FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

Head of Secretariat
Financial System Inquiry
The Treasury
Langton Crescent
PARKES ACT 2600

By email: fsi@treasury.gov.au

31 March 2014

RE: Financial System Inquiry

Dear FSI Committee Members

The Financial Planning Association of Australia (FPA) welcomes the opportunity to contribute to the Financial System Inquiry (the Inquiry) in line with the terms of reference.

The FPA's submission to the Inquiry makes recommendations on both the overarching principles which describe the purpose and objectives of the Australian financial system, as well as specific areas where the financial system could be improved.

The intention is to form recommendations for key policy areas for the Inquiry to include in their Interim Report.

Thank you again for the opportunity to make a submission to the Inquiry and we welcome further opportunities to provide feedback and consultation to the Interim Report.

If you have any questions, please do not hesitate to contact me on 02 9220 4500 or dante.degori@fpa.asn.au.

Yours sincerely,

Dante De Gori
General Manager Policy and Conduct
Financial Planning Association of Australia[1]

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[1] The Financial Planning Association (FPA) represents more than 10,000 members and affiliates of whom 7,500 are practising financial planners and 5,500 CFP professionals. The FPA has taken a leadership role in the financial planning profession in Australia and globally:

- Our first "policy pillar" is to act in the public interest at all times.
- We banned commissions and conflicted remuneration on investments and superannuation for our members in 2009 – years ahead of FoFA.
- We have an independent conduct review panel, Chaired by Professor Dimity Kingsford Smith, dealing with investigations and complaints against our members for breaches of our professional rules.
- The first financial planning professional body in the world to have a full suite of professional regulations incorporating a set of ethical principles, practice standards and professional conduct rules that explain and underpin professional financial planning practices. This is being exported to 24 member countries and the 150,000 CFP practitioners that make up the FPSB globally.
- We have built a curriculum with 17 Australian Universities for degrees in financial planning. As at the 1st July 2013 all new members of the FPA will be required to hold, as a minimum, an approved undergraduate degree.
- CFP certification is the pre-eminent certification in financial planning globally. The educational requirements and standards to attain CFP standing are equal to other professional bodies, eg CPA Australia.
- We are recognised as a professional body by the Tax Practitioners Board.

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Financial System Inquiry

FPA SUBMISSION | 31 MARCH 2014

Financial System Inquiry

Terms of Reference

FPA submission to:

FSI Committee

31 March 2014

FINANCIAL PLANNING
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Financial System Inquiry

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1 - INTRODUCTION

The operation and characteristics of Australia's financial system, particularly as it manages such a vast amount of our wealth, has a powerful influence on the lives of all Australians. To the extent that the financial system influences our social and cultural norms, and our quality of life, the purpose and management of the Australian financial system is a fundamentally political question.

A root-and-branch review of the fundamental values of the Australian financial system has become necessary in light of the Global Financial Crisis. While Australians were shielded from the worst of the GFC through strong terms of trade and sound fiscal and monetary policy, the current challenge to the Federal government's budget has provoked a wide-ranging discussion of the purpose of our system, including its private and public institutions.

The FPA's submission to the Inquiry makes recommendations on both the overarching principles which describe the purpose and objectives of the Australian financial system, as well as specific areas where the financial system could be improved. The intention is to form recommendations for key policy areas for the Inquiry to include in their Interim Report.

The structure of our submission is divided into two sections. The first relates to the conceptual framework of the Australian financial system. This section relates to the overarching principles which guide the purpose of our financial system, the basis on which regulatory intervention takes place, and the roles which various participants in the system play in producing outcomes. The objective of engaging with the conceptual framework of the financial system is to encourage the Inquiry to critically analyse the foundations of the system, and recognise international developments in markets and regulation which would help to improve the efficiency, stability, and fairness of the Australian system.

The second section of our submission relates to the substantive areas of the Australian financial system which require reform. These recommendations to the Inquiry are informed by the preceding discussion of the financial system, and are focused on the role which professional financial advice can play in the system. It covers a broad range of proposals which we encourage the Inquiry to raise with other stakeholders in the Financial Systems Inquiry.

Our submission incorporates a high-level approach to these issues with a broad scope of relevance. The FPA's response to the Inquiry's interim report will add greater detail and a more granular discussion of each recommendation.

2 – CONCEPTUAL FRAMEWORK OF THE AUSTRALIAN FINANCIAL SYSTEM

It is generally understood that the purpose of a financial system in a developed economy is to promote the efficient allocation of resources through a decentralised, competitive process. Some evidence of this fundamental position in Australia lies in the predecessor to the current Inquiry, the Wallis Report. That Report distinguished between the objectives of the financial system and the objectives of satisfying 'community service obligations;'

> *Financial institutions, like other business corporations, are designed to produce wealth, not to redistribute it.* This is not to say that their creation of wealth should ignore the claims of social and moral propriety. But it is another thing entirely to require financial institutions to undertake social responsibilities for which they are not designed or well suited.[2] (emphasis added)

The regulation of financial institutions in Australia also tends to confirm that we claim to take a value-neutral approach to our financial system. The Australian Securities and Investments Commission Act 2001 (Cth),[3] states that ASIC, as the principal financial market and corporate regulator, must strive to;

> (a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
> (b) promote the confident and informed participation of investors and consumers in the financial system; and
> (d) administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; and
> (e) receive, process and store, efficiently and quickly, the information given to ASIC under the laws that confer functions and powers on it; and
> (f) ensure that information is available as soon as practicable for access by the public; and
> (g) take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it

To a large extent, these objects do not promote specific policy objectives for the administration of the financial system. They instead promote the quick and efficient facilitation of the existing system, without reference to other norms. The Wallis Report identified three forms of regulation used to facilitate this objective;

- General market regulation: Regulation to facilitate disclosure and fair competition between formally equal market participants.[4]
- Regulation for financial safety: Regulation which facilitates disclosure and fair competition where "promises are judged to be very difficult to honour and assess, and produce highly adverse consequences if breached."[5]
- Regulation for social objectives: Regulation which confers "subsidies on one group of consumers in preference to others. Regulations of this kind are often referred to as 'community service obligations' and typically take the form of price controls."[6]

This tripartite model remains the predominant conceptual framework of financial regulation in Australia. We

[2] Treasury, Financial System Inquiry: Final Report (Canberra: AGPS, 1997), 196 ("Wallis Report").
[3] Australian Securities and Investments Commission Act 2001 (Cth), s 1(2).
[4] Wallis report, 186.
[5] Wallis report, 190.
[6] Wallis report, 178.

would propose that the Inquiry retain these distinctions, and recommend regulations which create higher standards of conduct for entities which operate within the financial system. In effect, we recommend that the Inquiry moves more of the financial system's functions to the category of financial safety regulation, and define the objects and function of financial safety with greater clarity.

Our recommendations frequently relate to fairness, equality, and other concepts which tend to indicate support for new objectives for the Australian financial system. The objective of these recommendations is not to prescribe objectives for the financial system beyond the efficient allocation of resources, but to encourage more effective, efficient, and fair processes of financial regulation and participation in the market. We believe that implementing these recommendations will create stability, efficiency, and competition *through* fairer and more equal markets and regulation.

In its Interim Report, the Inquiry should discuss the following issues relating to the conceptual framework of the Australian financial system;

- the centrality of disclosure regulation and the efficient markets hypothesis in Australian financial systems regulation;
- the role which disclosure-based regulation plays in entrenching existing inequality between market participants;
- the development of financial capability and literacy amongst retail investors;
- the rights and obligations of investors with respect to financial institutions and the financial system;
- the role of gatekeepers within the financial system, and how this role can be developed to improve the integrity of the financial system; and
- the facilitation of closer interaction and a common purpose between financial institutions and financial conduct regulators, while managing the risk of regulatory capture.

2.1 – Financial citizenship

A richer concept of financial citizenship in Australia, which addresses the key rights and obligations of Australian investors with respect to the financial system, would be ideal to foster prudence, public confidence, and stability in our financial system.

There are important reasons to focus on retail investors and their interactions with the financial system. As the Wallis Report identified, sophisticated investors are generally understood to be able to service their own informational requirements,[7] whereas retail clients generally have less experience and financial capability than sophisticated investors, and thus require more than general market regulation.[8] Furthermore, as a result of superannuation and the increasing social and cultural impetus to purchase insurance, mortgage, and consumer credit products, Australian society has experienced significant and compulsory financialisation.

