

choice

**CREATING A SYSTEM WITH FAIRNESS AT ITS CORE:
IMPLEMENTING THE FINAL REPORT OF THE
FINANCIAL SYSTEM INQUIRY**



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ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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INTRODUCTION

The Final Report of the Financial System Inquiry (FSI) shows Australia what a fairer financial system can look like. Its authors have shone a light into dark corners and asked one key question about the way our current system operates: is it fair?

CHOICE is grateful for the opportunity to share our views in this submission as the Federal Government considers its response to the Final Report. We recognise that no stakeholder will be entirely supportive of the 44 recommendations.

CHOICE rejects some recommendations, issues caution on a number and calls for more detail on implementation of many others. Even so, we congratulate the panel on a timely, thoughtful and constructive review of our financial system.

The Final Report has the potential to write a new chapter in Australia's recently troubled financial services sector. At its heart is the blueprint for a stronger corporate regulator, supported by measures that address systemic risks, many of which will no doubt be fiercely contested.

CHOICE sees four key areas in the Final Report that, if implemented well, would create a financial system that has consumer interests and fairness at its core. These are:

- Aligning the interests of businesses and consumers by requiring product issuers and distributors to take responsibility for the design and marketing of their products.
- Creating a better superannuation and retirement system that recognises consumer behaviour and the need for effective defaults.
- Aligning the interests of financial firms and consumers by removing conflicted remuneration and ensuring financial advisers have the skills to support their clients.
- Creating a strong and effective regulator through providing increased funding and powers to the Australian Securities and Investments Commission. This includes providing a new product intervention power as a proactive tool to protect consumers.

Financial institutions are seeking an increasing slice of household consumption across a broadening range of domestic activities. At the same time, our collective tolerance for unfairness has been shattered. This report is an opportunity for Australian financial institutions to enter into a new accord with Australian consumers that is fundamentally based on fairness.

CHOICE view of relevant FSI Final Report Recommendations

#	Recommendation	Position
1	Capital levels	Support
2	Narrow mortgage risk weights	Support but further consideration needed on banking system exposure to housing market
5	Crisis management toolkit	Support
6	Financial Claims Scheme	Support with current cap remaining
7	Leverage ratio	Support
9	Objectives of the superannuation system	Support but subsidiary objectives should be expanded to consider long-term interests of consumers and fairness of system
10	Improving efficiency during accumulation	Support
11	The retirement phase of superannuation	Strongly support
12	Choice of fund	Support but need updated data on consumer perception and experience
13	Governance of superannuation fund	Support principle of strong governance including independent directors but prefer the Cooper Review model
16	Clearer graduated payments regulation	Support making Epayments Code mandatory
17	Interchange fees and customer surcharging	Oppose: current surcharging rule requires an enforcement mechanism
19	Data access and use	Support but need to focus on consumer benefits

20	Comprehensive credit reporting	Oppose: review of impact on consumers is required
21	Strengthen product issuer and distributor accountability	Strongly support. Requirement must be extended to credit products
22	Introduce product intervention power	Strongly support. ASIC needs a broad power and PIPs should remain in force until resolution occurs
23	Facilitate innovative disclosure	Support, multiple stakeholders should be involved in development
24	Align the interests of financial firms and consumers	Requires further detail to achieve objectives. Funding is required for future shadow shops to monitor industry
25	Raise the competency of advisers	Support. Funding is required for research into consumer experience of mortgage broking
26	Improve guidance and disclosure in general insurance	A stronger focus on consumer needs is required, need for review of insurance arrangements
27	Regulator accountability	Oppose: requires stronger evidence base to implement
28	Execution of mandate	Support. ASIC also requires discretionary revenue raising ability.
29	Strengthening the Australian Securities and Investments Commission's funding and powers	Strongly support
30	Strengthening the focus on competition in the financial system	Support but competition must be assessed according to the long-term interests of consumers
31	Compliance costs and policy processes	Oppose, requires stronger evidence base to implement
37	Superannuation member engagement	Support but consumer testing is needed
40	Provision of financial advice and mortgage broking	Question benefit of renaming general advice

1. Chapter One: Resilience

CHOICE agrees with the Final Report: Australia's banking sector must be unquestionably strong. Based on this, CHOICE supports recommendations that will increase system stability, notably recommendations 1, 5 and 7.

Changes to capital standards may increase costs to Authorised Deposit-taking Institutions (ADIs). Balanced against this we must consider that consumers experience significant detriment as a result of financial crises through reduced access to credit, increased unemployment, reductions in savings (including superannuation) and reduced security in retirement. The cost of instability tomorrow is greater than a possible small increase to operational costs for ADIs today. Consumers benefit from a resilient system that they can trust will withstand most shocks and continue to provide essential services.

Recommendation 2: Narrow mortgage risk weight differences

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

CHOICE supports improving the competitive neutrality of capital regulation. This is likely to increase competition in the banking sector to the benefit of consumers.

More broadly, further consideration is needed of the various policies that encourage increasing investment in housing. Mortgages make up a significant proportion of assets for Australian ADIs. CHOICE shares the Final Report's concerns about the banking system's exposure to housing.

As noted in the Final Report, the tax treatment of investor housing encourages leveraged and speculative investment in this asset class.¹ Policies such as negative gearing on housing investment properties have increased the overall risk to the financial system. They also impact consumers, particularly non-investors, through increased costs for an essential good - shelter - either through higher rents or higher barriers to entry to the housing market.

