ASIA PACIFIC

Mr. Bernie Ripoll MP
Chairman
Parliamentary Joint Committee on Corporations and Financial Services
c/o Department of the Senate
PO Box 6100
Parliament House
Canberra, ACT 2600

Dear Sir

I am pleased to enclose the AXA Asia Pacific Holdings submission to your committee's inquiry into financial products and services in Australia.

AXA Asia Pacific Holdings is the Asia Pacific arm of the Global AXA Group and is separately listed on the Australian stock exchange. The AXA Global Group provides financial protection and wealth management products and services in 56 countries to 80 million clients and employs more than 200,000 people. AXA Asia Pacific Holdings also has international experience through its operations in 10 different countries with different regulatory approaches throughout the Asia Pacific region. It has access to the worldwide resources and experience of the Global AXA Group and as Chief Executive Officer of AXA Asia Pacific Holdings I sit on the Global AXA Group Executive Committee.

The global financial crisis has had a profound impact throughout the world. Within this, Australia has fared comparatively well due to its stronger economy going into this crisis and in part to the strong regulatory environment that has evolved in Australia over the past two decades. Nonetheless, there are always lessons to be learned and changes that can be made to better protect the Australian economy, its financial system, and its citizens, and your inquiry has an important role to play in this regard.

Australians are living longer and having fewer children. Our society, along with most other developed countries, is ageing. This is creating a greater need to increase national savings, and is placing a greater onus on individuals to invest in their futures. Given this and the growing complexity of our financial affairs as individuals, financial services will arguably be one of the most important industries in our society over the coming decades. The financial advice profession allows Australians to choose and access the best range of financial products and solutions that are suitable to them. It is therefore critical that we continue to enhance, develop and support this profession and through it, the provision of financial advice in Australia.

Given the genesis of this global financial crisis was the easy availability of credit, fuelling consumer demand and consumption, it is crucial that in responding to the implications of the crisis that we take a long hard look at this issue. As this crisis has shown, it is important that financial regulation focuses not just on our personal assets but on our liabilities as well. Unfortunately notwithstanding considerable product development, innovation, industry restructuring, policy initiatives and regulatory changes including the introduction of compulsory superannuation, the average Australian is no better placed today to meet their needs in retirement than in the past. Their retirement assets are substantially offset by their personal debt. In many respects it is the aggressive practices of lenders over the last 10 years that have caused this situation which is why it is so crucial that regulation of credit is incorporated into any industry and regulatory responses. In this regard we congratulate the State and Federal Governments on the steps that have been taken to improve regulation of lending practices.

It is also perhaps not surprising that credit sits at the heart of many of the failures that this inquiry is investigating and I am confident that your inquiry will identify further improvements in this area of our financial system.

This inquiry is one of a number of inquiries and reviews into the Australian financial system following the global financial crisis. It is important to remember that we went into this crisis with a strong, well regulated financial services industry, strong financial institutions, and a world leading superannuation system. It is important that we do not undermine this by introducing more complexity, more cost and more uncertainty, thus damaging confidence in our system and making financial advice less accessible. It will therefore be important that this inquiry as well as others adopts a holistic and integrated approach to reviewing their respective terms of reference and making any recommendations in the context of the broader system.

We would be happy to discuss any of the aspects of our submission with your committee, if you have any queries please contact Francine McMullen, Group Manager, Strategic Communications on 03 8688 4985.

Yours faithfully

Andrew Penn

Andrew Penn
Chief Executive Officer
AXA APH

Submission to the
Parliamentary Joint Committee on
Corporations and Financial Services
Inquiry into Financial Products and Services
in Australia

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1.0 COVER LETTER

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Australians are living longer and having fewer children. Our society, along with most other developed countries, is ageing. This is creating a greater need to increase national savings, and is placing a greater onus on individuals to invest in their futures. Given this and the growing complexity of our financial affairs as individuals, financial services will arguably be one of the most important industries in our society over the coming decades. The financial advice profession allows Australians to choose and access the best range of financial products and solutions that are suitable to them. It is therefore critical that we continue to enhance, develop and support this profession and through it, the provision of financial advice in Australia.

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Yours faithfully

Andrew Penn
Chief Executive Officer
AXA APH

2.0 EXECUTIVE SUMMARY

AXA believes that the failures which are the subject of your inquiry have resulted primarily from a combination of the excessive promotion of credit in conjunction with investing, poor and unethical business practices and in some cases poor advice. It appears that in many cases the investment strategies presented to clients included excessive levels of risk in the context of the client's personal circumstances and a level of risk that they did not fully understand as a consequence of gearing.

AXA also believes that these practices are not typical in Australian financial services, and do not point to a wholesale failure of the Australian financial system or the regulation thereof. There are, nonetheless always improvements that can be made which will provide real benefits for consumers.

AXA acknowledges the recent reforms that have been made to the regulation of credit, and these are required to minimise the recurrence of failures this inquiry is investigating. Given these changes our recommendations focus on the other areas of potential improvement. In summary we believe the following recommendations should be adopted to further enhance our system.

As a consequence of the failures which have arisen and our understanding of the issues that have given rise to them, AXA recommends enhancements in the areas of:

- The provision of credit and advice in relation to credit in the context of broader investment advice.
- The management of Australian Financial Services Licence (AFSL) holders and the process by which they interact with individual advisers.
- And finally in the further enhancement of financial literacy within our community.

Recommendations

AXA recommends:

1. Following the introduction of the new credit reforms the Government should commit to undertaking a review of their effectiveness by the end of 2012 and implement any further enhancements necessary.

2. Acknowledging the regulatory changes already taking place around gearing we believe it is important that any regulatory changes ensure that Statements of Advice should include a clear explanation of the leveraging impact of any gearing accompanying investments, including in particular additional exposure to the downside in the event of falling investment markets. Such disclosure should also make clear any margin loan trigger points.

