COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Financial products and services in Australia

WEDNESDAY, 26 AUGUST 2009

MELBOURNE

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Wednesday, 26 August 2009

Members: Mr Ripoll *(Chair)*, Senator Mason *(Deputy Chair)*, Senators Boyce, Farrell, McLucas and Williams and Ms Grierson, Ms Owens, Mr Pearce and Mr Robert

Members in attendance: Senators Mason and Williams and Mr Pearce and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on:

Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

WITNESSES

Committee met at 8.44 am

CHAIR (Mr Ripoll)—I declare open this public hearing of the Joint Committee on Corporations and Financial Services. It is part of a series of public hearings that the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses. In conducting its inquiry the committee has made a decision to focus specifically on non-superannuation products and services.

Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee. The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult with witnesses concerned before doing this.

McINERNEY, Mr Dallas, Manager, Government and Regulatory Affairs, MLC Limited

NUNN, Mr Richard, Executive General Manager, Advice and Marketing, MLC and NAB Wealth, MLC Limited

TUCKER, Mr Steve, Chief Executive Officer, MLC Limited

CHAIR—I welcome witnesses from MLC to the table. I will ask you to make a short opening statement in regards to your submission. We will then have a bit of a conversation, ask some questions and go from there.

Mr Tucker—Thank you for the opportunity to appear before the committee this morning to discuss our submission. We have put a lot of thought and effort into our submission. It is good to get a chance to take you through some of the more important aspects.

I would like to acknowledge the work of the committee to date in identifying and working through some of the very important issues that have been raised on behalf of Australian investors and for the financial services industry in general. We note by the number of submissions that you have received that this is obviously a very significant area for all Australians and we are happy to be able to make a submission.

There is no doubt that the last two years have been very challenging for the industry and investors, not only because of the local effects of the global financial crisis, but also due to some of the unresolved structural issues in the financial services industry which continue to potentially disadvantage some investors.

On a related point, I would like to make some comments in relation to Storm Financial, which I know has been a large focus of the committee. While I am here today in my capacity as CEO of MLC, we do form part of the larger National Australia Bank group and we do share the committee's concern for Storm's customers. I can inform the committee members that NAB has established an internal working group to fully assess its level of involvement with the Storm Financial group and any customer relationships that might exist between the two organisations. The working group is conducting a comprehensive review of all related processes and policies and this work is ongoing. Subsequent to the establishment of NAB's own review, the bank, along with a number of other financial institutions, received a notice from ASIC seeking similar information. NAB is cooperating fully with the regulator and is devoting all the necessary resources to accommodate ASIC's requests. This includes regular meetings between NAB and ASIC, and again this work is ongoing. When this information has been collated, having regard to NAB's other regulatory and legislative requirements, I will be happy to arrange for the committee secretariat to be appraised on NAB's response to this issue.

On broader matters being considered by the committee, you would be aware that MLC's submission contains some detailed discussions on investor related issues, but more importantly we have proposed several reform options for consideration of the committee and we are really happy to discuss those with you this morning.

When I appeared before the committee in 2007 there was a lot of debate around planner remuneration, shelf space fees and industry remuneration practices in general. As I am sure many of you are aware, some years ago MLC did break from the industry and led the way towards fee-for-service arrangements for our financial advisers. I am pleased to report that two years down the track the response continues to be overwhelmingly positive. Today, over 60 per cent of new business is written on a fee-for-service basis and many in the industry have taken or are considering similar courses of action.

This is to be welcomed; however, we do recognise that the challenges facing the industry extend well beyond planner remuneration. Mr Chairman, in the parliament last week, while debating the proposed national consumer credit legislation, you made an excellent point about the role of disclosure. You remarked that disclosure should not be about providing more and more information, but rather it should be about providing information up front and presented in a way where ordinary people can truly understand what they are buying into. MLC has the same view and our submission seeks to reflect this belief.

Our submission details a comprehensive alternative regulatory framework for Australia's investment advice industry and our proposals are informed by several factors. We have a very strong view that the need for Australians to have access to sound professional advice has never been greater. We have a firm belief that the customer should be at the centre of all considerations in the investment process, and transparency should be a guiding principle for all aspects of the industry's operations.

One of the central features of our submission is the proposal for a new licensing criteria for Australian advice businesses, delineating between two categories, the affiliated advice business and the independent advice business, each category reflecting their operating structure and providing a meaningful descriptor for investors. Importantly, we go further to say that the representatives of these businesses would also be licensed reflecting the structure of the companies, such as an affiliated financial planner or an independent financial planner. The benefits of this proposal would be to compel the industry to be fully transparent about any conflicts which exist in their businesses, particularly as it relates to remuneration payments between industry players. We believe this would be meaningful information for investors.