¹ Financial System Inquiry (2014), *Final Report*, p. 17. .

The tax treatment of housing is outside the scope of the FSI but needs urgent consideration given its impact on both individuals and the broader economy. CHOICE expects this issue to be given thorough examination through the tax reform process.

Recommendation 6: Financial Claims Scheme

Maintain the ex post funding structure of the Financial Claims Scheme for Authorised Deposit-taking Institutions.

CHOICE supports this recommendation. The ex post funding structure is a sensible approach as it achieves the objective of providing consumers confidence in the banking sector. An ex ante model is unnecessary at this time if other measures are implemented to increase system stability are implemented.

The Final Report notes that the current cap of \$250,000 is relatively high compared to other countries.² CHOICE sees the current cap as a strength of the system that increases consumer trust and confidence. As a series of measures are likely to be implemented to strengthen the banking sector that will reduce the likelihood that Australians will need to rely on the FCS, there is no strong argument to reduce the FCS cap at this time.

² Ibid p. 37,

2. Chapter Two: Superannuation and retirement incomes

CHOICE is broadly supportive of the Final Report's recommendations for superannuation and retirement policy and has offered specific comments on implementation challenges.

Recommendation 9: Objectives of the Superannuation system

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

CHOICE sees merit in establishing a joint parliamentary inquiry to develop objectives for the superannuation system. These objectives may bring greater consistency to policy-making across successive governments.

Consistency in purpose is important but policy innovation is critical in a compulsory superannuation scheme. The Final Report establishes the behavioural biases that limit the effectiveness of competition in the default superannuation market. Innovative regulatory and policy intervention will be required to deliver competitively priced and designed default products. As such, it is important to establish in the public's mindset that regular review and policy advancement is a constructive part of a compulsory superannuation system.

The proposed primary and subsidiary objectives form a good basis of discussion. CHOICE sees room for further development of these objectives. For example, it may be more appropriate for investment to be in the *long-term* best interests of members, prompting a broader debate about the role of environmentally and socially sustainable investments within funds.

We also suggest that the superannuation system should be simple, *fair* and efficient, allowing for policy makers to systematically address the inequality that is currently embedded in the system and continue to promote policies that facilitate fairness such as access to the Superannuation Complaints Tribunal and early release clauses for severe financial hardship.

Even after these objectives are legislated, it is likely that superannuation policy will remain a contested and politically divisive aspect of public policy. Fund owners and operators, as well as the financial advisor community, will continue to seek opportunities to expand their share of compulsory superannuation assets including through regulatory and policy

processes. The influence of industry lobbyists is strong and growing. By comparison, the interests of superannuation fund members are not well represented. A fully-funded research and advocacy body to represent superannuation members would be a useful step to address this imbalance and introduce a strong consumer voice to future public and political debates.

In early 2012 CHOICE convened an establishment committee for a Superannuation Consumers' Centre (the Centre). The committee included former Macquarie Bank CEO Allan Moss, Former Vanguard CEO and Financial Services Council Chairman Jeremy Duffield, and former ASX and ASIC Chairman Tony D'Aloisio amongst others. In August 2012 the committee took a proposal to the Federal Government to provide a one-off contribution to an investment fund to provide an endowment supporting the Centre for 20 years. The Federal Government agreed to make a \$10 million contribution, provided the industry matched that contribution. While a number of major funds agreed to contribute, the committee did not raise the matching \$10 million prior to the 2013 election.

The Centre has established itself as a legal entity and is operating on a limited voluntary basis. The business case for the Centre remains relevant. Trust and confidence in the industry is lower than it should be. This is producing suboptimal outcomes for consumers, government and industry. No single policy response will solve this problem but the establishment of a dedicated Centre is an important part of a suite of measures needed to build a stable superannuation system that operates in the long-term interests of consumers.

While it is not canvassed in the Final Report, we urge the government to support development of the Superannuation Consumers Centre by recommending that it receive specific listing in the Income Tax Assessment Act 1997 to enable the Centre to receive deductible gifts from those in the community who support it. The Federal Government could offer further support for the Centre by allocating a small portion of the superannuation levy to fund its operations or by providing seed funding.

Recommendation 10: Improving efficiency during accumulation

Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.

We see merit in the Productivity Commission looking at the full suite of alternatives canvassed in the Final Report, and testing the appropriateness of a formal competitive process to allocate new default fund members to MySuper products. We also support the proposed timeframe, which would allow for a proper assessment of the impact of the Stronger Super reforms. In addition to the matters raised in the Final Report, member engagement and rates of lost and multiple accounts should also be considered.³ To fully assess these aspects of the super system, steps should be taken now to develop and track the necessary indicators and data.

Recommendation 11: The retirement phase of superannuation

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

The recommendation to establish default product options during the retirement phase has the potential to radically transform the market for retirement products and to significantly improve consumer welfare. At the point of draw-down, many people become vulnerable consumers, finding themselves in an unfamiliar environment, obliged to make consumption decisions and facing severe consequences if their needs are not well matched to their financial choices. This recommendation represents a significant step forward in understanding consumer needs and incorporating elements of behavioural finance (defaults) in designing suitable policies.

CHOICE stands ready to work with government and industry as significant resources are invested in developing a new regulatory framework for the drawdown phase of

³ Ibid p. 113.

superannuation. The new strategy should specifically help people manage longevity risk with a sustainable income stream.

Recommendation 12: Choice of fund

Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.