3. Statements of Advice should be modified to ensure that the adviser is making a clear recommendation in relation to whether the financial plan incorporates gearing and the parameters of such arrangements.

4. The Government should continue to roll out its programme of initiatives in relation to further improving the level of financial literacy in Australia.

5. Consideration should be given to requiring all market participants who advertise financial products and services to do so under a formal code of conduct for responsible promotion.

6. The process for obtaining an AFSL should be enhanced to require applicants to provide further detail and commitments regarding the establishment of governance processes and the systems and resources necessary to meet its responsibilities as a registered licensee.

7. The role and responsibilities of responsible managers of AFSL holders (licensees) should be elevated to include the requirement for an annual certification regarding the licensees ongoing meeting of its licence obligations and requirements and the effective working of the governance processes in place.

8. Each licensee should be required to have a compliance committee whose terms of reference and responsibilities ensure appropriate measures and processes are in place to achieve compliance with the licensee's obligations and those of its authorised representatives. This would include responsibility for establishing and overseeing a formal compliance program, including processes for addressing breaches and dealing with complaints.

9. Licensees should be members of a recognised industry body and should be required to ensure that each of their authorised representatives are members of an appropriate professional body. The licensee should ensure that its authorised representatives comply with their membership obligations, including continual professional development and codes of conduct. (Refer to recommendation 11 below.)

10. The Government and ASIC should consult with the industry to identify a more appropriate level of capital adequacy for licensees which would afford greater comfort that the risk management, compliance, and adviser training and supervision functions are fully resourced to the standard necessary to meet these enhanced obligations.

11 The Government and ASIC should support the development by the industry of one or more recognised professional bodies for financial advisers which prescribe professional standards, minimum qualification levels, codes of conduct, supervision and sanctions.

12. The current arrangements and requirements in relation to Professional Indemnity (PI) cover for Authorised Representatives and AFSL holders should be reviewed including an appropriate estimate of the prudent level of PI cover. This should be more closely aligned to the number of clients and value of clients' funds invested rather than the current model that refers to licensee revenue.

Background to AXA's recommendations

Whilst AXA does not have access to all of the information relating to the matters your inquiry is investigating, it does appear that there are a number of consistent themes present in some or all of the failures being considered by the inquiry.

- Many investors appear to have taken on credit to fund in part their investments and sometimes a riskier investment strategy than was appropriate for their situation and circumstances. In many cases they failed to understand or to consider the full risks associated with the gearing of their investment strategies.

- Inappropriate gearing of investments has served to hasten and exaggerate the fall experienced by clients when financial markets started to decline. This has been compounded by margin loan triggers that have crystallised investor losses.

- The inclusion of gearing in financial strategies appears to be at least in part exacerbated by aggressive lending practices and the existence of arrangements between financial advice firms and lenders.

- In some cases there appears to have been ambiguity regarding the specific gearing arrangements and in particular ownership of the assets against which the loans have been secured. This led to clients' assets being the subject of margin calls of which they were unaware.

- Insufficient or inappropriate diversification resulting in an over exposure to a particular asset class or classes which had a resulting detrimental impact on clients' investment portfolios when those asset classes suffered large losses. The effect of this has also been compounded by gearing.

- Situations where firms' advice appears to have been generic across a range of different clients whose different needs were not appropriately differentiated and the advice was therefore not tailored to individual clients' requirements or situations.

- An undue emphasis on tax structuring, particularly in relation to the Agri-business failures.

- Licensees failing to fully meet regulatory obligations.

- Disclosure that has not always been helpful in protecting retail customers.

- It appears that there have been examples in these failures where risks associated with investments have not been fully disclosed and the overall proposition has been relayed to be more secure than it actually is. This might have been compounded where credit is also being provided by reputable institutions, which may have resulted in clients taking an additional sense of comfort that has not necessarily been consistent with the underlying investment risks.

- Some clients have an insufficient general understanding of investment principles and markets to make effective use of the disclosure provided to them.

- There are examples of high upfront charges associated with a number of these failures which are magnified when gearing is included in the proposition. It is interesting to note that customers appear to have been willing to pay for high upfront charges, regardless of whether they have been charged as a commission or as a fee and regardless of whether they have been deducted from the investment or charged separately.

- Finally, fraud and unethical behaviour are unfortunately always a risk and a sad fact in all aspects of life. Ultimately, no matter how good the system is there will always be instances where it fails some individuals, and some participants fail to meet regulatory requirements and/or act honestly.

Notwithstanding the causes behind the failures your inquiry is investigating and the very significant and serious consequences for the individuals affected, we need to bear in mind that Australia already has a world class financial services industry and regulatory system. Australia went into this crisis with a strong, well regulated financial services industry, strong financial institutions and a world leading superannuation system

The practices exposed by the failures which are the subject of your inquiry are not typical of the broader industry and while it is important to provide an appropriate level of protection for all consumers this should be achieved by measures that do not impose an unreasonably onerous regulatory burden on the industry more broadly. Regulation needs to strike an appropriate balance between being overly paternalistic at one end of the spectrum and an over reliance on 'caveat emptor' at the other end.

It is AXA's view that the Australian financial services industry already demonstrates the right balance along this spectrum and has many positive attributes, including:

- A high level of disclosure.
- A high level of professionalism in advice.
- An open architecture environment through which financial advisers, whether they be operating in licensees owned by product providers or independently, provide a broad range of advice on products from many providers in the industry.
- A range of remuneration models and options through which clients can select how to direct the costs of advice.
- A strong market conduct environment.
- A strong culture of continuous improvement in products and services.
- A growing competence in the area of financial literacy; and overall
- An effective regulatory system, as demonstrated by the resilience of the Australian financial services industry to the global financial crisis.