Our financial system identifies two characteristics of financial citizenship which are relevant to the experience of retail investors in Australia;

- <u>The 'rational investor' hypothesis</u>: The financial citizen "as a knowledgeable, competent, confident, self-reliant and willing market participant,"[9] and;

[7] Wallis report, 238; C.f. *Wingecarribee Shire Council v Lehman Brothers Australia Ltd* (in liq) [2012] FCA 1028.
[8] Wallis report, 175.
[9] Joanna Grey and Jenny Hamilton, *Implementing Financial Regulation: Theory and Practice*, (Wiley, 1st ed, 2006), 188

- Citizenship as compulsory participation: The financial citizen who is legally and socially compelled to be involved in the financial system,[10] who has rights and obligations regarding their mandatory participation in the system.

The existing disclosure-oriented forms of regulation present in our financial system rely on these concepts of financial citizenship, without the corresponding steps to address the challenges which individuals face when engaging with the financial system.

At present, the prevailing notion of financial citizenship in Australian financial services regulation is a "thin concept, lacking much of the rights content that even the spare liberal conception of legal or judicial citizenship has in the political arena."[11] To the extent that the concept of financial citizenship exists with our system's conceptual framework, it is only to create a legal subject whose interactions with the system are defined in strict contractual terms with the minimum financial safety regulations required to supplement the prevailing operation of disclosure obligations.

While the values of contract law underpin the Wallis Report's concept of a financial system which facilitates the exchange of promises, the involvement of financial citizens requires "the law of promises [to] do the work of boosting wealth, and reflect and align itself with the democratically evolved values of justice and market standards."[12]

A key issue for the Inquiry to consider is how a richer concept of financial citizenship might improve the principles and objectives of Australia's financial system. In particular, we would ask the Inquiry to modify the concept of financial citizenship to include:

- Financial inclusion: A regulatory and industry response to the institutional barriers to equality of participation and financial inclusion for all users of the financial system;
- Behavioural economics: A regulatory and industry response to the behavioural risks inherent in the financial system for all users of the financial system, and;
- Financial capability: A regulatory and industry response to raising financial literacy, and improving the standard of financial capability for those who interact with the Australian financial system.

Understanding investors through a modified conceptual frame of financial citizenship offers several advantages for the Inquiry:

- Financial citizenship identifies the investor as a subject with rights and obligations with respect to the financial system and the financial institutions which service them. This allows the Inquiry to perform several of its key tasks, such as considering how financial risk is to be allocated between financial citizens, financial institutions, regulators, and government.
- Developing a concept of financial citizenship will assist the Inquiry to recommend policy options which will meet the needs of users with appropriate financial products and services, as the needs and expectations of retail investors can be more clearly defined if the Inquiry also recommends a consistent conceptual framework for these users.
- The Inquiry will benefit from addressing financial citizenship when recommending policy options which promote a competitive and stable financial system that contributes to Australia's policy growth. In particular, improving the financial capability of retail investors will help to prevent the

[10] Grey and Hamilton, above n 6 at 193; Dimity Kingsford-Smith, 'Fairness, Regulation, and Financial Markets' in Janis P Sarra (ed), *An exploration of fairness : interdisciplinary inquiries in law, science and the humanities* (Carswell 2013) 251, 254 ('Fairness')
[11] Dimity Kingsford-Smith, 'Regulating Investment Risk: Individuals and the Global Financial Crisis' (2009) 32(2) *University of New South Wales Law Journal* 514, 524
[12] Gail Pearson, *Financial Services Law and Compliance in Australia* (Cambridge UP, 2009), 14

systemic misselling of products, which in turn improves financial system stability and confidence, as well as the efficient allocation of capital.

Recommendation 1:

The FPA recommends:

- the development of financial citizenship in Australia, and
- improving financial inclusion and capability for users of the system,
- improving the regulatory management of the behavioural risks which users of the financial system may encounter.
-

2.1.1 – Financial inclusion and opportunity

One of the limits of the current financial system is that it does not facilitate equal participation by all consumers. Of greatest concern is that the system does not allow those who enter the financial system with fewer resources and a lesser tolerance for risk to be afforded the same opportunity to make money through participation in the system. As the greatest opportunities offered by the financial system are for those with existing wealth, the Australian financial system reinforces the socio-economic divides within our society.

This issue is exacerbated by the disclosure-based system of regulation which currently underpins our financial system. The system has structural checks and balances which place sophisticated and institutional investors at an advantage over retail investors. To the extent that inequalities in intelligence, capital, access to the legal system, and other relevant factors exist, a disclosure-based regulatory system will *exacerbate* these existing inequalities and prevent fair and equal competition amongst all market participants.

The widespread financialisation of society, particularly with respect to mandatory participation in the markets through superannuation, makes inequality of opportunity an unacceptable outcome for competition, efficiency, stability, and consumer protection in a well-functioning financial system. The role of Government and regulatory agencies is to regulate the market to ensure that inequality of opportunity does not result in reduced consumer protections and market failure.

The Inquiry would benefit from adopting financial citizenship as a legal framework to attach rights and obligations of market participants, particularly with respect to equality of opportunity to participate in the financial system. Crucially, this framework would not interfere with the market to arrive at substantive outcomes such as distributive justice, but is directed towards meaningful procedural fairness in the market.

Recommendation 2:

The FPA recommends the financial system should:

- encourage equality of participation and procedural fairness, and
- recognise and respond to varying degrees of wealth and opportunity which prevent some users or potential users of the Australian financial system from fully engaging with the system.

Link to FSI Terms of Reference: 1.3, 2.1, 2.4, 3.1, 4.3, 4.5

2.1.2 – Behavioural economics

Regulation of the financial system, and particularly our concept of financial citizenship, should be informed by behavioural economics research. Furthermore, behavioural economics should be understood not just as an influence on the efficiency of the market for financial products and services, but as influencing the political rights and obligations of financial citizens and financial institutions.

Broadly speaking, behavioural economics concerns the way which individuals and firms make decisions – particularly when those decisions depart from the expectations of rational market participants who act in their own self-interest. Over the previous five decades, the academic scholarship on behavioural economics research have revealed significant irrationality which is ingrained in the way we assess risk, understand probability, and evaluate payoffs.

The role of behavioural economics research in financial services regulation has recently been recognised by *Report 384 – Regulating complex products* by ASIC. The Report, when discussing the difficulties which individuals face when trying to understanding complex products, stated that;

> "[w]hen faced with complexity, people respond automatically and unconsciously to try and simplify the decision-making process. This can cause them to make decisions based on less relevant but easily assessed criteria, while neglecting more relevant but hard-to-access information, leading to poor financial decisions."[13]

This research has directed similar policy and strategic development in foreign jurisdictions. In 2013, the United Kingdom's Financial Conduct Authority (FCA) released it's Occasional Paper No.1, *Applying behavioural economics at the Financial Conduct Authority*.[14] This comprehensive report addressed the risks associated with biases and behaviour, as well as explained the tools which the FCA use to understand the way in which behavioural science operates at a consumer and a firm level, as well as the compliance tools available to it to address those risks. The Paper stated that;

> "Much consumer detriment arises as firms design and sell products that benefit from consumers not overcoming mistakes or, at times, exacerbating mistakes…
>
> But firms may also play the opposite role, and actively use behavioural insights to help individuals to engage with financial services and make better choices by designing products that consumers are more likely to understand, and using marketing and selling tactics that do not trigger or exacerbate biases."[15] (footnotes omitted)

[13] Australian Securities and Investments Commission, 'Report 384 – Regulating complex products' (2014), 39
[14] Financial Conduct Authority, 'Occasional Paper No. 1: Applying behavioural economics at the Financial Conduct Authority' (April 2013)
[15] FCA, above n 14 at 21

The European Commission and European Securities and Markets Authority have also incorporated behavioural economics research, as well as insights from studies of retail investor engagement with the financial system, into their regulatory approach.[16] Some of this research has already been conducted in Australia with respect to the decisions which Australians make with regards to retirement savings, and directly connect the infrequency of superannuation fund switching to a 'status quo bias' when presented with complex decisions.[17]

Behavioural economics is also intimately connected with financial citizenship, as the legal framework of financial citizenship allows the Government to effectively regulate for the protection of financial citizens against behavioural exploitation. The integration of behavioural economics into the financial system is linked to the development of financial citizenship in Australia.

Recommendation 3:

The FPA recommends behavioural economics be adopted as a fundamental principle incorporated into the design of the financial system.