The submission also has recommendations about the role of licensees and how improved governance standards and capital requirements can enhance the advice process. Again, we are happy to expand on those issues.

There are several other recommendations in the document, some of which are similar to those made by other committee participants and, time permitting, we can discuss those as well.

I would like to finish my opening remarks by urging the committee to be bold. The need for reform in our industry is great. There are areas where self-regulation is proposed and where it has proven to work in the past, and I would urge the committee to consider this in its final report. However, there are some areas that do require other regulatory or legislative response and our submission has tried to identify some of these. If, at the end of the process, Australia emerges with a stronger more sustainable investment industry which serves and protects investors, then Australia more broadly will be the winner. I am happy to take any questions that the committee may have.

CHAIR—Thank you for your submission and recommendations. I would like to begin by making a comment. Lots of submissions that we have received have looked at different models and different ways they might approach to improve the sector. You have made particular reference to be bold, to make some improvements and to look at changing things. Can you give us some sense of how you think the FSR legislation is operating? It has been seven or eight years now since it was introduced into the parliament in 2001, so what is your sense of how that is operating?

Mr Tucker—In our submission we have recommended that we review the FSR and ensure that it is operating as intended when it was originally introduced seven or eight years ago. It does have some shortcomings. It is a product-based regime. We are really moving into the advice world and trying to rearrange the way we focus on the customer away from the product in the conversations that are going on out there between advisers and clients.

FSR has been a reasonable regime and it has held us in reasonable stead, but I do think it is time for review. Some of the issues around disclosure and the obligations have been problematic and we have ended up with a number of volumes of reports and requirements for clients to receive which probably have not been that helpful for them in understanding some of the issues that they need to understand, so it is time for us to have a good look at FSR to ensure that it is operating effectively and, if not, to make some changes.

CHAIR—Are you saying that we should look for a distinction between product legislation and advice legislation? Is that what you are aiming at?

Mr Tucker—Yes. Going back seven or eight years the industry was still in transition. You would all be aware that for the last many decades the industry has been based on product, distribution and sales of manufactured services. In the last seven or eight years it has quite significantly changed. Now advisers are concentrating on giving quality advice to the client; that is separate to the product outcomes in many cases and we just need to continue that journey. The opportunity now is for us to separate the product regime from the advice regime, beef up the requirements around the licensee to ensure that the clients that are given advice are given what they need in their interests and reform the regime to focus on the client.

CHAIR—Can you give us a view of what practical difference would be in place if there was this separation between affiliated and independent advisers? How would that distinction work? How would that look in the real world?

Mr Tucker—I will just go back a step. The reason why we proposed this separation is that we have been quite diligently trying to work through how we can solve the issues of different payments of remunerations that are in the system that can create conflicts. We, ourselves, are a proprietary model; that is, we are vertically integrated. We manufacture products and we run advice businesses. In many cases the advisers use those products, so we have a structural conflict in that model. It does not mean it is wrong and it does not mean it cannot be managed, but we have to be aware of it.

At the other end of the spectrum there are some advisers out there who take no remuneration from product sales, deal directly with the client and are independent in a sense. However, there is a large group in the middle that are operating halfway between. That is unclear for a consumer.

The example we would use is if somebody comes to a NAB or MLC affiliated planner it is quite clear that they are affiliated to our organisation. They should be designated as affiliated to our organisation. That does not mean that the advice will be biased; it does not mean that we cannot manage their conflicts, but it does mean that the client should know that there is a strong association between those companies. In the independent sense, if there is no association, that is no money at all is transferred into the adviser or the licensee's hand from the manufacturing part of the value chain, then the client should be very well aware that is an independent model. We think that the confusion lies in the middle where licensees are giving advice, but in many cases a large amount of the remuneration or the revenue generated by that business model is generated from affiliations that exist with product manufacturers.

CHAIR—Is it a too narrow view? How narrow would the band be for truly independent operators? If you did separate that out would everybody end up with an affiliated tag, except for maybe a very thin slice of the market which you could truly say is independent?

Mr Tucker—It would be up to the market to determine where they want to operate, if you think there is a significant competitive advantage in being truly independent versus being part of an affiliated model. From a consumer perspective, we think that both have benefits. For clients who come and deal with us in the proprietary model we stand by the advice in so much that if anything goes wrong, and it occasionally does, then the organisation is there to care for the client. The big brands are obviously protecting their reputations, the facilities and resources they have to provide the right quality, level of research, technology and so on.