It is important that this review and others into the industry build on these positive characteristics. AXA's recommendations are made in the context of promoting further enhancement of an industry that is generally working well and is responding to a small number of industry failures that have occurred. Ultimately we need to be careful to navigate our way through an appropriate level of regulatory and supervisory responses.

3.0 UNDERLYING CAUSES OF FAILURES

The Committee's current Inquiry has been triggered by some high profile collapses, such as Storm and Opes Prime, which have led to significant investment losses for their clients. These collapses raise the question of whether the current regulatory system is inadequate.

Whilst AXA does not have access to all of the information relating to the matters your inquiry is investigating, it does appear that there are a number of consistent themes present in some or all of the failures being considered by the inquiry.

Credit

A common and significant feature in a number of recent failures has been the easy availability of credit. This has led to significant levels of borrowing for investment purposes. It would appear that many clients have borrowed money to invest without fully appreciating the specific risks associated with doing so.

Gearing is a valid tool for some clients, but needs to be used carefully as it magnifies the effects of market movements. It is generally an inappropriate tool for clients who have lower risk profiles, shorter time horizons, and lower overall financial means, as these types of clients cannot afford to ride out the effects of an investment downturn.

Borrowing to invest increases the gains in rising markets; but in a falling market it means that the investor stands to lose not only the investments they have made but also any assets that they have provided as security (e.g. property). It seems unlikely that so many people would have mortgaged the family home, their only asset, if they had understood that there was a significant risk that they could lose it as a result of a decline in investment markets.

In some cases there appears to have been ambiguity regarding the specific gearing arrangements and in particular the ownership of the assets against which the loans have been secured, which led to clients' assets being the subject of margin calls of which they were unaware.

It appears that some credit providers did not undertake the normal enquiries required for the prudent provision of credit, including reasonable scrutiny of financial information to support the request for credit as well as a proper level of analysis of the borrowers' balance sheet, income and ability to pay. The 'responsible lending' provisions of the new National Consumer Credit Protection Bill should help address this issue.

Advice

Advice enables Australians to achieve their long term goals such as owning their own home. Importantly, it also plays an essential role in ensuring that their families have financial protection against unfavourable events and helps them achieve a more comfortable retirement. Advice does this, in part, through helping client to make informed decisions about how and where they invest their money. Understanding the risks associated with each investment strategy is central to this decision making, and explaining the risks to clients is one of the key functions of a financial adviser. The adviser's obligation in this regard goes beyond disclosure to ensuring that the client understands the risks associated with the strategy that is being recommended.

We have already indicated that the excessive use of credit was linked to an apparent failure to understand the risks associated with doing so. It is clear that in many cases the clients were not in a position to meet ongoing loan repayments when the markets declined, and that they had not anticipated that they could lose their properties.

An adviser needs to tailor an investment strategy to the client. To do so the adviser needs to understand the client's own financial situation, their objectives, and their attitude to risk. That so many of the clients affected by these failures had very similar investment strategies suggests that there was not sufficient regard paid to their own individual circumstances.

Another fundamental element of any investment strategy is diversification; it is a basic strategy for managing investment risk. This should be a key consideration of a financial adviser in preparing any investment strategy for a client. There is evidence, however, of overexposure to particular asset classes with the result that some clients' investment portfolios have been more adversely affected than the broader investment markets.

Knowing your client and explaining, evaluating and managing risk are all fundamental elements of good financial advice that appear to be absent from many of the cases being presented to the Inquiry.

Licensees

While a financial adviser deals directly with the client, they normally do so as the authorised representative of a company which holds an Australian Financial Services Licence (AFSL)- the licensee. The licensee has an obligation to comply with the licence conditions and with the Corporations Act, and to ensure that its authorised representatives also comply. The licensee is responsible for accreditation, training and supervision of advisers, and for determining the types of advice the financial adviser is able to provide. It follows that primary responsibility for advice failures must lie with the licensees. Any failures observed in the current inquiry must therefore potentially be the result of failures by the companies, as AFSL holders, to comply with their regulatory obligations.

Disclosure

Financial products can be hard to understand and conceptualise, as the underlying investments are often intangible. It is evident that many clients did not fully understand the products they were investing in, the credit contracts they were signing, or the investment strategies they were adopting.

While there is an obligation on financial advisers to provide disclosure documents to clients, and there is evidence that this did occur, there is also evidence that the disclosure did not lead to a full understanding by the clients of the strategies they were adopting.

The current principle articulated in the Corporations Act for disclosure is that it should be 'clear, concise, and effective.' It is fair to say that the industry, regulators and the Parliament have grappled with what this means in practice since this principle was introduced six years ago. The industry response has been to increase the disclosure, with detailed descriptions of how investments work, how fees are charged and earnings are credited, and of the relationships between different parties involved. Failure to take this 'complete' approach can result in action from the regulator for a lack of disclosure, yet at the same time regulators and the Parliament have criticised the industry for this approach.

Financial literacy

The purpose of disclosure is to provide clients with information about financial products. For clients to make effective use of this information they need to have a general understanding of financial markets and the basic principles of investment.

It appears that this more general understanding, financial literacy, was lacking among many of the clients.

Behavioural finance, a relatively recent branch of economics that examines the serious practical constraints that people face in their day-to-day financial decision making, shows us that pure rationality is not the only dimension on which even for the most sophisticated investors draw to make decisions. Unfortunately, it is a fact that investors chose these investment strategies. This is not to deny that many investors are innocent victims, but it is a reality that we sometimes make irrational decisions especially when it comes to matters of money.

While much is being done to improve the level of financial literacy in our society, knowing the right thing to do does not necessarily mean we will do it. Human behaviour is rarely logical and rational, particularly when it comes to matters of money. In fact, there is considerable research to back this up; studies in behavioural finance reveal that there are behavioural impediments which affect individuals' ability to make appropriate financial decisions.

