilly—I think hindsight is always very good in terms of where you would allocate your resources and—

CHAIRMAN—That is what we are doing. We are trying to use hindsight in our learning about this.

Mr O'Reilly—That is right. The recommendation that we have made is for a more risk based approach to be introduced in terms of the investigation and regulation of licensees.

Mr Brogden—The reality is that you are talking about thousands of different individuals acting for hundreds of licensees. Therefore, you can see why ASIC may have been challenged in getting across that field. But we would say that this act and this provision give them significant power. As David said, coupled with the ability they have for surveillance, we think they could have done more.

CHAIRMAN—Such as?

Mr Brogden—Surveilled.

CHAIRMAN—We have heard that from others. I appreciate what you are saying, but what do you do? You go in and audit the books? What do you find? Do you shut them down or suspend their licence—and on the basis of what?

Mr Brogden—On their failure to provide appropriate advice?

Mr Codina—I think the basis for any action is actually identifying any instances where the advice was inappropriate and therefore a breach of the act. Those surveillance powers effectively enable ASIC to go in and open the books or look at the statements of advice that that business through its advisers has provided to its clients and make an assessment about whether or not that advice is in fact appropriate. The shadow-shopping work which was referred to before is effectively that exercise. What we are saying is that the power is there to go and have a look. What we need to do on the industry side is assist ASIC in terms of what we think are the risk factors that ASIC should be considering, to assist it to develop a model that enables it to be more effective with the limited resources that it has about identifying where it needs to focus its energy.

CHAIRMAN—Again, I appreciate what you are saying. So, having done that, ASIC would then say to perhaps Storm, one of its investors or anybody else out there, 'We recommend you don't apply this model. We think this is a bad model. This is dangerous. It is aggressive'?

Mr Brogden—Not necessarily. They might say with respect to one individual, 'This advice isn't appropriate,' and with respect to another individual, who has a completely different profile, different income, different assets et cetera, 'This advice may well be appropriate—high-risk or risky, sure, but you walk in with open eyes and you have the assets to back it.' But, as David said, a pensioner who relies solely on the old-age pension and has a $400,000 home should not be geared up to billyo; it just should not happen.

Senator MASON—I appreciate your comments. In effect you would say, without putting it too bluntly, that Storm Financial, in pursuing this one-size-fits-all approach, is clearly in contravention of the Corporations Act. That would be your contention?

Mr Brogden—Yes.

Senator MASON—Do you think that this committee should recommend that the duties of financial planners be raised to a fiduciary duty—in other words, raise the bar? Do you think that is appropriate or not necessary? What would your view be?

Mr Brogden—We do think that the bar should be raised. In the submissions to the committee from quite a variety of sources, we have had suggestions for fiduciary obligations and for what is in the best interests of the consumer. We are happy to have that discussion about where that bar gets raised to. We do, however, want to guard against one very important thing. I like to think that one of the greatest mistakes we make in life is overcompensating for the last mistake we made. We cannot run away from the fact that 945A of the Corporations Act is not an insignificant weapon to defend and to advocate on behalf of consumers. Our view is that we believe the bar needs to be raised, particularly at entry level standards and on ongoing professional development. We are not convinced that it would necessarily lead straight to a fiduciary relationship. We are happy to see improvements but recognise at all times that the basis is in fact very strong.

CHAIRMAN—You are not really saying 'raise the bar', you are saying 'enforce the bar'.

Mr Brogden—A combination, yes, absolutely.

Senator MASON—So 945A is largely sufficient but you would be prepared to enter into discussions about whether the duty could be raised at all.

Mr Brogden—We believe it is sufficient in the current terms but we believe, just as markets change, you do need to consider options in the future.

Mr O'Reilly—The current licensing requirements require a licensee to act efficiently, honestly and fairly. They are generally a statutory version of certain sorts of trust obligations or equitable obligations. There are certain circumstances in the current law where a court would probably find a fiduciary relationship given the nature of the relationship between an adviser and their particular client, and there are other circumstances where they would find that no fiduciary

relationship exists; it is simply a contractual relationship. It is going back to the point that you raised before in terms of Storm. Is it appropriate to have a one-size-fits-all legal relationship across a range of individual relationships between clients and their adviser?

Mr Brogden—The last thing I would say is that we would be very happy to see ASIC throw the book at individual advisers or licensees who behave poorly. That would only stand to allow those who have acted both in the spirit of the law and to the letter of the law to improve their ability to market themselves.

Senator MASON—You mentioned an interesting idea before that all financial advice should be tax deductible. Have you got you any ideas what the impact on the budget would be? How much would it cost the government?

Mr Brogden—Tax deductibility for advice at the moment is provided effectively for ongoing advice, broadly speaking, in both superannuation and non-superannuation products. But it is at the front gate where it is denied. That is often where you want to get people in. You want to get them into the process so that they begin to think about their financial future. It is typically the case that most people wait until they are about 40 or 45 when they begin to worry about their financial future and their retirement. Often that is just a little bit too late. That is why we want to see introductory financial advice being tax deductible. We do not have a cost for it. We are not in a position to cost it out. When we say 'all financial advice', a good amount of financial advice is already tax deductible. It is the front-end financial advice that we think should become tax deductible, so it is not as frightening a request as it might sound. But the principle is quite important. It is very important when you consider that people get tax deductibility for their tax advice.

CHAIRMAN—But do you find it odd, on that point, that Storm Financial were obviously very successful at attracting new clients when their model actually worked on the fact that it was all charged upfront and there was no tax deductibility? They had no problems attracting people to pay exorbitantly high fees with no tax advantage. How does that work?

Mr Brogden—I think the promises they held out were over the top so maybe people thought the upfront fee was worth it in view of what the gain would be. Once again, for many people that was simply inappropriate.

Senator WILLIAMS—We heard evidence in Melbourne two days ago that some had trailing commissions of one per cent a year. Storm would have said, 'Well, in seven or eight years you have paid for it all and there will be no more fees,' when they charged seven per cent upfront.

Senator MASON—Mr Brogden, in your submission you argue in a sense that margin lending has received bad press recently and that in many cases it is suitable, and indeed in Australia it has been conservatively launched. Do you have any views about the new legislation currently going through the House of Representatives touching on margin lending?

Mr Brogden—I will ask Martin or David to talk about that.

Mr O'Reilly—I think Mr Miller from Treasury indicated earlier that it is unusual to have a credit product regulated as a financial product, but that was opportune in terms of the types of

safeguards around financial products. There are a range of safeguards. They are disclosure documents. You have product disclosure statements, you have licensing requirements and you have statements of advice et cetera. So lifting the bar in terms of those regulatory requirements is probably appropriate. My own view is that it is probably inappropriate to put it in chapter 7 of the Corporations Act, but it is appropriate that they be regulated given the mischief that has been caused. I think as Mr Miller indicated, the big element in that regulation is the responsible lending obligation. So an additional obligation has been imposed in terms of credit products for responsible lending, and it will also be imposed in terms of margin lending. That seems appropriate.

Senator MASON—Senator Williams has been talking about that for a while and about responsible lending. It is becoming the central point of the new margin lending legislation.

Mr O'Reilly—My fear, and one of the reasons why I would not want it to be in chapter 7, is the risk of having some sort of responsible investing obligation coming along at some stage in the future.

Senator FARRELL—Mr Brogden, a number of the witnesses so far today have spoken about the issue of training. There have been different views put. The Treasury in particular indicated that they were getting complaints that the training requirements were too onerous and perhaps too expensive. Do you have any comments about the training requirements and how you think they ought to be viewed?

Mr Brogden—Not having an understanding of exactly why people are complaining to Treasury, the first thing is to set the scene here ever so slightly. There is a shortage of planners so there is a need to see a growth in the number of planners. I imagine you may be seeing people coming into the market to undertake financial planning training who may be new to the sector, and maybe there are people who have lost their job in the last year or so who are looking for a new career. Maybe they, wrongly, see the standards as onerous. What we would say is that they are not onerous enough. Possibly the fact that there are complaints to Treasury is a good thing because it indicates that maybe there are people who are falling short of the standard. That is a good outcome. We want people who are quality people who meet a good standard of professional training to be able to sit down across the table with Australians and advise them on their retirement and financial future.

Senator FARRELL—Just on that point, you are suggesting that the training should be tougher. The United Kingdom, I think by 2012, is going to require financial planners to have qualifications equivalent to the first year of a university degree. Do you have any view as to whether that is acceptable?

Mr Codina—One observation we would make, again to pull back a little bit, is to say that, in our view at least, there is a generational argument to be made here. If you look at what you might call 'inflows' of new planners into the industry then I think you will find that, relative to existing planners, you are seeing many more tertiary educated planners coming into the industry. So I think there is a lot to be said for standards naturally rising over time, if you are talking about education and qualifications. As we have seen, with reference to Storm Financial, that does not necessarily translate into a better outcome; and that is something we would certainly alert the committee to.

Our submission does support the raising of standards. But, coming back to John's macro point, we think that needs to be done over time and we think that there needs to be recognition of the different paths to get to the same destination. So, for example, a number of our members have developed what they call 'financial planner academies'. Effectively it is about, given their understanding of the requirements of a financial adviser and what it takes to provide quality financial advice, developing tailored programs for both new planners who come into their advisory businesses as well as existing planners to make sure that they are maintaining those standards that are expected of planners.

So I think our approach, if you like our philosophical approach, would be to say that we need to make sure that we are not overly prescriptive as to how we get there. We also think we need to take a view about appropriate transition periods to get there so that, again, we do not compound this issue of availability of advisers in the market.

Ms OWENS—Mr Brogden, when you first started talking you were talking about what the world might look like if we got it right. We keep tending to go back to what the world looks like now that we have got it slightly wrong. Can I take you back there? In the last 15 years we have built enormous superannuation funds. We have a whole stack of inexperienced investors in their 50s with cash arriving in the market. There were the mum and dad investors who discovered shares with Telstra. And we are unique—we are new in this. We happen to have done it during a boom time, which was perhaps really lucky. You have talked a bit about financial advice not being affordable and the need to make it tax deductible. I am interested in hearing from you what you think it should look like if we were actually doing that well in normal times not boom times.