In implementing this recommendation CHOICE encourages the Government to update the data and track the proportion of employees who cannot choose their fund. 2010 ASFA research asked respondents whether they chose their fund and 23% reported that they did not have a choice. This figure is unsurprising given 66% reported they had opened their fund prior to the 2005 reforms that introduced choice of funds.⁴

A new survey should establish whether people are able to choose a fund – even if they did not have that choice at the time when their employment commenced or the fund was opened. New research should specifically ask whether employees are able to choose into which fund their current employer pays their superannuation and the new data should track the reason for lack of choice (government employee, EBAs – excluding defined benefit schemes etc.) and map these categories against member satisfaction with their fund(s).

Recommendation 13: Governance

Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.

CHOICE welcomes the Final Report's attention to governance of superannuation funds. Our funds should be held to the very best governance standards. We support reforms to strengthen conflict of interest requirements and the director penalty regime.

While the Final Report argues in favour of a majority of independent trustees, we favour the 'one-third/one-third/one-third' approach for industry funds as set out by the Cooper

⁴ Clare, Ross (2010), *Community attitudes to superannuation, retirement income adequacy and government policies on superannuation*, ASFA, <http://www.superannuation.asn.au/policy/reports>

Review. The Superannuation Consumers Centre supplementary submission to the FSI's Draft Report set out arguments in favour this approach, informed by recent research that independent directors have tended to lack relevant industry experience and understanding and have driven dramatic pay increases.

Other matters

CHOICE welcomes the observations regarding taxation made in the Final Report and the proposal to remove the exemption to the general prohibition on direct borrowing for limited recourse borrowing arrangements.

3. Chapter Three: Innovation

Recommendation 16: Clearer graduated payments regulation

Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.

CHOICE agrees that there is a need for clear guidance about thresholds and regulatory requirements for payment systems. Guidance needs to incorporate the principle identified in the Final Report of providing lower-intensity regulation for new entrants that pose smaller risks to the system. CHOICE strongly supports making the ePayments Code mandatory.

Recommendation 17: Interchange fees and customer surcharging

Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.

Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.

The recommendation on surcharging regulation does not provide a solution to excessive credit card surcharges. The major failing of the current system is the lack of enforcement of the Reserve Bank of Australia's (RBA) rule on surcharging. The Final Report proposes refining the current RBA rule on surcharges so that three tiers apply to surcharge limits. The recommendation does not address the lack of enforcement.

CHOICE agrees with the Final Report's assessment that surcharging can improve the efficiency of the payments system when it provides accurate price signals to consumers. Any return to a "no surcharge" regime would shift the costs from consumers who choose a specific payment type to all consumers, as costs are absorbed into the overall price of

goods and services. Such a change would disadvantage consumers using lower cost payment methods like eftpos or cash while subsidising users of higher cost credit cards.

It is clear that a small number of powerful businesses are openly flouting the RBA's current rule on surcharging. A change in the rule with no penalty for non-compliance is unlikely to change the status quo. Some of Australia's largest businesses, who are best able to negotiate low merchant service fees, are charging some of the highest card payment surcharges. This indicates that without some form of enforcement, businesses with substantial market power and little competitive pressure will continue to charge excessive surcharges.⁵

The Final Report notes that:

“The Inquiry considered imposing the current reasonable cost surcharging rules through Government regulation. However, regulators indicated this would involve considerable administration costs, as reasonable acceptance costs would need to be determined on a case-by-case basis. This option would also require strengthening regulators' powers to seek documents to prove over-surcharging, and creating new penalties to discourage over-surcharging.”⁶

The cost of regulation needs to be weighed against the costs consumers are bearing through excessive surcharging. Further work on the costs and benefits of this proposal should be publicly debated, based on the statements put forward in the Final Report and supported by evidence.

It is unclear if the FSI committee considered whether the proposals put forward required enforcement or if enforcement would be easier should the RBA's rule be refined. CHOICE is concerned that the surcharging recommendation increases complexity, introducing new problems while failing to solve the enforcement issue in the current system. The proposed rule changes do not specify what cards would be subject to surcharge limits, or how merchants and consumers could identify each tier of cards at the point of payment.

CHOICE maintains that a principles-based rule can be enforced by a regulator that has powers to demand documents and issue commercially significant penalties for non-

⁵ For airline surcharge mark ups see CHOICE, January 2014, *Excessive Credit Card Surcharge Update*: <https://www.choice.com.au/money/credit-cards-and-loans/credit-cards/articles/excessive-credit-card-surcharging-update>

⁶ FSI, *Final Report*, p. 176.

compliance. Equally, costs can be reduced as the regulator focuses on egregious breaches of the RBA rule. It is likely that a small number of regulatory actions would drive substantial change to surcharging practices.

The most effective solution to excessive surcharging is to empower a regulator to enforce the RBA ruling on limiting card surcharges to the reasonable cost of acceptance. CHOICE notes that the RBA has commenced an inquiry into payment system issues covering interchange and surcharges. This is unlikely to address enforcement issues, and therefore more immediate government action is justified.

CHOICE recommends that:

- No surcharges are permitted on lower cost payments (eftpos and debit cards).
- The current RBA rule should apply to all other payments, allowing surcharging that reflects the cost to the merchant for receiving the payment.
- The RBA rule should be enforced by a regulator that has powers to demand documents and issue commercially significant penalties for non-compliance.