The implications for public policy are that it is not possible to design a system which totally safeguards investors, and that the price of attempting to do so results in a system that is expensive, stifles innovation, and delivers poor aggregate outcomes for the community.

This is where financial advice comes in as a financial adviser can help clients navigate their way through the conflict between emotions and rationality, particularly when investment markets are volatile.

Remuneration

It has been suggested that the use of commissions by financial product providers has contributed to these failures. AXA observes that failures occur across all types of payment systems, commissions, ad-valorem fees or hourly based fees. There are examples of high upfront charges associated with a number of these failures which are magnified when gearing is included in the proposition. It is interesting to note that customers appear to have been willing to pay high upfront charges, regardless of whether they have been charged as a commission or as a fee and regardless of whether they have been deducted from the investment or charged separately.

An important consideration for the Committee is that regulation that directs how remuneration is determined may have unintended consequences and problems of its own. For example, fee for service charged on the basis of time has in some sectors resulted in unnecessary servicing. On the other hand, fixed fees can lead to under servicing and performance based fees can lead to unnecessary risks being taken.

Ultimately, what is important is that customers understand and direct the costs they pay for advice, administration and products, both upfront and ongoing. Effective disclosure is essential to this.

Fraud and unethical behaviour

Unfortunately, one common cause of client losses is outright fraud and/or unethical behaviour.

Whatever the legal and regulatory framework, it is almost impossible to eliminate fraud or unethical behaviour. While the incidence can be reduced through improved measures as set out in our submission, public policy needs to strike the right balance between regulation and control versus the efficient functioning of a market which enables innovation to occur for the long term benefit of consumers.

4.0 OUR INDUSTRY

It is important the current failures being investigated by the Committee are seen in the broader context of the financial services industry as a whole. AXA believes that the practices referred to in previous pages, and the failures they have caused are not typical of Australian financial services, and do not point to a wholesale failure of Australian financial regulation.

The Australian system already demonstrates many positive aspects.

A high level of disclosure
Disclosure is a cornerstone of the Australian regulatory regime for financial services. 'Clear, concise and effective' is a key principle enshrined in the Corporations Act. Overall product disclosure is of a high standard, covering key features of a product, fees and charges; and the risks associated with investing. Advisers are also required to provide high levels of disclosure in relation to the services they can provide and their remuneration. All parties are required to manage conflicts of interest, which includes their disclosure to clients.

An important consideration in regard to disclosure is that information is not only adequately disclosed, but disclosed in a way in which it will be understood.

A high level of professionalism in advice
Since the introduction of the Financial Services Reform amendments in 2003, the Australian financial services industry has undergone a period of prolonged and continuous improvement. This has included enhancements to the regulations governing the provision of advice. There are now clearer requirements around what an adviser must consider, how advice is to be documented, and the level of disclosure that must be provided. While there are ongoing concerns that these reforms have made financial advice more expensive, the standard of financial advice has risen across the industry. (This is not to deny that there continue to be instances of poor advice.)

An open architecture environment
Australia has one of the most sophisticated financial services markets in the world with the distribution of financial products occurring in an ‘open architecture’ environment, through which financial advisers sell the products of more than one product provider regardless of whose dealership they work for. This open architecture enables effective consumer choice, promotes competition, and enables innovation.

A range of remuneration models
In the past the financial services industry relied on commissions as a means of adviser remuneration and recently increasing criticism has been levelled at certain types of commission.

In recent years, there has been a trend towards the provision of a greater range of methods of payment and business models. This has included an increase in direct fee for service.

This mirrors AXA’s experience within its own licensee businesses, with an increasing percentage of advisers receiving their compensation from fees, AXA expects this trend to continue into the future.

AXA believes that:

- If Australia is going to successfully address the challenges posed by its ageing population then quality financial advice is essential.
- Quality advice should be accessible to all on an equitable and affordable basis.

- It is important that customers understand and direct the costs they pay for advice, Administration and Products, both up-front and ongoing. Effective disclosure is essential to this.
- Advice costs should be tax deductible.

Two key industry bodies, the Financial Planning Association (FPA) and Investment and Financial Services Association (IFSA), are currently engaged in member consultation on new principles for remunerating advisers. The FPA's Financial Planner Remuneration paper sets out a series of principles, the net effect of which is to put clients in a heightened position of control over the fees they pay for the services they receive. Similarly, IFSA's 'Draft Super Charter: A new commitment to super members' is underpinned by the principles of value, choice, transparency, comparability and competition. It too calls for advisers' remuneration to shift to member advice fees which are authorised by clients and paid directly or deducted from their investment accounts, rather than being paid from the margins of product issuers.

AXA supports these further enhancements to the system.

A strong market conduct environment
Market conduct is regulated to ensure fair and effective participation in a free market with appropriate safeguards against the market imbalances created by differences in the knowledge, size and sophistication of market participants. While there are some criticisms of product disclosure, it has been an important tool in promoting understanding of financial products and ensuring consumers are able to monitor the performance of their investments.

A strong culture of continuous improvement in products and services
There are a large number of participants in the Australian financial services industry. As a result, the industry is highly competitive and innovative, driving a continuous search for better products and services. This innovation and expertise lends weight to the Government's initiative to make Australia a regional financial services hub, although ultimately the single biggest barrier to the success of this initiative remains tax.

A growing competence in the area of financial literacy
Australia's diverse and innovative financial services industry requires an educated and well informed market for the potential benefits to Australian consumers to be realised. To this end the Government and industry have cooperated in measures to improve financial literacy. Media campaigns and websites such as ASIC's FIDO have been complemented by financial literacy classes in local communities. Existing efforts need to continue and be expanded if we are to capitalise on the benefits for the whole Australian community.

