



Submission to Senate Standing  
Committee on Economics  
Scrutiny of Financial Advice Inquiry

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## About CHOICE

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

To find out more about CHOICE's campaign work visit [www.choice.com.au/campaigns](http://www.choice.com.au/campaigns) and to support our campaigns, sign up at [www.choice.com.au/campaignsupporter](http://www.choice.com.au/campaignsupporter)



## Introduction

CHOICE appreciates the opportunity to provide the following comments to the Senate Standing Committee on Economics *Scrutiny of Financial Advice Inquiry*.

Comments in this submission have been limited to financial advice and the recent Future of Financial Advice (FoFA) reforms but CHOICE is strongly supportive of broader recommendations in the Final Report of the Financial System Inquiry which calls for reform to the wider financial sector to ensure consumers are able to trust the system and can expect to be treated fairly.

Consumers need financial advisers to provide them with sound, independent and trustworthy advice on complex issues. Financial advice must be a service, not a sales pipeline.

The relatively recent reforms to financial advice offer much needed protections for consumers. However, there is more to do to ensure that all conflicts of interest are removed from advice.

A review of research shows an ongoing issue with conflicts of interest. It is too early to determine if the FoFA reforms alone will address this. Given that FoFA has only recently been finalised CHOICE recommends minimal amendments to FoFA until a full review is conducted, a consideration of conflicts of interest that were not addressed by FoFA and the adequate resourcing of the Australian Securities and Investments Commission (ASIC) to ensure that the regulator is able to prevent further misconduct.

CHOICE recommends that:

- ASIC is adequately resourced so that it is able to continue to undertake shadow shopping research into the quality of advice and measure the impact of FoFA reforms;
- No further major changes are made to FoFA until a full review of the impact and effectiveness of the reforms is conducted in 2018;
- Further research is commissioned into the distortionary effect that conflicted remuneration has on the quality of advice;
- Industry groups consider options to increase disclosure of institutional restrictions on advice from major financial institutions;
- ASIC is given the power to ban individuals from managing a financial advice business;
- ASIC is adequately resourced to ensure it is able to monitor financial advisers, prevent misconduct and take appropriate action when misconduct occurs; and
- An industry-funded compensation mechanism of last resort is established.



## 1. Current level of consumer protections

CHOICE considers the current level of consumer protections to be the minimum required. The *Corporations Act 2001* (the Act) provides the following protections for consumers seeking financial advice:<sup>1</sup>

- A requirement that advisers act in a client's best interest.<sup>2</sup>
- A ban on most, but not all, forms of conflicted remuneration that distort the recommendations made by advisers.<sup>3</sup>
- A ban on misleading, deceptive or dishonest behaviour.<sup>4</sup>
- A requirement for advisers to contact their clients every two years to determine if they wish to continue to pay ongoing fees for advice (known as the opt-in requirement) and to issue annual fee statements.<sup>5</sup>
- A requirement to disclose information to consumers about the services available and the advice received.<sup>6</sup>

Most protections were introduced or strengthened by the FoFA reforms. CHOICE was heavily involved in the 2009 Parliamentary Joint Committee Inquiry into financial products and services in Australia (known as the Ripoll Inquiry) and the subsequent development of the FoFA reforms. FoFA offers significantly improved protections for consumers but issues remain.

## 2. Research review

As a starting point, it is helpful to review the research to assess the impact of recent reforms and additional problems that need to be addressed. Good financial advisers always put the interests of their clients first but the experience of recent years has shown that conflicted and poor advice is common.

### The financial advice market

There is no central record of how many individuals are providing financial advice or the size of the market. CHOICE expects this to be rectified in 2015 with the establishment of the financial advice register.

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<sup>1</sup> In addition to legislative requirements advisers also have obligations to clients under the general law tort of negligence and fiduciary obligations.

<sup>2</sup> This is primarily located in s961B of the Corporations Act 2001 but further defined in s961E and regulatory guidance. See ASIC (2014), *Regulatory Guide 175, Licensing: Financial product advisers Conduct and disclosure (RG175)*.

<sup>3</sup> Part 7.7A, Division 4 of the Act.

<sup>4</sup> See s1041E-H of the Act.

<sup>5</sup> Largely contained in s962 and s1317 of the Act.

<sup>6</sup> Part 7.7 of the Act.



Roy Morgan research shows that 42 per cent of Australians have sought financial advice.<sup>7</sup> This number is reasonably high considering that many consumers may not need advice at this current point in their life, have simple affairs or that one member of a household may seek advice that will assist a whole family.