Mr Brogden—Thank you, that is a very interesting question. On your point about superannuation, in about two years or so the dollar value of superannuation in Australia will equal the capitalisation of the Australian stock exchange, which is extraordinary. As some of our members say with a smile on their faces, we saw superannuation in Australia go over $1 trillion and come back down again. So we have seen movements in recent times. With long-term investments like superannuation you will see ups and downs, but all our economic history teaches us that the overall benefit over, say, 50 years will be significant.

Somebody who started working when compulsory superannuation started with the superannuation guarantee would now be in their late 30s. So arguably they have a minimum of another 20 to 25 years left in their working life—and who knows if working ages will change in the future; it may be up to 40 years left in their working life. So we are seeing a significant change in people's working habits. We are seeing a change in government pressures in terms of providing welfare payments. Every Western economy is moving to having fewer and fewer working people paying for the pensions of people who have retired.

If we go back to the original principle, which is pretty bipartisan, of compulsory superannuation we can ask: was it simply to require that people had the pension and a bit of money or was it that we had a huge number of people having full self-sufficiency based on superannuation? We are strong advocates of increasing the superannuation guarantee from nine to 12 per cent.

Therefore, you are going to have more people who have two large assets in their life. One is their family home, and 62 or 64 per cent of Australians own their homes. I do not know the

current figures. We were second only to the UK in terms of homeowners as a percentage of population. The second is their compulsory superannuation. We have also seen—and this is a little alarming—a significant drop in personal savings, because people sit back and say, 'My super is looking after my savings; my home's looking after my savings.' That gives them little flexibility as a consequence, so we would like to see an increase in national savings beyond just superannuation. So people have two large investments in their life. One, their family home, they are extraordinarily involved in. They live in it. Two, superannuation, the majority of the population has an absolutely minimal understanding of the complexities of it. That is why we would like to see continued financial literacy programs. We think that is very important. We do not want people making bad decisions about their superannuation. We want them engaged in their superannuation. They are going to live a lot longer than their grandparents and greatparents did after they retire, so having a very well-planned superannuation is quite critical.

You are right: we have had a whole generation of people forced to be investors. We have had a whole generation of people who have had shares arrive in the mailbox through government actions or demutualisations and the like. We are slowly seeing an increase in financial literacy, but we would like to see that increase significantly. The greater the financial literacy, the more people will partake in this.

Ms OWENS—The affordable issue is quite important as well. We heard from the Treasury that virtually every time they looked at changing the system, the cost would go up and that would make it unaffordable. I would question whether advice, if it is not good advice, is worth having at all. But I would like to hear your views about affordability. How do we make it affordable for everybody?

Mr Brogden—There are a number of subsidised arrangements that exist in the value chain of a financial product. Some of those have been widely criticised by some of the submissions here. But the reality is that if you begin to strip out some of the fees, such as volume based fees—which we support—you push more and more down directly to the consumer and you make it very expensive for them; you make it frighteningly expensive for them. That means that they simply will not seek the advice. We strongly believe in transparency and in disclosure. IFSA regards that as a foundation stone of our charter. We have full transparency; we have full disclosure. There is a challenge, because that leads to thick and complicated product disclosure statements. That is why we are very pleased that the government is going down the path of shorter product disclosure statements. We are very happy about that.

We are also pleased that the minister for financial services just three weeks ago announced—and this happened to be at our conference—he will be moving quickly on product rationalisation. This is very technical and a little boring. But our members have hundreds, if not thousands, of old products that they want to rationalise and bring into the 21st century. That is a horrific process for them administratively—almost prohibitive. So we are very keen to see shorter product disclosure statements that therefore deliver on transparency and to see product rationalisation that allows products to be brought into the 21st century.

The cost relationship is transparent and disclosed. But it does provide cross-subsidies that make the front end less expensive for consumers. Treasury is right: the more that you begin to pick away at that, the more you collapse the cost down to the consumer and unquestionably the less likely it is that people will take advice. If you add to that increasing regulation—raising the

bar—that will also push costs up. It will push some planners out of the game, because they simply will not want to meet those requirements. People who are 58 and thinking of retiring in two years time will not bother, not unlike when the GST came in. A lot of people retired early because of the complexity of it. We think that all of those factors mean that there is a balance in place, a balance of cross-subsidies with respect to fees, a critical balance of transparency and disclosure and increased regulation and tax deductibility. Those are elements of an improved financial advisory landscape in Australia.

Ms OWENS—Is there regulation out there now that you do not think is giving us the benefit of the work?

Mr Brogden—The benefit of which work?

Ms OWENS—Regulation which is not contributing.

Mr Brogden—Regulation that is burdensome?

Ms OWENS—Regulation which is burdensome and not getting the benefit.

Mr O'Reilly—There are probably a few issues. One of the issues that IFSA, for example, has been raising for a number of years now revolves around the definition of 'personal advice' and the complications that it creates. If an adviser takes into account even one of the personal circumstances of the individual to whom they are talking, the advice is personal advice and necessarily the statement of advice requirements et cetera follow. Many of our members have been, with their call centres or whatever, taking requests from clients. They want to be able to provide them with a greater level of detail and information about their options and what they may or may not do. The fact that they know many of their personal circumstances means that automatically the personal advice requirements come in. This makes it much more expensive for them in terms of providing advice or assistance. We have put up recommendations in relation to amending the definition of 'personal advice'. We think that the government's step in terms of intra fund advice is a step in the right direction. But we think that more needs to be done in that area to enable our members to provide more information to their clients, about who they know quite a lot of information, by and large.

Senator McLUCAS—This is a question I have asked of all of the witnesses. Two elements have occurred since the collapse of Storm Financial. We have had the development of the plain English documents, which will help consumers—hopefully—make more informed decisions about the products that they are purchasing and we have the changed regulatory regime around margin lending coming, provided that it is passed by the parliament. If those had been in place, would they have stopped the collapse of Storm Financial?

Mr Brogden—The first thing to say is that we would hope that, regardless of the recent financial circumstances, there will be a drive towards simpler product disclosure statements. We think that that would be absolutely beneficial to consumers, regardless of the financial circumstances. And beneficial to us—there is no doubt about that. So I hope that that would have happened regardless. Equally, we hope that the rationalisation with respect to products would have happened regardless.

On the broader question of whether we would have avoided consumers being hurt in some of these collapses if those two things had been in place, it is very hard to say. I guess I go back to where I started when I argued that the requirement for appropriate advice is significant. We believe that the activities of Storm with respect to some of their clients were not appropriate. They did not give appropriate advice. And that act existed well before the crisis.

Senator McLUCAS—I also note that in your submission there is significant focus on financial literacy, which is part of the reason why what happened happened—a very big part.

Mr Brogden—Yes.

CHAIRMAN—Thank you very much for your submission and for your time before the committee today.

Proceedings suspended from 12.29 pm to 1.34 pm

CLARK, Mr Douglas, Policy Executive, Securities and Derivatives Industry Association

HORSFIELD, Mr David, Managing Director and Chief Executive Officer, Securities and Derivatives Industry Association

CHAIRMAN—I welcome to the table witnesses from the Securities and Derivatives Industry Association. I invite you to make some opening remarks in relation to your submission.

Mr Horsfield—The Securities and Derivatives Industry Association represents Australian stockbrokers and investment banks and is grateful for the opportunity to address the joint committee on these important matters. I would like to note a few key points, further details of which have been outlined in our written submission to the joint committee. By way of introduction we will say that, generally speaking, we do not believe that the recent events justify a significant reregulation of the financial sector. This is particularly the case with stockbroking. For example, complaints about stockbrokers to the Financial Ombudsman Service for the last few years have consistently run at around 100 complaints per annum out of a total of around 1,200, which includes financial planners. Stockbrokers complaints actually dropped 23 per cent in the six months to June 2008, the last reported by FOS. This is a very low rate of complaints, especially when you consider that on the ASX there were over 100 million transactions in the past year.

As well as being subject to ASIC regulation, our members are regulated by ASX. As such, they are also subject to further more rigorous requirements, including higher capital adequacy standards, dealing, manipulation and orderly market rules. From April 2008 the ASX has been able to fine members up to $1 million, and in the last 18 months ASX has levied over $2.3 million in fines against market participants.

In relation to the first term of reference, the role of the financial advisers, licensed financial advisers, including stockbrokers, are already subject to a raft of requirements, particularly in relation to retail clients, including trading, suitability of advice, disclosure of interest, complaints handling and compensation. Some of these carry criminal sanctions. A suggestion has been made that a statutory obligation to act in the client's best interests be introduced. We would argue that this is not necessary, as the existing suitability in disclosure requirements supplemented by common-law fiduciary obligations is sufficient.

In relation to the second term of reference, the regulatory environment, we have commented in our submission on the inquiries and reforms that have taken place since the early 1980s, including most recently financial services reform. FSR made important structural reforms to financial services, giving far more rights and protection to consumers and more power to ASIC. In its implementation it has been costly and burdensome for financial service providers. If the government is now considering wholesale changes to financial services, bearing in mind the long and expensive implementation of FSR, it is important that such changes are made for the right reasons and their consequences are fully thought out. They should not include automatically adopting changes implemented or under consideration overseas, particularly those in the US and the UK, as noted in our submission.

In relation to the third term of reference, commission arrangements, without commenting on the part played by financial planners, stockbroking is conducted normally in a fully disclosed environment, with brokerage and other fees earned directly from the client, not built into arrangements with the issuers. It is important to distinguish between commissions paid by the client to the adviser directly and those arrangements where the commissions are paid by product issuers to the adviser. Where the latter arrangements with issuers do exist and could reasonably influence advice to clients, the law already requires them to be disclosed to the client at the time that the advice is given. Many have, and no doubt will, advocate to the committee the adoption of a prohibition approach in this area, such as what is being adopted overseas. However, before throwing out the existing Australian regime there needs to be shown that there would be demonstrable benefits for the investing public in general as a result.

In relation to the fourth term of reference, marketing and advertising campaigns, we wish to make no further comment. In relation to the fifth term of reference, adequacy of licensing arrangements, we would say that an assessment of the adequacy of the current provisions should await the conclusion of pending legal and regulatory actions against those involved. In relation to the sixth term of reference, the appropriateness of information for consumers, it appears that the disclosure documents required under the Corporations Act do not necessarily assist the consumer to properly understand the service product offered. This is particularly the case with product disclosure statements and statements of advice.