An effective regulatory system
Working hand in hand with a regulatory focus on market conduct, Australia has a strong prudential regulation system for financial companies such as banks and insurance companies, which are essential to the economy, and for superannuation, which is essential to the long term financial security of Australia's growing population of retirees. The effectiveness of the regulatory system in protecting against systemic failure has been evident in the current global financial crisis. Reforms currently underway in countries around the world reflect existing aspects of Australia's regulatory environment.

5.0 ROLE OF ADVISERS AND ADVICE

Substantial aspects of the Terms of Reference of the inquiry go to the heart of the role of advice and advisers in our industry and market conduct more generally. AXA recognises the crucial role financial advisers play in educating consumers, helping them to articulate their financial objectives, and assisting them to implement the financial strategies needed to achieve these objectives.

The role of advice is crucial not only for individuals but for our community as a whole. Increasing the individual net wealth of Australians reduces the burden placed on future generations to meet the retirement needs of our increasingly ageing population.

5.1 THE NEED FOR ADVICE

Over the past two decades, most OECD countries, including Australia, have shifted to policies which have resulted in Government and industry reducing their role in the provision of retirement savings, with individuals bearing much more of this responsibility. While the Age pension remains a key pillar of the Government's retirement incomes policy, the introduction of the Super Guarantee Contributions (SGC) and the phasing out of defined benefit funds in favour of contribution accumulation funds has placed a greater responsibility on individuals to make investment decisions to support their own lifestyle and retirement.

By most estimates a considerable retirement savings gap exists. For example, IFSA research estimates the gap to be around $450 billion or $93k per person by 2050. [Source: IFSA, 'Policy Options for Retirement Incomes and Long Term Savings, March 2006] Appendix 1 outlines more details on Australia's significant retirement savings gap.

Australians are living longer and having fewer children. Our society, along with most other developed countries, is ageing. Over the coming decades there will be a dramatic increase in the number of older Australians, and a parallel reduction in the number of people in the traditional working age groups.

This outlook constitutes one of Australia's most significant economic and social challenges. Meeting this challenge will require contributions from us all. Governments will need to continue to adjust their policy settings. Individuals will need to save more for their retirement. And the financial services industry will need to help them to do so.

Central to addressing this issue will be helping Australians better manage their finances over the long term. As a result, financial literacy and quality financial advice play a critical role.

Financial literacy and quality financial advice are two ends of the same spectrum. On the one hand better educating Australians in relation to the financial decisions they will face in life and on the other offering them advice, support and counsel in making those decisions.

Financial advice has a critical role to play in assisting clients to successfully manage their increased savings responsibilities to save for longer and in prudent ways, thus ameliorating the fiscal strain for future Governments and the taxation burden on future generations.

5.2 THE IMPORTANT ROLE THAT ADVICE PLAYS

There are several elements to financial advice.

Understanding
The first element is to help the client to understand their current financial situation, and their objectives. This includes considering their current income, liability and assets, future earning capacity and liabilities, and the lifestyle they want in 5, 10, 15, or 30 years.

Setting objectives
Once this has been established, the adviser can work with the client to assess what is achievable, and the specific targets or objectives that will need to be achieved along the way to attain this outcome. Research commissioned by AXA found that the aspect of financial advice that people value most is the opportunity to work through their own financial goals with an expert [Source: 'Quality Financial Advice – A values perspective', AXA, February 2005].

Strategy
When the objectives have been established, a strategy can be developed which takes into account the client's objectives, their current income and assets, their future earning ability, and their tolerance for risk. This includes a range of actions such as reducing debt, increasing disposable income, and identifying appropriate investments types. Due consideration needs to be given to diversification and other measures to manage investment risk.

Implementation
The next step is implementation. The key role of the financial adviser in this phase is to help the client to make informed decisions about how, when and where they will invest their money. Understanding the risks associated with each investment is central to this decision making, and explaining the risks to clients is one of the key functions of a financial adviser. The adviser's obligation in this regard goes beyond disclosure to ensuring that the client understands the risks associated with the strategy that is being recommended. The adviser also has the significant responsibility of recommending a financial plan that optimises the client's financial situation, taking into account the very complex and frequently changing interplay of the taxation, social security and superannuation systems in Australia.

Review
The final stage is coming back to regularly review and refine the objectives, strategy and the investments. Are these all still appropriate? Have there been lifestyle changes (marriage, children, new job) which require changes to be made to the strategy?

Behavioural change
Mainstream economics assumes people operate in a rational way — identifying all the possible courses of action and then assessing their expected value against a comprehensive set of clear-cut, fully articulated and consistent preferences.

Simply put, life is just not like that.

There are many examples in life where people know what they need to do (give up smoking, lose weight) but they need motivation, support and advice from colleagues, friends and professionals to achieve the goal.

Research by 2002 Nobel Economics prize winner Daniel Kahnemann, and others in the field of behavioural finance, has shown that the complexity, intangibility and uncertainty associated with long term savings and investment markets can cause investors to adopt behaviours that are unwittingly irrational and wealth destroying.

In the modern world with so many choices and experiences in front of us and debt so easily available the temptation for immediate consumption and gain is overpowering. Behavioural finance strongly suggests that merely providing people with the means to save more is unlikely to ensure that they will, which is why advisers play a key role in assisting clients to change their long term savings behaviour.

Greater wealth

Oliver Wyman & Co in the UK and others have shown that financial advisers are effective in helping people increase savings.

This research suggests that a significant portion of voluntary savings can be directly attributed to financial advice, with advisers increasing savings by 31-54% depending on the household income.