### **Quality of financial advice: before FoFA**

Poor advice has been strongly linked to the presence of commissions and to advisers failing to act in a client's best interests.<sup>8</sup>

Prior to the introduction of the FoFA reforms, a significant proportion of advice provided was of a low standard. A 2012 ASIC shadow shop of retirement advice found that 39 per cent of advice was poor (failed to meet requirements of the law at the time), 58 per cent was adequate (met requirements of the law) and 3 per cent was good (complied with the law, met clients' needs, improved their situation and clearly explained recommendations). Many people had trouble objectively assessing the quality of financial advice. 86 per cent of participants felt they had received good quality advice, and 81 per cent said they trusted the advice they received from their adviser 'a lot', even though only 3 per cent received objectively good advice.<sup>9</sup> ASIC found numerous examples of advice that complied with the law but still delivered a negative outcome for consumers as "a combination of the product fees and advice fees effectively cancelled out the value of the advice."<sup>10</sup>

Prior to the implementation of FoFA, large sections of the industry were using financial advice as a sales pipeline. The 2011 ASIC shadow shop of financial advice found "widespread replacement of existing financial products with 'in-house' products."<sup>11</sup> Roy Morgan Research found that from 2007 to 2011 the six largest institutionally owned advice groups had directed 73 per cent of superannuation recommendations to their own products.<sup>12</sup>

### **Quality of financial advice: after FoFA**

The FoFA package of reforms were only recently finalised and full implementation has been delayed until June 2015 with ASIC taking a facilitative approach to enforcement. Research conducted since 2012 indicates that there are still gaps in consumer protections but more time and research is required for a fulsome assessment.

A notable gap in protections is the exception that allows advisers to receive commissions on life insurance. A 2014 ASIC review of retail life insurance advice found high levels of churn. 37% of advice failed to prioritise the needs of the client and comply with the law. High up-front commissions are strongly correlated with poor advice; 45% of advisers who were paid through up front commissions failed to comply with the law.<sup>13</sup>

Consumers also remain confused about adviser independence. A 2014 Roy Morgan study found that consumers are extremely confused by multi-branding of financial advice businesses. 55 per

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<sup>7</sup> Financial System Inquiry (2014), *Interim Report*, 3-70.

<sup>8</sup> For example see ASIC (2003) *Report 18 Survey on the quality of financial planning advice*, p. 5-6, ASIC (2012) *Report 279 Shadow shopping study of retirement advice*, p 8.

<sup>9</sup> ASIC (2012) *Report 279*, p. 8, 54.

<sup>10</sup> *Ibid*, p. 43.

<sup>11</sup> *Ibid*, p 45.

<sup>12</sup> Roy Morgan Research 2011, *Superannuation & wealth management in Australia*, quoted in *ibid* p 45.

<sup>13</sup> ASIC (2014), *Report 413: Review of retail life insurance advice*, pp. 5-7.



cent of clients of Financial Wisdom, owned by CBA, thought their adviser was independent. Similarly, 50 per cent of clients of Godfrey Pembroke (NAB), 48 per cent of clients of Charter FO (AMP) and 37 per cent of clients of RetireInvest (ANZ) perceived their adviser to be independent.<sup>14</sup>

Surprisingly, 13 per cent of ANZ, 20 per cent of St George and 14 per cent of Commonwealth clients perceived their advisers to be independent even though they clearly work for a major institution.<sup>15</sup> This likely links to how advisers represent themselves and their services. Financial advisers often present as professionals able to guide consumers through difficult decisions and meet financial goals. Major institutions state that they offer the best and most effective advice, implying that the full range of products across the market and strategies beyond product recommendation are considered when this may not be the case.

### Impact of poor advice on consumers

The effects of major financial advice scandals in the last decade have been catastrophic, resulting in consumers losing \$5.7 billion in funds as well as their homes and life savings.<sup>16</sup> Case studies demonstrate the human impact of poor financial advice, with consumers noting the detrimental impact on personal lives and mental health as well as their finances.<sup>17</sup>

An alarming number of consumers continue to pay for services they do not use and may not even know about due to trailing commissions or ongoing fees. ASIC's 2011 survey of the top 20 financial services licensees found that 3.1 million or two thirds of clients were inactive.<sup>18</sup> In other words, they were paying commissions and ongoing advice fees but not receiving any benefit.

CHOICE suspects that the number of inactive clients remains high due to extensive grandfathering allowed by FoFA. Advice firms continue to receive substantial funds from 'grandfathered benefits' including trail commissions. On average, one-third of financial advice licensees' total income in 2014 came from grandfathered benefits and this income tends to be a greater proportion of large licensees' revenue streams.<sup>19</sup> To put this into perspective, in 2014 Commonwealth Bank financial planning businesses made a total income of \$829 million.<sup>20</sup> A third of this income equates to \$273.6 million.