In the independent model it will tend to be a smaller business, but there are benefits in some clients' minds that that means they will get truly unbiased advice. I think where it would settle is that right now a client going into a conversation with an adviser in that middle band, which is the hybrid between the two, does not realise in many cases that they are dealing with an organisation that has strong affiliations to a big manufacturer. If they want to continue in that model that is fine, but they need to identify themselves as being part of that model, move to the left if you like and operate as a proprietary model or stop having revenue generated from product sales and move to the right in an independent sense. I do not know where it would settle in terms of numbers? It depends on a number of factors, including what clients and which model clients prefer. I suspect the majority will end up being affiliated.

CHAIR—I am trying to understand where the failure might be. I understand what you are saying with the distinction of the consumer knowing who is who and what their roles are, but is that where the problem exists? Is that where people find that problems occur later on because they did not understand who they were dealing with in terms of independence or affiliation, or is it more about disclosing? Is what you are defined to be part of the root cause of any problem?

Mr Tucker—The reason why we have proposed this solution is that we cannot just sit back. We have a strong view that volume rebates, shelf-space fees and other incentives in the system need to be managed much more clearly than they are. The proposed solution suggests that if you are in that affiliated model where there is going to be revenue generated up and down the value chain, identify yourself clearly as being part of that model. Redefine that model as being the affiliated model. Redefine the financial planner as being an affiliated financial planner so the client will have a much clearer understanding. Is the problem that bad advice is being given if it is not clearly identified? Not necessarily. The problem is that there is a significant number of payments moving between parties in the industry that the client has no chance of being able to understand so they think that they might be getting an independent outcome when, in fact, they are not.

CHAIR—Why is it important that the clients understand where all the money is transferred? If you disclose that you are affiliated, and obviously there are some complex fee structures that exist, why would that be important that the person understand where the fees are generated from, rather than just knowing the fact that the affiliation exists?

Mr Tucker—One of the aspirations we have is that 50 per cent of Australians get access to a financial planner or a good financial plan. One of the reasons why they do not, in our view, is that they find it difficult to understand the system and trust it. One of the reasons why they do not trust it is that there are confusing payments going on between different parts of the value chain, and it is hard for them to understand what influence that might have on the advice that they are getting. By clearly identifying the two different models the client can walk in the door with a NAB/MLC affiliated financial planner and they should not be surprised if they end up with some services from that group. It is also much easier to have the conversation: what does that mean; how does that impact on the advice that I am getting; am I happy with the advice that I am getting: I know that there is an association there. Right now the client has little chance of understanding the relationships that exist between the licensees, the advisers and the manufacturers in the current model.

Senator MASON—Are there any precedents in other contexts for the affiliated/independent split?

Mr Tucker—The UK has had a version of that type of model which has not worked particularly well in my view.

Senator MASON—It has not worked?

Mr Tucker—It has not worked.

Senator MASON—That is the chairman’s concern.

Mr Tucker—It did not go the same way we proposed. We proposed a much simpler split of different types of advice models. In the UK they went to a model that actually tried to define a number of different aspects of advice which is just too complicated. The simplest form is to say that it is this type of model with nothing in between. We think that has a much better chance of taking root and working well.

Senator MASON—I know it is a good try, but how and who would regulate it?

Mr Tucker—We think that the definition of affiliated financial planner and independent financial planner should be defined. Depending on the structure that you sit in, you need to be able to determine which model you should be licensed under. Licensees should be able to determine whether they want to operate as an independent or as an affiliated model. That should be the type of licence that they hold and they should provide authority to advisers who operate under one or the other model. It should be regulated by ASIC.

Senator MASON—Drafting laws like that is going to be an enormous grey area. What do independent and affiliated mean? It is quite difficult. Do not take this the wrong way, but any inducement or kickback, in effect, if that takes you from independent to affiliated would make the stratum extremely broad. Trying to regulate that is quite difficult.

Mr Tucker—We need to work it through in terms of the practicalities.

Senator MASON—I am just saying that as legislators it is difficult to draft and difficult to regulate.

Mr Tucker—Yes. I think we can over complicate it. To be independent it should be quite clear that the only payment you can receive is from the client and revenue can only be generated from the client. If there are any other forms of revenue sharing it should be that you operate under—

Senator MASON—If there are any fees or commissions then you are affiliated?

Mr Tucker—No, fees from the client.

Senator MASON—Any commissions?