Household annual income	£9,500- £13,500	£13,500- £17,500	£17,500-25,000	£25,000- £35,000	£35,000+
No of households (million)	2.0	2.2	2.6	3.1	4.3
% who would not have saved/ invested unless persuaded by the adviser	46%	42%	32%	35%	26%
% additional benefit driven by adviser recommended optimisation	13%	12%	12%	11%	6%
Total benefit* (persuasion + optimisation)	54%	49%	40%	43%	31%

Source: The future regulation of UK savings and investment - Targeting the savings gap Oliver, Wyman & Company September 2001

Quality financial advice is able to increase savings rates through helping people to understand the value of savings and investments and by providing them with clear strategies and motivating them to act.

6.0 REGULATION OF FINANCIAL ADVICE AND PRODUCTS

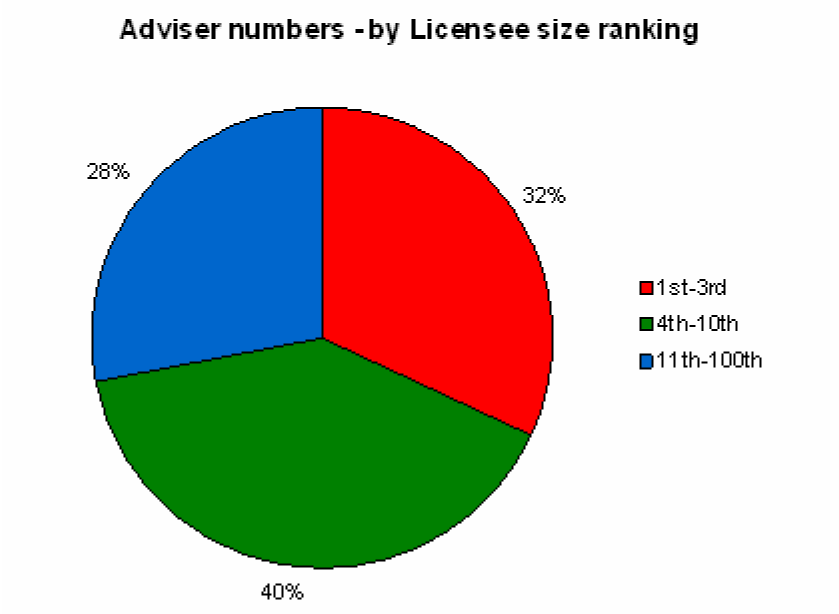
The Inquiry's Terms of Reference include: the role of advice, the relationships between advisers, licensees, product providers and credit providers, and the adequacy of the current regulatory regime in promoting positive outcomes for consumers.

Legislation

The broad framework of the Corporations Act is clear and effective, especially for products. Regulation of advice focuses on product sales and recommendations, and does not capture other dimensions of advice. The term financial adviser / planner is not regulated.

The regulator

ASIC adopts a risk based approach to monitoring market conduct by industry participants. The graph below illustrates that the top ten licensees in Australia account for some 70% of all authorised representatives. By default this can lead to supervisory activity being tilted towards the larger licensees. More weight needs to be given by ASIC to other risk indicators such as complaints, the complexity of products being recommended and reports from industry participants.



Source: Money Management top 100 dealer group survey - 2008

Professional bodies

Professional bodies exist in financial services, but membership by licensees and advisers is not mandated. This is could hamper the evolution of the industry towards becoming a profession, with more uniform standards and codes of conduct which would benefit consumers by improving the quality and consistency of financial advice. AXA submits that the current environment would be enhanced by requiring licensees to adopt a common framework on issues which go to the heart of professionalism, and by requiring advisers to belong to a recognised professional body.

Licensees

Financial advice is best characterised today as an industry evolving towards a profession. Legally, the licensee is the entity responsible for the conduct of its advisers. The principles based approach to legislation, which is appropriate, requires a significant degree of interpretation at the licensee level, and allows for a range of different approaches. The large variation in the size, structure and philosophy of the licensee entities interpreting and applying these principles can lead to different standards.

Advisers

The advisers are the individuals dealing with clients- considering their circumstances, developing strategies, and recommending products. Advisers are not directly regulated by ASIC but via licensees. This is appropriate, as ASIC does not have the resources to directly regulate such a large number of individuals. This arrangement does, however, reinforce the important role of the licensees. It also highlights the need for a recognised professional body for advisers, promoting professional standards among advisers.

In summary, all stakeholders – Government, regulators, professional and industry associations, licensees and advisers – have a role to play in further improving our financial system.

7.0 RECOMMENDATIONS

Our submission thus far has sought to analyse some common causes of failure, to examine the role that financial advice and financial advisers can play, and to evaluate the current regulatory structure.

In this section, AXA provides recommendations which we believe will help to strengthen the financial system and provide better outcomes for consumers individually and the community as a whole.

7.1 RECOMMENDATIONS FOR GOVERNMENT

7.1.1 CREDIT

Recommendation:

1. Following the introduction of the new credit reforms the Government should commit to undertaking a review of their effectiveness by the end of 2012 and implement any further enhancements necessary.

AXA has noted the role that the easy availability of credit and excessive gearing has played in exacerbating the impact of some of the failed investments. AXA is aware that, following agreement at the Council of Australian Governments in 2008, legislation is in the process of being enacted to make the Uniform Consumer Credit Code national legislation. This will include 'responsible lending' provisions. Further, margin loans will be regulated under proposed amendments to the Corporations Act as a financial product, requiring margin lenders and advisers to:

- hold an AFS licence;
- comply with general conduct standards; and
- provide appropriate disclosure.

AXA supports these reforms, which should result in more responsible credit provision and provide better outcomes for consumers.

AXA notes that the current poor lending that has prompted these reforms occurred at the height of a bull market, and was exposed by the current market downturn. It may be that in this current stage of the economic cycle we will naturally see less demand for gearing and margin loans, and greater conservatism from lenders. It will therefore be difficult in the current economic climate to determine whether the new credit reforms have been effective. Any assessment of the effectiveness of the current reforms will need to consider developments across the cycle including a return to increasing investment markets and greater economic growth.