<sup>14</sup> Roy Morgan Research, August 2014, *Confusion with Financial Planner Independence Continues*:

<http://www.roymorgan.com/findings/5716-confusion-with-financial-planner-independence-201408040221>

<sup>15</sup> Ibid.

<sup>16</sup> Losses from Opes Prime, Storm Financial, Timbercorp/Great Southern, Bridgecorp, Fincorp, Trio/Astarra, Westpoint and Commonwealth Financial Planning sourced from figures in ASIC (2014), *Submission to the Financial System Inquiry*, pp. 192-193 and Industry Super Australia (2014), *Exposure Draft: Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014*, ISA Submission, pp. 37-38.

<sup>17</sup> For an example, see Lyndi's story available at [www.choice.com.au/financialprotection](http://www.choice.com.au/financialprotection)

<sup>18</sup> See ASIC (2011), *Report 251: Review of financial advice industry practice*, p. 4.

<sup>19</sup> ASIC (2014), *Report 407: Review of the financial advice industry's implementation of the FOFA reforms*, p. 31. Note, this figure is based on a limited sample of 48 licensees but it is the only publicly available data on grandfathered income.

<sup>20</sup> See Commonwealth Bank (2014), *Annual Report 2014* p. 15. NB: Colonial First State income incorporates all income from financial planning businesses at CBA.



### **Further research is required to properly assess the impact of FoFA**

As noted, certain components of the FoFA reforms will not be enforced until 2015. More time and more research is required to properly assess gaps in consumer protections. It is vital that ASIC continues to assess the quality of advice through shadow shopping exercises and other research and that it is adequately resourced to do so.

#### **Recommendations 1 and 2:**

- ASIC is adequately resourced so that it is able to continue to undertake shadow shopping research into the quality of advice and measure the impact of FoFA reforms.
- No further major changes are made to FoFA until a full review of the impact and effectiveness of the reforms is conducted in 2018.

## **3. Further reforms to prevent misconduct**

### **Need to remove all conflicts of interest**

To protect consumers and strengthen industry, all conflicts of interest should be removed from financial advice. CHOICE believes that commissions, soft-dollar payments, asset-based fees, and any other form of remuneration that incentivises advisers to recommend a product or volume of products must be removed. As a starting point, current exemptions to the conflicted remuneration ban should be removed from the Corporations Act.<sup>21</sup>

The Committee should consider recommending an extension of the ban on conflicted remuneration to asset-based fees. Asset-based fees are ongoing fees calculated as a percentage of the total funds under advice. They have many of the same market distorting features created by commissions, which have already been recognised as inappropriate for advisers.

Asset-based fees encourage advisers to direct clients into certain types of investments. They are significantly less transparent than fixed fees, and in cases where an adviser accepts asset-based fees from long-term inactive clients, they allow fee-for-no-service business models to thrive (where a client continues to pay a fee long after they have received advice). Fixed fees for advice, either hourly rates or lump sums, remove these failings, as demonstrated in Table 1.

#### **Recommendation 3:**

- Further research is commissioned into the distortionary effect that conflicted remuneration has on the quality of advice.

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<sup>21</sup> As defined in s963B(a-b), s963C(a), s963D of the Act.



**Table 1: impact of payment type on quality of advice**

<b>Failing</b>	<b>Level of Risk</b>		
	<b>Commissions</b>	<b>Asset-based fees</b>	<b>Fixed fees</b>
Adviser incentivised to recommend sale of non-financial assets (like real estate) to invest in financial assets	High	High	None
Adviser incentivised to recommend gearing	High	High	None
Adviser biased against liquid/safe assets which pay low or no commissions	High	Moderate	None
Lack of transparency in total remuneration to the adviser	High	Moderate	None
Value of advice relative to the cost of the advice is difficult for client to determine	High	Moderate	None
Adviser incentivised to recommend inappropriate products with big commissions	High	None	None

### Need for increased education and professional standards

Current education and qualification requirements for financial advisers are extremely inadequate.<sup>22</sup> CHOICE supports raising minimum education and competency standards for all financial advisers. Recognising that existing advisers come from a range of educational backgrounds, CHOICE's preference is for the establishment of a national exam with education and training requirements to be phased in over time.<sup>23</sup>

<sup>22</sup> See Senate Standing Committee on Economics (June 2014), The Performance of the Australian Securities and Investments Commission and Parliamentary Joint Committee on Corporations and Financial Services (November 2009) Inquiry into financial products and services in Australia p 13, 129.