In relation to the seventh term of reference, consumer education and understanding, perhaps financial service licensees could do more to ensure that clients understand the document they are given. However, licensees ought to be able to assume a basic understanding on the part of the consumer. The authorities and educators could do more to increase consumers' financial understanding, particularly at the secondary school level.

In relation to the eighth term of reference, adequacy of insurance arrangements, professional indemnity insurance is the best and most equitable method of ensuring consumers are adequately compensated. A centralised compensation fund would present the danger of moral hazard, where those guilty of misconduct are able to escape responsibility for compensating those affected by their actions.

In relation to the ninth term of reference, the need for legislative or regulatory change, whilst we see no need for substantive legislative structural and regulatory change, we do see a number of areas that could be improved. One area of weakness is licensing arrangements in the use of the term 'stockbroker'. The law already limits the use of the term to the market participants or authorised representatives of market participants authorised by ASIC to do so. However, we have seen a number of occasions in recent years where people call themselves stockbrokers who are not properly authorised to do so. 'Stockbroker' is a professional term. Its misuse can lead to confusion to investors who may be misled into thinking that they are dealing with someone of a certain standing. In order to call themselves stockbrokers, advisers should be properly qualified. They should have to satisfy professional standards set by an appropriate body, like the SDIA, in excess of the minimum required by law.

Another area is 'bad apples'. Unlike other countries, like the US and the UK, Australia has no proper regime for the reporting of misconduct by individuals on leaving a firm so that future employees and consumers can be protected from these individuals. SDIA has for years

advocated a system of compulsory reporting of specified matters on termination and the protection for licensees in making and having access to those reports.

Compulsory training for wholesale clients. Australia has no minimum standards for training for wholesale advisers. Retail advisers must meet ASIC's RG 146 minimum standards. There are no requirements for wholesale. We believe that there should be compulsory minimum training—like other markets, including the US—for all people, retail or wholesale, involved in the financial markets.

In relation to the 10th term of reference, the involvement of banking and finance in Storm, Opes Prime and other matters, we wish to make no further comment except to say that the introduction of margin lending regulation next year should address some of the main issues which arose in these matters.

To sum up, we believe it is difficult and perhaps premature to comment on the activities of the two companies mentioned in the terms of reference, especially where investigations and regulatory and legal actions are ongoing. The new consumer credit legislation will address some of the issues raised in those matters under inquiry. Apart from the area of the use of the term 'stockbroker', 'bad apples' and training requirements for advisers, we see no urgent need or substantive reform to the regulation of financial services in this country. The emphasis should be on the enforcement of existing provisions, and ASIC should be supported in this role.

CHAIRMAN—Thank you, Mr Horsfield. Could I draw your attention term of reference 5, in terms of licensing. We have asked other witnesses to comment. With respect to the licensing regime, do you think the bar is set too low, too high, or is it exactly right? Can it be improved? Do you believe it meets the requirements it is set out for?

Mr Clark—I suppose in terms of stockbroking the balance is about right, probably because of the additional requirements of ASX. For non-ASX participants, there could well be an argument that the bar is set too low.

CHAIRMAN—Would that be in relation to individuals or licensees, particularly licensees who may have a whole range of individuals working under them? One thing we have identified is that the licensing issue is not clear-cut. It is not necessarily about a person. It is usually more about the licence holder and then all the people who work under them. If you have perhaps a poor licensee, that will obviously filter downstream as well.

Mr Clark—That is definitely the regulatory emphasis, as it stands. ASIC licenses firms and then does not have a great deal to do with the individuals underneath.

Senator WILLIAMS—As the Chairman pointed out, a business or company can have a licence and there could be 20 or 30 people working under that licence who are not actually licensed themselves. Wouldn't there have to be some way to see that those people working under that licence are properly trained and know their product very well?

Mr Clark—In the retail area now there are good standards set by ASIC. Perhaps they could be better. In the wholesale area, as we have mentioned today, I think there are some gaps in

education of advisers in that there is none prescribed. We would argue that anyone advising any client should have a minimum level of training.

Senator WILLIAMS—Yes, exactly.

CHAIRMAN—One issue that has been raised in terms of the licence is that it is really just a one-step hurdle, if you like. Once you apply, you cannot be refused a licence unless you are a person of particularly bad character. It would be highly unusual to be refused a licence. As long as you tick the boxes for compliance, you are granted the licence and then really it is a self-regulatory system. Then there is this enormous weight placed on a licensee to self-manage everyone that is under them. Do you see that in itself as being a potential source of conflict, given that there have been collapses and there are issues around how that might work?

Mr Clark—It could be a weakness in those who only hold ASIC licences, AFSLs. I have seen instances where, as you say, the licence is granted and basically there is very little follow-up regulation from ASIC in terms of that firm's business. We distinguish that in stockbroking: ASX has a very high level of regulation—that is, of continuing compliance requirements and annual checks or more frequent checks if issues arise. Without the additional regulation of ASX, I think there is an argument that ASIC regulation alone of licensees could be better, especially of the ongoing requirements.

CHAIRMAN—How does that apply? How does that transfer across to stockbroking firms such as Opes Prime? It obviously was licensed and would have met compliance requirements of the ASX but yet had a model which we are led to understand really was more a wholesale model that was sold to retail clients. How does that fit in with the licensing and compliance arrangements?

Mr Clark—I suppose history will tell us that it did not fit in very well and there were weaknesses in that particular firm. It is difficult to comment. I know ASX was looking very closely at Opes Prime. We would have to leave it to ASX to explain what happened.

CHAIRMAN—As the securities and derivatives body, as the association, are people necessarily compelled to join your association? Or is it really a voluntary membership group?

Mr Clark—Yes, it is voluntary.

CHAIRMAN—Completely voluntary?

Mr Clark—We represent the vast majority of market participants in Australia.

CHAIRMAN—Were Opes Prime one of your members?

Mr Clark—They were, yes.

CHAIRMAN—What process is in place internally in your association to either monitor or manage? Is there any particular stipulation on anything in your association? What I am asking is: can anybody just join? Can they use your logo and have whatever credibility is attached to that without any sort of oversight work by you as an organisation?

Mr Clark—We do not have a regulatory role, but they do have to fulfil 'fit and proper' reputational tests. We obviously recognise and place a lot of emphasis on the fact that they are ASX participants and ASIC licensees and leave the formal checks to those bodies.

CHAIRMAN—So what does your association do in terms of what it provides to its members or, more broadly, to consumers of your members' services?

Mr Clark—We represent stockbrokers. As we are today, we present their views to government and other regulators. We also have a code of conduct which members are expected to follow. We do not have a formal disciplinary process or enforcement regime at this stage.

CHAIRMAN—Is that something you are looking towards? Is that something you are looking to use to lift the standard within the sector itself?

Mr Horsfield—We are always trying to lift the standard, and we are doing that more through education because we do not have the disciplinary rules behind us to be able to do that. But we are trying to lift the bar in that area and we hold lots of education workshops. They have to do a certain amount of CPD and they have to do a certain number of compliance hours et cetera. About a year ago we introduced a professional diploma, which again is lifting the standards through the industry, which I think both ASIC and the ASX have been happy to see us do. We believe a better educated adviser is going to be better able to liaise and help the mums and dads of this world, if you like.

CHAIRMAN—What sorts of representation percentages have you got? Out of all the people who could be in your organisation, what percentage do you have as members?

Mr Horsfield—Our membership is a little bit different to that of lot of other associations, in that we have organisational members on one hand and individual members on the other hand. We have about 67 organisational members, which make up 98 per cent of the market by value, and we have about 1,200 individual members. Our individual membership is quite low, and the reason behind that is that a lot of people who are employees of market participants believe they do not have to join because their firm is a member and they come under the control of that firm. We would like to have more individual members. If you can help us with that, we would love to hear it!

CHAIRMAN—We will try our best to the standard across the board. Finally, what lessons would you say your organisation has learnt, particularly from Opes Prime, being one of your former members? What lessons have you learnt out of that? What can be improved in the system?

Mr Horsfield—Firstly, I think when you look at the ramifications of what happened under the global financial crisis, it is not good to see an Opes Prime or a Storm because it hurts individual investors, and there is a reputational risk within the market because a market is only as good as the integrity of the market. We are all about trying to maintain the integrity of the market. Maybe the ASX listing rules can be looked at a bit more closely in that area, or maybe the Corporations Law can be looked at a bit more closely in that area. It is very hard for us. We can provide the education and we can provide the platforms, but it is very hard for us—

CHAIRMAN—So you are saying it was a behavioural problem? You are not saying we should change the regulations; you are saying it is about educating people to use them.

Mr Horsfield—I think we are very well regulated anyway, because our members are regulated by the listing requirements of the ASX and also the corps act. Also, as we can see, the number of complaints that have come through under FOS is very low when you look at the actual number of trades. I think with anything, if someone sets out to misrepresent, it is pretty hard to stay on top of it. That is not only Opes Prime; it is HIH and all those types of things.

Senator MASON—I refer you to your submission in relation to the third term of reference:

… the role played by commission arrangements relating to product sales and advice, …

You refer in your submission to developments in the United Kingdom and also in the United States that will—those in the United Kingdom—prohibit 'commission paid by product issuers to advisers from 2012'. You also say that in the United States the government has also announced measures that could 'lead to the abolition of commissions by product issuers'. You said:

The Parliamentary Joint Committee will no doubt pay careful attention to these offshore developments. However, it is worth noting that Australia already addressed this issue by requiring disclosure.

Over the last couple of days this committee has heard evidence that disclosure has not in fact solved the problem and that it has not meant transparency. Do you accept that?

Mr Clark—It remains a legal obligation. There have been different levels of compliance, different levels of disclosure and more effective disclosure by some than others.

Senator MASON—You hit the nail on the head: it is more effective disclosure. You can comply with the law and give a 70-page disclosure document but that does not make the client aware of the risks or the fact that, potentially, an adviser is receiving commissions. It might in fact, but it does not inform them because many people—we have heard this evidence—do not read them or do not understand them. Do you accept that?

Mr Clark—It seems to be the reality that not all of these documents required to be given by the law are read by the client.