7.1.2 DISCLOSURE

Recommendation:

2. Acknowledging the regulatory changes already taking place around gearing we believe it is important that any regulatory changes ensure that Statements of Advice should include a clear explanation of the leveraging impact of any gearing accompanying investments,

including in particular additional exposure to the downside in the event of falling investment markets. Such disclosure should also make clear any margin loan trigger points.

3. Statements of Advice should be modified to ensure that the adviser is making a clear recommendation in relation to whether the financial plan incorporates gearing and the parameters of such arrangements.

Disclosure has not always been helpful in protecting retail customers. It appears that there have been examples in these failures where risks associated with investments have not been fully disclosed and the overall proposition has been relayed to be more secure than it actually is. This might have been compounded where credit is also being provided associated with reputable institutions which has resulted in clients taking an additional sense of comfort that has not necessarily been consistent with the underlying investment risk.

7.1.3 FINANCIAL LITERACY

Recommendation:

4. The Government should continue to roll out its programme of initiatives in relation to further improving the level of financial literacy in Australia.

Financial literacy can help consumers with the knowledge required to make better decisions, be aware of scams and participate more effectively in a modern economy.

In a world of choice, and mandated savings for super, with complex taxation arrangements, sophisticated products and increasing disposable incomes, the Government and the financial services industry have an obligation, over time, to commit to increasing the financial literacy standards of Australians.

AXA applauds the Governments' financial literacy initiatives to date, which have received bipartisan support. These are long term initiatives, but AXA is positive that they are necessary, and are beginning to make a difference.

Financial literacy capability across the community can be further developed by:
- Financial literacy being built into the school curriculum across core subjects in the new national curriculum.
- Financial literacy being included as a key component of technical training delivered via VETS and TAFES.
- Financial literacy programmes being included as part of work place training.
- National awareness programmes promoting financial literacy, free public programmes and websites such as FIDO and Understanding Money.

AXA is committed to supporting the further growth of financial literacy in a number of ways. Our recent announcement of a $500,000 grant to The Smith Family to help break the poverty cycle in families is an example, as are our workplace financial literacy programmes for employees.

7.1.4 ADVERTISING AND PROMOTION

Recommendation:

5. Consideration should be given to requiring all market participants who advertise financial products and services to do so under a formal code of conduct for responsible promotion.

The general quality and appropriateness of advertising and marketing is sound. Some weaknesses that AXA observes are set out below.

Some promotions of financial products use estimated rates of return
Products which are promoted based on a forecast rate of return may imply to consumers that they will receive that rate of return, without appropriate disclosure of the risks. Two examples are:

- Past performance being extrapolated in order to forecast future performance;
- Quoting 'point in time' rates of returns which are subject to regular change.

Promoting product or service features in isolation of other factors
Promotional material which focuses on individual features of financial products or services in isolation may mislead consumers and lead to consumers making a financial decision based on limited information.

The true risks of yield driven products are not fully understood by investors
Over every full market cycle, there are examples of advertised high yield products failing, often associated with mortgages, debentures and property related firms. These appeal particularly to clients who desire investment cash flow and are inevitably attracted to such offers in periods of declining or low interest rates. We are entering such a period of time now.

7.2 RECOMMENDATIONS IN RELATION TO LICENSEES

7.2.1 AFSL ISSUANCE AND SUPERVISION

The promulgation of the Financial Services Reform Act (FSR) elevated the role of the licensees to the primary party responsible for the authorisation, training, monitoring and compliance of individual financial advisers. It follows, then, that the conduct of licensees is central to the quality of advice provided to consumers.

When submitting a new application for an AFS Licence, an organisation needs to provide a description of its business and documented 'proof' of capacity with specific requirements relevant to:

- organisational competence;
- compliance arrangements;
- representatives (appointment, monitoring, supervision and training of authorised representatives);
- adequacy of resources (including nominated responsible managers);
- dispute resolution;
- risk management;
- compensation and insurance arrangements; and
- research and benefits.

This is an extensive list of obligations, requiring considerable resources and management focus to discharge and monitor properly. AXA submits that some licensees do not have the requisite resources or skills to properly discharge these obligations, which in turn contributes to poor advice and failures.

The four key areas below require reforms to improve the outcomes for consumers:

- compliance arrangements;
- the role and responsibilities of responsible managers;
- monitoring, supervising and training representatives; and
- capital adequacy requirements for licensees.

7.2.1.1 Licensee resources and skills to achieve effective compliance

Recommendation

6. The process for obtaining an AFSL should be enhanced to require applicants to provide further detail and commitments regarding the establishment of governance processes and the systems and resources necessary to meet its responsibilities as a registered licensee.

FSR obligations are principle-based and licensees are responsible for interpreting and implementing the principles. This has generally resulted in licensees implementing comprehensive programs to document, monitor and report on compliance, but some do not have sufficient skills or resources to put in place the necessary framework.

7.2.1.2 The role of the responsible manager

Recommendation

7. The role and responsibilities of responsible managers of AFSL holders (licensees) should be elevated to include the requirement for an annual certification regarding the licensees ongoing meeting of its licence obligations and requirements and the effective working of the governance processes in place.

8. Each licensee should be required to have a compliance committee whose terms of reference and responsibilities ensure appropriate measures and processes are in place to achieve compliance with the licensee's obligations and those of its authorised representatives. This would include responsibility for establishing and overseeing a formal compliance program, including processes for addressing breaches and dealing with complaints.

Responsible managers are key individuals that licensees rely on for their organisational competence. Before nominating a new responsible manager, a licensee is currently required to ensure that the person concerned:

- is directly responsible for significant day-to-day business decisions about the licensees ongoing provision of financial services;
- is of good fame and character; and
- has the appropriate qualifications and experience.

