FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

FSI Final Report: Treasury consultation

FPA SUBMISSION | 31 MARCH 2015

Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: fsi@treasury.gov.au

31 March 2015

RE: Financial System Inquiry – Final Report

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) welcomes the opportunity to provide a submission to the Treasury on Financial System Inquiry's Final Report. The Final Report, also known as the Murray Report, has put forward 44 key recommendations to improve the financial system's resilience, innovativeness, and fairness, as well as improving the Australian superannuation system and financial regulatory framework.

Our submission responds to the issues raised by the FSI's Final Report, and draws on our first and second-round submissions in order to form observations and practical recommendations for the Treasury and the Government to consider for their policy programme in response to the Murray report.

Furthermore, our submission also incorporates several other policy initiatives of the FPA that are relevant to the recommendations of the Final Report, such as our work with the Parliamentary Joint Committee on Corporations and Financial Services inquiry into proposals to lift the professional, ethical and education standards in the financial services industry.

Thank you for the opportunity to make a submission to the Treasury and we welcome further opportunities to provide feedback. 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

FSI Final Report

Treasury consultation

FPA submission to:

The Treasury

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1. **INTRODUCTION**
2. **CONCEPTUAL FRAMEWORK OF THE AUSTRALIAN FINANCIAL SYSTEM**
3. **PRODUCT REGULATION AND PRODUCT ISSUER REGULATION**
   - **3.1 Life risk regulation**
   - **3.2 Complex products**
   - **3.3 Suitability regulation**
4. **SUPERANNUATION AND RETIREMENT INCOMES**
   - **4.1 Objectives of the superannuation system**
   - **4.2 Leverage in superannuation**
   - **4.3 Retirement income and longevity risk**
   - **4.4 Default superannuation market**
5. **FINANCIAL ADVICE**
   - **5.1 Separation of financial advice and product information**
   - **5.2 Separation of financial advice and financial products**
   - **5.3 Protecting the term “financial planner”**
   - **5.4 Retail investor and sophisticated investor definitions**
   - **5.5 Automated advice**
   - **5.6 Tax deductibility of financial advice**
6. **REGULATORY STRATEGY AND ARCHITECTURE**
   - **6.1 Product intervention powers**
   - **6.2 Industry co-funding model**

APPENDIX A – List of recommendations

APPENDIX B – Table of FSI recommendations

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1 - INTRODUCTION

The Final Report of the Financial System Inquiry is a landmark in the history of financial services regulation in Australia. We are encouraged by the policy direction of the Final Report, and our view is that the implicit conceptual framework of the Final Report presents a new direction for the Australian financial services system. We are also encouraged by many of its recommendations, which are informed by a principled understanding of the objectives and social legitimacy of the financial services system.

Our submissions to the Financial System Inquiry Panel, as well as our various consultations with the Panel and with other stakeholders, have been framed within a progressive, holistic strategy to fundamentally improve Australian financial services system. This strategy endorses the view that changes to the architecture of the system, no matter how minute, should be informed by the broader conceptual framework and objectives that justify the system.

In line with this approach, our first-round submission made comprehensive recommendations regarding the conceptual framework of the Australian financial system – including recommendations regarding how we should understand the rights and obligations of the end users of the system, the financial intermediaries who work within the system, and the regulatory organisations who currently hold the primary responsibility for ensuring the proper functioning of the system.

Our further recommendations, as well as our second-round submission, translated this conceptual framework into practical policy positions which the FSI Panel, ASIC, the Treasury, and the Government could consult upon and implement in due course. These substantive avenues for policy reform included changes to financial intermediary regulation, product issuer and distributor regulation, financial product regulation and governance, the default superannuation sector, leverage in superannuation, life risk regulation, and other matters.

The FPA, while we have significant concerns with some of the recommendations, as well as the limited conceptualisation of 'fairness' as a value in the system, we are pleased with the majority of the substantive policy recommendations of the Financial System Inquiry Final Report. Many of these recommendations contain laudable (and even visionary) objectives for system, as well as the fair treatment and participation of Australians who are involved in the Australian financial system.

This submission addresses the recommendations made by the Final Report, as well as matters that we believe were not adequately discussed in the Report. We look forward to further consultation on the Report with the Treasury and the Government.

2 – CONCEPTUAL FRAMEWORK OF THE AUSTRALIAN FINANCIAL SYSTEM

One of the most promising aspects of the FSI Final Report is its emphasis on the conceptual framework of the Australian financial system. The FPA's response to the initial FSI terms of reference included significant submissions on the ideal conceptual framework for the financial system, and framed our recommendations in light of that conceptual framework. We are encouraged that the Final Report has taken a similar approach to the relationship between high-order regulatory concepts and their embodiment through law and policy reform.

While the recommendations themselves are important to understand and consider, it is the principled nature of these recommendations which gives them their value. Our view is that the Government should adopt a similar approach to the 44 recommendations by critically reviewing the conceptual framework of the financial system, and using that framework to guide its approach to the Report's recommendations.

The Final Report describes a conceptual framework that incorporates four major themes:

- Efficiency
- Resilience
- Fair treatment
- Roles and responsibilities of participants

The FPA supports these four themes as useful guiding principles to understanding the Report. We also support the Report's approach to seeing these themes as inherently connected to each other. However, our view is that the Report does not go far enough in challenging the existing conceptual framework with respect to fairness and with respect to the roles and responsibilities of participants in the financial system.

In particular, we do not believe that the latter two themes – fairness and responsibility – are adequately canvassed by the Final Report. Our principal objection is that these two themes remain reliant on the overarching disclosure-based regulatory strategy that dominates the Australian financial system architecture.

There is a clear tension between the Report's tendency to make recommendations which alternatively support and undermine the existing system's reliance on disclosure and informational symmetry. For example, the product intervention powers recommended by ASIC rely both on a disclosure-based regulatory system and on concepts such as product safety, consumer protection, and financial rights.

Our view is that the tension between disclosure-based regulatory systems and systems which incorporate holistic and detailed conceptions of financial citizenship and the responsibilities of financial intermediaries will continue to constrain the development of Australian financial services regulation until a new conceptual framework which recognises these concepts is in place.

End users of the financial system

A central tenet of the FPA's approach to the conceptual framework of the financial system is the importance of holistic financial citizenship for participants in that system. Our first-round submission criticised the prevailing concept of a "consumer" or a "retail investor" in the Australian financial system as a "thin" concept of financial citizenship. Instead, we proposed three key criteria for conceptualising the participation of end users and beneficiaries of the Australian financial system:

- 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.[1]

This richer, holistic conceptualisation of financial citizenship recasts the individual who interacts with the financial system as a citizen and an equal participant. This framework draws on the most current academic literature on the fair treatment of individuals who interact with a financial system. We described the benefits of this approach in the following ways:

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

While the FSI Final Report did engage with the concept of fairness in the financial system, it did so on the basis of a thin concept of financial citizenship – one where consumers and retail investors are generally owed little more than accurate disclosure documentation.

[1] Financial Planning Association, 'Financial System Inquiry: First-round submission' (March 2014), p 6

Regulating financial intermediaries

The FPA is generally supportive of the FSI Final Report's focus on the roles and responsibilities of participants in the system. While the Murray Report has not explicitly adopted the "gatekeeper theory" of financial intermediary regulation as our first-round submission recommended, there is nonetheless considerable focus on how to improve the conduct of financial intermediaries.

Further avenues for reform and improvement would be the facilitation of co-regulatory structures in aid of improving the culture of financial firms, as well as adopting the FSI's recommendation to give ASIC the power to ban individuals from managing a financial services business.

Recommendation 1:

The FPA recommends that the Government and the Treasury responds to the Financial System Inquiry Final Report recommendations by addressing the conceptual framework that underpins them. In particular, we recommend that the Government respond to key themes and principles in the Report, such as the role of fairness in the financial system and the continuing primacy of the efficient capital markets hypothesis.

3 – PRODUCT REGULATION AND PRODUCT ISSUER REGULATION

3.1 – Life risk regulation

The FPA fully supports the principles underpinning Recommendation 24 in the Murray Report, which establishes the goal of aligning "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."[2] Our consistent position has been that the financial system should serve the public interest, which requires the interests of financial intermediaries and end users of the system to align towards commonly-held economic, social, and political values.

To that end, we recognise that remuneration structures in the life risk sector create conflicts of interest that can misalign the interests of financial intermediaries and users of the financial system. Our ambition, which we urge the Treasury and the Government to share and help to facilitate, is the life risk sector can move away from structural impediments towards values alignment. With respect to financial planning, our ambition is that life risk advice will eventually move from conflicted remuneration structures towards structures that align the interests of advisers and clients.

This structural change requires initiative and commitment across the financial services sector, as well as the political willpower of the Government and of professional associations who contribute to the culture, values, and standards in the life risk sector. This structural change, like the structural changes that have occurred in the wealth management space, cannot occur simply through banning upfront commissions.

The value of life risk advice

Any structural change to the remuneration model for providing life risk advice relies on clearly defining the service that is being provided. ASIC's recent report on life insurance advice[3] identified shocking examples of misconduct that flow from both the remuneration model for advice and the lack of clarity around the service offering that life risk advisers provide.

From that report, ASIC stated that 63% of the advice surveyed complied with the law, whereas 37% of the advice did not. Post-FOFA advice has been considerably better (67%/33%) than pre-FOFA advice (59%/41%). Where the adviser received an upfront commission for the advice, there was a 55% pass rate and a 45% fail rate. Startlingly, where another commission model was used, the pass rate increased to 93% with a 7% fail rate. Of the advice rated a fail by ASIC, 96% of that advice was remunerated through an upfront commission, though 80% of the total advice surveyed was remunerated through upfront commissions.[4]

The report also provided case studies of "advice" services which functioned as a thinly-veiled product switching exercise designed to generate upfront commissions for the adviser. This is a fundamentally

[2] Financial System Inquiry, 'Final Report' (December 2014) p 217
[3] Australian Securities and Investments Commission, 'Report 413: Review of Retail Life Insurance' (October 2014)
[4] ASIC above n 3 at pp 5-7

flawed approach to financial advice, as it places the interests of the adviser ahead of the client and is solely concerned with financial product advice.

The FPA sees life risk advice differently. A key part of our mission to stand with Australians for a better financial future is to ensure that the end users of the Australian financial system are offered professional, client-centric financial advice on their personal risk. We want the Australian public to recognise the immense value that professional life risk advice can offer, and to contrast that service offering to other parts of the life insurance market.

The FPA considers life risk advice to be valuable to consumers in the following ways:

- **Field underwriting:** In comparison to direct insurance and group cover in superannuation, life risk advice that places the needs of the client first will also allow the adviser to assess the appropriate types and level of cover which the client requires. This reduces misselling, and complements the client's (often quite limited) understanding of insurance products and the claims process – both of which can be very complicated.

  There are also significant benefits to the underwriting process being completed at the point where the advice is implemented, rather than at the point of claim. The client will know exactly what they are covered for and the value of their cover, and field underwriting permits far fewer opportunities for insurers to contest a claim.

- **Strategic life risk advice:** The value of strategic life risk advice (i.e. where the adviser limits their advice to helping the client understand their insurance need as opposed to making a product recommendation) is that it allows the client to understand their insurance need whilst minimising the potential for conflicts of interest to affect that advice.