Recommendation 19: Data access and use

Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

CHOICE is very supportive of this recommendation. In addition to the advantages open data would bring to small and large businesses, open data could directly benefit consumers if constructed to allow increased access to personal information in a standard, machine-readable format. The proposed Productivity Commission Inquiry should specifically consider the benefits of open data to individual consumers and the steps government needs to take to facilitate access to personal data.

Access to insurance data should also be considered by the Productivity Commission. It is difficult for consumers to understand and compare complex insurance products, leading to poor competitive pressure and inefficient outcomes across the industry. Comparison sites can assist with product comparisons (if they follow best practice guidelines) but struggle to access all information about insurance products and accurate premiums.

The costs involved in researching and compiling product information, particularly on insurance products, act as a barrier to entry for comparison sites. These costs can be relatively low for a comparison site that only includes information on products from

providers that are willing to pay to be listed. These costs are, however, significantly higher for a comparison site that seeks to be comprehensive and in doing so comply with best practice standards. This situation perpetuates the current business model of comparison sites, which in general terms involves only listing products of providers who are willing to pay to be listed and, in some cases, ranking results based on the amounts providers are willing to pay.

In order to overcome these problems and better realise the potential competitive benefits of comparison sites, thought should be given to the way in which information on products is made available, so that it is readily adaptable to use in a comparison site. Internationally there is a trend to make machine readable data available to third parties for the express purpose of aggregation into comparison services and similar moves would likely bring benefits to Australian consumers.

Recommendation 20: Comprehensive credit reporting

Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit-reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.

Comprehensive credit reporting has only recently been introduced and further time is needed to assess if the system is working to the benefit of all consumers. Rather than reviewing the uptake and implementation of the system in 2017, a review should focus on whether credit data sharing should be extended and if further consumer protections are needed, particularly for low-income and vulnerable consumers.

CHOICE strongly opposes extending access to repayment history information to non-credit licensees. Extending access will make it harder for customers with poor credit ratings to access credit and other essential services (such as telecommunications and utilities). This information is unnecessary for credit providers that are not licensees as they are not subject to responsible lending obligations.

4. Chapter Four: Consumer Outcomes

Recommendation 21: Strengthen product issuer and distributor accountability

Introduce a targeted and principles-based product design and distribution obligation.

CHOICE strongly supports this recommendation.

There is broad consensus among the stakeholder community for straightforward, practical steps to improve accountability through the supply chain.

The obligation will bring greater transparency to the product design process. It will ensure that product issuers identify and justify the target markets for their products and, just as importantly, which consumers their products are not intended or suitable for, and whose financial needs their products will not meet.

The Final Report lists four objectives of the reform. They are:

1. Reduce the number of consumers buying products that do not match their needs, and reduce consequent significant consumer detriment.
2. Promote fair treatment of consumers by firms that design and distribute financial products.
3. Promote efficient and limit or avoid the future need for more prescriptive regulation.
4. Build confidence and trust in the financial system.

CHOICE endorses these important objectives of the proposed reform. We encourage the Federal Government to commence a new exercise in objectively tracking progress against these objectives over time. Ideally, when the next major review of the financial system is announced in two decades, there should be a rich body of evidence about these core indicators of financial markets.

The Final Report suggests that it will not be necessary for these obligations to extend to credit products regulated under the *National Consumer Credit Protection Act 2009*. We urge the Federal Government to reconsider this approach. These obligations are complementary to responsible lending obligations and should help all participants meet these obligations. The post-sale aspect of product issuer obligations is not replicated in

responsible lending and would form a critical component of consumer protection in credit products.

Implementation

We look forward to working with the Federal Government on the detailed implementation of the product accountability measures. Aspects of the obligations that CHOICE expects to see in the detail of the measures include:

- Transparency and registration of product issuer documentation to enable ASIC to review and monitor product issuer obligations.
- Availability of product issuer documentation to customers at their request (for example where a dispute arises with a distributor channel).
- Availability of product issuer documentation to consumer advocates.
- Ability for ASIC to dispute the identified target and non-target markets, distribution channel, consumer testing of accessibility or any other aspect of product issuer obligations.
- Penalties for product issuers that fail to adequately implement their obligations.

Recommendation 22: Introduce a product intervention power

Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

CHOICE is strongly supportive of the recommendation to provide ASIC with a Product Intervention Power (PIP). This addition to the regulatory toolkit will enhance ASIC's ability to limit consumer harm in financial markets. The rationale for the reform is powerful: targeted early intervention would be more effective in reducing harm to consumers than waiting until detriment has occurred.

We encourage the government to implement PIPs in a way that maximises consumer confidence in financial service markets. This can be achieved by:

- Ensuring all financial products and services are subject to the power.
- Enacting robust accountability measures to ensure that product innovation is not stifled.
- Requiring evidence of remediation prior to a PIP order being withdrawn.

Costs and benefits

It is appropriate to look back at recent financial sector scandals and test whether PIPs could have been usefully deployed to limit consumer harm. Research commissioned by

ASIC's Consumer Advisory Panel has analysed the cases of Westpoint, Storm Financial and Agribusiness Managed Investment schemes (Timbercorp and Great Southern) to test whether PIPs would have assisted in each case.⁷ It is apparent that not every failure could have been prevented or lessened through PIPs (notably those cases where ASIC had little to no forewarning about a business practice) but in most cases ASIC was aware of the business practices and had exhausted its avenues of action.