Senator MASON—Therefore, you would agree that disclosure would not satisfy this committee that that would equate with transparency.

Mr Clark—Under the law as it stands this disclosure is meant to be clear, concise and effective.

Senator MASON—It is not clear, it does not seem to be too concise and it does not seem to be too effective.

Mr Clark—Then we have a failure to comply by certain people in the industry and ASIC should take the appropriate action.

Senator MASON—Are you sure about that? So you think the law is still okay but in fact it is a compliance issue. The 70-page document is not necessarily clear and concise.

Mr Clark—I disagree that the 70-page document will be clear and concise.

Senator MASON—Indeed.

Mr Clark—That was a relic from the beginning of FSR in 2004. Since that time things have become a lot briefer and a lot more succinct, clear and concise, at least in the stockbroking industry.

Mr Horsfield—That is one of the reasons that we have seen the refinements to FSR. We have seen two refinements to FSR because it was too cumbersome. It had not been thought through. When FSR first came in we fought and said that some of these things were far too lengthy and people would not read them. They needed to be more concise and this was found to be the case.

Senator MASON—It does seem to be the practice, doesn't it?

Mr Horsfield—Yes, absolutely.

Senator MASON—We heard some more evidence this morning from the Commonwealth Treasury that again another committee is to work on this—and I know ASIC is working on it—to refine, streamline and shorten that memorandum of advice. Would you agree with that process?

Mr Clark—Yes.

Mr Horsfield—Absolutely.

Senator McLUCAS—I refer to the comments you made about the use of the term 'stockbroker'. Currently, if you are a stockbroker I think, from reading your submission, you are authorised by ASIC. Is that correct?

Mr Clark—That is correct.

Mr Horsfield—Yes.

Senator McLUCAS—Is there a published list of stockbrokers?

Mr Horsfield—Yes, there is one on the ASIC website. It is actually market participants, but it is the same thing.

Senator McLUCAS—Your submission says that people who are not on that list from time to time use the word 'stockbroker' to describe their operations. What happened then?

Mr Horsfield—What happens to that?

Senator McLUCAS—What happens if your organisation becomes aware of somebody purporting to be a stockbroker, or using the term? What do you do?

Mr Horsfield—Do you want to answer that?

Mr Clark—When we are informed of those companies calling themselves stockbrokers our members are very concerned about it, because they believe that being a stockbroker has a certain status and importance within the financial community and for the clients, and we inform ASIC.

Senator McLUCAS—What does ASIC do?

Mr Clark—Well, I—

Senator McLUCAS—Maybe I should ask ASIC that question.

Mr Clark—I think you should, Senator.

Mr Horsfield—When you use the term 'stockbroker' you are bound by the ASX rules, which comes back to the National Guarantee Fund liquidity requirements and core liquid capital requirements. If other people are using that term—or suggesting that they are stockbrokers; they may not quite use that term but they may give the impression that they are—then it does actually misrepresent what some of these people are all about. It is something we have brought up before.

Senator McLUCAS—We had similar commentary from the Financial Planning Association about the use of the term 'financial planner' or 'financial adviser'. I will follow it up with ASIC. Thank you.

Senator WILLIAMS—Could I bring you back to the point about education you made in your opening statement? It is a long time since I left school, but I think you have touched on something really important there. Something perhaps not so much within our terms of reference but to consider is educating our students. We are very good at teaching our students how to read, write, add up and everything else—their tables and so on—but isn't one of the most important things for someone to learn in life how to manage money and invest wisely? I think this should be taught at a young age, perhaps in year 11 or 12. Would you like to comment?

Mr Horsfield—I think you are absolutely right. People can do various subjects that are ongoing preparation for life, but if you can get people when they are young and make them aware of the risks of investing et cetera then that is very important. So I would go along with you; I think, from an educational perspective, at least in the last couple of years some subjects should be put in place that make them aware of that—basically, what people say is financial literacy.

Senator WILLIAMS—Even about the management of credit cards. When I left school there was no such thing as a credit card. Bankcard appeared in 1976 or 1977, around then. I know that my children have sometimes had debts on credit cards, which are difficult to pay off. Thankfully they do not have the problem now, but I am sure that many, many young people get into enormous trouble just with credit cards. This comes back to financial management and education and making the young ones of today more aware of what is out there in the marketplace and

where they can invest safely. Of course, they are all going to be working and involved with superannuation anyway.

Mr Horsfield—I could not agree more.

Senator McLUCAS—Could I pick up on that?

Senator WILLIAMS—Yes, go for it.

Senator McLUCAS—I question the relevance, in terms of its timing, of spending all this time in school when you are 16 or 17 working out what a reverse mortgage is or explaining what a margin loan is. The time when a person will actually want to start using these products is probably at the other end of their life. I am sorry; I am making a bit of a commentary here. I am really not sure that putting an extra couple of subjects into high school is actually going to fix the problem.

Mr Horsfield—I think there does need to be some type of financial literacy, though, and I think it is probably not a bad place to start.

Senator McLUCAS—I suppose my view is that financial literacy is something you should be adding to all your life rather than being a one-hit wonder when you are 16 years old.

Mr Horsfield—Agreed. This is why our people have to do continuing education to make sure they are up to date with the various trends. That is one of the things we make sure of. They have to do 20 hours per year in continuing education and eight hours of that has to be in compliance.

Senator McLUCAS—Thank you.

Ms OWENS—Thank you for your submission. I think you are saying in it that it was the global financial crisis that actually led to the collapses of Storm Financial and Opes Prime; is that essentially right?

Mr Horsfield—I would not say that it led to that happening but it probably did not help.

Ms OWENS—No, it probably did not help. Given that it appears in both those cases that there are people who invested in those products who did not understand them, for whatever reason that was, if there had not been a crash and those companies were still going, would you see something problematic in the way they operated? In other words, is it the outcome that concerns you or is it the action?

Mr Clark—Perhaps the crisis brought the pre-existing problems to the surface. They may not have come but for those problems.

Ms OWENS—We might not have noticed them.

Mr Clark—One of the aspects there was the problem of margin lending and scrip lending, in particular, being offered to retail clients, which were arguably much more appropriate for the wholesale end of the market. The government, to its credit, has addressed that through the new

margin lending and consumer credit legislation, which picks up scrip lending arrangements as well and puts some heavy requirements on advice to retail clients and offerings to retail clients.

Ms OWENS—So if that had been in place at the time, then this may—

Mr Clark—Perhaps, yes.

Ms OWENS—I am trying to dig a little bit on the notion that we are appropriately regulated and that enforcement alone could have stopped what happened here. Apart from the margin lending, is there anything else?

Mr Clark—It is the fringe players, really, who brought the worst crisis to the fore here. The product issue is advertising in the paper and we have seen others in the last few years—Westpoint advertising huge returns in the newspapers—and people not knowing any better going into those products. We say that our industry is very well regulated but these people were operating outside ASX regulation. Opus Prime was within that envelope, but I leave ASX to comment on that one.

Ms OWENS—You have talked a few times in your submission about the risk of over-regulating if we move forward. Do you see areas where we are over-regulated now?

Mr Clark—Our members would always say that very thing. Our members are working hard to comply with the current law. We have been through a revolutionary process with FSR and we cannot easily wind back the clock.

Ms OWENS—We had discussion earlier in the day about separating the roles of advisers and people who sell products, sales people. Do you see a value in that?

Mr Clark—Yes, and it all comes back to disclosure so that the client understands exactly what they are getting, are they getting advice in their best interests or in their adviser's best interests.

Ms OWENS—Would our current disclosure regime provide that information? Is it already there and people are not noticing it or do we need to strengthen it in some way?

Mr Clark—It is clear that there are different levels of compliance but we would argue, as we have in our submission, that the Corporations Act, supplemented by the common law with cases like Daly and the Sydney Stock Exchange already provide strong obligations on advisers to act in clients' best interests, including the disclosure of interests of the adviser which would conflict with the clients.

Ms OWENS—If it is a matter of enforcing compliance, how big a job do you think that is? How widespread do you think non-compliance is?

Mr Clark—It is impossible to say, but I do know that our members' compliance departments have increased about sixfold in the last 10 years.

Ms OWENS—That is the over-regulation thing, is it?

Mr Horsfield—It has become an industry within itself.

CHAIRMAN—Is that not the wrong focus, strictly focussing on compliance? Does that not become self-serving? It is all about ticking the boxes, just complying, and makes the focus no longer what your task is, looking after your clients' best interests.

Mr Horsfield—I think that is just one part of the jigsaw puzzle. Education is another very important part of the jigsaw puzzle. There are lots of areas that add to it, and compliance is just one of those things that have grown a lot, probably because it needed to grow. It has probably grown a lot more under FSR than it has ever done before.

Senator MASON—On Ms Owens's disclosure point again, people start to think that, if they give this huge, 70-page disclosure document, that is sufficient disclosure. That develops over time and becomes industry practice—isn't that right?

Mr Clark—I have already taken issue with the '70-page' part of that question, but I suppose—

Senator MASON—Are you saying it does not happen? What are you saying?

Mr Clark—I am saying that they are a lot shorter than 70 pages these days.

Senator MASON—Some are; some are not. That is the evidence we have heard. Your evidence, though, is that a 70-page document would not comply with the law. Isn't that your evidence?

Mr Clark—I merely ask whether such a document that could ever be clear, concise and effective.

Senator MASON—That is my point. So often industry practice develops and no-one takes any action until there is strife and stress on the system. I think that is the chairman's point—that it takes market failure and a crisis before the law is applied appropriately.

Mr Horsfield—We have always argued that they should be more concise.

Ms OWENS—In terms of the definition of 'clear, concise and effective' in real terms, not legal terms, it would depend on who was looking at it the document. If you were dealing with a really experienced investor in a complex product then 70 pages might actually be necessary. But, for a little mum-and-dad investor, 70 pages would not seem like English. Is there sufficient definition of 'clear, concise and effective' in terms of the way it is used?

Mr Clark—ASIC have put out some guidance on that. They have endeavoured to address that very issue—that you need to consider the reader. Again, I will leave that to ASIC.

Senator MASON—Is there any common law on the meaning of those words?

Mr Clark—Not yet.

Senator MASON—There may be soon.

