Submission on the

Exposure draft - FoFA Amendments

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Superannuation Consumers' Centre
ABN 34 163 636 566
Contact: jennimack2@gmail.com or 0429 300 458

About the Superannuation Consumers' Centre

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

Nonetheless the Superannuation Consumers' Centre has established itself as a legal entity, has received ACNC endorsement and is operating on a voluntary basis. The Centre's Board remains of the view that there is a very strong need for a consumer voice in superannuation, especially with the financial system inquiry on foot. Without financial resources it will be very difficult for the Centre's volunteers to undertake sophisticated research and analysis from a consumer perspective. The Board continues to explore funding options, many of which require deductible gift recipient status.

The areas of retirement incomes policy that the Centre intends to contribute to debates include:

1) access to **quality advice** in the accumulation, transition to retirement and retirement phases;
2) what we call **retirement risk zone** issues ie the issues faced by consumers in roughly the five years either side of retirement; and
3) the **policy settings and products available in the retirement phase**, in particular the need for good default products.

Centre for SUPERANNUATION CONSUMERS

Summary

While we respect the **Government has a mandate to introduce some of these reforms, notably the removal of the opt-in provision** we are concerned that **these amendments introduce new drivers in the industry** that will **reinvigorate what was a dying sales culture in the industry. The will distort the market towards general advice and execution only services.**

We are very concerned that **they will mean average Australians will continue to pay commissions on financial products**, **which will be sold to them via general advice rather than personal advice**.

Some consumers will be locked into commission paying products, possibly until they die, and a **significant legacy product problem will be created.**

Rather than reducing conflicted remuneration and increasing access to personal advice in the general community we think these proposals will mean **conflict free personal advice will become available only to the very wealthy**.

Further allowing advisers to contract out of the best interests duty will **make it very hard for the Financial Ombudsman and ASIC to take action** in the face of inappropriate and poor advice.

We think there has been **over-reach in the detail** of some proposals and **the industry's interests have been put well above the interests of the general community.**

Our chief concerns are with the:

- **Width of the general insurance carve** which will drive advisers towards commission paying general advice and reduce the availability of personal advice
- The **execution only exemption** which will see new business models separating advice and execution increasing costs to consumers
- **Allowing advisers to contract out of the best interests duty by way of contracting with clients to scale advice**
- The **removal of the heart of the best interests duty**

We are also concerned that **some proposals are inconsistent with the governments stated objectives**. These include **proposals that relax the conflicted remuneration ban on personal advice**, **some of which have not been previously contemplated** including:

- Allowing **commissions** to be paid **to advisers whose firms use the balanced scorecard approach** to remuneration
- Provisions to **allow conflicted remuneration if a client agrees to it**
- Allowing **commissions on life insurance sold inside super**
- **Grandfathering** provisions that **cover the transition from an accumulated superannuation account to a pension account under multi-product offerings**.

What was FoFA about?

FoFA was about **changing the drivers in the industry to restore consumer trust and increase access to advice.**

FoFA was necessary because compulsory super is forcing us to become a nation of investors at a very vulnerable point in our lives. It doesn't matter who you are or what you have done with your life; if the first time you have a large amount of money to manage is at age 55 or 65 at retirement you are by definition a vulnerable consumer.

Government **policy settings that force people to defer their wages** until retirement **create a very high duty of care** towards people's retirement savings, especially **for government** but also for industry.

Yet **the behaviour of the financial advice industry was not only sometimes wiping out people's life savings** through disasters like the collapse of Westpoint, Storm Financial, Trio, Fincorp and all the corps, but **commissions have been quietly eroding the nation's retirement incomes savings pool**[1].

The problem was **the drivers in the industry created a sales culture not an advice culture**. They **put advisers' interests ahead of their client's interests.**

FoFa is about realigning the drivers in the industry towards professional advice giving, an industry providing advice that consumers can confidently trust because it is free of conflicts.

We accept that **FoFA doesn't solve all the problems** – **asset fees** have to some extent replaced commissions, but at least they can be turned off. **Vertical integration** whereby the large institutions make, sell and advise on product remains a problem. But **FoFA was helping the industry transform.**

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[1] Rainmaker Consulting, Commissions Revenue Report, 2010 available at http://www.industrysuperaustralia.com/wp-content/uploads/2010/04/Rainmaker_Commissions_Rev_Rpt_-_Apr_2010_v3.pdf

The industry, on one hand wants to be trusted advisers, but on the other is addicted to the remuneration structures of a salesforce. FoFA reorients the drivers in the industry away from a sales culture and towards an advice culture.