It will be difficult for victims of these scandals to hear that a better regulatory system might have limited their losses. But evidence-based policy demands that policy-makers put numbers to costs and benefits of reforms. We believe it is appropriate that policy-makers tally the costs of thousands of Australians losing their homes and financial future, add to that the emotional and psychological impact of pursuing a remedy that will never replace what was lost, and place that figure on the benefits ledger of this reform. While this reform will not prevent every future financial sector scandal, it will help limit attacks on consumer welfare in the future.

We encourage the government to expand on the evidence in the Final Report to identify the consumer benefits of PIPs in markets outside of the investment sector. Consumer losses that occur because of market failures in the deposit-taking or insurance sectors can be harder for individuals to quantify or might seem insignificant until the scale of the impact is identified. Previous ASIC reports into consumer credit insurance, term deposits and life insurance indicate how PIPs might complement regulatory activity across a range of markets.

PIPs may also assist to improve culture in the financial sector. PIPs are likely to be implemented as a rule-making power, and as such, they fall at the lower end of the regulatory spectrum. PIPs are not an enforceable undertaking or other enforcement activity. In other words, we would expect that PIPs will support ASIC's informal persuasion and negotiation activities. ASIC has stated that "if well designed, this power ought to enable ASIC to be more proactive and allow for more targeted and timely intervention".⁸ We think that PIPs are likely to improve ASIC's influence on financial sector activities in a very light-handed way and in turn help to develop a culture of fair treatment of consumers.

The Final Report suggests that for the most part compliance costs of this reform will be low, particularly for firms that have a strong track record of treating customers fairly. We

⁷ Research to be provided to Treasury in a separate submission.

⁸ Stewart, Tim, (2014), *ASIC needs a 'big stick': Kell*, Investor Daily: <http://www.investordaily.com.au/regulation/37200-asic-needs-a-big-stick-kell>

would welcome discussion with any business or industry group about the specific implementation or operational costs of this reform. Our assessment of similar rules in comparable jurisdictions is that they have been implemented with minimal cost and disruption to business.

Accountability

CHOICE acknowledges the financial sector's trepidation about aspects of this recommendation. The Final Report notes industry concerns on the potential constraint on product innovation. CHOICE shares this concern. PIPs should not limit legitimate business activities that meet consumer needs. We stand ready to work with government and industry to develop accountability measures to ensure that the rules are used as they are intended. We believe that this need can best be met through existing public accountability mechanisms, supported by public reporting on the way in which PIPs are exercised and procedural fairness provisions for product issuers. In addition to any legal avenues of accountability, an adequately resourced regulator is essential to ensure that PIPs are used where market surveillance, research and analysis exposes risks of significant consumer harm.

Scope

The Final Report proposes to exclude situations involving “problems with retail pricing where consumers might be paying more than expected for a particular product” or where “large numbers of consumers have incurred a small detriment”.⁹ These exclusions are not justified in the paper and CHOICE can not see any benefit in retaining these features in the implementation of the new powers.

It is our view that ASIC needs the ability to use PIPs across the entirety of the financial products and services it regulates. We can envisage situations where consumer detriment is inherently linked to pricing (either too high or too low) or where small individual losses are having a significant detrimental affect on a large scale. For example, ASIC's recent research into consumer credit insurance (products sold to people who were ineligible to claim) and previous work on term deposits (rolling term deposits that lock consumers into a low default interest rate) demonstrate how significant consumer detriment can arise across different consumer markets. In the UK, the Contingent Convertible bonds have come to the attention of the Financial Conduct Authority in part because the retail price indicates that

⁹ FSI, *Final Report*, pp. 206-207..

the risks are not sufficiently priced into the products. PIPs should be scoped to facilitate intervention wherever there is a risk of significant detriment to a class of consumers.

The Federal Government should seek to maximise the value of the PIP initiative by providing ASIC with a power of a broad application.

Delivering lasting change

The Final Report proposes to limit the product intervention to 12 months (with an optional government extension), assuming that during this period either industry will have changed its practices or government will have implemented permanent reform.

We agree with the principle that either industry or government action should address the core concern raised by ASIC. However, consumers should receive greater certainty that these steps *will* take place. Rather than assuming that industry or government will act, PIPs should be implemented so that they remain in force until the requisite remediation or permanent regulation is in place. The onus should be on the affected industry to demonstrate to ASIC that it has addressed the consumer issues at the heart of a PIP. A PIP order should specify what objective measure will be used to assess the remediation and/or the steps that the affected industry will need to take to demonstrate that the order can be terminated.

Recommendation 23: Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

CHOICE agrees that steps should be taken to further facilitate innovative disclosure to benefit consumers. Any change must preserve consumer choice of disclosure methods and provide safeguards, particularly for vulnerable consumers.

CHOICE strongly supports the recommendation that consistent standards are developed to improve disclosure of risk and fees.¹⁰ This will increase clarity to consumers researching complex products and increase consumers' ability to properly compare products offered by different providers.

¹⁰ FSI, *Final Report*, p. 195.

The Final Report calls for industry to develop standards to disclose risk and recommends that if progress is not made within a short time frame that government should consider a regulatory approach. Industry cannot develop these standards alone. The most effective way of implementing this recommendation is to include consumer advocates, regulators and academics as part of the standards development process and to rigorously test draft documents to ensure disclosure is as clear as possible to consumers. CHOICE supports plans to consumer-test ASIC's pilot program for innovative disclosure.¹¹

The Federal Government also needs to provide guidance on the timeline to develop standards and the minimum benchmarks it expects industry to meet through this process. CHOICE suggests a period of no longer than 18 months to pilot, test and create final standards before the Federal Government considers a regulatory approach.