Link to FSI terms of Reference: 1.2, 1.3, 2.1, 2.3, 2.5, 3.1, 4.1, 4.3, 4.4, 4.5

2.1.3 – Financial capability

Building financial capability, particularly through financial literacy, is important for the future of Australian financial markets, and is central to financial citizenship. While it is important to recognise that financial institutions have a role in understanding and adapting to the needs and behaviours of users of the financial system, it is equally important to address the underlying financial capability of market participants – particularly retail investors.

The prevailing mode of disclosure-oriented financial regulation relies on the participation of rational, informed market participants who act in their own best interests. Strategies aimed at improving the financial literacy of retail investors, particularly as Australian consumers experience increased financialisation, will improve the effectiveness of disclosure as a regulatory strategy.

To an extent, financial advice can and does provide protection against financial illiteracy, as professional financial planners act to compensate for the potential financial illiteracy of their clients. However, there is significant evidence to suggest that those who are most in need of financial advice – whether due to unequal levels of wealth or ability or for another reason – are least likely to seek it out.[18]

Policy recommendations which support building financial capability are different from those which support financial inclusion and equality of participation in the financial system. Financial capability is directed to the financial literacy of individual market participants, whereas financial inclusion involves managing the barriers to participation in the financial system which result from inequalities of opportunity. To illustrate the

[16] European Commission, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective' (November 2010); European Securities and Markets Authority, 'Economic Report: Retailisation in the EU' (July 2013); European Securities and Markets Authority, 'Opinion: MiFID practices for firms selling complex products' (February 2014)
[17] Clark et al., 'A Review of Retirement Savings Investment Behaviours: Theory and Evidence' (CSIRO-Monash Superannuation Research Cluster, June 2013)
[18] Cliff A Robb, Patryk Babiarz, Ann Woodyard, "The demand for financial professionals' advice: The role of financial knowledge, satisfaction, and confidence" (2012) 21 *Financial Service Review* 291-305; Michael J Collins, "Financial advice: A substitute for financial literacy?" (2012) 21 *Financial Services Review* 307-322

difference; financial inclusion may require the implementation of simplified disclosure or more affordable access to financial advice, whereas financial capability may require investor education, and minimum standards of understanding before investment into particular kinds of products.

While we would not expect retail investors to possess the financial capability of a financial planner, we would expect that they both have a minimum degree of knowledge to understand the market and the investments which they make. This builds resilience into the financial system, as financially literate investors can better evaluate the advice they receive and the outcomes of their investments, as well as identify misconduct.

Recommendation 4:

The FPA recommends the Government continue its support of ASIC's mandate to deliver on a conceptually consistent national strategy on financial literacy.

Link to FSI terms of Reference: 1.3, 2.1, 2.3, 2.4, 2.5, 3.1, 4.1, 4.3, 4.5

2.2 – Financial intermediaries

Financial institutions play a central role in the functioning of Australia's financial system. Wherever those institutions sit along the public/private spectrum, the integrity of our financial system relies on the efficient, honest, and fair conduct of Australian financial institutions. As such, the outcomes for users of the financial system, where their use of the system is intermediated by financial institutions, are influenced by the culture of Australian financial services. These outcomes are also influenced by the regulatory strategy which ASIC and other market regulators adopt, as well as the structure of financial regulation in Australia.

To complement the integration of financial citizenship into the conceptual framework of the Australian financial system, financial intermediaries should be encouraged to form corporate cultures that recognise the value of financial citizenship at the highest levels of corporate governance.

Whereas the needs of clients in the market for other products and services are generally well understood by manufacturers and service providers in other industries, the structure of financial services frequently creates wide institutional barriers between those who research and develop financial products and investors. Systemic barriers that separate financial institutions from investors encourage unethical and unfair business practices, as the rights and obligations of users of the system are reduced from professional and ethical duties to a perceived compliance burden. This is true of individual and institutional behaviour.[19]

Disclosure regulation has exacerbated this systemic trend, as the fundamental interaction between institutions and users is framed in terms of an exchange of promises based on full and accurate disclosure. Remuneration structures can also incentivise selfish behaviour and discourage considering the rights and perspectives of others. By contrast, professional financial planning relies on the ability to understand the perspectives of investors, and respect their preferences and behaviour as part of the advice process. Financial planning, where professionals are required to provide objective advice in the best interests of the client, is an excellent Australian example of a financial institution which embodies professionalism, gatekeeper responsibilities, and self-regulatory structures.

[19] Janis P Sarra, 'Embedding fairness as a fundamental norm in financial markets' in Sarra, Janis P, *An exploration of fairness : interdisciplinary inquiries in law, science and the humanities* (Toronto, Carswell 2013) 193, 196-206.

Recommendation 5:

The FPA recommends that

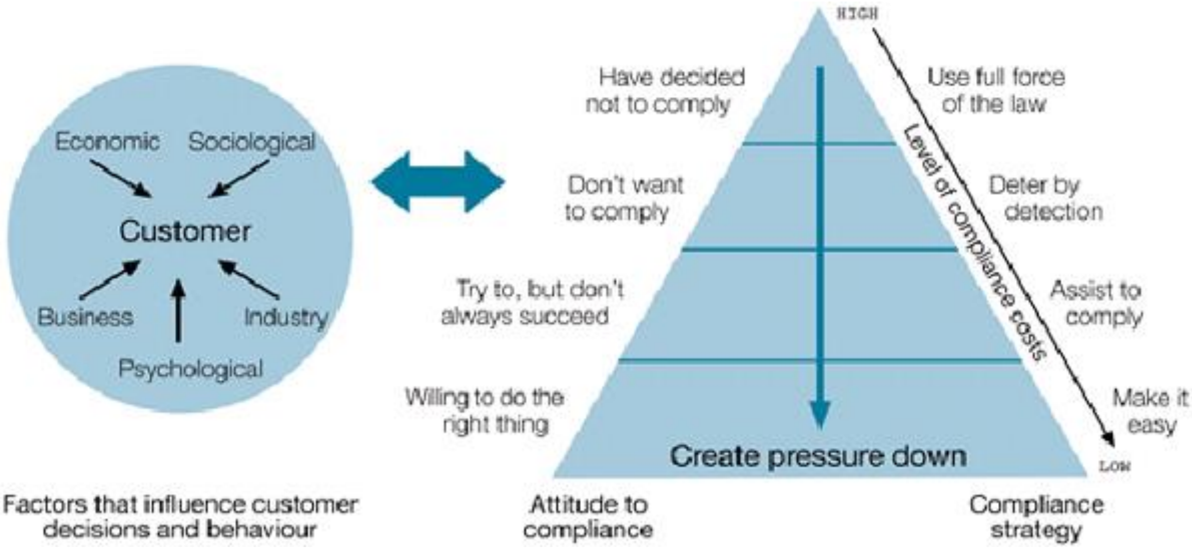
- the Inquiry review the conceptual framework which informs government, regulators, financial institutions, and users of the system as to the rights and responsibilities of financial institutions, and
- all financial institutions should be obliged to consider the best interests of the end users of the system, as well as the stability of the financial system itself.

Link to FSI terms of Reference: 1.3, 2.1, 2.3, 2.4, 2.5, 3.1, 4.1, 4.3, 4.5

2.2.1 – Self-regulation, coregulation, and the role of regulators

There are three key features of the regulatory design of Australia's financial regulatory structure;

- Command-and-control: While Australia divides prudential regulation from markets, services, and corporate regulation through a twin-peaks model, it is still fundamentally based on regulation by a central authority. The character of command-and-control regulation is to enforce a clear structural distinction between regulators and financial system participants, and use methods of regulation which are ultimately backed by criminal sanctions.[20] ASIC and APRA are command-and-control regulators for the majority of the financial system, despite the availability of civil penalties and other forms of enforcement, as our regulatory structure relies on the compulsion of criminal sanctions as opposed to industry or professional sanctions, or incentives through tax.
- Responsive regulation: Responsive regulation is a regulatory strategy which allows regulators to adopt graduated force to responds to the compliance strategies of market participants. Responsive regulation is usually depicted through a 'pyramid of enforcement' as depicted here;[21]



[20] Robert Baldwin, Martin Lodge and Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford University Press, 2012) 106-107.
[21] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992)

The pyramid illustrates the relationship between the 'attitude to compliance' of regulated entities, the expected proportions of market participants who adopt each strategy, and the regulator's best strategic response to market misconduct for each kind of market participant.