The proposed changes

We are very concerned that **the changes will place new drivers in the industry that will make average Australians worse off[2].**

We are very concerned that the proposed changes will:

- **drive the industry towards general advice and execution only services; and**
- **reduce access to advice for ordinary Australians.**

They will do this primarily by carving out general advice and execution only services from the commissions ban. The changes will make general advice a lot more attractive to the industry: limited compliance obligations and no troublesome duties to clients with commissions to boot!

1) Exempting general advice from conflicted remuneration

We are extremely concerned that the width of the general advice exemption **will introduce powerful new drivers in the financial advice industry that will act to deny low and middle income Australians access to personal advice and will lock them into commission paying products.**

It will do this by making general advice a much more attractive proposition for advisers: general advice will be free of the responsibilities that currently do and should attach to selling complex products product and sales will attract commission based remuneration.

In short it will distort the market in favour of general advice and thereby reinvigorate the sales culture in the investment industry.

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[2] We are not the only ones with these concerns see Prof Kingsford Smith of the UNSW Centre for Law, Markets and Regulation http://clmr.unsw.edu.au/article/compliance/market-conduct-regulation/coalitions-future-financial-advice

It will do so at a time when the industry was showing signs of responding the new drivers instituted by the FoFA reforms and was taking steps towards professionalism.

Perversely, it will mean **sophisticated high net worth clients with better information and financial resources** will continue to obtain wholistic personal advice and **will be the only group to will benefit from the commission ban**. By contrast ordinary Australians and in particular vulnerable clients will continue to be sold commission paying products.

This matters because investment is no longer the preserve of the rich. Compulsory super is turning us into a nation of investors at a vulnerable time of life. It doesn't matter who you are or what you have done with your life. If the first time you have a large amount of money to manage is at age 55 or 65 at retirement you are by definition a vulnerable consumer.

2) Execution only exemption

This proposal effectively undermines the commission ban on personal advice.

Until now execution only services have been rare, and product manufacturers have charged large commissions, to avoiding undercutting their distribution chain.

The execution only exemption provides incentives for new business models to emerge whereby advice is given in one part of the business, with the adviser walking the client to the next cubicle or down the hall to hand the client to the execution part of the business, where commissions will be charged.

This exemption will provide a whole new revenue stream for advice firms and will almost certainly mean extra charges for clients.

3) Scaled advice

The proposals effectively shift the onus of responsibility for scaling advice from advisers to consumers and provide a way for advisers to contract out of the best interests duty.

Clients go to an adviser for advice – that is the nature of the relationship – driven by a huge differential in knowledge and expertise. It is the most vulnerable clients, those on lower incomes, with fewer assets, who are most dependent on an adviser[3]. If an adviser says the advice can be scaled and the fees lowered, clients will agree to that, because that is the nature of the relationship.

The proposed change will legally transfer responsibility for scoping advice from advisers to clients who will have "agreed" to the scope of advice, even though they are dependent on the adviser for that advice. The proposed change will absolve the adviser from responsibility. This effectively provides a means of contracting out of the best interests duty.

Determining the scope of advice is one of the most important things an adviser can do, but there is considerable, very recent evidence that the industry engages in inappropriate practice in this regard. ASIC's 2012 shadow shop study of retirement advice[4] found examples of clients agreeing to scope mortgages and other debts out of transition to retirement advice. At paragraph 125 the report said "In several instances, particular topics were excluded from the scope of the advice**, to the potential benefit or convenience of the adviser, and to the significant detriment of the client**. For example, an adviser might have excluded consideration of a client's debts from their retirement advice."

Similarly ASIC's review of structured products[5] late last year found **numerous instances of consumers agreeing to scope advice to only structured products**. At para 44 the reports says "A feature of the majority of the advice in the sample was that the scope of advice was limited to consideration of a specific structured product (about two-thirds of the advice files). Often, there was no consideration or comparison of alternative strategies or products to meet the client's needs."

This change will undermine the best interests duty as it reverses the responsibility for scoping of advice from the adviser to the client.

Moreover it will **make it even harder for ASIC to successfully bring cases against advisers**. It is also **likely to reduce the Financial Ombudsman Service's capacity to decide inappropriate advice cases in consumers favour.**

4) Destruction of the best interests duty

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[3]

[4] Available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep279-published-27-March-2012.pdf/$file/rep279-published-27-March-2012.pdf

[5] Available at http://asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep377-published-4-December-2013.pdf/$file/rep377-published-4-December-2013.pdf

Clause 961 2 (g) is the heart of the best interests duty. It is the only clause that mentions the words best interests. It is the clause that brings into the duty the value add that a professional adviser provides to a client. It is the clause that gives the duty resilience, longevity and flexibility to sustain new industry practices, for example developments driven by technology.