- **Holistic advice:** The value of holistic advice which includes life risk advice is that it considers the role of insurance within the client's overall needs, objectives, and circumstances before making any product recommendations. This plays a critical role in how to structure premium payments, deciding whether to hold insurance inside or outside of superannuation, estate planning, and other concerns which are difficult for most Australians to understand on their own.

  An ongoing relationship between the adviser and the client within a holistic advice framework also facilitates full and frank discussions around different models for adviser remuneration, including refunding upfront and/or ongoing commissions to the client.

- **Ongoing services for the client:** Ongoing services that life risk advisers provide play a critical role in the success and timeliness of an insurance claim. The assistance which life risk advisers can provide in the claims management process (including in any dispute resolution proceedings) cannot be overstated.

- **Professional Standards:** The FPA is a firm advocate for higher professional and education standards. The FPA has developed specialisation training for financial planners with the Life Risk

Specialist (LRS®) designation program and irrespective of remuneration models, FPA members are bound by its Code of Conduct and are held accountable to this. Specifically the FPA can point to Rule 4.10 in the Code that states:

> *The Member must only make a financial planning recommendation to a client requiring the client to dispose of, cancel, or replace one product or service with another where it is consistent with the requirements in Rule 4.7 and appropriate for the client having regard to any cost, benefit, risks or adverse consequence of:*
>
> *(a) acquiring the replacement product or service;*
> *(b) maintaining the existing service or holding the existing product; and*
> *(c) disposing of, or cancelling, the existing product or service.*

Further the FPA has commenced work on developing guidance that provides best practice guidance to members on providing life insurance advice that meets their professional obligations.

Consumer experience

Research conducted by Ernst and Young: *Voice of the consumer, global consumer insurance survey 2012*, provided some interesting insights into what consumers actual want and what they are likely to do.

A key area is in respect to their understanding of insurance products and the growing internet trend of consumers wanting to do their own research. Historically, 40% of customers did little or no research before purchasing, but the research shows a marked shift in customers' intentions to conduct more research in future with the Australian consumers increasing to over 50% intending to do a fair amount or great deal of research in future. Interestingly the main items that will be researched are product and features and the financial stability of the insurance product provider.

The survey results show that while insurance is still being "sold" there is increasing "ownership" of the process by customers themselves. Customers expect financial planners and intermediaries to do the necessary research, but if this trend continues, it is likely to be matched by a greater demand for sources of quality research.

Competition of products should be maintained and encouraged so that consumers will benefit from access to better products; not be locked into any products if it no longer suits them and have mechanisms available to them to switch when they need or want to. Therefore any solution must not erode the benefits available to both new and existing clients of competition.

We must ensure that existing insurance policy holders are not discriminated against, by creating disincentives for financial planners to proactively source best of breed solutions in the market place for their clients.

It should be noted that life companies themselves contribute to policy changes by consumers as they compete not only on pricing but also terms and conditions.

The FPA is very concerned that this debate is all about financial planners, seeing their actions as the problem to be fixed. The proposal seeks to change the behaviour through the adoption of product restrictions possibly to the detriment of a much wider group of clients (existing policy holders).

This subverts the vital role that financial planners can play as the client advocate to improved insurance outcomes.

There are obvious compliance and process costs to be considered in any change, which have not been identified in the FSI proposal. In any change of this nature there are likely to be winners and losers. The FPA is concerned with the lack of appropriate data identifying the real impact this proposal will have on consumers and financial planners.

From a consumer perspective there is no information or evidence of how premiums will be impacted as a result of this proposal. A very important issue facing life insurance policy holders and potential policy holders is the cost of premiums.

There is some life insurance products that provide up to 30% reduction in premiums when commissions are dialled down to zero, however there is no comment or research provided in the FSI report on how the proposed change to a level commission structure would impact on premium pricing or whether life insurance companies would even commit to review let alone reduce premium pricing for policy holders.

Further there is no discussion or analysis done in respect to tax deductibility of premiums – for example how will the FSI model impact on income protection policy premiums (including the embedded commission) that are generally tax deductible to the policy holder, especially if the policy holder will now need to pay for financial advice costs (which are not tax deductible) in addition to the premium.

The Underinsurance problem

Underinsurance in the Australian Life insurance industry is an ongoing debate. For individuals having adequate Life Insurance is one of the most important parts of a financial plan.

The majority of Australians (who need insurance) are underinsured. According to global reinsurance giant Swiss Re, Australia ranks as one of the most underinsured developed nations, ranking only 16th in the world for life insurance penetration (i.e. premiums as a percentage of GDP) and density (i.e. premiums per capita).

Rice Warner estimates that underinsurance costs taxpayers more than $250 million a year in additional social security payments, as they have to support the beneficiaries of individuals that are underinsured. The actuarial company also estimates life insurance purchased through superannuation funds (ie. Default super funds) only provides 20% of what is needed, and more importantly, a large number of working Australians get life insurance coverage through their superannuation fund.

Some of the reasons for underinsurance in the Australian Life Insurance market include a lack of awareness to the financial impact that can be caused by sudden illness, injury or premature death and an understanding of the products that can protect them which include Life and TPD Insurance, Income Protection Insurance and Trauma Insurance.

Other reasons include the perception government benefits (i.e. NDIS, Social Security, Private health insurance) and workers compensation will provide adequate support, that the cost of insurance is too expensive when in reality the cost of life insurance in some cases can be lower than health, home and car insurance and that insurance companies will not pay out in the event of a claim.

On a positive note research by KPMG has shown that Australian's are four times more likely to have life insurance cover if they receive financial advice from a licensed adviser than those who do not. They are also more adequately insured, with an average of more than two times the level of cover than those who have not sought financial advice. A client who has received financial advice is on average insured for $308,212 compared to $99,954 for a client who has not received advice.

The implementation of the Future of Financial Advice reforms, requiring financial advisers to act in the best interests of their clients will likely have a positive impact on the number of people have appropriate and adequate insurance protection.

Though Rice Warner state that the insurance gap has reduced since 2005, there still remains a significant gap of at least half of what the insurance cover should be. Rice Warner Actuaries found as at June 2010, the overall level of underinsurance in life risk was at $669 billion, which compares favourably to $1,000 billion of underinsurance in 2005.

On an income replacement basis, the level of life underinsurance is $3,073 billion, while for total and permanent disability (TPD) sits at $7,182 billion. Income protection underinsurance sits at $437 billion.

Any solutions which the Government and the financial services sector implement should seek to address the underinsurance problem in Australia, and any change to the insurance sector should not add to that problem.

Sustainability (and premiums)

While conflicted remuneration structures do pose risks to the integrity of the life risk sector, they are not the only issue in life risk or in the insurance sector generally. Sustainability is one of the toughest challenges for the entire insurance market, and one of the key causes of rising premiums. Conflicted remuneration structures and sustainability issues are linked, but analysing life risk advice only in the context of this connection is a superficial analysis.

As an example, the group insurance market has seen extreme increases in premiums as a result of sustainability issues in that sector, particularly around unsustainable pricing practices, poor claims experience, pressure on reinsurance rates and automatic acceptance. Last year, the Australian Financial Review reported that insurance premiums for AustralianSuper members increased by 75%,

after a 35% increase in the previous year.[5] CBUS also raised their group life premiums in 2014,[6] and Zurich left the group insurance market – citing sustainability and scale as key reasons for its departure.[7] This is a sector that does not offer personal financial advice and does not pay commissions, yet faces sustainability issues nonetheless.

The Murray report produced a compelling narrative of how premiums may decrease due to a decrease in unjustified product switching, but the Report's discussion of recommendation 24 does not address these other systemic factors in the insurance sector. As such, we have seen little evidence that forcing a move to level commission will comprehensively reduce premiums for risk insurance, especially given that there are a variety of other factors to consider.

If anything, the greater risk is that clients will move even further towards direct and group insurance, placing pressure on the courts and ADR schemes as a result of claim underwriting. The flow on effect on premiums for insurance schemes with automatic acceptance is that they will also rise as a result of a lack of confidence in direct insurance and in risk advice. The other possible consequence is that the uneven cost recovery timeline will force non-aligned risk advisers to consolidate, align with larger institutions, or perish.

This is a risk that the Murray report contemplates, but comes to the view that the costs of advice and underwriting can be recovered through higher premiums on a level commission model. The FPA is not as confident about this conclusion as the FSI Panel, and we certainly have not seen evidence to support this.

Foreign regulatory structures

The FPA notes that similar issues concerning conflicts of interest in risk advice have been identified in foreign jurisdictions such as the UK, Ireland, and the European Union. However, none of these jurisdictions have recommended the restriction of commission payments except along a principles-based model.

The United Kingdom insurance regulatory model implements a principles-based regulation of commissions through the Insurance Code of Business Sourcebook (ICOBS). ICOBS defines the term *inducement* as "a benefit offered to a firm, or any person acting on its behalf, with a view to that firm, or that person, adopting a particular course of action".[8] This explicitly includes commissions, which are separately defined as well.

It is not illegal to offer or to accept inducements, but these business practices have to be consistent with the Principles for Businesses that apply to financial intermediaries operating in the UK. These include:

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[5] Sally Patten, 'Insurance industry faces hard choices over group cover', *The Australian Financial Review* (24 March 2014) <http://www.afr.com/business/insurance/insurance-industry-faces-hard-choices-over-group-cover-20140324-ixbqw>

[6] CBUS, 'Cbus maintains members' insurance cover but premiums to increase' (27 May 2014) <http://www.cbussuper.com.au/about-cbus/news/latest-news/Cbus-maintains-members-insurance-cover-but-premiums-to-increase>

[7] Zurich Insurance Group, 'Zurich to withdraw from Australian group life insurance market' (7 May 2014) <http://www.zurich.com.au/content/zurich_au/media/media_releases/2014/zurich-to-withdraw-from-australian-group-life-insurance-market.html>

[8] Financial Conduct Authority, 'Insurance Code of Business Sourcebook', s 2.3.1

- Principle 5: "A firm must observe proper standards of market conduct."
- Principle 6: "A firm must pay due regard to the interests of its customers and treat them fairly."
  Principle 8: "A firm must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*."
- Principle 9: "A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment."[9]

The Irish regulatory framework has some aspects in common with the UK's system, in that they have adopted a consumer protection that is similar in many respects to the UK's ICOBS and PRIN. They have also defined commissions in the Insurance Act 1989 as

> (3) (*a*) A commission payment, for the purpose of this Act, is a payment, including a commission or other remuneration, reward or benefit in kind, paid or payable by or on behalf of the holder of an authorisation to an insurance intermediary in connection with the insurance business of the holder and includes the time allowed by the holder to the intermediary for the payment by the intermediary to the holder of premiums received by the intermediary for the holder for contracts of insurance entered into by the holder.
>
> (*b*) The value of the time allowed by an intermediary for the payment of a commission is to be taken into account in the calculation of the value of the time so allowed by the holder. [10]

The principal legislative instrument affecting the sector is the Insurance Act, which also gives the Minister the power to require a holder of a financial services authorisation to reduce commission payments if they form the view that those payments are excessive.[11] This power may become a *blanket power to reduce commissions* across *any number* of other authorisation holders to not pay commissions any higher than that amount.[12]

According to that Act, insurance intermediaries may not accept commission payments which are higher than the level prescribed by the Minister in section 37 when dealing with an authorisation holder to which such a restriction applies, or a payment banned by section 38.
Contracts for life assurance are voidable if a violation of section 37 and/or section 38 of the Insurance Act occurs.[13] Any insurer who is convicted of a breach of section 37 and/or section 38 may have their authorisation revoked and are forbidden from advertising insurance services.