CHAIRMAN—It is unclear as to what 'clear' means!

Mr Clark—Quite so!

CHAIRMAN—It is an issue for us, whether it is 70 pages or over 100 pages, as some disclosure documents are—I am sure there are some shorter and some longer. I know it is an issue that is being dealt with at the moment by the Financial Services Working Group.

Mr Horsfield—We look at some of the research material that comes out from some of the global brokers. The disclaimers on those are huge, and they have to satisfy the global standard.

CHAIRMAN—Do you read those ones?

Mr Horsfield—No.

Senator MASON—Mr Chairman, that is the point—

CHAIRMAN—It is the point.

Senator MASON—if industry is arguing that it is not appropriate to prohibit commissions and relying on disclosure, unless disclosure is effective—in other words, transparent—your argument fails. It is either one or the other; you cannot have it both ways. It is pretty clear.

CHAIRMAN—I suppose what we have heard is that, regardless of the intent, disclosure documents are now, rather than designed for the investor or the reader, designed as a protection mechanism for the writer—hence, it does not matter how long or short they are. Thank you very much, gentlemen.

[2.14 pm]

ANNING, Mr John Melville, General Manager Policy Regulation, Insurance Council of Australia

THOMPSON, Ms Catherine Louise, Member Professional Indemnity Insurance Committee, Insurance Council of Australia

CHAIRMAN—I welcome representatives of the Insurance Council of Australia. Thank you for appearing today. I invite you to make some opening remarks.

Mr Anning—Thank you. The Insurance Council of Australia appreciates the opportunity to appear before the committee today to discuss the issues associated with the recent financial product and services provider collapses. The Insurance Council is the representative body of the general insurance industry in Australia. Our members provide insurance products ranging from those usually purchased by individuals, such as home and contents insurance, to those purchased by small businesses and large organisations, such as product and public liability insurance, professional indemnity insurance and commercial property insurance. Our members represent more than 90 per cent of total premium income written by private sector general insurers.

As most of the terms of reference of the inquiry do not relate directly to the insurance industry, our interest focuses on point 8 of the terms of reference: 'the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers'. As committee members would be aware, under section 912B of the Corporations Act Australian financial services licensees must have arrangements for compensating retail clients for losses they suffer as a result of a breach by the licensee or its representatives of their obligations under chapter 7 of the Corporations Act. The arrangements must satisfy the requirements in the corporations regulations, which require that licensees must obtain professional indemnity insurance that is adequate, having regard to the nature of the licensee's business and its potential liability for compensation claims. The Insurance Council has consistently supported this approach, subject to PI insurance not being expected or portrayed as offering a guarantee that money will be available to pay compensation awarded to those who have suffered financial loss through a licensee's breaches of their obligations. There may be many reasons why the policy will not respond, including but not limited to, an excluded peril, breach of condition, non-disclosure or misrepresentation, exhaustion of the policy limit or policy expiry.

PI insurance provides cover to the insured professional for losses sustained by third parties as a result of a breach of the insured professional's duty. The policy would react in the event of the insured being sued for professional negligence. This would include most areas of breach under chapter 7, such as the provision of inappropriate advice and/or non-compliant disclosure documents. The coverage available from individual insurers can vary. In some circumstances the policy will be provided as an all-encompassing package; in other situations people may need to seek specific endorsements or separate policies to cover particular risks. For example, PI policies may not automatically include fidelity cover—that is, protection for policy holders against theft or misappropriation—or may only provide cover for third-party loss arising from employees'

fraud and dishonesty but not cover any first-party loss. This is an important matter of public policy and risk management for the insurer. Some PI policies—for example, for financial advisors—may specify that liability for any product recommendation that is outside of the licensee's approved products list is not covered. PI insurance may include an excess amount above the average claim made by retail clients, meaning that the licensee would ultimately be responsible for providing compensation rather than the insurer.

When ASIC first issued regulatory guide 126 in late 2007 it had hoped that the coverage offered by PI insurance would expand in order to maximise the chances of compensation being paid to wronged clients. Consequently, ASIC set out in regulatory guide 126 that, at the end of a two-year transitional period—that is, from 1 January 2010—the PI insurance required to be held by licensees would in addition need to cover particular situations where products had been recommended that were not on the licensee's approved product list, and also that licensees would need to have at least one year's run-off cover. It is important to note that a hardening insurance market, exacerbated by the global financial crisis, has negatively impacted on the ability of insurers to underwrite higher-risk activities. Under these circumstances, and given the increasing levels of risk associated with some parts of the financial services sector, some major insurers have tightened their underwriting criteria while some have withdrawn from the financial advisor sector of the market altogether. In the present and projected environment we are advised by those of our members that offer PI insurance that the availability of PI insurance for financial advisors or licensees, even as currently required by ASIC, is becoming scarcer and there is upward pressure on prices. Therefore, it is likely that ASIC's objective that a higher standard of PI insurance cover apply from 1 January next year is now commercially unrealistic.

Unless ASIC revises its requirements in relation to guide 126, licensees will need to assess whether they will need to make additional arrangements to complement the protection provided by the PI insurance. The Insurance Council and our members believe that PI insurance will continue to play a key role in assisting professional advisers to manage efficiently the risks of carrying on business, in providing an indemnification mechanism which allows many compensation awards to be successfully paid. However, if the policy goal is to enable consumers to receive in all cases the compensation they are awarded then there needs to be consideration given to establishing a compensation fund. Such a compensation fund would then act as a safety net for those instances where the client is not able to rely on their licensees' PI insurance to fund their compensation.

The Insurance Council would be pleased to provide input to a review to identify situations where consumers could potentially be exposed to non-payment through inadequate financial resources by a licensee—for example, where there was intentional wrongdoing by the financial adviser or licensee or similar cases where multiple excesses need to be paid. It is important to identify the scope of the problem—for example, the actual number of consumers being left uncompensated—so that a compensation fund can be designed appropriately. Again, for example, a fund based on overestimates of the problem to be addressed would be a burden for the government to administer and for the industry to fund, with consumers ultimately paying the cost.

The UK Financial Services Compensation Scheme has been discussed as a possible model for an Australian compensation fund. Without commenting on the merits of the UK scheme, the Insurance Council notes that the Australian government established in October 2008 a financial

claims scheme to protect customers of authorised institutions regulated by APRA—for example, policyholders and third-party claimants of a failed general insurer. We submit that it would be unnecessary for an Australian compensation fund to duplicate the protection that the financial claims scheme already provides for insurance policyholders and bank deposit holders. In summary, while supportive of the case to consider the advantages of a consumer compensation fund if government wants to ensure satisfactory compensation is paid in all cases, the Insurance Council submit that the financial services regulatory framework with regard to PI insurance is basically sound.

CHAIRMAN—Thank you, Mr Anning. Can you give us a clearer understanding of the level of available PI insurance generally to the market and then maybe more specifically? Obviously, it has tightened up, given market conditions, but how bad is it for people trying to get PI insurance?

Mr Anning—Perhaps Ms Thompson could talk about the trends in the market and the availability.

Ms Thompson—It is not as available as it was. A number of insurers have stopped writing professional indemnity insurance for financial services providers, and the numbers that were writing it anyway—even in the good times—were fairly limited compared to other occupations. All insurers I know of in the Australian market have tightened the amount of indemnity limits they are willing to put out. I do not know of any insurer willing to provide more than $10 million to any single licence holder at the moment, although the insurers that are continuing to offer the cover are willing to do so on an excess layer basis and as co-insurance to build up those levels to $20 million or beyond for individual licence holders. However, the guidelines have been tightened up so that they are looking with more scrutiny at what the licence holders are doing before they are willing to offer cover. Also, policy conditions have been tightened for some members as well.

Mr Anning—I just want to add to that. Our members are advising that their reinsurers are actually tightening up the guidelines in this area. So it is not only a domestic reaction to the assessment of risk; the foreign reinsurers are also reacting to that risk.

CHAIRMAN—Are there cases now where people that had PI insurance can no longer either renew or obtain ongoing insurance? Are there cases where new entrants to the market simply cannot get insurance? Is that the case?

Ms Thompson—It is difficult to know. We certainly have knocked back a number of applications, but we do not know what ultimately happens to those potential insureds—that is, whether or not they actually get cover.

CHAIRMAN—But that is a potential risk out there at the moment now that there are insufficient bodies willing to insure at all.

Ms Thompson—It is possible that some licence holders may become uninsurable.

CHAIRMAN—What happens to them in that case? Do they not longer meet their licence agreements?

Ms Thompson—I guess they go to ASIC and ask them to consider alternative arrangements.

Mr Anning—There is the possibility that, if the licensee cannot find at all the PI cover they need or the cover does not match the requirements that virtually guide 126, they need to approach ASIC for approval of alternative arrangements.

CHAIRMAN—What arrangements could they put in place?

Mr Anning—It would depend on the individual licensee. Some licensees do consider self-insuring in this area, but that possibility is obviously limited to the particular licensees that can afford it.

CHAIRMAN—It seems to be a major issue. It seems quite serious that people cannot either renew or continue their professional indemnity insurance.

Ms Thompson—The only reason they would not be able to continue or renew would be because of a very poor claims history, and usually a very poor claims history is indicative of very poor systems. You might argue that they are the people who should no longer be in business.

CHAIRMAN—Do we know this for a fact or is there a general trend that is emerging now that insurers just do not want to insure?

Ms Thompson—An insurer recently pulled out of the market completely and said to all their policy holders, no matter how good or bad they were, 'I am sorry, we are not offering renewal.' That is very unusual, and it is very unusual for an insurer to refuse renewal to any insured. In fact one of the standard questions on every insurers proposal form for professional indemnity insurance is: 'Have you ever had your policy cancelled or failed to be renewed by an insurer?' We take the answer to that question extraordinarily seriously because it usually indicates that there is some sort of moral hazard or some underlying problem with that insured. Refusing renewal is not something an insurer would do lightly. There would have to be very good reasons for them to do it.

Senator MASON—How many financial service providers currently have PI insurance?

Ms Thompson—Sorry, is your question: how many financial service providers have PI insurance?

Senator MASON—Yes.

Ms Thompson—I have no idea.

Senator MASON—Do you know how many claims—

Ms Thompson—I do not know how many financial service providers there are. Do you?