<sup>23</sup> Further detail on CHOICE's preferred approach is outlined in our submission to the Parliamentary Joint Committee Inquiry into proposals to lift the professional, ethical and educational standards in the financial services industry. See submission 20 [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Joint/Corporations\\_and\\_Financial\\_Services/Financial\\_Adviser\\_Qualifications/Submissions](http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Financial_Adviser_Qualifications/Submissions)





### Disclosure of adviser independence

Because of the greater likelihood of being steered into a particular product, there must be greater clarity for consumers regarding the differences between independent and aligned advisers. One option is for Australia to adopt the UK system of labeling advisers either restricted or independent. CHOICE believes that this move could greatly benefit consumers but, in order to find the most meaningful term for Australian consumers, CHOICE would like to see independent consumer testing of any changes to the way advice is labeled.

At a minimum, the Committee should call for better transparency and disclosure of aligned advice through increased public branding, as suggested by the Final Report of the Financial System Inquiry.<sup>24</sup> These changes could be implemented with the cooperation of industry.

### Recommendation 4:

- Industry groups consider options to increase disclosure of institutional restrictions on advice from major financial institutions.

## 4. The role of regulatory agencies in preventing poor advice

Regulatory agencies should play a vital role in preventing poor advice. However, in order to perform this role they need adequate and stable funding. Recent cuts to the ASIC restrict its ability to protect consumers. CHOICE is broadly supportive of a user-pays funding model for ASIC and is currently reviewing the specific recommendations made in the Final Report of the Financial System Inquiry for stable funding for the regulator.

ASIC has noted multiple instances where senior people in a financial firm with poor practices are able to establish new businesses. ASIC should be given the power to ban individuals from managing a financial services business, building on their existing power to ban individuals from providing financial services. CHOICE also strongly supports increased powers and penalties for ASIC to assist in its enforcement role and is again reviewing the specific recommendations made in the Final Report of the Financial System Inquiry.

### Recommendations 5 and 6:

- ASIC is given the power to ban individuals from managing a financial advice business.
- ASIC is adequately resourced to ensure it is able to monitor financial advisers, prevent misconduct and take appropriate action when misconduct occurs.

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<sup>24</sup> Financial System Inquiry (2014), *Final Report*, Recommendation 40 at p 27.



## 5. Compensation processes

As the Financial Ombudsman Service (FOS) submission notes, there remains a number of instances where consumers have received a positive outcome through External Dispute Resolution but compensation has been not paid. FOS notes that between January 2010 and 30 September 2014, 114 determinations remain unpaid at a value of over \$12.5 million (plus interest).<sup>25</sup> 68% of unpaid determinations relate to disputes in financial planning and advisory sector.<sup>26</sup>

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

The issue of unpaid EDR determinations was not addressed in the Final Report of the Financial System Inquiry and represents a worrying gap in consumer protection arrangements for the sector.

### Recommendation 7:

- An industry-funded compensation mechanism of last resort is established

## 6. A centralised register

CHOICE supports the introduction of a public register of financial advisers. CHOICE has participated in the working group developing the first iteration of this register and will soon be providing comment to Treasury about implementation. The register will address some transparency issues within the industry and allow ASIC to track disreputable advisers. Over time CHOICE expects to see additional fields added to the register, increasing its usefulness to consumers.<sup>27</sup>

## 7. Financial sector response to misconduct

The financial sector response to misconduct has been inadequate. Companies have been slow to recognise conflicts and misconduct. Significant action and redress for consumers has only been pursued after pressure from the public, media and parliamentary inquiries. CHOICE encourages the Committee to investigate further cases of misconduct through the Inquiry, particularly any possible misconduct from major financial institutions.

CHOICE continues to monitor financial institutions' responses to known major instances of misconduct. Current efforts to ensure that Internal Dispute Resolution services are independent

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<sup>25</sup> Financial Ombudsman Service (2014), *Submission to Senate Economics References Committee Inquiry into scrutiny of financial advice*, p 2.

<sup>26</sup> Ibid p. 3.

<sup>27</sup> For further detail see <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Enhanced-register-of-financial-advisers>



and thorough are welcome. However, some aspects of recent high profile responses could be improved. At a minimum, financial institutions should proactively contact clients when something goes wrong and inform them of redress mechanisms.

The CBA Open Advice Review Program, launched as a result of poor advice provided from 2003 to 2012, is currently underway. After initially only communicating with customers through public advertising, CBA announced it would be issuing 300,000 current Commonwealth Financial Planning customers with notices about the Review process.<sup>28</sup> Gaps in communications remain. It is unclear how or if CBA will be proactively contacting customers who received financial advice through Financial Wisdom who are also eligible for review. In addition, CHOICE has concerns about efforts being made to contact people who are no longer customers of CBA but are still eligible for the Review.

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<sup>28</sup> <https://www.commbank.com.au/about-us/news/media-releases/2014/commonwealth-bank-appoints-independent-customer-advocates-and-expands-customer-contact-program.html>