Under this regime, Insurance brokers, in order to receive any commissions, must either be a member of a recognised professional body or are exempt,[14] and insurance providers must not provide commission payments to any insurance intermediary who does not satisfy this condition.[15]

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[9] Financial Conduct Authority, 'Principles for Businesses' s 2.1.1
[10] Insurance Act 1989 (No. 3 of 1989), s 2
[11] Above n 10 at s 37(a)
[12] Above n 10 at s 37(c)
[13] Above n 10 at s 42

Finally, the European Insurance and Occupational Pensions Authority (EIOPA) has recently published its Final Report and Technical Advice on its consultation around *Conflicts of Interest in direct and intermediated sales of insurance-based investment products*. Both reports favour principles-based regulation of insurance intermediaries with respect to remuneration arrangements, and the EIOPA does not favour either a legislated or de-facto ban on commission-based models.[16]

EIOPA's Technical Advice on "the proper management of conflicts of interests resulting from third party payments" requires examining measures in three key areas:

- "Firstly, measures that the insurance undertaking or intermediary should take to ensure the inducements are for the benefit of the customers and do not lead to detriment for the customer, including the ability to demonstrate this to national competent authorities;
- Secondly, measures to ensure strict compliance with the requirement that inducements do not impair compliance with the insurance undertaking's or insurance intermediary's duty to act in accordance with the best interest of the customers; and
- Thirdly, measures to ensure the inducements are clearly disclosed to the customer."[17]

The FPA endorses this approach, particularly with respect to measures which priorities the best interests of the customers and the pro-active requirement to ensure that inducements do not result in consumer detriment. We believe that a mixed strategy of enforcement involving co-regulatory methods to achieve principles-based regulation through cultural change, as well as an enhanced federal regulatory toolkit which target products, product governance, and senior management.

Changing the model

Our view is that lasting change in the life risk sector will be driven by higher professional standards and improving the public perception of the life risk advice service offering. In particular, we aim to drive a competitive, professional, and ultimately a valuable service to Australian consumer through a separation of life risk advice from life risk products.

The FPA's own research in 2009 (at the time of developing the FPA's remuneration policy) did not identify churning or commissions as a substantial barrier to improved pricing. Instead, the general view of our members is that the more significant barrier to efficient process and pricing lies in an improved underwriting process and an improved claims management and client support system, especially as cost of claims support is at risk from pressure on commission models of payment.

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[14] Above n 10 at s 44
[15] Above n 10 at s 46
[16] European Insurance and Occupational Pensions Authority, 'Technical Advice on Conflicts of Interest in direct and intermediated sales of insurance-based investment products' (January 2015) pp 13-16
[17] EIOPA, above n 16 at pp 15-16

The form of regulation proposed in the FSI Final Report would only serve to inappropriately benefit the life insurance providers and potentially push more Australians away from life insurance coverage due to the failure of addressing the real structural issues within the industry. Premiums are increasing, products remain complex and misunderstood and Australians are still underinsured.

The FPA believes that remuneration for insurance work should be compensated commensurate to when the work is undertaken in an open and transparent manner. Given that most of the work involved in putting insurance policies in place through a SOA and underwriting is in the establishment phase this would preclude support for a flat or level commission structure.

The following principles should be adopted in developing reform to the life insurance advice sector:

1. **Ban other forms of Conflicted Remuneration:** Volume-based payments, rebates, profit sharing and shelf space fees should be banned. This was not addressed in FoFA and should be rectified.

2. **Open Approved Product Lists (APL):** Remove heavily restricted approved products list. Life risk products should be competitive on the basis of their suitability to the client and financial planners should be supported in meeting their best interest duty.

3. **Consumer benefit:** Life insurance companies should be required to pass on savings in the form of premium reductions and sustainable premium pricing structures across all channels including retail, group and direct.

4. **Funding models:** Notwithstanding the form that remuneration may take, professional life risk advice should be provided using remuneration models that are affordable, transparent, and sustainable. Financial planners should be supported through better product design that caters for different funding models that can be offered to clients.

5. **Stronger and smarted enforcement:** The regulator should work better with industry to monitor and enforce poor life insurance advice practices and do not meet the best interest duty. A system should be established where life insurance companies are required to provide a list of financial advisers that have replaced insurance policies to the regulator for review.

Recommendation 2:

The FPA recommends that government does not accept the FSI recommendation 24 in regards to life insurance.

3.2 – Complex products

The FPA is encouraged that the Murray Report includes several recommendations which address the risks which complex financial products bring to the Australian financial system and the users of that system. In particular, we are encouraged that product intervention powers and product issuer regulations have been recommended in the Murray Report.

In our first-round submission to the Financial System Inquiry, we identified several risks that follow from the issuance and distribution of complex products in the Australian financial services system:

- "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."[18]

In combination with measures to improve the accessibility of financial advice and improve the civil penalty regime to better target individuals in senior management, we believe that the Murray Report's proposed improvements to the regulatory toolkit would be a beneficial step forward for the Australian financial system. This submission expands on product intervention powers and product issuer regulation in sections 3.3 and 6.1, suffice to say that we support those recommendations.

Our only further recommendation specifically directed towards complex products is that, after the implementation of product intervention powers and product issuer obligations, ASIC guidance and further reports on complex products should incorporate commentary on the use and effectiveness of these regulatory tools.

Recommendation 3:

The FPA recommends that the use and effectiveness of product issuer regulation and product intervention powers should form a key aspect of ASIC's future reporting and/or guidance on the regulation of complex financial products.

3.3 – Suitability regulation

The FPA supports the implementation of suitability regulation through a targeted and principles-based product design and distribution obligation. In our view, product issuers are key gatekeepers in the Australian financial system, and decisions made by these financial intermediaries have significant consequences for the end users of the financial services system.

Suitability regulation with respect to financial product manufacture and distribution requires financial intermediaries to form judgements about the financial capability of the clients they serve. In other jurisdictions, the term 'financial product governance' constitutes similar regulations and professional obligations with respect to the manufacture and distribution of financial products.

[18] FPA, above n 1 at p 21

These obligations may require financial intermediaries who produce and distribute financial products to tailor their disclosure obligations to the needs of their intended client. These regulations may also require these intermediaries to reasonably adjust the scope of their professional obligations to those needs as well.

Our second-round FSI submission made the following recommendation:

> **Recommendation 16:**
> The Final Report should review whether the existing product licencing conditions are sufficient to regulate the conduct of product issuers. If the Panel are of the view that these conditions are insufficient, the Report should recommend that statutory duties to the consumer and/or to protect the stability and transparency of the Australian financial system should be implemented.

Following from that position, in our second-round submission we wrote that:

> "[I]t is difficult to argue that product issuers would be able to understand and cater to consumer demand in a market without having a general sense of what the consumer's interests might be. However, there should be a clear distinction between a guarantee of the suitability and effectiveness of the product for an individual, and a guarantee that minimum standards of conduct and design apply to the product, and has been designed for consumers with particular needs in mind. Commercial realities will rarely admit black-and-white distinctions, but professional judgment can and should be applied in the relevant circumstances."[19]

We are broadly in support of regulations which enhance the role of financial product governance arrangements in Australia. The FSI Final report explains the role of these obligations at three stages:

- "**During product design**, product issuers should identify target and non-target markets, taking into account the product's intended risk/return profile and other characteristics. Where the nature of the product warrants it, issuers should stress-test the product to assess how consumers may be affected in different circumstances. They should also consumer-test products to make key features clear and easy to understand.

- **During the product distribution process**, issuers should agree with distributors on how a product should be distributed to consumers. Where applicable, distributors should have controls in place to act in accordance with the issuer's expectations for distribution to target markets.

- **After the sale of a product**, the issuer and distributor should periodically review whether the product still meets the needs of the target market and whether its risk profile is consistent with its distribution. The results of this review should inform future product

[19] Financial Planning Association, 'Financial System Inquiry: Second-round submission', p 24

design and distribution processes. This kind of review would not be required for closed products."[20]

We note that similar practices exist in the European Union but are more comprehensive than the Murray Report's recommendation. Following from the European Securities and Markets Authority's (ESMA) report into Structured Retail Products published in July 2013, ESMA published an Opinion on good practices for product governance arrangements for these products.[21] This Opinion indicates that the manufacture of Structured Retail Products (as well as their distribution to investors) ought to be accompanied by product governance arrangements on the following matters:

a. general organisation of product governance arrangements;
b. product design;
c. product testing;
d. target market;
e. distribution strategy;
f. value at the date of issuance and transparency of costs;
g. secondary market and redemption;
h. review process[22]

Each of these matters is a principles-based obligation, and is explained in significant yet practical level of detail in that Opinion. ASIC ought to adopt a similar approach when issuing guidance and reporting on product design and distribution obligations.

Following from this, ESMA published its Final Report and Technical advice on MiFID II and MiFIR in December 2014, which provides detailed principles for financial product governance.[23] The Technical Advice requires product issuers and product distributors to consider a variety of factors before producing and distributing financial products, including:

- That product design and product distribution methods comply with proper conflicts of interest management (including remuneration), and that the product design and features do not pose risks to consumers or market stability.[24]
- Competency and training requirements so that the staff of product issuer firms understand the products which they manufacture.[25]
- Continuing review of product governance arrangements in order to detect any risk of non-compliance after the point of issuance.[26]
- Identification of the product's target market in sufficiently granular detail, and tailoring of the product to that target market.[27]

[20] FSI, above n 2 at p 198
[21] European Securities and Markets Association, *'Structured Retail Products – Good practices for product governance arrangements'* (March 2014)
[22] ESMA, above n 21 at p 4
[23] European Securities and Markets Authority, 'Final Report: ESMA's Technical Advice to the Commission on MiFID II and MIFIR' (December 2014).
[24] ESMA, Final Report at n 23, pp 55-56
[25] ESMA, Final Report at n 23, p 56
[26] ESMA, Final Report at n 23, p 56
[27] ESMA, Final Report at n 23, pp 56-57

- Undertaking scenario analyses of products.[28]

The FPA endorses these forms of product suitability requirements and financial product governance arrangements, and we also endorse the ESMA Technical Advice in so far as it applies to suitability regulation and financial product governance.

Recommendation 4:

The FPA recommends that the Government adopt recommendation 21 of the Financial System Inquiry Final Report. Product design and distribution obligations implemented in Australia should be informed by international experience in suitability regulation and financial product governance.

[28] ESMA, Final Report at n 23, p 57

4 – SUPERANNUATION AND RETIREMENT INCOMES

4.1 – Objectives of the superannuation system

The FPA supports the establishment of broad political objectives for the superannuation system, as we recognise the Australian financial system as inherently political and social in nature. This is particularly true of the superannuation system, which has direct impacts on the quality of life that older Australians experience.