- Risk-based regulation: In addition to considering the compliance strategies of market participants, risk-based regulatory strategy prioritises the available resources of the regulator(s) towards the areas of the financial system which pose the greatest risk of misconduct, as well as those where misconduct has more severe consequences.[22]
- Rules versus principles: Finally, the legislature and financial regulators recognise the difference between rules and principles as modes of regulation. For example, where rules are generally more certain, less costly, and more prone to creative compliance, principles are more ambiguous and hence more costly, but cover more different forms of conduct and are more normative. The characteristics of rules and principles allow financial services regulation to respond to the unique circumstances of markets, services, and end users with greater detail.[23]

The FPA believes that there is a fundamental need to recognise, in the regulatory structure of the Australian financial system, the role of coregulation and self-regulation. We believe that professional bodies can perform fundamental functions within this framework in order to maximise the capabilities of the system. The Australian financial system depends on a degree of self-reflection and industry engagement in regulation in order to remain focused on efficient and effective solutions for market failures. Regulatory structures which facilitate self-regulation, coregulation, and other collaborative forms of regulation can instil professionalism and ethical behaviour in market participants. The Wallis Report recognised the value of coregulatory structures, as it stated;

> "[c]oregulation works best where there are established industry associations covering all industry participants, with the willingness and resources to monitor, enforce and publicise regulations. This approach is more responsive to market developments as codes, rather than laws, are more readily modified to reflect developments in the market. It also places the cost of regulation directly on businesses and consumers who benefit from it rather than on general taxpayers."[24]

However, the Report did point out that coregulation is more susceptible to regulatory capture, and have the potential to mire the financial services sector in overlapping self-regulatory and coregulatory bodies. The Wallis report recommended an appropriate balance between a single, institutional regulator and coregulatory structures, by recommending that the market and securities regulator have the power to use a combination of regulatory structures through the adoption of industry codes of conduct.

Self-regulation can also play an important role in the Australian financial system. ASIC has recognised the risks and benefits of self-regulatory structures in the past, stating that;

> "[f]or self-regulation to be effective, it needs to be properly integrated into the overall regulatory framework – that is, it needs to dovetail with the law and the regulator's policies – not repeating or confusing requirements, but assisting and possibly extending them in some areas… If self regulatory schemes are inconsistent with the underlying principles of the overall regulatory framework, or do not operate within the parameters clearly laid down by the law, then the fundamental purpose to be served by self-regulation may be defeated and consumer welfare

[22] See e.g. Julia Black and Robert Baldwin, 'Really Responsive Risk-Based Regulation' (2010) 32 *Law and Policy* 2, 181-213
[23] See e.g. Gail Pearson, *Financial Services Law and Compliance in Australia* (Cambridge UP, 2009), 14
[24] Wallis report, 259

may be compromised."[25]

If the Australian financial system is going to retain its world-leading status into the future, it will require self-regulation and coregulation in various forms. The primary reason for this is that the cost inefficiencies of command-and-control regulation with respect to supervision and enforcement can only increase with the increasing size of the Australian financial system. The trajectory of growth and innovation in Australia's financial sector means that measures which encourage cultures of self-compliance and self-reporting of misconduct will become more cost-effective than the degree of supervision required to enforce the present single-regulator risk-based regulatory strategy.

Recommendation 6:

The FPA recommends incorporating the role of coregulatory and self-regulatory models in the regulatory design in a way that will deliver improved efficiency, professionalism, and outcomes for the users of the financial system.

Link to FSI terms of Reference: 1.2, 1.3, 2.1, 2.3, 2.4, 2.5, 3.2, 3.4, 4.1, 4.4, 4.5

2.2.2 – Gatekeeper regulation in the Australian financial system

Regulatory standards for financial institutions must be tailored to the role which institutions play in the financial system, and aimed towards formal 'custodial' or 'gatekeeper' responsibilities across the system. Crucially, we must still regulate to correct the informational asymmetry and related market failures. For example, the substantial informational asymmetry between product providers and retail investors, particularly regarding complex products, as retail investors don't have the means or data to evaluate the features, risk, liquidity of those products

While ASIC's regulatory strategy has recently adopted gatekeeper theory, the uptake in the legislature, financial services sector, and the public has been lacking. There is rich and diverse academic scholarship on the concept and operation of gatekeeper theory in financial markets,[26] which should inform the Inquiry's understanding of the rights and obligations of financial institutions with respect to the integrity of the financial system.

The best example of gatekeeper regulation in the Australian financial system is the regulation of professional financial planners. Financial planners and the institutions which provide financial advice are an important intermediary between users and markets. The Ripoll Report recommended that financial advisers should be subject to a fiduciary duty towards their clients, and the Future of Financial Advice (FoFA) reforms implemented a statutory 'best interests' duty which clearly defines the rights and obligations between financial planners and clients.

While the FoFA reforms did not institute a strictly fiduciary standard of conduct, it did establish a minimum gatekeeper standard that surpasses the baseline disclosure standard of conduct. These obligations, such as the duty to prioritise the client's interests over your own,[27] and requirement that financial advice be

[25] Jillian Segal, 'Institutional self-regulation: what should be the role of the regulator?' (Speech delivered at the National Institute for Governance Twilight Seminar, Canberra, November 2001), available at <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/NIGConf_081101.pdf/$file/NIGConf_081101.pdf>
[26] See e.g., Reinier Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 *Journal of Law, Economics, and Organization* 53 ; John C. Coffee, *Gatekeepers: The Role of the Professions in Corporate Governance*, (Oxford University Press, 2006); Frank Partnoy, 'Barbarians at the Gatekeeepers: A Proposal for a Modified Strict Liability Regime' (2001) 79 *Washington University Law Quarterly* 491; Andrew F Tuch, 'Multiple Gatekeepers' (2010) 96 *Virginia Law Review* 7, 1583-1672.
[27] Corporations Act 2001 (Cth) s 961J.

appropriate for the client's interests,[28] require financial planners to service the needs and consider the perspective of others, namely consumers.

This standard of conduct should be applied uniformly across the Australian financial services sector, in so far as those sectors interact with the investment outcomes of retail investors. Gatekeeper obligations which reflect this standard of conduct should be built into the conceptual framework of the Australian financial system, and reflected in legislation, regulatory structures, supervision, and enforcement. Behavioural research is also highly relevant to the organisational culture of financial services, and can inform the gatekeeper role which financial institutions play in providing appropriate financial products and services.

Recommendation 7:

The FPA recommends

- the application of gatekeeper theory to the regulation of financial services in Australia, to ensure that financial institutions recognise their role in preserving the integrity of the financial system.
- gatekeeper obligations to retail investors, throughout the financial services sector, particularly where the conduct of financial institutions affects retail investors.

Link to FSI terms of Reference: 1.2, 1.3, 2.1, 2.3, 2.4, 2.5, 3.2, 3.4, 4.1, 4.4, 4.5

2.2.3 – The role of government and regulators

Regulators and government must understand that they themselves are within the financial system, not outside of it. This requires collaboration with industry, but with an independence of funding and governance structures to protect against regulatory capture. There are several projects, particularly in the development of codes of conduct, improving education standards for institutional users of the financial system, and other self-regulatory and coregulatory models which rely on closer interaction between government, regulators, and financial institutions.

The perception of regulatory capture is particularly detrimental to financial regulation, as it affects the capacity of government and regulators to implement these vital projects. An example is the use of enforceable undertakings as a form of restorative enforcement, which have been well documented in academic scholarship as useful and timely.[29] However, the public perception of enforceable undertakings is that they are evidence of regulatory capture and a 'light touch' to systemic misconduct.[30]

Importantly, regulators and the financial services sector must understand that the interests of regulators and the financial services sector must align, as their cooperation is essential to systems where market-based solutions are introduced to replace previously state-backed models. David A Westbrook, writing on the "custodial regulation of financial institutions", stated this imperative thus;

> "As the GFC has demonstrated, the institutions of contemporary societies depend on well-functioning financial markets as much as they depend on electricity, hence 'social capitalism'. The social, and hence broadly political, character of contemporary financial capitalism is particularly obvious in the United States, where education, retirement, and healthcare are often

[28] Corporations Act 2001 (Cth) s 961G.
[29] Marina Nehme, "Enforceable Undertaking: A Restorative Sanction?" (2010) 36(2) *Monash University Law Review* 108; Richard Johnstone and Michelle King, "A Responsive Sanction to Promote Systematic Compliance? Enforceable Undertakings in Occupational Health and Safety Regulation" (2008) 21 *Australian Journal of Labour Law* 280
[30] See e.g. Bernard Keane, 'Online activists and exemplary punishment' *Crikey*, available at < http://www.crikey.com.au/2013/01/21/online-activists-and-exemplary-punishment/>

> directly dependent on portfolio management, rather than the taxing power of the state. If financial capitalism is understood to be social, then financial regulation is a custodial enterprise in which bankers and their regulators come to mutually agreed understanding on how to manage assets. *Thus the relationship between regulator and regulated could be transformed, from one of opposition to mutually reinforcing, and interdependent, participation in the custody of social assets*." (references omitted, emphasis added)[31]

Regulatory strategies which are responsive to methods of regulating corporate culture and influencing professionalism and integrity in the financial sector will require a closer working relationship between regulators and financial institutions.