Recommendation 24: Align the interests of financial firms and consumers

Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.

Consumers need financial advisers to provide them with sound, independent and trustworthy guidance on complex issues. Reforms are still needed to ensure that financial advice is a valuable service, not a sales pipeline.

CHOICE supports the objectives outlined in the Final Report, agreeing that steps must be taken to:

- Improve the culture of financial firms and build consumer trust in those firms;
- Align remuneration structures with a customer-focused culture; and
- Promote efficiency in the financial advice sector through increased consumer participation and engagement.¹²

The recommendations put forward do not fully realise these objectives, only going part of the way to improve consumer outcomes.

¹¹ Ibid, p. 215.

¹² Ibid, p. 217.

Steps required to achieve objective one: improve the culture of financial firms and build consumer trust

CHOICE supports providing additional powers to ASIC to achieve this objective.

Further thought is needed on how to raise standards of conduct and levels of professionalism. The Final Report suggests that industry associations could lead this process through introducing individual codes of conduct.¹³ An approach which encourages multiple codes with various requirements is likely to result in vastly different standards, and place pressure on professional associations to compete in a 'race to the bottom' to attract advisers. A single code of conduct would provide consistency across the industry and be easier for consumers to understand.

Should the Federal Government encourage multiple codes of conduct, all codes must be registered with ASIC. This means that codes will:

- Be developed in consultation with stakeholders;
- Be enforceable;
- Include provisions for dispute resolution, remedies and sanctions; and
- Require effective and independent administration.¹⁴

Industry associations have had a number of years to coordinate efforts to lift standards in the sector. To date, no financial services sector code of practice has been submitted to ASIC for approval.¹⁵ CHOICE fears that the industry is currently too fractured to take responsibility for this task. Without government encouragement it seems unlikely that adequate codes will be developed.

To ensure action in this area, the Federal Government should outline to a clear timeline and outcomes required for codes of conduct, including plans for regulation or legislation should industry not meet stated objectives.

Steps required to achieve objective two: align remuneration structures with a customer-focused culture

¹³ Ibid, p. 220.

¹⁴ As per ASIC Regulatory Guide 183, Approval of financial services sector codes of conduct.

¹⁵ See <http://asic.gov.au/for-consumers/codes-of-practice/>

CHOICE is encouraged by the Final Report’s recognition that more work is required to improve remuneration structures to increase consumer outcomes. A review of available research since the introduction of the Future of Financial Advice (FoFA) protections suggests an ongoing issue with conflicts of interest within financial advice.¹⁶

CHOICE continues to oppose commissions, soft-dollar payments, asset-based fees, and any other form of remuneration which incentivises advisers to recommend a product or volume of products. Recognising that the industry is likely to face further changes through increased professional standards, CHOICE agrees with the Final Report that, for the moment, instances of conflicted remuneration should be monitored.

A review of FoFA should be conducted in 2018, three years after all components of the legislation have come into force. To assist with the review, specific funding should be provided for ASIC to conduct bi-annual shadow-shopping exercises and publish research reports on the quality of financial advice received by consumers. This research has previously been essential in pinpointing issues within the industry and will be necessary in future reviews of the effectiveness of bans on conflicted remuneration.

Shadow shopping exercises should explore compliance with FoFA requirements, the influence of ownership structures on recommendations and quality of advice, the influence of asset-based fees on advice and the experience of consumers who remain in grandfathered products.

The Final Report does not adequately address remuneration issues for life-insurance advice. The Final Report confuses two distinct issues - addressing conflicted remuneration structures and increasing consumer uptake of life insurance - stating “the Inquiry does not recommend removing all commissions, as some consumers may not purchase life insurance if the advice involves an upfront fee.” Commissions incentivise advisers to arrange life insurance but not quality insurance for clients. Commissions are clearly linked to high churn rates and in some cases the selling of highly unsuitable insurance.¹⁷

The recommendation that upfront commissions are not greater than ongoing commissions does not address the distorting influence of conflicted remuneration. We do not support

¹⁶ CHOICE (2014), Submission to the Senate Standing Committee on Economics, Scrutiny of Financial Advice Inquiry, available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Scrutiny_of_Financial_Advice

¹⁷ ASIC (2014), *Rep 413: Review of Retail Life Insurance Advice*, available at <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-413-review-of-retail-life-insurance-advice/>

this recommendation and maintain that all commissions should be banned as they incentivise the sale of particular products based on the adviser's interests over genuine advice. Other policy interventions should be considered if the Federal Government wishes to increase consumer uptake of life insurance.

Steps required to achieve objective three: Promote efficiency in the financial advice sector through increased consumer participation and engagement

CHOICE supports this objective but tangible steps need to be taken to achieve increased consumer participation and engagement with advice.

As a starting point, the industry needs to give consumers a reason to place their trust in the sector. The sector should address issues with conflicted remuneration, quality of advice, education standards and professional behaviour.

There is also important work to do to guarantee that consumers can expect fair redress when something goes wrong. There remain a number of instances where consumers have received a positive outcome through External Dispute Resolution (EDR) but compensation has been not paid. FOS notes that between January 2010 and 30 September 2014, 114 determinations remain unpaid at a value of over \$12.5 million (plus interest). 68% of unpaid determinations relate to disputes in financial planning and advisory sector.¹⁸

Professional indemnity insurance is typically used to meet compensation arrangements but this insurance product was not designed to function as a compensation mechanism, creating instances where insurance doesn't cover all compensation requirements. Consumers require a default compensation scheme funded by licensed entities in the financial product distribution process.