Building public trust in superannuation

Australia's superannuation policy settings are a reflection of far more than budgetary concerns with the Age Pension, or the tax concessions afforded at various stages of the superannuation cycle; it is a political and social statement about the standard of living which Australians can expect in their final years, as well as the means by which Australians agree to maintain that standard of living.

Part of the project of building a successful retirement income system for Australians, and integrating that system into the Australian financial services system, is to engender public confidence in the efficiency, resilience, and fairness of that system. Another critical part of this project is to encourage public confidence that the various financial intermediaries which interact with the financial system to produce results for the end users of the system (i.e. members of superannuation funds in this case).

The FPA believes that the particular objectives enshrined in the FSI Final Report are laudable goals for the Australian superannuation system, and for the most part the FPA endorses their content. We are concerned about the predominance of financial product solutions to problems in the superannuation system which can better be solved through financial advice once the superannuation system has reached a mature stage. This submission expands on our objection to product-focused policy settings below.[29]

The FPA also endorses the view that superannuation funds should not be diverted to infrastructure funding and other projects for which the use of superannuation assets is tempting but not justified by the sole purpose test. Any benefit to the Australian economy – whether the benefit is directed to the real economy or not – should be incidental to the functioning of the Australian superannuation system. However, a serious and rapid review of policy settings would be required if the Australian superannuation system (or a part of that system) were to function to the detriment of the real economy.

It is important to note that engendering public trust in the Australian superannuation system relies not only on the superannuation system itself, but improving trust in the various other aspects of the financial system with which the superannuation system operates. For example, building public confidence in the efficacy of the superannuation system as a retirement income strategy involves building public confidence in the financial planning profession, whereas building public confidence in

[29] See sections 4.3 and 5.2 of this submission

the legitimacy of direct leverage inside superannuation requires public trust in the credit and accounting sectors at a minimum.

Statutory oversight body for superannuation

Our concern with the approach taken in the FSI final report is that the recommendation does not include a vision for how to promote these objectives as the cultural and ethical framework of the Australian superannuation system. Enshrining these goals in legislation will not necessarily bind Governments, federal regulatory bodies, or financial intermediaries who operate in this space. Legislation can be changed, and principles-based legislation which lacks a concerted effort to embody the principles on a structural level – including regulatory strategies for guidance and enforcement – simply will not succeed in solving the policy issues at stake.

In our view, these objectives require the political will to build social, political, and economic institutions on a non-partisan basis. At a minimum, establishing an independent statutory body to monitor and implement these objectives would be a worthwhile result of the Financial System Inquiry. This statutory body would provide advice to the Government and make recommendations around policy settings. However, this body's work will be hotly contested on a partisan basis, especially if that body's work extends to recommendations to federal regulatory agencies.

However, an alternative is to establish or co-opt a body like the Corporations and Markets Advisory Committee to provide this advice to Government. The FPA is aware that the current Government has introduced legislation to the federal parliament to abolish the CAMAC. Without commenting on the long-term implications of abolishing this body, the CAMAC has provided excellent non-partisan advice to the Government on highly complicated financial sector issues. A similar body could evaluate existing and proposed policy settings against the enshrined objectives of the superannuation system.

There are also questions about how these objectives will inform more granular processes, such as the sole purpose test. However, our view is that the objectives are to be aligned with the systemic processes, and inform the actions of trustees through regulators, professional bodies, and other entities acknowledging and endorsing those objectives through their actions and guidance.

Superannuation and social security

It is important to recognise that the three pillars of Australia's retirement income strategy – voluntary savings, compulsory superannuation, and the Age Pension – are all fundamentally tied to each other and to the inherent values of the system itself. Changes to the superannuation system will affect how individuals make decisions with respect to their voluntary savings as well as their access to the Age pension.

The interaction between compulsory savings and the Age Pension is quite complicated based on our current policy settings, primarily as a result of two factors; the current means testing settings for Age Pension eligibility, and the tax implications of holding assets inside superannuation in the pension phase.

A more ambitious project than that attempted by the Financial System Inquiry's Final Report would be to align the goals and operation of the Australian retirement income strategy, with a view to non-partisan political support for a minimum standard of living for Australian retirees. At a minimum, policy settings for the Age Pension and the superannuation system should be aligned to produce efficient, sustainable, and equitable retirement outcomes for Australians.

Recommendation 5:

The FPA recommends that, should the appropriate mechanisms to bind the Superannuation system to overarching objectives be implemented, the FSI Final Report recommendations regarding the objectives of the superannuation system should be implemented to the extent that these recommendations do not endorse particular financial products or classes of financial products.

Building an equitable superannuation system

Part of the crisis of trust in the Australian superannuation system stems from the public perception that, while many rely on the retirement income system for an income in retirement, others use the superannuation system as a favourable tax structure.

The FPA believes there is some truth to this perception, and we understand why many in the Australian public would be sceptical of a system which affords generous tax concessions to those who are sophisticated and/or wealthy enough to take advantage of them. We are also concerned with the public perception of the Australian superannuation system as a mechanism for facilitating intergenerational transfers of wealth outside of the Australian taxation system.

To better align the Australian superannuation system with the proposed objectives of the system, political consensus on a minimum retirement standard for Australians must be achieved.

Recommendation 6:

The FPA recommends that the Government establishes an Australian minimum retirement standard which the efficacy, resilience, and fairness of voluntary savings, compulsory superannuation, and the Age Pension can be evaluated against. This standard should be robust to aged care needs and changing healthcare needs.

4.2 – Leverage in superannuation

Recommendation 8 of the FSI Final Report stated that the Government should:

> Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds

The FPA does not support this recommendation. We encourage the Government and the Treasury to adopt a measured, evidence-based approach to the potential systemic and individual risks associated with leverage in superannuation.

Recommendation 8 of the Final Report

In our view, the FSI Final Report has not offered sufficient justification for the banning of direct borrowing by superannuation funds as called for by recommendation 8. The Report identified several risks associated with the growth of direct borrowing by superannuation funds:[30]

- **Insufficient ring-fencing of leveraged assets:** Limited recourse borrowing arrangements do not adequately limit potential losses to one asset in the fund as a result of the operation of personal guarantees and other covenants on the loan. As such, where there is a dramatic reduction in the value of the asset, trustees are likely to sell other assets of the fund to repay a lender.

- **Budgetary concerns:** Borrowing within super creates systemic risks that, if they eventuate, are underwritten by taxpayers through the Age Pension.

- **Insufficient diversification:** Superannuation funds which use leverage are more likely to be less diversified, thus increasing the risk of the portfolio generally.

- **Mitigating systemic risk:** The absence of leverage in the superannuation system during the GFC allowed the superannuation system to have a stabilising influence on the broader financial system and the economy. By introducing more debt into the superannuation system, we increase the systemic risk for the entire Australian financial system, and introduce systemic risk to retirement income savings.

- **Contribution caps:** Borrowing by superannuation funds allows them to circumvent concession caps and accrue larger assets in the superannuation system.

We acknowledge that there are risks associated with leverage in superannuation, and that these risks are connected to each other and can be exacerbated by each other. However, to justify an outright ban on direct leverage through Limited Recourse Borrowing Arrangements, we believe that more evidence is required. In particular, the Report did not give clear information regarding the seriousness of the potential harm to individuals, the financial sector, and the financial system; the extent to which these vulnerabilities pose systemic risks; or the likelihood of these risks eventuating.

We also hold doubts about whether some of the conclusions of the Murray Report are reasonable given the evidence cited in the Report. For example, the majority of the five submissions which the Report cites to support its recommendation do not directly support recommendation 8, notwithstanding the evidence and arguments contained in those submissions. Instead, they consider alternatives to an outright ban, such as limited prudential regulation (e.g. caps on borrowing, minimum diversification standards) and encouraging the existing self-regulation and co-regulation of lender conduct. Of the

[30] FSI, above n 2 at p 87

submissions referred to in the Final Report, only the APRA second-round submission unequivocally recommends a ban on direct borrowing in superannuation through LRBAs.

The Report also does not state why the eighteen-fold growth in LRBAs since June 2009 has occurred, neither has it discussed any drivers for this behaviour or whether or not borrowing is likely to increase at that rate in future. It is important to note that LRBAs have only been available to super funds from September 2007, which the Report does not mention.

Furthermore, some of the contentions stated in the Report in support of banning direct leverage in superannuation are questionable given the evidence. For example, the Report cites Rice Warner's second-round submission to the Financial System Inquiry at page 30 as supporting the view that "small funds that borrow are already more likely to have a concentrated asset mix."[31] That submission stated that

> "The use of LRBAs has generally led to a significant concentration of investments within SMSFs. Given average SMSF account balances and median house prices, it is clear that for many SMSFs using LRBAs, the underlying property represents a significant proportion of fund assets."

Yet in 2013 LRBAs only comprised 3.16% of SMSFs with an asset value of $200-$500k, 2.57% of those between $500k-$1m, 1.34% of those between $1-2m, and 1.05% of those between $2-5m.[32] It is not self-evident how such a small proportion of the total assets could drive a "significant" concentration of investments in SMSFs. It is also not clear what the asset concentration of funds at these values might have been if the rules on leverage were not relaxed in 2007.

At any rate, the evidence available does not indicate that smaller funds are more likely to have a concentrated asset mix, or that this poses any extra risk with respect to using direct borrowing in superannuation.

FPA membership view

We conducted a small survey of our membership to understand their views on borrowing within superannuation, as well as the use of limited recourse borrowing arrangements and personal guarantees. The result was that a majority (around 65%) of our members supported the legality of limited recourse borrowing arrangements. However, 71% supported the proposition that limited recourse borrowing arrangements should be regulated as a financial product, and 84% of respondents supported the proposition that the use of personal guarantees by lenders on limited recourse borrowing arrangements needed to be stopped.

We also sought more detailed comments from our members, which revealed a substantial minority who view borrowing within SMSFs - and particularly its link to property spruikers and rogue elements

[31] FSI, above n 2 at p 87
[32] Australian Tax Office, *Self-managed superannuation fund statistical report – June 2014 (Asset allocation tables)* (June 2014) < https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Quarterly-reports/Self-managed-super-fund-statistical-report---June-2014/?page=2#Asset_allocation_tables___m_>

in the credit space – as a risk to consumers and to the stability of the system. Many of those who did not support the FSI recommendation stated that they nonetheless wanted tighter regulation of LRBAs and loan-to-value ratios.

Reviewing the existing policy settings

In our view, Recommendation 8 is an overreaction to a loosely defined and poorly understood vulnerability in the Australian superannuation system. Our preferred response to the risks identified in the FSI Final Report is to collect more information about the actual, potential, and perceived risks of direct borrowing in superannuation through LRBAs, as well as to canvas alternative legal and policy solutions to address those risks. Self-regulatory and co-regulatory mechanisms should be considered and constructed to the extent that a self-regulatory and/or a co-regulatory solution are appropriate to the systemic risk and the risk to consumers.

We support the Cooper Review's analysis of the role of leverage in SMSFs, and particularly Principle 8 which states that:[33]

> "Leverage should not be a core focus for SMSFs. While views will differ on this issue, the Panel believes that there is room for leverage in SMSFs, but it should be ancillary to the main strategies employed to build retirement savings over the longer term."