Senator MASON—Sorry for asking the question! License holders then. Do you know?

Ms Thompson—No, I do not know.

Senator MASON—Do you know how many claims were made in the last 12 months?

Ms Thompson—I have no way of knowing that.

Mr Anning—We do not have that data.

Senator MASON—Do you know how many successful claims were made?

Ms Thompson—I have no idea. I could speak of my own company's experience if I had come prepared—

Senator MASON—Do you know if the Insurance Council has an overall picture of this?

Ms Thompson—No.

Senator MASON—That is not very helpful, Ms Thompson, is it?

CHAIRMAN—Could you explain to us why?

Mr Anning—The Insurance Council does not gather the data on claim; APRA, the prudential regulatory authority, gathers data on the policies and the number of claims, but I am not too sure what level of detail it would go to.

Ms Thompson—APRA has—

Senator MASON—You can see why I am asking the question. I want to find out how many claims have been made so that we can determine risk. It is not a particularly sophisticated question.

Ms Thompson—Every insurer would love to know that. APRA collects the statistics but there is always a great deal of debate about to what level down they reveal those statistics to the public. They have just recently released statistics showing at a very high level the number of claims, the cost of those claims and the average size of premiums. But most insurers petition APRA not to drill down too deeply into the provision of those figures because it is an extremely competitive industry.

CHAIRMAN—So you are saying that there is no capacity to know, rather than that you just do not know.

Senator MASON—No-one wants to know, it would seem.

Ms Thompson—Everybody wants to know but we have no way of knowing.

Mr Anning—There are a few difficulties with the statistics in that I do not think the professional indemnity statistics are actually divided up into financial services licensees and others.

Senator MASON—They are not.

Mr Anning—There is also an ongoing debate at the moment over the level of data that APRA releases in this area. They are having public consultation at the moment on the data that is to be released. APRA collects very detailed data on policy and claims but because of concerns about confidentiality and because some insurance markets have a limited number of players, some are concerned that if the data was released their market share would become obvious to all.

Senator MASON—Can you tell the committee whether and by how much claims have risen over the last few years in relation to financial service providers?

Ms Thompson—I cannot give you an exact figure, but I can tell you—

Senator MASON—This is a fruitful line of inquiry that I have embarked on, isn't it?

Ms Thompson—that claims have risen dramatically in the last 12 months.

Senator MASON—They have? Okay.

Ms Thompson—I can give you a small example.

Senator MASON—That would be very helpful.

Ms Thompson—I had a submission this morning from a large licence holder who in the years 2001 to 2008 had reported gross incurred claims of somewhere in the order of $800,000. But for this calendar year to date, their level was $943,000.

Senator MASON—Okay. That is of some help. Thank you. So it has increased in the last year or so—dramatically.

Ms Thompson—Dramatically, yes.

Senator MASON—You spoke about the government perhaps needing to consider establishing a compensation fund to act as a safety net in those cases where a licensee's PI cover provides inadequate to cover their compensation. Other witnesses that the committee has heard from have said that that is a bad idea because of the moral hazard and that the adviser should remain liable and so forth. What do you say to that? Why do you think that this is a good idea? I might add that some people think that what you are suggesting is a good idea as well. There is a mixed view on this.

Mr Anning—Right. I would like to clarify that the Insurance Council takes no position on the actual merit of a compensation fund as such. Why we are pointing to the need to consider the benefits of a compensation fund is that we have seen various attempts through regulations and ASIC's regulatory guidance to make PI insurance into a guarantee that the money will be there to pay compensation.

Senator MASON—Yes.

Mr Anning—PI does not function in that way. It is a commercial product with limitations as a guarantee mechanism. What we have been pointing out consistently to Treasury and the government is that you cannot make a commercial product into a compensation mechanism. If there is the policy decision that a compensation mechanism is necessary to maximise the chances of a wronged consumer being paid compensation then you need to look at the pros and cons of a compensation fund.

Senator MASON—We have heard evidence that that fund might be funded either by the government or levy on the industry or both. That is right, isn't it?

Mr Anning—There are various models. You could have a statutory fund or the industry could take the initiative and fund it.

Senator FARRELL—In your submission, you indicate that you do not think that it is necessary for Australia to establish a financial services compensation scheme like the one in the United Kingdom, because it will duplicate the financial claims scheme in Australia. Could you perhaps elaborate a little bit more on the differences between the two schemes, if you are familiar enough with both of them, and the relative advantages of the Australia scheme as it is at the moment versus the English proposal.

Mr Anning—As I understand the English scheme, it provides universal cover. That does not mean that it provides 100 per cent compensation, but in terms of its spread across the financial services industries it does provide cover. We were pointing out in our submission that, given the financial claims scheme that has been set up in Australia, which we see as almost a belts and braces mechanism—given the very strong prudential regulation we have in Australia anyway—there is the policyholder mechanism in place to ensure that Australian policyholders would receive appropriate compensation in the event of a general insurer failing. So, given that that scheme exists—and the general consensus is that it does provide a very strong fallback mechanism for policyholders—there is no need to replicate that coverage within a compensation fund, if that is the route that it is decided to take.

Ms OWENS—We have been hearing to date and in recent hearings about some areas where definitions are unclear—for example, 'clear, concise and effective disclosure'. From an insurance perspective, are there areas of the regulation where definitions are unclear, where companies are not sure how to proceed, where there are things that you would like cleaned up or made clearer or would like left alone?

Mr Anning—Speaking from the Insurance Council's point of view, those issues actually have not been raised with us from an insurance perspective, but we are aware of the general policy debates around that. Ms Thompson may have something to add.

Ms Thompson—Part of the difficulty is that we are asked to cover any breach of chapter 7, and all policies have inherent limitations in them. Our understanding from discussions with ASIC is that the civil responsibilities under that chapter are the sorts of things that we would expect to be covering for our policyholders.

Ms OWENS—In relation to the collapse of Storm, Opes Prime and the others, are there issues that have been raised?

Ms Thompson—The main issue for insurers is how to recognise them before they happen, so you do not insure them.

Ms OWENS—And that is actually a very good question. We would like to know how to do that.

Mr Anning—I suppose to look at the insurance process, in assessing the application of someone for PI insurance—and correct me if I am wrong—I would have thought that the insurer would actually look at what the licensee was doing rather than just going on that they had put stockbroker or financial planner on the application.

Ms Thompson—That is right. A number of things are taken into consideration. We look at the licence and what they are allowed to do and, especially with the larger firms, you have client meetings to find out and test the rigour of their compliance regime. We look at their complaints register, compliance registers and so forth and discuss with them their models and so on. But it is very, very difficult because, at the end of the day, we are there to help our policyholders and protect their business. Where that differs slightly from what you are hoping to achieve in consumer protection is that, if the policyholder has been dishonest, we do not want the policy to respond. We will cover the policyholder if they are unfortunate enough to have dishonest employees but, if the actual individual—the insured themselves—is dishonest, the policy is there for fortuitous events; it is not there for intentional dishonesty on the part of the owner of that business.

Ms OWENS—If I am reading that correctly, then, really, there needs to be a history of breach, error or claims in order for you to identify a potential problem.

Mr Anning—As I understand it from members, it is not just about the history; questions are also asked about the licensee applications, compliance procedures, the training their give their representatives et cetera. There is a whole list of questions which the insurer would use to assess the risk that they were undertaking.

Ms OWENS—But it obviously was not sufficient in these cases. Has there been debate about what else there is? Obviously the process was not sufficient in the case of Storm, Opes Prime, Timbercorp or a few others. Is there any debate at all about what other factors there might be? That looks like a no.

Mr Anning—I would say it is a no. It is not so much a debate about the factors, because I think the factors are probably well recognised; it becomes a question of the risk which the insurer is willing to take on in response to the answers to the questions that they ask about the compliance procedures et cetera that a licensee has in place.

Ms OWENS—If you had the answer, you would have been the first ones, by the way.

CHAIRMAN—Thank you very much. Thank you for your submission and your evidence today.

[2.40 pm]

COOK, Mr Anthony, Chairman, Wealth Management Committee, Institute of Actuaries of Australia

RAFE, Mr Barry Edwin, Vice President, Institute of Actuaries of Australia

CHAIRMAN—Welcome. Would you like to make some remarks in relation to your submission?

Mr Rafe—Thank you for the opportunity to be here. It is an important review and we are obviously keen to contribute. I should note upfront that John Maroney, our CEO, is leaving Australia to Basel. He has got the job of insurance regulator for the Bank for International Settlements. So he apologises for not being here today. The Institute of Actuaries of Australia is the sole professional body for actuaries in this country. Actuaries manage risk for a lot of financial services organisations and designed products. Our role here is to talk to you from the perspective of that professional body. Our recommendation is looking at some of the issues around personal stress test and managing that risk. We have made some comments about product design and also financial planner remuneration from our perspective of having to manage professionals.

The global financial crisis has reminded us all that the unexpected can happen. People who invest long term, which is most people saving for retirement, should expect that this is going to happen again. It could happen a few times in their path between now and retirement age. A lot of individuals have had bad outcomes. We are not going to go into specifics here. They all have their own story. Some might have had bad advice, some might have had bad products, some might not have monitored the risk, and for some there might be just no blame. Our thought here is that people did not really understand the risks they were taking on. Our submission tries to put a practical way forward in putting a personal stress test so that people can actually see the implications of some of the risks they are bearing. We have some observations around product design and financial planner remuneration.

CHAIRMAN—It is an interesting point: they did not understand the risk. They are two interesting points: that the unexpected can happen but it is not unexpected. The reality, particularly from an actuarial point of view, is that it is completely expected. In fact it is 100 per cent guaranteed that an event will happen. It may happen this afternoon, it may happen next year or the year after. I do not know when it will happen but I know it will happen. It is 100 per cent guaranteed. History teaches us that. It is an odd concept that it is unexpected when it is completely expected. People do forget. I might get some comments on that a bit later. I am really interested that people did not understand the risk. That might be a fair statement in terms of an ordinary mum-and-dad investor. How does that sit with the Commonwealth Bank of Australia? Didn't they understand the risk when they invested their money, their funds, into loaning people massive amounts of money and in effect took massive risks themselves? Did they have no understanding of risk?