Recommendation 8:

The FPA recommends the development of public policy which

- facilitates professionalism and integrity within the culture of financial services in Australia,
- aligns the aims of regulators and financial institutions, and
- allows regulators and the financial services sector to collaborate more effectively to deliver a more participatory and protected system for financial citizens, while managing the risk of regulatory capture.

Link to FSI terms of Reference: 1.2, 1.3, 2.1, 2.3, 2.4, 2.5, 3.4, 4.1, 4.2, 4.3, 4.4, 4.5

3. Key areas of reform for the Australian financial system

Building from the conceptual framework established in the first section of our submission, the FPA has identified several key areas where reform of the Australian financial system would improve the system's efficiency, as well as foster stability, prudence, and public confidence in the financial system.

Our recommendations to the Inquiry are intended to facilitate the reconceptualised model of financial services which we established in the first section of this submission. While they are not intended to form a complete solution for the various challenges facing the financial services sector, they are intended to highlight potential reforms which, from the FPA's perspective, would improve the financial system.

3.1. Professionalisation of the financial services sector

The Australian Council of Professions defined a profession as:

> "..a disciplined group of individuals who adhere to ethical standards and uphold themselves to, and are accepted by the public as possessing special knowledge and skills in a widely recognised body of learning derived from research, education and training at a high level, and who are prepared to exercise this knowledge and these skills in the interest of others".[32]

Financial institutions should aspire to meet a professional standard of conduct, as the outcomes of the Australian financial system, as well as the way that users interact with the system often depend on the conduct of financial institutions.

[31] David A Westbrook, 'Neofeudalism, Paraethnography and the Custodial Regulation of Financial Institutions' (2013) *JASSA: The Finsia Journal of Applied Finance* 2, 57-61, 59
[32] Australian Council of Professions, AGM, 1997.

The FPA have put forward recommendations in three areas which we have identified as likely to create and improve professional standards in the financial system. In further consultation with the Inquiry and other stakeholders, we are keen to analyse other areas where professionalism may improve the Australian financial system.

Recommendation 9:

The FPA recommends the role of professionalism and professional obligations be included in the regulatory design, including identifying:

- the sectors of the Australian financial system where professional obligations would improve the efficiency, competitiveness, financial stability, public confidence, and capacity of the financial system
- appropriate and adapted obligations which are specific to the role which each of these sectors play within the financial system, and
- the methods and structures of regulation which are most appropriate for creating and improving professionalism within particular sectors of the financial system.

Link to FSI terms of Reference: 1.3, 2.1, 2.3, 2.5, 3.4, 4.1, 4.3, 4.4, 4.5

3.1.1. Gatekeepers

The concept of a “gatekeeper” in financial services has evolved in the last thirty years to describe the obligations of a financial intermediary whose purpose is to protect against misconduct by another party.[33] To function effectively in this role, gatekeepers are understood to possess reputational capital as a result of their position of trust, and lose that capital if they engage in misconduct themselves.[34] Several professions, such as auditors and lawyers, have already been described as gatekeepers in so far as their interactions with financial systems are concerned, and we believe that it is a useful concept to describe how professionalism should work in financial services.

For the financial system to operate effectively, product issuers must be seen as intermediaries and adhere to similar consumer and system-oriented obligations and values as those that currently apply other market participants. Product issuers should not be treated as outside this intermediary function. All participants must comply with the same type of obligations otherwise the financial system will fall apart. This includes responsibilities to both financial citizens and to uphold the integrity of the financial system itself.

These obligations are already in place in many sectors of the financial system, as the AFS licencing conditions require licensees to act “efficiently, honestly, and fairly.”[35] This is particularly true with respect to financial planners. The FPA has embraced the spirit of these regulations, and has developed a Code of Professional Practice to reflect the professional standards which this role requires. We believe that the conceptual framework of the Australian financial system should include gatekeeper theory as a powerful tool to describe the obligations of financial intermediaries. We also believe that these obligations should be implemented throughout the financial services sector.

Further, credit rating agencies (CRAs) and research houses who provide research and analysis of financial products and the market, should be also regulated as financial intermediaries. Australian consumers rely on information from CRAs and research houses to make investment decisions, so they play an important gatekeeping role in the financial system. This is particularly the case where few, if any, users of the market could individually evaluate either the products which are covered by research[36] or the research methodology CRAs and research houses use to form an opinion.

ASIC has recognised that there are significant risks if CRAs and research houses fail to fulfil this role, as they state in Regulatory Guide 79:

> “Poor quality research or research that is not reliable, credible or current, damages confidence in the research sector itself and in the financial services industry more broadly. Risks for the investment community are amplified where there is undue reliance on research reports and a lack of awareness of real and potential conflicts of interest which may adversely impact on the independence and therefore the reliability of those reports.”[37]

Although Regulatory Guide 79 does provide guidance on the obligations of CRAs and research houses through their licensing conditions, there are few forms of Australian regulation which directly affect the conduct of these financial intermediaries.

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[33] Reinier Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (1986) 2 *Journal of Law, Economics, and Organization* 53.
[34] John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid" The Business Lawyer, Vol. 57, No. 4 (August 2002), pp. 1403-1420; c.f. Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 *Washington University Law Quarterly* 619.
[35] Corporations Act 2001 (Cth) s 912A(1)(a).
[36] Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5) [2012] FCA 1200 at [2459].
[37] ASIC, *Regulatory Guide 79: Research report providers: Improving the quality of investment research*, 5.

A better solution exists for three of Australia's major CRAs, who have been granted relief from the AFS licensing regime[38] provided that they comply with IOSCO's *Code Of Conduct Fundamentals For Credit Rating Agencies*. That Code of Conduct includes several financial intermediary obligations regarding conflicts of interest, transparency of reports, and the integrity of employees. The European Union has also introduced key regulations of CRAs which impose many similar standards of conduct for these agencies.

The Inquiry should consider the various sectors of the financial system which are most appropriate to regulate as financial intermediaries, given the high standard of conduct and degree of responsibility which intermediaries owe towards the financial system and its participants.

The Inquiry should also consider how different intermediaries in the financial system have unique cultures and roles to play in the system, and how best to regulate those sectors so that they perform their role efficiently, honestly, and fairly.

Recommendation 10:

The FPA recommends that:

- all financial intermediaries whose conduct substantially affects the end users of the financial system, and the financial system itself, should be subject to appropriate and adapted gatekeeper obligations.
- product issuers, credit rating agencies and research houses be regulated as financial intermediaries.

Link to FSI terms of reference: 1.3, 2.1, 2.3, 2.5, 3.4, 4.1, 4.3, 4.4, 4.5

3.1.2. Regulatory Design: Coregulation and self-regulation

Regulatory design is a powerful influence on the success of regulation, particularly with respect to the efficiency, competitiveness, and consumer protection provided by the regulated system. The right regulatory structure can encourage virtuous market conditions, such as professionalism and compliance-oriented corporate cultures, as well as facilitate surveillance, deter misconduct, and remove 'bad apples' from the market. On the other hand, careless or outdated regulatory designs can frustrate these virtues through paper compliance, creative compliance, infrequent surveillance and/or enforcement, disproportionate punishment, and regulatory capture.

As stated above, Australia's financial regulatory system relies heavily on a "twin peaks" model of command-and-control regulation. While this model does offer conceptual convergence with the doctrine of responsible government, there are several weaknesses inherent in this structure. These weaknesses include;

- fostering adversarialism between regulators and users of the system;
- difficulties with engaging with the culture of financial services, and;
- maintaining financial and policy independence from government.

In response to these challenges, the Inquiry should form policy recommendations which facilitate coregulation and self-regulation within Australia's regulatory design of the financial services sector. These

[38] ASIC [CO 05/1230].

forms of regulation would be most effective in sectors of the financial services industry who are willing to comply with the law and would respond best to a facilitative approach. Regulatory models which rely on close engagement with the regulated population also benefit from influencing norms and values within the sector, and are therefore able to promote professionalism within that sector. Finally, we believe there are significant gains in efficiency, and lesser reliance on taxpayer funding, where the financial services sector can regulate its own conduct with supervision from ASIC, APRA, or other government entities.