In many cases, insufficient attention seems to have been paid to the role of responsible managers.

The role and purpose of responsible managers needs to be given greater authority and responsible managers need to be held accountable when licensees fail to meet their obligations.

7.2.1.3 Licensee monitoring, supervision and training of representatives

Recommendation

9. Licensees should be members of a recognised industry body and should be required to ensure that each of their authorised representatives are members of an appropriate professional body. The licensee should ensure that its authorised representatives comply with their membership obligations, including continual professional development and codes of conduct. (Refer to recommendation 11 below.)

A number of obligations apply to a licensee relating to its authorised representatives, including to:

- take reasonable steps to ensure that its advisers comply with the financial services law;
- ensure that its advisers are adequately trained and are competent to provide the financial services covered by their authorisation; and
- maintain a record of the training that each of its advisers has undertaken.

It may be the case than in some licensees these obligations are not always met, for example:

- Advisers who continuously fail to complete their ongoing training requirements are permitted to continue advising.
- Many licensees may not have the dedicated resources to fulfil their compliance obligations e.g. advisers not completing induction training.
- Issues and breaches identified by external service providers in audits may not be addressed.
- In some cases licensees may not conduct sufficient remedial training or address systemic issues.

7.2.1.4 Capital Adequacy requirements

Recommendation

10. The Government and ASIC should consult with the industry to identify a more appropriate level of capital adequacy for licensees which would afford greater comfort that the risk management, compliance, and adviser training and supervision functions are fully resourced to the standard necessary to meet these enhanced obligations.

AXA considers the current capital adequacy requirements are too low, resulting in some licensees not having access to adequate resources to be able to discharge their duties.

The current capital requirements for a licensee (broadly) are to:

- be solvent;
- have enough liquid assets to pay debts; and
- hold $50k in Surplus Liquid Funds plus 5% of liabilities between $1m-$100m and 0.5% beyond.

In practice, this means many licensees only have a capital base of $50,00-150,000. Whilst the capital base may not be directly correlated to the size of resources that a firm has. AXA suggests that an insufficient capital base is likely to indicate a lack of resources. Regardless of the level of professional indemnity insurance that may be held, AXA contends that a substantial capital base is a source of consumer protection.

AXA is aware that any reform needs to ensure that smaller players are still able to hold an AFS License. We believe that the industry will be stronger and more vibrant if it has healthy competitors, both large and small.

7.3 RECOMMENDATIONS IN RELATION TO ADVISERS

7.3.1 ADVISER PROFESSIONALISM

Recommendation:

11 The Government and ASIC should support the development by the industry of one or more recognised professional bodies for financial advisers which prescribe professional standards, minimum qualification levels, codes of conduct, supervision and sanctions.

Clients have a right to rely on the advice being provided as being appropriate for their needs, and being factually and technically correct. The quality of the advice depends on the adviser's experience, training, professionalism, and ethics.

Whilst the advice industry has evolved and matured substantially, it is not yet a profession; it is made up of practitioners who are 'specialists'. Some of the key elements required of a profession – such as mandatory accreditation via an independent body to gain and keep a practicing certificate – are not yet present. Indeed, the regulatory structure is built around the concept of regulating 'product advice', and the term financial adviser itself is not defined or regulated.

While requirements in relation to disclosure and recommendations are mandated, professional standards, codes of conduct and ethics - together with licensee activities - are the appropriate tools for further improving advisers' capabilities and conduct.

The current 'entry requirements' for advisers are too low - ASIC's guidance is set at roughly Diploma level for personal advice, and at Certificate III level for more general and limited advice. Even within these guidelines, training standards vary across licensees.

AXA supports the ongoing evolution of advice standards by continuing to upgrade the minimum training requirements required to provide advice at different levels, and enforcing a higher level of consistency and conformity to these standards. The professional bodies have an important role to play here, and Government and regulator support for the evolution of their role would be welcome.

AXA appreciates that this recommendation 11 requires the regulator to establish a framework by which associations can be evaluated in order to be recognised. There are precedents for such action, and AXA believes that this approach will be to the benefit of the industry and assist ASIC in its regulatory role.

7.3.2 PROFESSIONAL INDEMNITY COVER

Recommendation:

12. The current arrangements and requirements in relation to Professional Indemnity (PI) cover for Authorised Representatives and AFSL holders should be reviewed including an

appropriate estimate of the prudent level of PI cover. This should be more closely aligned to the number of clients and value of clients' funds invested rather than the current model that refers to licensee revenue.

One of the terms of reference of this inquiry is the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers.

Following the collapse of Westpoint, ASIC released Regulatory Guide 126: Compensation and insurance arrangements for licensees. One key aim of this guide was to try and ensure consumers were protected where a licensee collapsed.

This guide recommends PI insurance must have a claim limit of at least $2 million for licensees with total revenue of $2 million or less. Above this, minimum cover should be the actual or expected revenue from retail clients, up to a cap of $20 million.

The guide also requires a licensee's PI policy to include cover for fraud and dishonesty by directors, employees and other representatives. Cover for fraud is usually excluded under most PI policies, but can be obtained by a Crime extension to the policy.

In practice, as a result of market forces PI premiums have increased significantly in the past few years and licensees have struggled to obtain the recommended cover and meet the high, and rising, costs.

From a policy perspective, a sensible level of PI cover for licensees is prudent. Its role should be to protect the business operations enabling a practice to trade as an ongoing concern in the face of an occasional client claim.

AXA notes that ASIC's guidelines use licensee revenue as a proxy to estimate the required PI cover. Client numbers and size of the clients' funds would be a better proxy to estimate a prudent level of PI cover.

AXA believes that the current arrangements for PI cover are broadly sensible and practical. Any further changes contemplated must have regard to the commercial availability of PI cover and its cost.