The other change that is of concern to us is the removal of s961B 2 a). We cannot find a rationale for this proposal in the explanatory memorandum but it appears to significantly narrow an adviser's responsibility for investigation of a client's needs and circumstances. It appears to limit investigations to information provided by the client to the adviser. We are worried that this will expose vulnerable clients who do not have a sophisticated understanding of financial matters, particularly those with poor language skills. It must always be borne in mind that compulsory super has brought all Australian employees into financial markets, many of whom would not otherwise participate, and it brings them in at a very vulnerable time in their lives, usually around retirement.

5) Relaxing the commissions ban for personal advice

The Ministers' announcement of the reforms says "the government will ensure that the ban on conflicted remuneration applies on to personal financial advice"[6] but the proposal allows a number of ways for commissions to be paid on personal advice.

- The **balanced scorecard remuneration** proposals allow a portion of salary to be paid by commissions. While the portion is not completely defined the ES says "10% is likely to be considered low". **This means at least 10% of salary can be made up of commissions, possibly more.**

Further we understand balanced scorecard methodology applies to firms with scale which creates an uneven playing field and suddenly makes being an adviser with a large dealer group very attractive. This is likely to drive further consolidation in the industry.

This issue has not been previously ventilated and is inconsistent with the government's announcement. It allows conflicted remuneration for personal advice.

- **Allowing conflicted remuneration if the clients accepts it**

[6] http://axs.ministers.treasury.gov.au/media-release/011-2013/

This is a new provision – not mentioned in the Assistant Treasurer's announcement but buried in the detail of the explanatory memorandum and regulations. This is **inconsistent with the Assistant Treasurer's overarching statement that commissions will be banned on personal advice.**

Clients go to an adviser for advice – that is the nature of the relationship – driven by a huge differential in knowledge and expertise. It is the most vulnerable clients, those on lower incomes, with fewer assets, who are most dependent on an adviser. If an adviser says advice costs can be lowered and payments deferred (via conflicted remuneration though those words will certainly not be used) clients will agree to that, as they have been doing for years.

The reason commissions had to been banned was because behavioural research[7] found disclosure did not work when dealing with conflicted remuneration.

This proposal undermines the government's commitment that remuneration for personal advice will remain conflict free.

- **Allowing commissions on insurance sold inside super**

This is likely to drive sales of super products based on the availability of commissions rather than the best interests of the client.

This is another way in which the ban on conflicted remuneration for personal advice is being relaxed.

We must reiterate the compulsory nature of super means Government has a higher duty of care to employees who are forced save in this way. Government must ensure consumer savings are protected against inappropriate conduct and there is a wealth of evidence here and internationally that conflicted remuneration drives mis-selling.

6) Width of the grandfathering provisions

The proposals include extensive grandfathering that means consumers will become trapped in what will effectively become commission paying product for years. Some people, in their 30 and 40s today, may still be paying commissions when they die. The proposals will also create a major legacy product problem in around 15 – 20 years as there will be no incentives for advisers to move

[7] The dirt on coming clean: The Perverse effects of Disclosing Conflicts of Interest
http://www.cmu.edu/dietrich/sds/docs/loewenstein/dirtclean.pdf

consumers to modern flexible products as they emerge. No adviser will want to cut off a lucrative passive income stream. The extensive grandfathering provisions combined with the removal of the opt-in provisions means the passive income will remain for many consumers, perhaps until they die.

There is one grandfathering provision that has not been previously publicly ventilated, nor as far as we are aware, even privately contemplated.

The grandfathering of **commissions inside multi-offering super funds** (the switch from accumulation products to pension products) **means commissions will continue to unnecessarily erode pensions** year on year until a person dies.

Until the development of policy settings for the retirement phase and in particular default products it is inconceivable that personal advice would not be required at this time. **This is another instance of how these changes introduce drivers that will reduce personal advice**. As mentioned previously, for many people their superannuation will be the largest amount of money they have had in their life. They will be required to manage it at a particularly vulnerable time and they will be in need for personal advice.

It is an example of overreach in the proposals.

Taken as a whole we are somewhat shocked that the industry has sought to persuade the government for this extensive grandfathering. We are disappointed that the sale of books and transfers of advisers between dealer groups have been grandfathered. These are other ways **these proposals as a whole will trap consumers in legacy products**. It is shocking the industry has so little confidence in itself that it believes it must trap consumers to generate fees. We are concerned that they will create a huge legacy product issue in years to come, not dissimilar to those created by Tower life insurance policies sold in the 1980s for example.

7) Opt-in and fee disclosure provisions

We are hugely disappointed at these proposals. The financial advice industry is perhaps the only industry exempt from the requirement to properly account to clients for fees.