Mr Rafe—It is hard for us to comment from the perspective of the Commonwealth Bank.

CHAIRMAN—I am using that as an example. When you say that people did not understand the risk, that is a pretty broad statement. I accept that you are probably just referring to individuals.

Mr Rafe—We were.

CHAIRMAN—Yes, I know. If the CBA did not understand the risk, if the ANZ in terms of Opes Prime did not understand the risk, if professional planners did not understand the risk, if people who actually ran significant businesses who bought into the Storm model did not understand the risk, how is a mum-and-dad expected to understand the risk?

Mr Rafe—My view would be that the CBA understands long-term risk. They are in the business of running a mismatched balance sheet that makes profit on risk. But I think from their perspective this was probably an operational issue. It was not a risk management issue. I think some of the operational issues fell down.

CHAIRMAN—That is interesting—it was operational issues rather than risk. But there was a great risk, in fact. There was a double-geared multiplier risk, which meant the risk did not just exist in reality but—

Mr Rafe—That is right. If you look at an investor like a superannuation fund, the superannuation fund would understand the risk. They invest long term. They understand the effect of diversification and that sort of thing. So from an asset investment perspective they understood the risk. When you look at CBA and their relationship with financial planners and their loan book, we saw that as more of an operational issue to the extent that it was not an investment risk from their perspective. It was the way they run their business and the way their operations work.

CHAIRMAN—So, whether it is them or somebody else, how would they have seen the risk—as somebody else's risk or their own risk?

Mr Rafe—Potentially as somebody else's risk, I would say, yes. I would have thought that they saw the risk as investor risk. People borrow money to make investments and it is an investor risk for them.

CHAIRMAN—In terms of your recommendation about introducing a mandatory personal stress test disclosure, what you are in essence saying is there should be some sort of standard format test, I am assuming, where people would sit down, fill out a form and somehow come out profiled in a particular way, which would be standardised across the sector. That would indicate what? What would that do in practical terms?

Mr Cook—If I can just take a quick step back from that. Risk is a difficult thing to understand. We all know different outcomes happen but we do not have crystal balls. We do not know what is going to happen at any particular point in time. The best that can really be done to communicate risk is to show people different scenarios, and the concept here is just that. The most powerful way to get people to understand something is to show them, and the concept of the stress test is a means of doing that. You talked about scribbling down on a piece of paper—I think it would be a little more sophisticated than that. It would dovetail, we think, quite well with

the current 'know your client' regime. There is a lot that financial advisers now have to do to understand their clients' circumstances. That information is already captured and most of that information is actually the information that is needed to test what likely outcomes would be in the future, and you could therefore paint a picture of what it might look like under particular scenarios for particular customers.

CHAIRMAN—Can I ask for some detail about that? It is often in life that we have too much information rather than too little, and I am assuming that with the test everyone gets profiled on the way in—what sort of risk taker you are, whether you like to jump out of planes, climb tall buildings or whatever it might be. But once they have collected all that data don't they just fold it up, put it in the folder and say: 'Here's our product. You ought to buy this product. You ought to invest in this vehicle'?

Mr Cook—There is always that risk. If this was just about disclosure, this would not be effective. There really are three parts to this. It is about showing people outcomes, trying to encourage the right conversation to happen and performing to a certain standard. But, again, if that is not performed, not followed through or does not take place, it will not achieve that objective if someone wants to work around that.

CHAIRMAN—Is that caught up in the compliance regime or in the licensing? Is that an effective mechanism?

Mr Cook—I think one of the powerful things about doing the stress test is what it produces in terms of information and metrics as a result. You put in a person's circumstances, you put in some parameters for stocking various scenarios and you will get some outputs around what will happen to a person's balance sheet and what will happen to their income and expenditure under those various scenarios. That information could easily be used to define how risky this outcome is or how big that outcome is and could quite easily be dovetailed into our compliance monitoring program to send some warning lights in particular circumstances. So we would envisage that the compliance regime would have an extra tool allowing us to see some of those warning lights in a way that may be difficult now to appreciate. Most of that, we anticipate, would come off the back of not much more information, if any, than is collected today or is required to be collected today.

Mr Rafe—The point you made at the beginning was valid. We all know these things are going to happen; we just do not know when. The idea of the scenario planning tool, the stress test tool, is that you assume it is happening—you say, 'Assume this happens now.' There is no probability about it; it is a 100 per cent chance. It says, 'If this happens now then this is what the outcome will be.' That is the difference. We are not putting probabilities around it; we are locking in a scenario.

Senator MASON—It is an interesting point. Over the last couple of days we have been discussing disclosure, but, as you say, Mr Cook, that disclosure often does not work per se—for all sorts of reasons but, to put it simply, because the disclosure is not transparent. This proposal, stress testing individuals in relation to various products, is much more transparent, isn't it?

Mr Cook—We think so. Again, it comes back to the point that it shows a reality. It shows what it would look like after a particular scenario, and that is much easier for most people to understand.

Senator MASON—Indeed. It is like the warning on cigarette packets.

Mr Cook—Yes. The warning comment is a good one. We have said in the proposal that it is not just about showing the numbers but about having a couple of questions after those numbers: 'Can you handle this outcome? What would you do if this happened?' The real power, if it is done properly, is in fact in the discussion that follows, not in the numbers themselves.

Senator MASON—Interestingly, you are not talking about stress testing the product; it is the individual.

Mr Cook—Yes, absolutely the individual.

Senator MASON—Why is that? Is it because there is nothing innately wrong with a product—it is only in relation to an individual that it becomes an issue?

Mr Cook—There can be problems with products, but you are absolutely right: some products might not be right for some customers in some circumstances, given the other products they have, like their home loan, and so on.

Senator WILLIAMS—You could have the warning sign, 'Beware: this could cost you your house,' and the financial planner selling the product could say, 'Don't worry about that—it's on everything.' That would obviously be a problem. If you are looking down the road, say, 15 years, they could say, 'This has been around for 15 years,' and disregard it. Do you see that as a problem for the future, as far as the warning signs go?

Mr Cook—No. If someone wants to break some rules, no amount of disclosure or regulation is going to deal with that issue. Disclosure is a first step; the stress test information is a first step. We think what helps in this scenario is that it does produce that information. That part of the compliance program can be used to pick up some orange or red lights, importantly, for deeper investigation. It is not just because those ratios are high that something is wrong. It does not say something is bad; it says look under the covers, look a little bit deeper. The compliance and monitoring process could actually be built to do so.

Senator MASON—The fourth point in your submission is about the separation of the remuneration that a planner receives for providing advice and any remuneration that is received for selling products. Are you proposing there that, if you are selling a product, you cannot receive a commission?

Mr Rafe—Our submission says that, if you are providing advice, you should not be getting any commission. By 'commission' we mean trail commission, travel perks and all that sort of thing. If you are demonstrably just selling a product with no advice attached then that is really part of disclosure. The individual can make a decision on that because they see you as a product provider, not as an adviser. The thing about advice is that, when you go to an adviser, you have obviously picked that person for a reason. That person, just like a doctor, has an authority about

them, so you accept their advice and assume it is in your best interest. So there is quite a difference between a product and advice.

Senator MASON—Oh, we know that—this committee knows that after two days!

Mr Rafe—Because we are a professional association about giving advice, we are commenting on the professional advice part of it. On the product disclosure parts, as far as commission goes, that is okay, but certainly not when it is bundled in with advice. That is when you cross that boundary, in our view, anyway.

Senator MASON—Our challenge as a committee is to make that workable, if not legislatively, at least in a code of ethics or something. That is our difficulty. There are challenges, as you are aware, trying to demark between those two.

Mr Rafe——The other point to make there is that the adviser generally acts as a pipeline to the product. You would expect that to keep going—you would expect the adviser to be able to help you implement products; but you would not expect the adviser to get paid through the back door for that product advice. I suppose that is the demarcation.

Senator MASON—That is right.

Ms OWENS—We have heard evidence from a few players today that separating the two would raise the cost of advice, in particular, and price it out of the range of the less affluent. Mind you, that would just leave the less affluent with commission based advice.

Mr Rafe—That is right.

Ms OWENS—Do you have a view on the effect on price?

Mr Rafe—The advice costs what it costs. It is a case of how you package the thing. I think, with respect to those other issues, there are some short-term issues certainly when the whole business model is built around the fact that advisers get that money often through commission or often through trail. That is factored into the price a person pays. I think longer term the whole issue around those who are less affluent is a bit of a furphy. Who are we talking about for starters? We are talking about 90 per cent of people whose best investment advice is to pay off the mortgage or put money into super—none of which would give any sort of commission or trail to an adviser. So we are talking about that 10 per cent who are left—in which case they are more sophisticated and in which case people should know how much they are paying for advice. Advice is expensive. For a financial planner the hourly rates might look high, because there are overheads, research and that sort of thing. But I think people have to see what that advice is. The profession has to stand on its own two feet. People need to understand that this is the cost of that advice.

If they are putting money into super then most super funds have default products and the advice is basically built into those default products through the fact that the trustee has taken advice and built this product to suit that sort of group of people in a balanced fund or whatever. They are already getting the advice built into their products. So I am not sure who these less affluent people are that people are talking about.

To answer your question directly, going to an adviser would cost more for people if the adviser did not get the income—it would cost them more upfront. Long term it is highly unlikely it would cost them more upfront. Asset fees are insidious. As actuaries we live on compound interest. If you look at the effect of a small asset fee on an asset over a long period of time then you will see that it is an enormous amount of money. Once it is in an investment there is a certain inertia and it will stay there. People will not know how much they are paying. It is an insidious way of pulling out fees.

Ms OWENS—We do seem to have a new issue in Australia because of the large number of people who suddenly find themselves with super payouts, and it maybe their first investment ever or they may have discovered shares through Telstra or whatever. I have had people in my office who got their workers comp payout and were advised to put all their money into Pasminco. Bit by bit, they go back each year and the adviser tells them to invest more. They may have put their money in the share market and a company has gone broke. They come to me wanting to know where their money is. Their financial literacy is so low—never mind a stress test, it is almost a case of 'do you understand what a share is'. For those people disclosure and all of that sort of stuff means nothing because they are basically taking advice from a person. Do you see any answers on that issue?