Recommendation 11:

The FPA recommends the development and implement of a regulatory design which recognises and facilitates the role of professional bodies in assisting regulators to achieve their consumer protection and confidence mandates.

The Inquiry should also consider whether various roles of regulation (e.g. supervision, enforcement, education) are most appropriate for coregulatory, self-regulatory, or government responsibility on a case-by-case basis.

Link to FSI terms of Reference: 1.3, 2.1, 2.2, 2.3, 2.4, 2.5, 3.4, 4.1, 4.3, 4.4, 4.5

3.2. Product regulation

There are a large number of financial products available to consumers. As previously mentioned, product issuers play a vital intermediary function which significantly impact on consumers and the financial system itself. There is a significant consumer protection gap in the financial system as product issuers are not required to comply with the consumer and system-oriented obligations and values currently applied other market participants. The FPA recommends that the Inquiry consider a more holistic and appropriate solution to consumer protection, by reviewing the regulation of financial products available to consumers.

3.2.1. Complex products

Complex products were a substantial cause of the Global Financial Crisis, and are a significant stressor on the overall stability of the Australian financial system. However, complex products do offer benefits to users of the Australian financial system, particularly when allocating financial risk and fostering innovation. The Inquiry should examine ways to regulate the development and distribution of financial products, so that Australia can retain the benefit of financial product innovation while managing their associated systemic risks.

The definition of complexity in products stems from a principles-based approach to how users of financial products understand the features of those products. ASIC has consulted IOSCO, FINRA, and EU regulation to identify potential indicators of complexity in financial products, including:

- terms, features, or complex structures which are relatively difficult for average investors to understand;
- difficulty in assessing the risk, reward, or other factors which materially affect the value of the product;
- whether there is actual or potential liability for the investor that exceeds the cost of acquiring the product;
- whether there exists a liquid secondary market for the product, and;

- whether there is adequate and public disclosure of the product's characteristics which can be readily understood by the average investor.[39]

Importantly, the report establishes that complexity is a concept relative not only as between financial products, but also depends on the financial literacy of the investor.[40]

Innovation is an important driver of complexity, and the Australian financial system should be robust to innovation-driven complexity. However, where innovation-driven complexity creates systemic risks, or the drivers of complexity are informational asymmetry or behavioural vulnerabilities as between intermediaries and investors, complex products pose a threat to financial systems. The European Securities and Markets Authority has noted the systemic risks posed by 'retailisation' of complex products, and stated that:

> "[n]otwithstanding the potential benefits brought by these products, trends linked to retailisation have been closely monitored by securities markets supervisors as it could increase risks for the financial system… If retail investors do not properly understand the risk and reward profile of complex products, unexpected losses might lead to complaints, reputational risks for issuers and a loss of confidence in the regulatory framework and, more broadly, in financial markets. From an issuer's perspective, complex products targeted at retail investors may be used to generate profits through fees and may also provide an alternative source of funding."[41]

The risks associated with complex products have been comprehensively documented by international and domestic regulators and academic scholarship. These risks include:

- <u>Misselling due to difficulty understanding the product</u>: In relation to complex products, ASIC has stated that it is "more difficult for investors to evaluate the level of risk posed by the financial product and to decide whether they can tolerate it, given the expected returns"

  ASIC has also identified several factors which "may lead investors to misunderstand the nature of a product and its risks by increasing:

  > (a) the difficulty in describing a product in a clear, concise and effective manner;
  > (b) the difficulty investors face in comprehending a product's key features and the risk/reward trade-off associated with these features;
  > (c) the difficulty in comparing products;
  > (d) the difficulty in understanding a product's pricing structures;
  > (e) the potential that an investor will not understand when the product is performing poorly, and will inappropriately judge when to withdraw; and
  > (f) the difficulty in withdrawing from the product, particularly if the complexity relates to, or produces, illiquidity and difficulty in valuation." [42]

  Because investors find it so difficult to understand complex products, there is a clear risk that resources will be misallocated to the wrong complex products or to complex products where a simpler product might have been in the client's best interest.

  For example, in 2013 the European Securities and Markets Authority found that Structured Retail Products with inbuilt capital protection guarantees have remained popular, even though they

[39] ASIC, 'Complex Products' above n 13 at 11-12.
[40] ASIC, 'Complex Products' above n 13 at 12.
[41] ESMA, 'Retailisation' above n 16 at 5.
[42] ASIC, 'Complex Products' above n 13 at 14-15.

significantly underperformed against risk-free investments, despite the potential credit risk of SRPs.[43]

- Inappropriate product features: Generally, innovation regarding product features is encouraged as it allows the market to be more responsive to the needs of consumers. However, the complex features embedded in some products can expose investors to costs and risks which they may not understand without detailed financial advice. The Lehman Brothers Minibond scandal is another example of complex products that exposed investors to risks and costs which were inappropriate to their tolerance for risk.

- Intermediation risks: The systemic risk posed by complex products involves and affects more users of the financial system than the issuer and the investor. For example, Janis Sarra has pointed out that credit derivatives have created a 'principal-agency issue,' as the payoff from these derivatives is a perverse incentive to offer credit on easier terms, conduct less comprehensive due diligence, and to adopt a less facilitative approach on negotiating and enforcing loan covenants.[44] Furthermore, the involvement of credit rating agencies and distribution channels based on financial advice can actually enhance the systemic risk, if they are perceived as an intermediating entity designed to mitigate the issuer's litigation risk.

With respect to the conceptual framework of Australian financial regulation, complex products are problematic for the following reasons;

- complex products require a high degree of financial capability to understand;
- where a complex product would be in the best interests of a retail investor, that investor will almost always require a financial intermediary to engage with the product on her behalf;
- behavioural economics indicates that product complexity encourages irrational decisions with respect to the product or advice in relation to that product;
- issuing and distributing complex products involve the arms-length collaboration of several financial intermediaries, of whom few owe any gatekeeper obligations to the end users or the financial system itself, and;
- Australia's regulators are not sufficiently empowered to address product regulation, either collaboratively or on a command-and-control basis.

There are several existing methods to regulate complex products which have been adopted in overseas jurisdictions. These include;

- Suitability requirements: These requirements are intended to ensure that the end user of complex financial products is sophisticated enough to understand the product, and/or the intermediary has formed a judgement about the suitability of that product for the client. For example, the IOSCO final report on the *Suitability Requirements With Respect To the Distribution of Complex Financial Products* recommends a series of principles, such as duties, warnings, disclosure, and judgement with respect to the 'classification' of a customer, the information required to make a reasonable recommendation, and conflicts of interest.[45]

[43] ESMA, 'Retailisation' above n 16 at 17.
[44] Janis P. Sarra, 'Fairness' above n 19 at 209-10; Janis P. Sarra, 'Credit Derivatives Market Design, Creating Fairness and Sustainability', Network for Sustainable Financial Markets (2008) available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1399630 > at 5-6
[45] IOSCO, *Suitability Requirements With Respect To the Distribution of Complex Financial Products* (January 2013); see also ESMA, 'MiFID practices for firms selling complex products' above n 16 at [15]

- Merits regulation: Merits regulation involves the regulator, and/or the financial intermediaries who distribute, advise, or issue complex products, to form a judgement about the value of a complex product. This value judgement will inform the basis on which the financial product can be distributed, or if the product can be sold or advised on at all. For example the European Securities and Markets Authority has recently published a legal opinion indicating that,[46] if the internal controls of a financial intermediary indicate that "a particular complex product will never meet the best interests of their clients, or there is a lack of sufficient information available to ascertain the main features and risks of a product", that product should not be sold or advised on.

- Disclosure obligations: Enhanced disclosure obligations are another way to approach complex products, that provide clear and easily accessible information about the particular features of complex products which make them so difficult to understand. However, the FPA do not believe disclosure obligations alone are sufficient regulation for complex products.

Recommendation 12:

The FPA recommends Australia's regulatory framework must effectively regulate complex products.

Link to FSI terms of Reference: 1.2, 1.3, 2.1, 2.2, 2.3, 3.1, 3.4, 4.1, 4.3, 4.4, 4.5

3.2.2. SMSFs

SMSFs have been a 'success story' in the provision of retirement planning for Australians. SMSF members like the flexibility and control offered by SMSFs to better manage their retirement funds, both in investment choice and with regard to costs and fees, particularly as they can choose the services they use and pay for.