The issue of unpaid EDR determinations was not addressed in the Final Report and represents a worrying gap in consumer protection arrangements for the sector. EDR is held up as a very great strength of consumer redress in financial services. However it is undermined by the failure to ensure that Ombudsman determinations in favour of consumers are paid out. We urge the Government to commit a last resort compensation scheme for consumers.

¹⁸ CHOICE (2014), Submission to the Senate Standing Committee on Economics, Scrutiny of Financial Advice Inquiry, available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Scrutiny_of_Financial_Advice.

Recommendation 25: Raise the competency of advisers

Raise the competency of financial advice providers and introduce an enhanced register of advisers.

CHOICE agrees that education and professional standards for advisers must be increased, with sensible transition arrangements for existing advisers. Low competency standards have been a feature in the industry for far too long.

CHOICE supports the introduction of a public register of advisers. The register will address some transparency issues within the industry and allow ASIC to track disreputable advisers. Over time additional fields should be added to the register to increase its usefulness to consumers.

The Final Report does not comment in detail on standards for mortgage brokers. However it notes that “ASIC should continue to monitor consumer outcomes in this area and the performance of the industry in relation to its obligations under the *National Consumer Credit Protection Act 2009*.” This should be achieved through additional project funding for ASIC to investigate how mortgage brokers are meeting consumer needs. CHOICE suggests that funding is provided for annual shadow-shopping exercises and proactive monitoring of the industry.

Recommendation 26: Improve guidance and disclosure in general insurance

Improve guidance (including tools and calculators) and disclosure for general insurance especially in relation to home insurance.

We believe that the problems of inadequate competition and complexity for consumers justify a much deeper analysis of problems in the insurance market than that presented in the Final Report.

While increasing financial literacy and education are important, these alone are not solutions. Consumers cannot be expected to accurately estimate the costs of their home and contents for the purpose of arranging insurance even with improved calculators and tools. Consumers would benefit from a discrete review of insurance as a high priority.

5. Chapter Five: Regulatory system

Recommendation 27: Regulator accountability

Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

CHOICE is not convinced of the necessity of a new oversight mechanism for financial regulators. As noted in the Final Report, there is already a complex accountability framework with oversight from the Australian National Audit Office, the Office of Best Practice Regulation, the Australian Parliament through inquiries, estimates and annual reports and additional requirements recently imposed through the Regulator Performance Framework.

Further evidence is needed to justify the establishment of a new oversight mechanism. Particularly, evidence needs to be gathered to demonstrate what specific value the proposed Financial Regulator Assessment Board would add to regulators' day-to-day operations and how it would practically assist them in achieving their mandates.

The Final Report says it seeks to avoid a situation where the proposed Financial Regulator Assessment Board becomes "another accountability process that adds to costs without adding value."¹⁹ The objectives of an additional oversight mechanism may be able to be achieved in a less costly manner such as through additional requirements within annual reports.

Should the Federal Government establish the Financial Regulator Assessment Board then it should be implemented with an eye to ASIC's priorities of promoting investor and financial consumer confidence and ensuring fair, orderly and transparent markets. To achieve this CHOICE suggests that:

- The Board includes dedicated consumer representatives. Ideally 50 per cent of Board members should have experience with consumer issues, 50 per cent should have

¹⁹ FSI, *Final Report*, p. 243.

experience with industry and the Chair should be independent and suitably experienced.

- Greater consideration is given by the Board to the consumer and broad market stability outcomes of regulatory action given that the separate Regulator Performance Framework process focuses solely on the impact of regulation on regulated entities.
- That Statements of Intent and Statements of Expectation outline clear expectations for consumer protection and increased welfare.

Recommendation 28: Execution of mandate

Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.

CHOICE supports a more stable and flexible funding model for ASIC. We are confident that a three-year review period is the right timeframe to enable ASIC to set and deliver its objectives.

The Final Report raised specific concerns about the adequacy of funding to carry out its consumer protection mandate in relation to the financial services industry “let alone the more proactive role the Inquiry recommends ASIC should adopt in the future”.²⁰

ASIC’s consumer protection function is critically important. The new approach to funding must ensure that ASIC has the ability to perform across the full range of its consumer protection role including: engagement with consumer representatives; access to justice for socially and economically disadvantaged communities; investigating and monitoring industry compliance with consumer protection laws; leading and coordinating financial literacy initiatives; oversight of EDR; and promoting consumer confidence in financial markets.

We support the Final Report’s position that consumer stakeholders should be consulted in the proposed reviews. The advice of the Commonwealth Consumer Affairs Advisory Council and ASIC’s Consumer Advisory Panel will be critical in identifying the priorities and funding requirements of ASIC’s consumer protection function.

²⁰ FSI, *Final Report*, p. 248.

We support a prompt capability review following the government's action on key measures proposed by the Inquiry.

In addition to the three-year budget process, CHOICE recommends an additional discretionary revenue raising capability to fund urgent or emergency consumer protection functions. The trigger for this discretionary funding could be a major financial corporate collapse, scam or investigation affecting either a large number of consumers or a smaller number of very vulnerable consumers.