Mr Cook—There are a range of things that have to be working to make all of this work. Clearly education is part of it but there is only so much they can be educated and only so much depth they can be educated in. We need to make sure that advisers can operate and give good advice to people who need that good advice, whether they are operating at the high end or the low end. We need to make sure that there is that communication of implications, whether it is through the advice process or whether it is for a person who comes off the street and wants to take a risky product when they have no advice. The best scenario is that we actually get them some advice, and the right advice. We must make sure that we do not end up in a situation where that cannot happen.

The final step is where we have the checks and balances in place, and in the right place, so that if bad advice is being given by a small number of people or if the wrong things are happening then there is a high probability that it can be picked up before too much damage is done. We think the stress test, because it has some of those components, can work at both ends of that and can help. It cannot solve the whole problem. It does not educate by itself. It does not do that. It cannot make every financial planner a brilliant communicator. But it can raise the bar, it can lift the standard and it can give us approaches to monitor better.

CHAIRMAN—Does the stress test add more cost? Would that really add cost?

Mr Cook—There are a number of ways of handling that. I do not think so because of where we are. We already have 'know your client'. Where is cost going to come into the system? It is going to come in where we have to get more information. It is going to come in where it is going to cost something significant to actually provide the risk advice or where it is going to cost something significant to do the compliance monitoring. If we take each of those in turn, the 'know your client' rule is already required. So we do not think there is much additional cost, if any, required in that space. Maybe some other things that are less relevant could be dropped to compensate.

In that middle space of doing the work we think that once you have the software in place—and most advisers have software already—that is actually linked to what they already do. So I would not anticipate it being hugely incremental. There may be a one-off cost to get there and there are various ways in which that could be tackled. At the final end we already have a compliance monitoring process. It may have to be enhanced. There are different ways in which that could be tackled. So I do not think as a wholesale thing that it need cost a lot. There are a couple of mechanisms that could potentially be used to mitigate that.

We have put in the submission that you could look at the level of trigger events and various risk scenarios to determine whether in fact the stress test is required. Those trigger events could be dialled up or down. Clearly if you dial them down then more stress testing needs to be done for more people and that is likely to be more costly than, say, doing it for fewer people. So getting that parameter right can control cost and also effect and that sort of thing.

Similarly, with the back-end and the monitoring regime someone just this morning said to me that if you could capture electronically some of those issues that come out of the outcomes—what happens to balance sheets and what happens to people's income—and if that was captured centrally in some shape or form then you could actually run a profiling process over that data and target the compliance monitoring to areas where it is needed most and move away from just having a general approach. I say that as an aside rather than as something we have thought through deeply, but it is an interesting idea.

Senator McLUCAS—I want to come back to the issue of the stress test and how that fits with the section of the act that says that you have to know your client and determine the relevant personal circumstances et cetera. Is this an add-on to that understanding of the client's circumstances?

Mr Cook—We do not think so. We think it is actually already part of the regulations. You have to know your client and it is already part of the regulations. If you are giving advice or recommendations that lead to a potential for high risk or bad outcomes then advisers need to cover that now. Where this comes in is that knowing your client today means knowing the products they have got—what their mortgage is and what their circumstances are. That data is already captured in the needs analysis process. It is largely the same data that would be needed to feed into this process.

Ms OWENS—Is the point of having that on file that, firstly, it forces the conversation and, secondly, it lists on file that you knew this was their only asset and you knew that they were 68 and had no future earnings so that if you get it wrong it actually sits on the file.

Mr Cook—It certainly does.

Ms OWENS—So it actually acts as a—

Mr Cook—In fact it sits on the file today.

Ms OWENS—So if you get it wrong then the client can come back—

Mr Cook—If this is done well then the stress test actually can not only improve the professionalism of the financial planner but also protect them. It demonstrates that you communicated the potential outcomes in a way that maybe is not demonstrated today.

Senator McLUCAS—So what is the purpose of recommending the formulaic stress test as you have? Is it that you believe that currently the 'know your client' activities are poorly done or that if they are being done then they are not being acknowledged—they are not being used in terms of designing a package or giving advice.

Mr Cook—On the whole, I think they are done and, on the whole, represented in the advice that is given to clients. We are not sitting here talking about most of the population having problems; we are talking about a small percentage. This is about putting in a layer that can help that communication and raise the standard to an acceptable minimum level.

Senator McLUCAS—In terms of your recommendation about being far more prescriptive about which types of clients can have which types of products: who would make that assessment of the suitability of certain products and how would you regulate it?

Mr Cook—It is a good question, and I cannot give you a lot of detail on that. It is an area that needs to be looked at. We are really flagging that there are certain products that are complex, that are very difficult to communicate and that have certain risks in them that are outside the norm. One of the learnings out of this last period is that we need to think very carefully about which of those products should and should not be used and in what circumstances. I think there is work to be done there to actually answer your question, but certainly ASIC, as well as others, may have a role.

Senator McLUCAS—ASIC does not have a role in assessing products at the moment. It would be a change of its activity.

Mr Cook—Yes, that may well be the case. I will give you a contrast. Many of us as actuaries work in or for life companies. Capital requirements are one of the things we look after there and, as part of that, we need to look forward to what happens if there are certain bad outcomes. Can the balance sheet survive? Can we meet the obligations to customers? That is not unlike what is happening with some structured products, where their very survival depends on future cash flow and so on. They need certain capital standards to protect them but they also need to be used in the right way.

Senator WILLIAMS—Julie was speaking earlier about people who went to her office asking, Where is my money?' and the company was falling over. Surely there are a lot of Australians who have worked hard, who have saved their money, are perhaps poorly educated and have put trust in financial planners and financial advisers. Surely what we must have for the future is a high ethical standard among the people carrying out this job in the financial planning and advice industry. They should know their job and they should have high standards, because people who do not understand investment or the market system are putting their trust in these very people.

Mr Rafe—In our submission we recognise the fact that it is hard to legislate for ethical standards. We are saying that there should be a requirement that people who give financial

advice be members of professional associations. Professional associations have codes of conduct, guidance rules and disciplinary committees, and that sort of professional association has to be recognised by the regulator as being acceptable for that group of people.

Senator WILLIAMS—We have had all that. I know people who had no idea of investments but trusted Storm and have lost their life savings, yet Storm was a member of the FPA.

Mr Rafe—That is right.

Senator WILLIAMS—That has not been bullet-proof, has it?

Mr Rafe—No.

CHAIRMAN—In example 1 in your submission you have a break-out box where, in simple numbers, you demonstrate what happens with gearing on an investment of $100,000 with a 20 per cent rise or 20 per cent fall in the market. In particular, you show what would happen with that investment if there were a fall in the market of 33.3 per cent, which would wipe out the investor's complete portfolio. Could you explain that for the record and explain the dangers inherent in not comprehending that a 33.3 per cent fall is a 100 cent loss.

Mr Cook—Certainly. It really comes down to how much money does the client have at stake here. They may start off with $50,000 at stake—that is their net worth. When they take out a gearing, suddenly, instead of having $50,000 invested, they may have $100,000 invested. That $100,000, therefore, is what is at stake and if the market moves they will lose more in absolute dollar terms than they would have if they had just that the $50,000. They will lose twice as much. Of course, they do not really have $100,000 of net worth; they only had $50,000. The other side is the debt. The debt has not moved and therefore that absolute increase can wipe out their whole net worth.

CHAIRMAN—How does that example work in terms of an LVR? There has been lots of discussion and submissions about LVRs and what is a safe loan to valuation ratio. If we just use your example here that you have provided, what sort of LVR is that based on?

Mr Rafe—This is not based on an LVR at all. It is simply an illustration.

CHAIRMAN—It is just an example, I know, but in terms of gearing.

Mr Rafe—If you are asking what is an appropriate LVR, I will have to defer—I am not an expert in banking, mortgages, property valuations and movements, and those sorts of things.

CHAIRMAN—That is fine. Obviously the example you gave obviously is based on leverage and a borrowing amount which you could equate to it a loan to value ratio that they would have loaned you the money on. The amount is equivalent to how much LVR they put in place.

Mr Rafe—That is right. This is a demonstration.

CHAIRMAN—That is fine. I appreciate the example, but particularly the point you make that a 33 per cent fall is a 100 per cent loss, which I do not think many people would have understood.

Mr Rafe—No, it is because of the fact that the loan is fixed. So the only variable is your equity.

Ms OWENS—You have listed a few things that have contributed to recent collapses: the high levels of gearing, concentration in single assets and investments in products that require further ongoing cash flow. Again in my experience in the electorate those things extend far beyond Storm and Opes Prime. It is actually quite common for people with a one-off payment to be told not to pay off their mortgage and to put it in this product instead and really get themselves in serious trouble. Although you are already supposed to know your client, I wonder for those advisers that are giving that sort of advice whether the stress test would make any difference at all. With these particular customers that I am talking about they would have to know that this is all they had and all they would have and yet they have still put them in these incredibly vulnerable positions.

Mr Cook—If the financial planner actually performed the stress test and showed it to the client we would expect more customers or clients would actually ask a few more questions. But that is not going to be the case for everybody. It may protect some but not all. Some advisors may just not do it at all. Again, no disclosure can stop that. That is why it is important that the monitoring—the orange lights, the red lights we talked about before—is in place; ways of picking up if that is happening.

Mr Rafe—If you as an investor, no matter how little education you had in investments, were given a piece of paper that says you have to sign the bottom and you have got to recognise that you could lose your house, that would make a difference. That does not specifically happen at the moment. What we are saying is that the stress tests will say that you must recognise that you might lose your house if you sign this form. So that will create that added sense of urgency, added sense of risk.

CHAIRMAN—You are saying that under the scenarios in the stress test where the 100 per cent fall in the largest stock or 50 per cent fall, 25 per cent fall would give you three different outcomes and you would clearly understand, no matter who you were, what the possible outcomes would be?

Mr Rafe—That is right. Even with 'know your client', that does not explicitly happen at the moment.

Mr Cook—I would say it does not specifically happen to a uniform standard. I think some advisors may do that very, very well and others not do it at all.

CHAIRMAN—Gentlemen, can we thank you very much. We appreciate your submission and also your evidence today.

Committee adjourned at 3.14 pm