In our view, the operation of leverage in superannuation funds can support building retirement savings over the long term, and may be an appropriate strategy depending on the individual's needs, objectives, and tolerance for risk. Alongside the government's response to the Cooper Review which required extensive data collection from SMSFs, the Review made the following recommendation which spoke directly to understanding and mitigating the risks of direct borrowing within superannuation.[34]

> **Recommendation 8.10**
> The 2007 relaxation of the borrowing provisions and the consumer protection measures that have recently been announced should be reviewed by government in two years' time to ensure that borrowing has not become, and does not look like becoming, a significant focus of superannuation funds.

We recommend that the Government commission this review into leverage within superannuation, with a focus on leverage in SMSFs. Some of the matters that this review should clarify in order to assist the Government and the financial services sector to ensure consumers are protected and to mitigate systemic risk in the superannuation system include:

- What is the current exposure of SMSFs to LRBAs that are not used for short-term liquidity purposes? What is the average and range of LVR for LRBAs in the superannuation sector?
- How much of the systemic risk, and the risk to consumers, stems from the use of SMSF structures notwithstanding the use of leverage?

[33] Super System Review Panel, *Super system review: final report* (July 2010) p 220
[34] Above n 33 at p 242

- How has the financial service sector (and in particular the credit sector) responded to the risks tied to leverage inside superannuation?
- To what extent are personal guarantees used in connection with limited recourse borrowing arrangements? To what extent have these personal guarantees circumvented the 'limited recourse' aspect of LRBAs?
- Which users of the Australian superannuation system can benefit the most from allowing leverage inside superannuation through limited recourse borrowing arrangements? Do those users actually use these strategies?
- To what extent is professional advice (including advice from authorised financial planners who are members of a professional association) sought by users of the superannuation system who decide to use a gearing strategy through an LRBA?
- How much regulatory coverage exists over businesses who market gearing strategies in superannuation? To what extent are these businesses horizontally integrated (e.g. one-stop-shops which address tax advice, residential and/or commercial property sales, lending, and marketing)?
- To what extent are unregulated or minimally regulated individuals and businesses involved in recommending strategies which use direct leverage through LRBAs? To what extent are rogue individuals and businesses involved in recommending strategies which use direct leverage through LRBAs?
- Is there a correlation between leverage inside small superannuation funds and asset concentration? If so, are these assets being concentrated towards particular classes of assets?

Once these and other relevant matters are more clearly understood, alternative solutions can also be canvassed to address the specific vulnerabilities stated in the FSI report, further risks identified in the review process, and the risks that emerge from the intersection and culmination of these risks and factors outside of the Australian superannuation sector. Some of those solutions which the review should consider include:

- **Prudential regulation of leverage in SMSFs:** These could include measures such as caps on borrowed amounts relative to the assets in the fund, minimum LVRs, minimum diversification requirements for SMSFs which incorporate direct borrowing through LRBAs, requiring LRBAs to be recommended by a professional regulated under a relevant professional framework, restrictions with respect to retail clients (where retail investor status is assessed on income and assets held *outside* of superannuation), and stricter regulation of personal guarantees in SMSFs.

- **Regulation of SMSFs:** Some form of suitability regulation, or the use of product intervention powers, may be appropriate for the distribution of SMSFs. For example, legislation could be implemented to prevent retail investors from commencing an SMSF without professional advice from a lawyer, accountant, or a financial planner. Incorporating individuals with professional obligations into the process could help to prevent some of the most flagrant violations of the law and business ethics in this space.

- **Self-regulatory and co-regulatory strategies:** There are existing safeguards against the proliferation of unsuitable and unsafe lending to SMSFs. Some are part of the legislation whereas others form part of the financial sector's response to the potential for commercial and reputational

harm. Cross-industry initiatives – especially where they involve professional associations – can be used to set common standards, promote good practice through transparency, and alienate rogue operators in the system.

- **Property as a financial product:** While purchasing real property as an investment has been largely unregulated by the financial services laws and regulatory architecture, a review may find that there is a case for regulating property as a financial product where real property is being purchased within superannuation by retail investors using leverage.

The FPA advocates for evidence-based policy reform in the public interest, and advocates for policy initiatives which promote professionalism. We also advocate for policy initiatives which are responsive to the structure of the Australian financial services sector and incorporate self-regulatory and co-regulatory structures wherever appropriate.

On this basis, our view is that an outright ban on direct leverage in superannuation through limited recourse borrowing arrangements is unwarranted on the evidence currently available. Serious and considered policy-making initiatives ought to be initiated in this space, while the regulators in this space (ASIC and the ATO) should adopt a regulatory strategy that responds to the consumer risk in the interim. A ban on direct leverage in superannuation through LRBAs should only be adopted if these strategies and arrangements pose a significant consumer risk and systemic risk that cannot be mitigated through other methods.

Recommendation 7:

The FPA recommends that the Government not support Recommendation 8 of the Final Report, and instead commission a comprehensive review of leverage inside superannuation and to be completed by 2017. On the basis of this review, targeted measures should be proposed, considered, and adopted where appropriate to address the specific risks identified by that review and by the FSI Final Report.

Immediate avenues for reform

Notwithstanding the need for a comprehensive review of borrowing in SMSFs, there are several avenues for reform which could be addressed in the short term:

- **Single acquirable asset rule**: Section 67A of the Superannuation Industry (Supervision) Act states that Regulated Superannuation Funds may only borrow money for the acquisition of a "single acquirable asset". This rule has functioned to significantly limit using geared investment in an appropriate, diversified manner. The Treasury should consider the continuing justification for this rule.

- **LRBAs as a financial product**: Since 1 January 2010, margin lending facilities have been considered financial products for the purposes of financial services regulation. The FPA is of the view that there is a case for considering LRBAs as financial products for broadly similar policy

reasons. In our view poor advice (or no advice) on whether or not to use an LRBA poses a similar systemic risks, and risks to individuals, as margin lending facilities for investment.

- **Cross-insurance and risk management**: From 1 July 2014, regulation 4.07D(2) of the Superannuation Industry (Supervision) Regulations states that:

  > A trustee of a regulated superannuation fund must not provide an insured benefit in relation to a member of the fund unless the insured event is consistent with a condition of release specified in item 102, 102A, 103 or 109 of Schedule 1.

  The ATO's view is that this regulation prevents insurance being held on a cross-insurance basis.[35] This, and other impediments to appropriate risk management in the fund, should be reviewed.

- **Limited recourse in LRBAs (personal guarantees)**: As a priority, existing practices requiring personal guarantees for superannuation assets acquired using LRBAs should be reviewed for their consistency with 67A of the Superannuation Industry (Supervision) Act.

- **Ban on related party LRBAs**: Our view is that the self-regulatory arrangements in the credit space are an effective (but not sufficient) measure against the abuse of LRBAs. However, these arrangements do not apply to related party loans to SMSFs. The ATO has released data which shows that compliance breaches in relation to LRBAs commonly (if not exclusively) arise from related party loans to SMSFs. As such, related party lending in the SMSF space poses a significant risk to retail investors and, to a lesser extent, a systemic risk.

Recommendation 8:

The FPA recommends that the following policy settings and industry practices should be reviewed as a matter of urgency in order to prevent detriment to users of the superannuation system:

- The **single acquirable asset rule**.
- The **limited regulation of LRBAs as an investment product**.
- The ban on **cross insurance** in superannuation, and other impediments to **appropriate risk management** in SMSFs.
- The use of **personal guarantees in connection with LRBAs**.
- The use of **related party** and **non-arms length borrowing**.

4.3 – Retirement income and longevity risk

The FPA is concerned that the public discussion on longevity risk is unduly focused on solutions which are product-centric rather than holistic and focused on outcomes for the end users of the financial system. We are also concerned that the discussion around the role of private longevity risk insurance

[35] Australian Taxation Office, *'Self-managed super funds: Questions and answers"* (February 2015) < https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/News/Questions-and-answers/?page=1#Can_an_SMSF_take_out_insurance_on_a_cross_insurance_basis_>

is being conducted without a serious consideration of the efficacy, equity, and sustainability of public longevity risk insurance.

Regulatory and tax settings

In our view, there are some regulatory settings which interfere with some longevity risk solutions based on product, but there are issues in policy and in the market which are far greater impediments to a flourishing market for private longevity risk insurance.

The existing tax-free environment for income generated by pension products in the pension stage has caused significant difficulties for the government and the private sector. This creates potentially conflicting objectives for financial advisers where the most effective advice for providing a consistent retirement income that is protected against longevity risk may be different to the most tax-effective solution.

In part, the difficulties that stem from the tax-free pension phase are connected to the conflicting purposes of the superannuation system. The stated objectives of the client with respect to their superannuation assets and retirement outcomes complicate the issue further. If the superannuation system is designed to compel individuals to adopt a retirement income strategy, then the adviser has a justification for recommending products and strategies with respect to superannuation assets which are less optimal from a tax perspective but offer a secure retirement income strategy. The ability to prepare retirement income strategies which are designed to deliver a tax-effective benefit to beneficiaries potentially conflicts with the intended purpose of the superannuation system.

Public versus private longevity risk insurance

The FPA believes that weak consumer demand for longevity risk products significantly reduces the availability of relevant and appropriate products. This is partly due to the effectiveness of account-based pensions and financial advice, but also due to the function of the Age Pension as a form of public longevity insurance.

However, we recognise that more Australians are concerned about whether their retirement savings will be sufficient. Research conducted by Investment Trends indicates that 34% of Australians surveyed were concerned about not having enough money to retire on.[36] This is an increase of over 6% from 2013. Additionally, 23% of those surveyed were concerned about their retirement savings running out. The demand for financial security, if not longevity risk products, is certainly going to increase as a result.

Financial planners who advise on retirement strategy will maximise their client's access to the age pension if possible, and this usually involves structuring the client's superannuation assets in order to be tax-effective and to be exempt from social security asset tests. As long as these strategies remain useful for clients, it will be difficult to justify specific longevity risk products in many cases.

[36] Investment Trends, 'FPA Member Satisfaction Report' (December 2014)

The FSI Final Report includes high-level policy discussion regarding mandatory, default, and pre-selected products for the pension phase of retirement. The FPA strongly disagrees with policy settings that prescribe a mandatory or default product for the pension phase. In our second-round submission to the FSI, we stated that:

> "If policy incentives, default options for retirement benefits, and/or mandatory retirement income products are implemented by the Australian government, then Australians can spend their entire lives completely disengaged from the privatised retirement income system in Australia. It is possible to make the economic case for an efficient retirement system which provides identical (or even superior) outcomes for entirely disengaged consumers. The political, social, and cultural consequences of discouraging financial citizenship in favour of technocratic administration make these policy options unfair to Australians and corrosive to our values."[37]

In our view the "pre-selection" of a retirement income product is a de-facto default product offering, and the availability and affordability of advice (both intra-fund advice and personal advice outside of superannuation) is a far preferable solution.

We also made the recommendation that "…any changes to superannuation policy settings in the pension phase in relation to longevity risk must articulate the interaction of that policy with the age pension." So far, neither the FSI Final Report nor any other Government consultation in recent times has been able to articulate how this interaction should operate.