The ability to better target investment strategies and undertake sophisticated estate planning strategies are other reasons cited. From a financial planning perspective, SMSFs provide a useful vehicle to provide tailored advice and strategies (investment, insurance, estate planning etc) to meet the goals and aspirations of each member individually, which can lead to a more effective outcome, such as increased levels of adequacy, than might otherwise be the case.

There has been significant growth with SMSFs surpassing the retail sector with assets now exceeding $500 billion and there are over 900,000 members/trustees within the SMSF sector. The SMSF sector is expected to hold over $2.2 trillion in an estimated super system of $7.6 trillion[47] by 2033.

The challenge in the SMSF sector is to maintain flexibility and variety of available investment and asset choices, provide affordable access to professional services including financial planners, accountants and auditors, while minimising the negative impact that many spruikers and unlicensed individuals have in influencing Australians in setting up an SMSF.

The FPA welcomes comment made by ASIC[48] that they are aware of and understand the concern with the rise in property spruikers and promotion of purchasing property using a SMSF:

[46] ESMA, 'MiFID practices for firms selling complex products' above n 16 at [14]
[47] Deloitte Actuaries and Consultants "Dynamics of the Australian Superannuation System. The Next 20 Years: 2013-2033"
[48] ASIC Consultation Paper CP216

More generally, ASIC is also experiencing an increase in reports of misconduct about aggressive marketing of investments, notably direct property, through SMSFs. These reports have come both from retail investors and from professional associations.

Since the changes to the SIS Act requirements relating to SMSF borrowings made in 2007, there has been increasing promotion of schemes to enable funds to make use of the greater flexibility. The requirements are broader than initially anticipated by industry and are not restricted to traditional instalment warrants.

Allowing SMSFs to gear up property has become a controversial issue, in particular the possible impact on the residential property market. In reality a very small percentage (3.5%) of SMSFs assets are invested in property and this figure appears to have remained steady over the past 5 years.

However, the Cooper Review panel did not believe that borrowing was consistent with Australia's retirement incomes policy but did not make a specific recommendation against it. Rather the Cooper Review recommended a review of the borrowing arrangements to occur within two years of their report. This has not occurred and the FPA would encourage the Inquiry to recommend a review of borrowing arrangements in SMSFs.

Recommendation 13:

The FPA recommends the Government follows Cooper's recommendation and undertakes a formal review of the decision to allow SMSFs to gear up property in their fund.

Link to FSI Terms of Reference: 1.3, 2.1, 2.2, 2.3, 3.1, 3.4, 4.1, 4.2, 4.3, 4.4, 4.5

3.3. Access to the financial system

As part of its consideration of market participants and the users of the financial system as financial citizens and intermediaries, the Inquiry should consider whether the financial system is presently accessible for all current and potential users of the financial system, and if not then what can be done to facilitate access and remove barriers to entry for all potential participants.

The FPA recommends that the Inquiry consider our proposals to improve access to the financial system, either directly through building equality of opportunity to participate, or indirectly by improving the efficiency and stability of the financial system, as well as public confidence in our financial institutions.

3.3.1. Retail/sophisticated investor distinction

To meet the needs of users of the financial system, the regulatory strategy of the Australian financial system incorporates a core distinction between "retail" and "sophisticated" investors. The predominant general market regulation requires that different degrees of disclosure for these two categories of market participant would satisfy the rational investor hypothesis underpinning our expectations of market participants.

Our approach to informational asymmetry in the financial system has largely followed from this approach. When understood through the notion of financial citizenship created through the existing conceptual framework of Australian financial regulation, the retail/sophisticated investor distinction creates an efficient baseline standard of conduct for financial institutions.

As argued in the first section of this submission, we believe that the present conceptual framework of Australian financial regulation is out of date, and the current understanding of financial citizenship does not reflect reality. When considered from an updated conceptual framework, there are several difficulties with the retail/sophisticated investor distinction;

- the distinction is based on the wealth of the investor, rather than a qualitative and/or quantitative measure of their financial literacy;
- the distinction does not incorporate behavioural elements into the categorisation or basic understanding of how these participants will operate;
- the distinction functions to remove judgement and discretion from financial intermediaries regarding their conduct towards clients with differing degrees of financial capability, and;
- the distinction, when paired with a disclosure-based system of regulation, encourages documentary compliance with little consumer protection benefit or improvement in financial capability or opportunity.

An updated concept of the financial citizen, as a standard that incorporates the behaviour, capacity, and opportunity of investors, is preferable to the present artificial distinction between retail and sophisticated investors. It would also offer greater flexibility to the financial services sector as to how institutions manage their relationships with clients.

There are several ways to characterise the relevant differences between kinds of investors for the purpose of appropriate and adapted regulatory strategy. Many of these methods have significant scholarship supporting them, as well as support from regulators in other jurisdictions and international regulatory bodies. These alternative classifications include;

- <u>Investor/consumer</u>: Market participants could be categorised with respect to the purpose they have engaged with the financial system. In particular, users who rely on carrying risk for profit as the basis of their use of the financial system should have different regulatory rights and obligations to users who purchase financial products as a consumer.[49]
- <u>Suitability regulation</u>: Suitability regulation may also be appropriate outside of recommending complex products. If financial intermediaries are required to form a judgement about the financial capability of the clients they serve, it will help them to tailor their disclosure obligations to the needs of the client and to reasonably adjust the scope of their professional obligations to those needs as well.
- <u>Institutional/individual</u>: This distinction relies on the institutional checks and balances available to the client in order to mitigate behavioural, capability, and exclusion-based inefficiencies. Where suitability regulation is intended to respond to the unique financial capability of the client, regulation which focuses on the ability of the investor to access financial intermediaries to help that investor make better financial decisions.

Recommendation 14:

The FPA recommends a review of the effectiveness and value of the retail/sophisticated investor distinction as a consumer protection mechanism, and a barrier to financial inclusion.

Link to FSI terms of Reference: 2.1, 2.2, 2.3, 3.1, 4.2, 4.3

[49]For more detail on the investor/consumer distinction, see Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) *European Business Organization Law Review* 13, 169-193; Dimity Kingsford-Smith and Olivia Dixon, 'The Consumer Interest and the Financial Markets', in Eilis Ferran, Niamh Moloney and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (2014 - forthcoming).

3.3.2. General/personal advice

Financial advice is one of the most important avenues by which users of the financial system, particularly retail investors, engage with the market. While financial advice can be very rewarding, there are severe consequences for poor advice. In the worst case scenario, retirees, for example, can lose a lifetime of prudent saving if they are advised to invest in schemes like Australia's infamous failed agribusiness investments, or the Minibond scandal in Hong Kong and Singapore.

Where retirees and other retail investors are completely or substantially wiped out by poor investments purchased through bad advice, the costs extend far further than the victims of fraud. The financial cost of regulatory action, further supervision of the advice sector, legal costs for enforcement action, and pension payments to supplement the financial position of fraud victims, are all borne by Australian taxpayers. Furthermore, the cost of public goods such as health care also increases as fewer Australians will have the means or confidence to engage with the market for those goods. Poor financial advice has a detrimental social cost, as the public has less confidence in regulators and the financial system as a whole.

Financial product advice is presently divided into general advice and personal advice. The crux of the difference between the two is that personal advice takes into account the specific objectives, needs, and circumstances of the client, whereas general advice is limited to information about financial products. This general/personal distinction informs the regulation of financial product advice in a similar fashion to the retail/sophisticated investor distinction.

We are concerned that defining financial product advice on this basis makes it more difficult for investors to distinguish personal financial advice from marketing material or product sales. This risk is confirmed by ASIC's *Report 384 – Regulating Complex Products*, where the Report states;

> "Our research has indicated that marketing information plays a particularly strong role in product distribution and may influence investors' decision making more than other product disclosure. In particular, when investors approach product issuers or other intermediaries responsible for selling products directly, rather than going through advisers, the information contained or implied in product issuers' marketing information is often the first, and may be the only, information that investors use to decide whether or not to invest in that product."[50]

In particular, we believe that financial product advice, if it is to be called advice, should always be based on whether it concerns the personal circumstances of the client. Furthermore, this distinction does not address more salient factors, such as the client's financial literacy and capability. Framing 'general advice' as advice plays into the behavioural aspects of financial decision-making by giving the impression that the advice has a reasonable basis or is appropriate for the client, and thereby exposes retail investors to decisions made under uncertainty about the regulatory framework for that advice.

Recommendation 15:

The FPA recommends a review of the general/personal advice definitions, including:

- their relevance in regulating financial advice, and;
- the risks they pose for financial citizens.