Recommendation 29: Strengthening ASIC's funding and powers

Introduce an industry funding model for ASIC and provide ASIC with stronger regulatory tools.

CHOICE strongly supports this recommendation.

We are confident that a funding model can be designed that maintains the independence, accountability and integrity of the institution.

In support of these principles CHOICE would like to see a funding model that prioritises simplicity. It should be easily apparent to an outside observer how funds are levied and who pays what.

We also note that the scope of the recommendation is limited to funding of ASIC's regulatory functions. ASIC performs a range of other functions—including many of the consumer protection functions listed on page 29 of this submission. It is important that these continue to be funded by government.

We are equally supportive of the need for ASIC to have stronger powers. The Inquiry's findings help us to understand how the structure of financial regulation is fuelling the low levels of community confidence and trust in financial markets. We agree with the Final Report that current penalties are unlikely to act as a credible deterrent against misconduct, particularly against businesses with significant financial resources.

The re-building of trust in financial services has been a constant theme in recent years and we are not yet at the end of a notorious period in the history of the Australian financial services sector.

The financialisation of Australian households means that financial institutions are seeking an increasing slice of our collective consumption across a broadening range of domestic activities. At the same time, our collective tolerance for unfairness has been shattered. This recommendation is an opportunity for Australian financial institutions to enter into a new accord with Australian consumers that is fundamentally based on fairness. We urge the financial service sector to support a better funded ASIC with stronger powers.

The Federal Government has a role to play in rebuilding the community's trust in the financial sector, and this should begin with granting ASIC the funds and powers it needs to do its job well.

Adequate resourcing of ASIC is the catalyst to achieving the objectives of a suite of the Inquiry's proposed reforms. The Federal Government's response to the Final Report will need to send a clear signal to the Australian community that there is a new ASIC on the block: better funded and better equipped to deliver a fair financial marketplace.

Recommandation 30: Strengthening the focus on competition in the financial system

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

CHOICE supports this recommendation.

The government-commissioned periodic external reviews of the state of competition should consider how competition in the sector is delivering for the long-term interests of consumers.

While these reviews should be system-wide, as recommended by the Inquiry, they should also explicitly consider competition in the banking sector. Considerations should be given to:

- The quantity and quality of products on offer to consumers and whether consumer needs are being met;

- Consumer satisfaction with specific products and providers compared to consumer use of products and providers;
- Any barriers to switching;
- Consumer perceptions of switching or reasons for not switching;
- Trends in interest rate movements for standard banking products compared to the official cash rate; and
- Trends in complaints figures.

Recommendation 31: Compliance costs and policy processes

Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.

CHOICE does not support this recommendation. Broad prescriptive timelines for industry to implement regulatory change are unrealistic and unhelpful. While it is important that implementation timelines are feasible, the Federal Government also needs to weigh the consumer detriment in delaying implementation of any change. The current system of setting implementation time-frames on a case-by-case basis allows the Federal Government to balance the needs of consumers and the demands of industry.

There is also no strong argument for post-implementation reviews on top of existing requirements. The Federal Government has already implemented the Regulator Performance Framework which requires post-implementation reviews. It is important to note that the Regulator Performance Framework does not consider the benefits of regulation or the specific needs of consumers.²¹

The costs of a regulatory intervention cannot be considered in a vacuum. Regulatory interventions must be assessed against the intended and actual outcomes desired, the most likely outcomes for consumers, or the outcomes most likely to enhance the effective functioning of markets.

²¹ Regulator Performance Framework available at <https://cuttingredtape.gov.au/resources/rpf>

6. Significant matters

Recommendation 37: Superannuation member engagement

Publish retirement income projections on member statement from defined contribution superannuation schemes using ASIC regulatory guidance. Facilitate access to consolidated superannuation information from the ATO to use with ASIC's and superannuation funds' retirement income projection calculators.

CHOICE welcomes proposals to improve information and communication to fund members about their retirement savings. We would welcome the opportunity to work with industry and government on how to present the information. Consumer testing should take place before a standard approach is rolled out.

Individuals should be able to access their own fund data and use that data in innovative ways to facilitate either financial literacy initiatives or product comparisons. The proposal to facilitate access to member data could be combined with Recommendation 19 (Data access and use) and explored as part of a Productivity Commission Inquiry.

Recommendation 40 : Provision of financial advice and mortgage broking

Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

CHOICE supports increased requirements to disclose ownership structures. Disclosure is required because of the greater likelihood of consumers being steered into a particular product based on ownership and potential and actual conflicts in vertically integrated business models. We note concerns based on research from behavioural economics that disclosure may increase the trust a consumer places in an adviser, rather than take the disclosure as a warning about conflicts. Any disclosure method should be monitored and research conducted to examine how consumers react to and use the information provided to them. Research should be used to refine disclosure rather than as a reason to not provide consumers with basic information about the service they are using.

Disclosure needs to be obvious to consumers at the point when they are considering seeking advice, likely requiring disclosure in prominent sections of websites, on external

signage and on business cards. In order to find the most meaningful form of disclosure for consumers, CHOICE would like to see independent consumer testing of any changes.

Further thought is needed on renaming general advice. The term is not an adequate description of the variety of activities that occur under the label. Again, consumer testing is required to find a meaningful term. The Federal Government should be open to creating sub-categories to capture the information, promotional and sales activities currently called general advice. CHOICE cautions against adopting a term such as 'general financial information' that does not capture the sales nature of a number of activities currently occurring under general advice.