Strategic advice in retirement

As stated above, the FPA is concerned that the FSI Final Report is too product-focused in its analysis of issues regarding retirement income. We are particularly concerned that the Murray Report implies that the financial services sector, the academic establishment, and/or the Government are of the view that professional financial advice from a qualified financial planning professional would fail to consider their client's longevity risk. This perception certainly runs counter to the established practice of financial planners who address their clients' risk in other aspects of their lives.

The reality is that the best practice of financial planning professionals frequently encounters issues around retirement planning, estate planning, aged care, and other matters which are impossible to adequately address without considering the client's longevity risk. For example, financial planners will frequently seek to mitigate this risk by implementing account-based pensions which incorporate the Age Pension as a longevity risk management strategy.

Our research indicates that over two million Australians have an unmet advice need with respect to retirement planning.[38] In our view, a more pressing issue in this space is not the availability of financial products to manage longevity risk, it is that so many Australians face retirement without a retirement plan implemented through professional financial advice.

[37] Financial Planning Association of Australia, *Financial System Inquiry: Second round submission* (August 2014) p10
[38] Investment Trends, 'FPA Member Satisfaction Report' (December 2014)

In our view, the focus on financial products as a solution to longevity risk demonstrates a lack of commitment to Australia's three pillar policy. The three pillars framework should be sufficient to meet the needs of all Australians who are faced with retirement decisions. Financial advice should be available to Australians in order for them to understand this system, and how their personal circumstances fit within the system.

Recommendation 9:

The FPA recommends that the Government not adopt recommendation 11 of the Financial System Inquiry Final Report without arriving at a comprehensive framework for the roles and interaction of public and private longevity risk management products, as well as a strategy to improve access to professional financial advice at retirement.

4.4 – Default superannuation market

The FSI Final Report made significant claims about the efficiency of the default superannuation market, and criticised the comparatively high fees of the Australian system. While the FPA is generally non-partisan on the question of whether the current market for default superannuation funds is competitive, our view is that the MySuper reforms have not yet been given sufficient time to mature. The costs associated with that transition continue to flow to consumers, and fees will decrease in line with the time required to recover those costs.

However, we are conscious that fees are not the only relevant measure by which the default superannuation market ought to be judged, unless all MySuper products offer equivalent risks, performance, and features. In our second-round submission to the Financial System Inquiry, we argued that:

> "If different MySuper products offer materially better or worse performance for materially similar risk (either for a particular individual, class of persons, or generally), then fee competition is not the only viable form of competition in the default superannuation space. If they offer materially similar performance for materially similar risk, then fee competition should be encouraged.
>
> If we accept that MySuper is an appropriate minimum standard of service for a default superannuation product, then measures which aim to improve fee competition in the default superannuation market must not detract from that standard. Facilitating fee competition will involve a review of how individuals elect to use a default superannuation fund, how that fund is chosen, and whether or not there is any value to the individual for having one default product over a different product beyond fee competition."[39]

Our support for an auction system, or a tender-based system, for the default superannuation market is dependent upon the veracity of the view that MySuper is a desirable minimum standard for default superannuation products. If the consensus amongst the political establishment and financial services

[39] FPA above n 19 at p 5

sector is that any product which met the MySuper minimum standards will provide an acceptable volume of savings at retirement for any Australian, then competition which encourages a race to the bottom is acceptable.

However, there is evidence to suggest that different MySuper products differ in performance, fees, and features enough to justify competition between funds on factors other than fees. In the Australian market, there is a degree of tailoring to the needs and circumstances of members of funds even in the default superannuation market.[40]

This can be attributed generally to the prevalence of industry funds, corporate funds, and public sector funds. These funds are more closely aligned with the needs and circumstances of their particular members as a result of being aligned with a particular industry or sector. This uniquely Australian approach has demonstrated value for Australians, and may well be worth the additional fee. An auction or tender system would almost certainly disrupt this market, making even the limited tailoring in default MySuper products (and the services attached to the product and fund) impossible to deliver.

The FPA believes that the FSI Report has approached the perceived problem of inefficiency in the default superannuation market in the wrong way. The current default system provides competition between two kinds of default funds; those which are tailored in a limited manner to the needs, circumstances, and objectives of the members of those funds where those members can be identified loosely as a group, and those funds which are not tailored and are offered to retail investors generally through their employer. The agent who participates in the market is almost always the employer and not the employee, i.e. not the direct beneficiary of the agent's decision.

The attendant problem of misselling default superannuation products with higher fees and fewer services than competitors to retail clients is a basic agency problem relating to the misalignment of the interests of end users and financial intermediaries. This is particularly the case in non-unionised sectors and small business, where existing business relationships can be leveraged at the expense of the employee's retirement income savings.

This basic agency problem could be enhanced by requiring the employer to choose a default superannuation fund on the basis of their employees' needs, circumstances, and objectives, but employers are generally not equipped to understand these matters or to act on their understanding of these matters. Limited tailoring does serve to align these interests to an extent. However, regardless of the behaviour of financial intermediaries or employers who participate in the market, the competition model does not facilitate the benefits of efficiency flowing to the *members*, only to employers.

In our view, the ideal market would function to facilitate efficient and fair decisions about whether an individual would be better served by a default fund with limited tailoring, or a default fund without. The market would then determine which fund provided either the most appropriate services, risk, fees, and performance for those in the former category, or the cheapest fund *for the employee* which still complies with the MySuper rules for those in the latter category. The current Fair Work system serves

[40] Adam But et al, 'MySuper: A Stage in an Evolutionary Process' (2014) Working Paper 048/2014

this to some extent, but relies upon whether or not the individual is covered by a federal award and is generally perceived to favour industry funds over retail funds for inclusion in the award.

Recommendation 10:

The FPA recommends that the Government should allow the MySuper reforms to mature, having regard to the impact of increased competition on fees, risk, service offering, and performance.

5 – FINANCIAL ADVICE

5.1 – Separation of financial advice and product information

The FPA has consistently called for the separation of financial advice from financial product marketing and product information. We are encouraged that the Financial System Inquiry Final Report has adopted this position through recommendation 40, and we urge the Government to implement this recommendation in full.

The FPA notes that the Parliamentary Joint Committee on Corporations and Financial Services came to a similar conclusion on this issue, and made the recommendation that the term 'general advice' should be replaced with 'product sales information', and the term 'personal advice' replaced with 'financial advice.'

We also note that there is presently a Private Member's Bill[41] which has been referred to inquiry stage in the Australian Senate that would amend the Corporations Act to provide that the term 'advice' only be used where the service takes into account the needs, objectives, and circumstances of the client. That Bill would also amend the Act to change the current term 'general advice' to 'general information', and amend what is known as the "general advice warning" to reflect the change in term. While we have some reservations about the impact of this Bill outside of the regulation and provision of financial planning services, we are supportive of its broad intent.

Our arguments in support of this recommendation have been consistent across a series of inquiries, both independent and organised by the Government. The FPA is of the view that general advice poses a significant risk to users of the financial system where they do not have the financial capability to determine if they are receiving a financial advice service, or are receiving financial product information. In our submissions to the Financial System Inquiry, we wrote that:

> "Framing general advice as financial 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."[42]

Research conducted by ASIC on complex financial products and the behaviour of Australian consumers has confirmed that:

> "[M]arketing 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

[41] Corporations Amendment (Financial Advice) Bill 2014 (Cth)
[42] FPA, above n 19 at, p 15

> 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."[43]

Australians who interact with the financial system are already often at a disadvantage in terms of their financial capability and financial literacy. They also have to confront the significant behavioural biases which affect individuals who make decisions under uncertainty. The FPA is of the view that consumers should not also have to contend with uncertainty around the services that they are being provided. Financial advice should always require that the advice addresses the needs, objectives, and circumstances of the client, it should always be in the best interests of the client, and should always prioritise the interests of that client over the interests of the advice provider and related entities.

Recommendation 11:

The FPA recommends that the Government should amend the Corporations Act to change the term 'general advice' to 'general information', and also recommend that the terms 'financial advice' and 'financial product advice' should only apply to personal advice as defined by the Corporations Act.

5.2 – Separation of financial advice and financial products

The FPA has been broadly supportive of the systemic dismantling of conflicted remuneration structures in the financial advice sector. These changes have improved the professionalism of the sector, and the future of financial advice is one where the interests of professional financial planners and the users of financial planning services are aligned. The FPA has consistently argued for further structural separation between the financial advice profession and other structures in the financial services sector.

Current policy initiatives endorsed by the Government and professional associations in the financial sector are set to improve minimum standards in financial advice. This includes minimum education, professional, and ethical standards of all individuals and financial advice practices who are authorised to provide personal financial advice on investment, superannuation, life risk, and other non-basic financial products.

The next most important driver of change towards that goal, after improving the minimum standards of education, professionalism, and ethics for financial planners, is the separation of financial advice from financial product distribution. The Future of Financial Advice reforms have driven some of that change by requiring remuneration structures that are driven by the service and value to the client, but further cultural change needs to be driven through changes to legislation and policy.

It is our view that a legislative and policy program for the separation of product and advice will disrupt the norms and values promoting product-centric service offerings, and establish norms and values which promote client-centric service offerings.

Proposals for a SoPA reform programme

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[43] Australian Securities and Investments Commission, *'Report 384 – Regulating Complex Products* ' (January 2014), at [46]

The current definition of personal advice in the Corporations Act is fundamentally tied to financial products. The structure relies on;

- conduct which is intended to influence to a person to make a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products, or conduct which reasonably could be regarded as having that influence;[44]
- that the provider of the advice has considered (or could reasonably be expected to have considered) one or more of the person's objectives, financial situation and needs.

Where the advice provider provides financial product advice but has not considered, or could not reasonably be expected to have considered, one or more of the person's objectives, financial situation, and needs, that financial product advice is considered general advice.

Our consistent policy position has been that the term "financial advice" needs to be separated from the definition of financial product in the Corporations Act. The regulatory system needs to be more fluid and better adapted to the circumstances of Australians than to limit the scope of financial advice to financial product. The definition also promotes a culture of product-centric financial advice, as compliance systems and training are all centred around how to meet obligations around product recommendations.

In our submission to the inquiry into proposals to lift the professional, ethical and education standards in the financial services industry, we recommended a broad, principles-based approach to the definition. Our proposed definition of personal advice was as follows:

> "Any recommendation made personally to a consumer on which that consumer could reasonably be expected to act in relation to an investment or financial decision, including but not limited to, any recommendations relating to shares, debentures, collective investments, futures or options contracts, life insurance, superannuation, property or other financial instruments, transactions or investments."[45]

This definition would function to separate, as far as the Corporations Act is concerned, the link between financial advice and financial products. However, the risk is that it remains too product-centric to produce meaningful change in the profession and will allow product-centric personal advice to continue without an effective change in reference. It also consists of a considerable departure from the language of the Corporations Act.

An alternative is to use a definition that incorporates existing terms in the Corporations Act. An example of this approach is:

[44] Corporations Act 2001 (Cth) s 766B
[45] Financial Planning Association of Australia, *'FPA submission to: Parliamentary Joint Committee on Corporations and Financial Services'* (September 2014) p 53

> For the purposes of this Chapter, financial advice is conduct which is intended to influence a person to make a decision to do one or more of the following;
>
> (a) make a financial investment
> (b) manage financial risk
> (c) make non-cash payments
>
> or conduct which reasonably could be regarded as having that influence

For further clarity, the definition could incorporate the language of "financial "decision", "financial strategy", "financial plan" and terms of like import. If the Government is concerned that conduct between private individuals could be covered by this definition, guidance and legislative provisions specifying the payment of a fee or a subsidy of an existing service could be incorporated. Selective enforcement could also play a role.