Link to FSI terms of Reference: 2.1, 2.2, 2.3, 3.1, 4.2, 4.3

[50] ASIC, *'Report 384 – Regulating Complex Products* ' (January 2014), at [46]

3.3.3. Affordability of financial advice

The cost of financial advice limits the capability of all users of the financial system to participate on a level playing field. For those who are compelled through superannuation to participate in the financial system, personal financial advice forms a way to reduce the informational barriers to participate meaningfully in the system. The educational value unlocked for consumers by the provision of advice is well documented and demonstrates that access to affordable financial advice is a critical element of the financial system, particularly the retirement income system.

However, research also shows that the cost of delivering advice in Australia is relatively high due to the strict regulatory regime and the costs of running a financial planning business, limiting the ability for many Australians to access affordable advice. Many consumers, particularly lower income earners do not currently seek professional financial planning advice because of the cost involved and their ability to pay for advice.

This results in unfortunate consequences, especially as the future of the aged pension remains in doubt, and individuals fear that their lack of financial capability might produce poor retirement outcomes. As has been stated above, decision-making is significantly impaired when made under fear and uncertainty, and leave retail investors less sceptical of the advice that they are given.

Investors, as financial citizens, should expect that the financial system can and will alleviate these concerns, and not take advantage of their impaired decision-making. Yet, in the present system the risks are very real. At best, this leaves individuals more susceptible to believe that general advice constitutes a guarantee that a financial product or series of products has been designed with their interests in mind, despite not having received personal advice on the subject.

Personal financial advice provided by a professional financial planner can mitigate the risks attendant on these behavioural vulnerabilities. Yet, consumers are paying for personal financial advice in varying ways that result in different taxation treatments for no apparent public benefit. This variety of treatment appears to be contrary to the ATO's obligation under the Taxpayers Charter it adopted in November 2003 to treat tax payers consistently.

A fee for service arrangement for the preparation of an initial financial plan is stated by the Australian Taxation Office to be not tax deductible under section 8-1 of the Income Tax Assessment Act 1997. This is because the ATO views this not to be an expense incurred in producing assessable income. Tax Determination TD 95/60 differentiates between a fee for drawing up a financial plan and a management fee or annual retainer fee. The determination states that the ATO is of the opinion that the expense incurred in drawing up a plan is not deductible for income tax purposes because the expenditure is not incurred in the course of gaining or producing assessable income but rather is an expense that is associated with putting the income earning investments in place.

Furthermore, Taxation Ruling IT39 states that where expenditure is incurred in 'servicing an investment portfolio' it should properly be regarded as being incurred in relation to the management of income producing investments and thus as having an intrinsically revenue character.

The inability to claim a tax deduction for the fees associated with an initial financial plan acts as a disincentive for people to take the first step towards organising their finances on a strategic basis. This has widespread cost implications, both for the individuals and the community as a whole. Encouraging the use of professional financial planning advice results in a more financially literate community, a more even playing field for participants in the financial system, and greater use of financial intermediaries who owe professional duties to clients and to the system itself.

Recommendation 16:

The FPA recommends:

- the introduction of payment options to help Australians access professional financial advice, and
- allowing consumers to claim the cost of the upfront advice as an immediate tax deduction.

Link to FSI terms of Reference: 1.3, 2.3, 3.1, 4.2, 4.3, 4.5

3.4. Longevity and retirement

Retirement adequacy and longevity risk for generations growing up under different superannuation and tax systems, are issues that are not unique to Australia, but are particularly prominent in public policy due to Australia's ageing population and the significant financial infrastructure we have created to assist Australians to fund their retirement. These are issues that we believe are critical to ensuring that more people are able to fund their own retirement to reduce reliance on social security benefits and create a more sustainable and fair system for all Australians.

The 'three pillars' of retirement income in Australia are the age pension, the superannuation guarantee system, and voluntary savings. Our view is that a main objective of the financial system, as part of the efficient allocation of capital, is to ensure a level of adequacy is available for all Australian retirees in a manner that is fair, flexible, accessible, sustainable, and encourages a self-funded retirement.

The three pillars of Australia's retirement income system have evolved in isolation of each other over the past century, with many amendments in an effort to improve system integration and a more targeted delivery to those in need - it was not an inherently designed system. Such complexity has resulted in increasing costs of system administration and compliance, reduced competition in service delivery, difficulty for providers to develop innovative products, and a significant reduction in consumer understanding and confidence in the system. As stated by a senior Treasury official, "people now need to get highly sophisticated advice just to interact with the system"[51].

Simplifying the financial system will improve the efficiency, approachability, acceptance, trust and useability in the system for consumers, Government and providers. In relation to retirement adequacy and longevity, effective interactive of the age pension and superannuation system cannot be achieved unless all Australians have access to the superannuation guarantee. Access for all Australians is necessary for a sustainable, fair system.

A fundamental risk to achieving a sustainable and effective retirement income system is longevity. The superannuation and voluntary savings pillars are particularly exposed to longevity risk as more and more Australians are entering retirement with a high level of debt which drains savings. Debt significantly impacts on the adequacy and longevity of retirement income and highlights that improving consumer saving habits generally should be a key element of the financial system. Australians have a responsibility to save for retirement but this will take Government policy to change consumer behaviour.

At 30 June 2006, average debt per household stood at $126,143, up from $31,524 per household at 30 June 1991, an average annual growth rate of 9 per cent. At 30 June 1991, household sector debt represented 69

[51] David Parker, Executive Director Revenue Group, The Treasury, *Super Policy Forum* (February 2009).

per cent of annual gross disposable income and by 30 June 2006, that percentage had grown to approximately 170 per cent.[52]

If Australians' savings behaviour does not change, household debt will increase even further and more people will enter retirement with sizeable debt. Given that Treasury has predicted that by 2047, ten years after maturation of the superannuation guarantee system, 75 per cent of the population will still be on some form of the age pension[53], household debt will have a significant impact on longevity, adequacy and the sustainability of the financial system as more Australians will need to rely on the age pension at an earlier age.

While the focus of this is on the individual problems related to a lack of savings, the broader impact should also be considered. The trend in overall national savings over recent years has been downwards to a sizeable degree due to negative household savings during much of the last decade. Mitigating government surpluses cannot be relied upon in the current economic environment with consequent risks to the macro economy of external imbalances and the funding of domestic investment.

The FPA suggests improving Government policy to encourage Australians to save through retirement, and to smooth the transition between work, self-funded retirement and the age pension, to greatly enhance retirement adequacy, reduce longevity risk and decrease reliance on the age pension. To achieve this balance, the successful and effective integration of the three pillars is necessary.

The FPA suggests a financial system should address the issues of retirement adequacy and longevity by:

- enabling the fair and efficient provision of retirement funding through a combination of public and private savings;
- flexibly responding to changing demographic needs and capabilities to enable people to retire on an adequate income without the compulsory extension of working life;
- ensuring retirement issues are not consider in isolation from lifetime funding needs;
- providing a comprehensive and holistic framework for adopting a change in behaviour to the accumulation of savings and retirement income needs, and;
- improving the system through the accumulation, transition to retirement, and pension deliverables of the system.

Much of this work can be achieved through appropriate and adapted financial products distributed through an efficient market. However, the three pillars need to function together in order to facilitate and support the market, and thereby achieve the best retirement outcomes for Australians. It also needs regulation in order to encourage the participation of low income earners and new entrants to the system. For example, the Low Income Superannuation Contribution (LISC) introduced by the Labor government is intended to address the inequality between participants in the superannuation system that results from the existing flat tax on superannuation contributions. Before the LISC was introduced, superannuation guarantee contributions were taxed at a higher rate than the marginal rate for the two lowest tax brackets in the Australian taxation system.

The FPA acknowledges the challenges of the current economic environment and highlights the need to adopt a medium to long-term view in determining appropriate and equitable policy to address the issues of retirement adequacy and longevity in Australia's financial system.

Recommendation 17:

[52] Australian Bureau of Statistics, 'Household Sector Balance Sheet – A National Accounts' Perspective' (March 2007).
[53] Treasury projections, *Intergenerational Report* (2007).

Financial System Inquiry

FPA SUBMISSION | 31 MARCH 2014

The FPA recommends policy proposals that address longevity risk, earlier engagement with Australia's retirement income system, and the adequacy of Australia's retirement savings and the Aged pension.

Link to FSI terms of Reference: 2.2, 2.4, 3.1, 3.3, 3.4, 4.1, 4.2, 4.3, 4.5