It is astonishing that large parts of the industry have so little confidence in their services that they fear consumers would not pay for them if they were aware of the actual costs.

While some companies may voluntarily choose to provide model fee disclosure, one of the unfortunate characteristics of this industry is that it tends to default to the bottom. It will become harder for these firms to retain and attract advisers given they will be able to earn passive income elsewhere through hidden charges, as MLC found ten years ago when it took the lead in reducing reliance on commission based remuneration.

Removal of the opt-in measure of course does not mean the problem it was designed to address goes away. Consumers will still pay hidden fees. Consumers will still pay for no service. The industry will continue to detract value from consumers. Trust will remain low.

We urge the Government to address this problem.

Other matters

We support the new wholesale/retail distinction.

Regulation impact statement

The impact analysis has made no attempt to describe or quantify the potential cost of these proposals for individual consumers, nor to the nation as a whole. For example no attempt has been made to describe or quantify:

- how much consumers will continue to pay in passive income because of the extensive grandfathering and removal of the opt-in provision (see the Rainmaker report on Commission Revenue 2010[8])

- potential consumer losses that could arise from inappropriate scoping of advice (information could be drawn from ASIC's reports on their shadow shop of retirement advice and surveillance of structure products advice[9])

[8] http://www.industrysuperaustralia.com/wp-content/uploads/2010/04/Rainmaker_Commissions_Rev_Rpt_-_Apr_2010_v3.pdf

[9] See http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep279-published-27-March-2012.pdf/$file/rep279-published-27-March-2012.pdf and http://asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep377-published-4-December-2013.pdf/$file/rep377-published-4-December-2013.pdf

- the extent of losses that consumers will sustain when they discover their avenues for recourse through FOS and the courts have been narrowed, because they have agreed to the inappropriate scoping of advice.

- The cost of distorting the market away from personal advice and towards general advice

- the losses to ordinary Australians that will arise from inappropriate product sales and poor financial management arising from the lack of personal advice (see Rice Warner Actuaries *The financial advice industry post FoFA*[10] especially appendix B

- The cost of commissions ordinary Australian's will pay for investment products sold via general advice and execution only services (products sold via personal advice will be commission free)

- The social cost to the community arising from financial loss arising from inappropriate advice (see ASIC report on the social impact of financial loss[11].

This last point is particularly important because the costs of these proposals will fall hardest on middle and low income Australians, who will become the target of the industry's sale force and inappropriate scoping of advice.

We **recommend that the Government contract a consultant who has the confidence of all stakeholders to prepare a proper cost benefit analysis that makes a serious attempt to quantify the costs to consumers of these proposals and seeks to determine whether they deliver a net benefit to society.**

Conclusion

We accept the Government has a mandate for the removal of opt-in but there was little community awareness of the scope of the proposals outlined in the consultation documents. Indeed some proposals have not previously been canvassed even with the FoFA policy community.

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10 http://www.ricewarner.com/images/newsroom/1374717972_Rpt%20The%20financial%20advice%20industry%20post%20FoFA%202013.pdf

11 For a description of the social impact of financial loss post Storm Financial see https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep240-published-May-2011.pdf/$file/rep240-published-May-2011.pdf

We urge the Government to **retain:**

1. the **best interests duty as it currently stands** especially the current clauses (g) and (a).
2. the **current approach to scoping of advice** so as to prevent advisers from using the proposed approach to transfer responsibility for scoping advice to clients and thereby contract out of the best interests duty.

We urge the Government to **rethink:**

1) the **width of the general advice carve out**; and the
2) the **exemption for execution only services**

These will significantly distort the market resulting in a reduction in personal advice and a surge in products sold via commission based remuneration.

We urge the Government to **remove** proposals that:

1) are **inconsistent with the policy announcement** and **will result in commissions being paid on personal advice** including:
   - the **balanced score card exemption**; and
   - the **exemption which allows clients to agree to conflicted remuneration**;
   - the **exemptions which allows conflicted remuneration on life insurance sold inside super**

2) will **lock consumers into commission paying products in perpetuity** including **grandfathering**:
   - of **a transition from an accumulation super account to a pension account** within a multi-product offering;
   - **when advisers move between licensees**; and
   - **when advisers sell their "book**".

Finally we urge that **a consultant with relevant expertise who has the confidence of all stakeholders – especially consumer groups – be employed to conduct a proper cost benefit**

analysis that makes a serious attempt to quantify the costs to consumers of these proposals and seeks to determine whether they deliver a net benefit to society.

For further information contact:
Jenni Mack
Chair, Superannuation Consumers Centre
jennimack2@gmail.com
0429 300 458