Recommendation 12:

The FPA recommends that the Government should commission the Treasury to review the legislative provisions which connect financial advice and financial products, and consult with industry on drafting alternative provisions which sever the legislative connection between product and advice.

5.3 – Protecting the term "financial planner"

One of the matters which was not directly addressed by the FSI Final Report was the need to enshrine the terms "financial planner" and "financial adviser" in the legislation. In our second-round submission to the Final Report, we made the following recommendation:

> **Recommendation 11:**
> The FSI panel should recommend the term financial planner/adviser is restricted under the Corporations Act to those individuals who are members of an ASIC approved/recognised professional body.

This recommendation has received support from the Parliamentary Joint Committee on Corporations and Financial Services. The Committee's inquiry into proposals to lift the professional, ethical and education standards in the financial services industry recommended that the term 'financial planner' and 'financial adviser' should be enshrined in the Corporations Act, and that only individuals registered as a financial adviser can use these titles

Our view is that these terms need to be enshrined in the Corporations Act on the grounds that only qualified, registered professionals should be legally permitted to provide financial advice in Australia. In our second-round submission, we stated that:

> There is a high level of confusion in the market, and within industry, media, Government and consumers, about who is qualified to provide financial advice in Australia. The current market for financial advice can include financial planners, financial advisers, financial product salespersons, unlicensed rogue operators, and those who misrepresent their products and services as financial advice and/or financial products. Some incorrectly represent themselves to consumers as financial planners without the appropriate, training, licensing, and professional standing and competency required. This significantly erodes consumer protection. The lack of constraint on individuals calling themselves financial planners puts consumers at risk of receiving poor advice from incompetent providers and creates confusion for consumers.
>
> The term financial planner is also increasingly being used in marketing and promotional material by persons who provide non-traditional ancillary services, such as realtors, stockbrokers, life insurance agents or brokers, mortgage brokers, property brokers, sales agents of various investment vehicles, accountants, and unlicensed individuals.[46]

The FPA has been a powerful advocate for the professionalisation of financial planning, and through our CFP program and Code of Professional Practice we have laid the ethical and professional framework for professionalism in Australian financial planning. Our view is that the legal protection of the terms “financial planner” and “financial adviser” is one of the next critical steps in the progress of the financial planning profession.

Certification for financial planners

The FPA’s view is that financial planners ought to hold a Practicing Certificate from a recognised professional association. The certification earned by a professional society provides evidence of acquired and continued learning, demonstrating an impartial third-party endorsement of an individual’s professional knowledge and experience.[47]

This is a practice followed by the Financial Conduct Authority (FCA) in the UK which requires financial planners and financial advisers to make an annual declaration that they are meeting standards and as evidence, hold a Statement of Professional Standing (SPS) from an accredited body.

A requirement of a recognised professional body should be to issue Practicing Certificates to members who meet the new education standards and adhere to its professional and ethical obligations, including ongoing CPD. Meeting these requirements and receiving a Practicing Certificate from a recognised professional body permits the individual to use the title financial planner or financial adviser.

Individuals who do not hold a current Practicing Certificate should not be allowed to use these titles.

[46] FPA, second round sub p 17
[47] P.A. Barnhart, *The Guide to National Professional Certification Programs* (HRD Press Inc. 1997)

Recommendation 13:

The FPA recommends that the Government should amend the Corporations Act to provide that the titles of "financial planner" and "financial adviser" will only be permitted to be used by individuals holding a Practicing Certificate as a member of a recognised professional body.

5.4 – Retail and sophisticated investor definitions

The FPA strongly supports a review into the definitions of retail, sophisticated, and wholesale investors. While the FSI Final Report did not address this particular point, our first-round submission to the Financial System Inquiry did raise the issue:

> "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."[48]

Our submission also proposed a series of reforms to the foundational legal and regulatory concepts which underpin the definition:

- "Investor/consumer: 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]

[48] FPA, above n 1 at pp 23-24
[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

- Suitability regulation: 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.
- Institutional/individual: 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."[50]

We are disappointed that the FSI Final Report did not address this issue, and we urge the Government to take steps towards a review of the retail, sophisticated, and wholesale investor definitions in the Corporations Act.

Recommendation 13:

The FPA recommends a review of the effectiveness and value of the retail, sophisticated, and wholesale investor definitions in the Corporations Act.

5.5 – Automated advice

The FPA did not raise this issue during the Financial System Inquiry process, nor did the FSI Panel seek to raise it independently. However, the FPA's view is that the advent of online and/or automated advice tools (known in the trade press as "robo-advice") presents as many challenges and risks as it does opportunities.

Automated advice tools can mean a variety of different levels of human interaction and input from an adviser, from wholly automated services to tools which assist advisers with asset allocation and product selection but leave strategic matters to the adviser. It also can mean a variety of different services, from holistic financial planning to advice of a very limited scale. Some of these matters may involve financial product recommendations, and others will focus on strategic advice.

We are also interested in what kind of regulatory regime would apply to automated advice tools. For example, Part 7.7A of the Corporations Act applies to both licensees and representatives of licensees, so a question of ultimate responsibility as between the adviser, licensee, and software provider arises where an adviser uses a faulty automated advice tool to generate poor advice.

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).
[50] FPA, above n 1 at p 24

Thus far, ASIC has taken a technology-neutral approach to regulation, but we have not yet formed a view on whether this is appropriate.

We are also concerned that, without appropriate and adapted regulation, conflicts of interest could be built into these programs through shelf-space fees, scaling of the advice to classes of products, and other practices. The fact that algorithms and online tools tend to give the impression of objectivity is further cause for concern.

However, we are enthusiastic about the possibilities of automated advice tools when used in a client-focused and professional manner. In particular, it sets an interesting minimum standard of competence for human financial advisers, for they would have to compete with automated advice providers.

They can also assist advisers with decision-making for clients, and help to differentiate financial planning advice as a holistic offering from investment advice or other advice that does not incorporate strategic concerns.

We are interested in whether or not automated advice tools will be able to appropriately challenge the client's expectations of financial advice, and whether or not these tools can be designed to appropriately communicate the competition of needs that clients often face when presented with options by their financial planner.

The experience of foreign jurisdictions may be relevant, although the FPA has not researched this matter in any detail. In particular, foreign jurisprudence on proportionate liability as between the owners of the automated advice tool and any advisers who use these tools to assist their clients would be useful. Foreign regulators may also have commissioned regulatory guidance on automated advice tools in foreign jurisdictions. We are particularly interested in whether there have been bans on particular kinds of products from being recommended in this way, e.g. managed discretionary accounts.

Recommendation 14:

The FPA recommends a proactive and consultative approach to assessing the risks and benefits of the growth of automated advice tools in Australia. Ultimately, a co-regulatory approach should be adopted with respect to any necessary legal reforms or updated policy settings in response to this innovation.

5.6 – Tax deductibility of financial advice

The FPA has consistently advocated for the tax deductibility of financial planning fees, in line with the tax deductibility for fees charged for other professional services. While the FSI Final Report did not address this matter, the Government now has an opportunity to amend this anomaly in respect to the tax deductibility of financial planning fees.

Since July 2014, financial planners have been required to progressively register with the Tax Practitioners Board as tax (financial) advisers, and adhere to the requirements of the Tax Agent Services Act along with their tax agent peers. The amendment to the Tax Agent Services Act in 2013 defines a tax (financial) advice service as a type of tax agent service.

Including financial planners in the Tax Agent Services regime, and the banning of commissions on financial advice through the Future of Financial Advice reforms, has set the right environment to introduce tax deductibility of financial advice fees.

Currently, a fee for service arrangement for the preparation of an initial financial plan is stated by the Australian Taxation Office[51] to be not tax deductible under section 8-1 of the *Income Tax Assessment Act 1997*.

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.

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.

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.

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, and benefits society overall.

Research commissioned by the FPA has found that 47% of Australians have an unmet advice need. This figure has actually *increased by 4%* since 2013.

Our research also indicates that 30% of those who have not used financial advice and do not intend to seek advice in future have stated that the high cost of advice is a key reason for why they have not sought the advice.[52] Public policy initiatives to improve access to affordable advice for all Australians - particularly those most in need of assistance in managing their finances - will reduce the cost of advice for consumers while maintaining consumer protections and advice quality.

[51] Refer to ATO Taxation Determination TD 95/60
[52] Investment Trends, 'FPA Member Satisfaction Report' (December 2014)

Rice Warner research[53] identified clear societal benefits of financial advice;

- reduced debt - increases disposable income for more productive purposes;
- higher rates of return on investments over long periods - building wealth;
- insurance protection - prevents people from relying on welfare;
- higher levels of savings – reduces reliance on government benefits during and after retirement;
- a financially literate and conscientious society that would make better long-term decisions.

Financial planners provide valuable advice that is important for the long-term economic welfare of Australians. The financial planning profession is uniquely positioned to help Australians build their wealth and plan for a financially independent retirement.

Specifically legislating for initial advice fees to be tax deductible would greatly assist consumers' access to affordable financial advice that is beyond filing income tax returns or concerning their superannuation. While this would involve some additional costs to the Budget, these costs would be significantly outweighed by the long-term benefits. To control the cost to revenue, the Government could include caps on either the size of the tax deduction or an income cap on those able to receive a deduction.

Recommendation 15:

The FPA recommends the preparation of an initial financial plan, and ongoing management fees or annual retainer fees, be expressly stated to be tax deductible.

To support this proposal, the FPA recommends that the Government engage the Productivity Commission to examine the short-term and long-term position of the Budget if the preparation of an initial financial plan and ongoing fees were tax deductible. This report should be robust to a variety of different solutions, such as means-tested or capped tax deductions.

[53] FPA Value of Advice Research, Rice Warner Actuaries, February 2008.

6 – REGULATORY STRATEGY AND ARCHITECTURE

6.1 – Product intervention powers

The FPA supports the FSI Final Report recommendation to grant ASIC product intervention powers. We have some concerns about inconsistencies in the conceptual framework within which these powers might sit, but we nonetheless are of the view that this addition to ASIC's regulatory toolkit is useful.

As identified in section 2 of this submission, the product intervention powers recommended by the Murray Report include powers such as requiring amendments to marketing and disclosure materials, and warnings to consumers, which are more closely aligned with a disclosure-based regulatory framework.

However, the recommendation also includes distribution restrictions and product banning powers, which are much more closely aligned with conceptual frameworks that recognise the political and social objectives of the financial system, and the regulation of financial products on their merits.

The FPA has called for an overhaul of the conceptual framework of the Australian financial services system. A fundamental theme of all our recommendations has been that a richer concept of financial citizenship should underpin the legislation, professional values, and ethical conduct of financial intermediaries in the Australian system.

As a consequence, our view is that product intervention powers, much like suitability regulation and financial product governance, should not be used solely to rectify product disclosure. Instead, our view is that a limited form of merits regulation, along the lines of regulating for product safety, market integrity, and/or systemic stability, would be an appropriate use of product intervention powers.

A similar approach has been adopted by the European Union and the European Securities and Markets Authority. These product intervention powers are implemented by Articles 40, 41, and 42 of MiFIR are an investor protection mandate and a systemic stability mandate. In particular, the ESMA's temporary product intervention mandate states that it shall only use product intervention powers if all the following conditions are fulfilled:

(a) the proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system in the Union;

(b) regulatory requirements under Union law that are applicable to the relevant financial instrument or activity do not address the threat;

(c) a competent authority or competent authorities have not taken action to address the threat or the actions that have been taken do not adequately address the threat.[54]

ESMA published its Final Report and Technical advice on MiFID II and MiFIR in December 2014, which provides detailed principles for the use of product intervention powers.[55] Some of these factors and criteria include:

- The degree of complexity of the financial instrument or type of financial activity or practice and the relation to the type of clients to whom it is marketed and sold.[56]
- The type of clients involved in an activity or to whom a financial instrument is marketed or sold.[57]
- The degree of transparency of the financial instrument or type of financial activity or practice.[58]
- The particular features or underlying components of the financial instrument or transaction, including any leverage a product or practice provides.[59]
- The degree of disparity between expected return or benefit for investors and the risk of loss in relation to the financial instrument, activity, or practice.[60]
- The pricing and associated costs.[61]
- The degree of innovation of a financial instrument, an activity, or practice.[62]
- The selling practices associated with the financial instrument.[63]
- The situation of the issuer of the instrument.[64]
- Whether a financial instrument or practice would threaten the investors' confidence in the financial system.[65]

The FPA endorses these criteria and the ESMA Technical Advice in so far as it applies to product intervention powers.

Default products and product features

The FPA supports the FSI Panel's decision not to recommend the introduction of default products and default product features. In our view, such features are only justifiable where individuals are legally compelled to participate in the financial services system – e.g. in the superannuation sector. Even in this circumstance, default products and default product features are not desirable unless the degree of disengagement in the system is so severe that not to act would pose risk to users of the system and to the system itself.

[54] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, article 40(2).
[55] European Securities and Markets Authority, 'Final Report: ESMA's Technical Advice to the Commission on MiFID II and MIFIR' (December 2014).
[56] ESMA, above n 55 at p 191
[57] ESMA, above n 55 at p 192
[58] ESMA, above n 55 at p 192
[59] ESMA, above n 55 at p 193
[60] ESMA, above n 55 at p 193
[61] ESMA, above n 55 at p 193
[62] ESMA, above n 55 at p 194
[63] ESMA, above n 55 at p 194
[64] ESMA, above n 55 at p 194
[65] ESMA, above n 55 at p 195

Recommendation 16:

The FPA recommends the Government adopts recommendation 22 of the Financial System Inquiry Final Report. The Government should grant ASIC product intervention powers after an extensive consultation with the financial services sector and with consumer groups on the purpose of and process for using these powers. ASIC, the Treasury, and the Government should be informed by international best practice on product intervention powers when drafting legislation and guidance on these powers.

6.2 – Industry co-funding model

The FPA's submissions to the FSI called for significant reform of the conceptual and legal framework in which Australian regulators operate. Our call for greater collaboration and co-regulation between regulators and the financial services sector included closer alignment of the goals and mechanisms of regulators and industry.

The Murray Report recommended that the Government introduce an industry funding model for Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.[66] In our final submission to the FSI, we supported an industry funding model as a way to align the interests of ASIC and the financial service sector.

Transitioning to a user-pays model, in whole or in part, requires that the cost of regulation is borne in an equitable, risk-based manner across the entire financial services sector. The recent transition of AUSTRAC's funding to a user-pays model provides an excellent example, as providers of designated services are required to pay according to their size and the complexity involved in regulating them.

Recommendation 17:

The FPA recommends that the Government consider recommendation 29 of the Financial System Inquiry Final Report and consider the AUSTRAC model as an example of implementing a model that would be fair and equitable considering the different business models in the financial planning sector.

[66] FSI, above n 2 at p 250.

APPENDIX A – List of Recommendations

Recommendation 1:

The FPA recommends that the Government and the Treasury responds to the Financial System Inquiry Final Report recommendations by addressing the conceptual framework that underpins them. In particular, we recommend that the Government respond to key themes and principles in the Report, such as the role of fairness in the financial system and the continuing primacy of the efficient capital markets hypothesis.

Recommendation 2:

The FPA recommends that government does not accept the FSI recommendation 24 in regards to life insurance.

Recommendation 3:

The FPA recommends that the use and effectiveness of product issuer regulation and product intervention powers should form a key aspect of ASIC's future reporting and/or guidance on the regulation of complex financial products.

Recommendation 4:

The FPA recommends that the Government adopt recommendation 21 of the Financial System Inquiry Final Report. Product design and distribution obligations implemented in Australia should be informed by international experience in suitability regulation and financial product governance.

Recommendation 5:

The FPA recommends that, should the appropriate mechanisms to bind the Superannuation system to overarching objectives be implemented, the FSI Final Report recommendations regarding the objectives of the superannuation system should be implemented to the extent that these recommendations do not endorse particular financial products or classes of financial products.

Recommendation 6:

The FPA recommends that the Government establishes an Australian minimum retirement standard which the efficacy, resilience, and fairness of voluntary savings, compulsory superannuation, and the Age Pension can be evaluated against. This standard should be robust to aged care needs and changing healthcare needs.

Recommendation 7:

The FPA recommends that the Government and the Treasury reject Recommendation 8 of the Final Report, and instead commission a comprehensive review of leverage inside superannuation. On the basis of this review, targeted measures should be proposed, considered, and adopted where appropriate to address the specific risks identified by that review and by the FSI Final Report.

Recommendation 8:

The FPA recommends that the following policy settings and industry practices should be reviewed as a matter of urgency in order to prevent detriment to users of the superannuation system:

- The **single acquirable asset rule**.
- The **limited regulation of LRBAs as an investment product**.
- The ban on **cross insurance** in superannuation, and other impediments to **appropriate risk management** in SMSFs.
- The use of **personal guarantees in connection with LRBAs**.
- The use of **related party** and **non-arms length borrowing**.

Recommendation 9:

The FPA recommends that the Government should not adopt recommendation 11 of the Financial System Inquiry Final Report without arriving at a comprehensive framework for the roles and interaction of public and private longevity risk management products, as well as a strategy to improve access to professional financial advice at retirement.

Recommendation 10:

The FPA recommends that the Government should allow the MySuper reforms to mature, having regard to the impact of increased competition on fees, risk, service offering, and performance.

Recommendation 11:

The FPA recommends that the Government should amend the Corporations Act to change the term 'general advice' to 'general information', and also recommend that the terms 'financial advice' and 'financial product advice' should only apply to personal advice as defined by the Corporations Act.

Recommendation 12:

The FPA recommends that the Government should amend the Corporations Act to provide that the titles of "financial planner" and "financial adviser" will only be permitted to be used by individuals holding a Practicing Certificate as a member of a recognised professional body.

Recommendation 13:

The FPA recommends a review of the effectiveness and value of the retail, sophisticated, and wholesale investor definitions in the Corporations Act.

Recommendation 14:

The FPA recommends a proactive and consultative approach to assessing the risks and benefits of the growth of automated advice tools in Australia. Ultimately, a co-regulatory approach should be adopted with respect to any necessary legal reforms or updated policy settings in response to this innovation.

Recommendation 15:

The FPA recommends the preparation of an initial financial plan, and ongoing management fees or annual retainer fees, be expressly stated to be tax deductible.

To support this proposal, the FPA recommends that the Government engage the Productivity Commission to examine the short-term and long-term position of the Budget if the preparation of an initial financial plan and ongoing fees were tax deductible. This report should be robust to a variety of different solutions, such as means-tested or capped tax deductions.

Recommendation 16:

The FPA recommends the Government adopts recommendation 22 of the Financial System Inquiry Final Report. The Government should grant ASIC product intervention powers after an extensive consultation with the financial services sector and with consumer groups on the purpose of and process for using these powers. ASIC, the Treasury, and the Government should be informed by international best practice on product intervention powers when drafting legislation and guidance on these powers.

Recommendation 17:

The FPA recommends that the Government consider recommendation 29 of the Financial System Inquiry Final Report.

APPENDIX B – Table of FSI recommendations

No.	Description	FPA position	FPA Recommendations
8	**Direct borrowing by superannuation funds** *Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.*	We <u>do not support</u> the recommendation. Instead, we recommend that the Government conduct a broad enquiry into leverage in superannuation (particularly concerning SMSFs and LRBAs) by 2017, as well as reforms and review of various aspects of SMSFs and LRBAs in the short term. <u>See section 4.2</u>	**7, 8**
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.*	We <u>support</u> this recommendation. We also invited the Treasury to consider whether a minimum retirement standard is appropriate in Australia, so that the three pillars of Australia's retirement income policy can be aligned around a particular standard. In line with this recommendation. <u>See section 4.1</u>	**5, 6**

No.	Description	FPA position	FPA Recommendations
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 do not support this recommendation until further research has been completed on whether the limited tailoring that is possible through the current system is worth the cost inefficiency over an auction or tender process. See section 4.2	**13**
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.*	We do not support this recommendation, as the pre-selection of a comprehensive income product for members is a de-facto default product offering. The FPA's view is that a default product offering should be a last resort, and further efforts to improve engagement with the superannuation and financial advice sectors need to be pursued before a default financial product solution is offered. See section 4.3	**9**

No.	Description	FPA position	FPA Recommendations
21	**Strengthen product issuer and distributor accountability** *Introduce a targeted and principles-based product design and distribution obligation.*	We support this recommendation, and encourage the Government to immediately commence consultation on the legislative drafting and guiding principles for targeted, principles-based product design and distribution obligations. We encourage the Treasury and ASIC to consider the European Union as a model jurisdiction in this regard, and to use the Technical Advice of the EU financial services regulators as a framework. See sections 3.2 and 3.3	**3, 4**
22	**Introduce product intervention power** *Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.*	We support this recommendation, and encourage the Government to immediately commence consultation on the legislative drafting and guiding principles for the use of product intervention powers. We encourage the Treasury and ASIC to consider the European Union as a model jurisdiction in this regard, and to use the Technical Advice of the EU financial services regulators as a framework. See sections 3.2 and 6.1	**3, 16**

No.	Description	FPA position	FPA Recommendations
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.*	We support this recommendation.	**N/A**
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.*	We do not support this recommendation in so far as it would require a level commissions model for life risk advice. Our view is that a holistic approach to the issues facing the life risk advice sector, and the insurance sector generally, is a preferable approach. We have also recommended several principles and avenues for reform to help transition the sector from remuneration models which embody conflicts of interest. We support the rest of this recommendation. See section 3.1	**2**

No.	Description	FPA position	FPA Recommendations
25	**Raise the competency of advisers** *Raise the competency of financial advice providers and introduce an enhanced register of advisers.*	We support this recommendation. See our submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into proposals to lift the professional, ethical and education standards in the financial services industry.	**N/A**
29	**Strengthening the Australian Securities and Investments Commission's funding and powers** *Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.*	We support this recommendation. See section 6.2	**17**