Mr Tucker—Then you are an affiliated model. None of those payments should provide any bias to in-house products, as is our system. For example, NAB Financial Planning operate on a fee-for-service basis. There is no bias towards in-house products. The conflicts are being managed clearly. If we over complicate it with what sort of payments are okay and what sort of payments are not, I think you are right, but if we just simply say in a model where the only revenue is generated by the client to the adviser and therefore to the licensee, if you like up the chain, then that is independent. If there are any other payments you should be operating under the affiliated model. Further, under the affiliated model, volume based arrangements should go. There should be no bias to sell in-house products and advisers should be operating on a fee-for-service basis.

Senator MASON—Would that be regulated by ASIC?

Mr Tucker—Yes.

Senator MASON—You spoke in your introductory remarks about disclosure. Correct me if I am wrong. In effect, you said disclosure of itself is not sufficient, which I and the committee would agree with, and disclosure as currently manifest in the industry is not sufficient. What would you like to see disclosure manifesting itself as? How would you like to see disclosure?

Mr Tucker—We need to simplify the disclosure regime. I think that the fundamental premise that disclosure has become the only way that a client will receive information or be able to make decisions is wrong. What we have to deal with is the root cause around trust, which is the cultural issues and the concern we have for the client being at the centre of the decisions that are made. Acting in the client’s interests has got to be the first and foremost driver of the client’s outcomes, and disclosure needs to support that. The idea that we can find a 70-page document disclosing enough information to protect everybody’s interests and give the client meaningful information is flawed. We think simplification of disclosure, but also relating to that, the obligations of the adviser to act in the client's interests needs to be paramount.

Senator MASON—You spoke about transparency before. Do you agree that disclosure can get lost within transparency?

Mr Tucker—In many cases we have disclosed ourselves into trouble. Clients get confused. We try to rely upon that as a defence, but at the end of the day what we have to be doing, as an industry and as an organisation, is acting in the client's interests. If you can combine that premise with disclosure that allows the client to make decisions or at least find more information if they want to, then you have a better regime than one that simply says, 'I've disclosed it so therefore the job is done.'

Senator MASON—Some of the submissions before us touch on the idea that perhaps we should legislate to preclude certain advice being given to retail investors. You are against that and do not think that should happen. Why is that?

Mr Tucker—It comes down to what we are asking advisers to do. We believe that the qualifications for financial planning requirements should go up. We think there should be more education and requirement for particular qualifications to be met. If they are and a financial planner is qualified under those requirements to give advice, then they should be able to advise on the whole range of products and services that are available to the retail investor. Quite clearly, where we got to in some parts of the bull market was products that were not appropriate at all for retail investors. I think there is a role in product regulation to determine what is appropriate for any investor. If an adviser is qualified, they should be able to advise on all products.

Senator MASON—I only asked that because after the global financial crisis it seems that much of what the industry did was incorrect and lacked due diligence. Among the submissions someone describes margin lending and some of the other practices as gambling. I am not saying it is a good thing, but if people want to gamble and they are fully informed then they can go down to the casino if they want to, can't they?

Mr Tucker—Absolutely, they can. This goes to the heart of the role of the licensee. In our submission we have suggested that we need to beef up the role of the licensee and their obligation to ensure that appropriate advice is given.

In our group of companies we have very strict dealer standards that determine how gearing can be used and what the requirements are when gearing is put in place for the client to be able to meet. For example, can they sustain a large sudden increase in interest rates in a cash-flow sense? Is the risk profile matched to the understanding of what they are doing in terms of gearing? What is their future income generating capacity? In our case we think gearing is a reasonable strategy for many clients.

Senator MASON—That is the issue, rather than the risk per se.

Mr Tucker—Yes. It is how you manage it. The licensee has obligations through the dealer standards and in the way that they supervise the advice that is given. At the end of the day when advice is given that is inappropriate or there is a problem with it, the licensee has to stand there and be accountable for the advice. That means that we need to make sure that licensees and boards that run licensees have independence and the capabilities. We believe there should be capital put aside behind issues where poor advice or problems emerge so that clients can be protected and so on. I think it is time for us to accept, and we certainly do, that the role of the licensee is critical in making sure appropriate advice is given. It is even more critical than making sure products are appropriate.

Senator MASON—Thank you.

Mr PEARCE—I would like to back up and get your views on what you think of Australia's overall regulatory framework? You are a very experienced executive in this sector and we have seen with the global financial crisis the collapse of many regulatory systems in other countries, but we have not seen that here in Australia. How do you summarise our total regulatory system as it applies to financial services?

Mr Tucker—We have a very strong track record if you consider, as you say, where we have found ourselves now part way through the crisis. We are in good shape. I think twin peaks has worked well. I think having a prudential regulator separated from a consumer regulator is the right model. I believe that in other jurisdictions where that has not been the case there has been a lot of confusion as to role clarity from a regulator point of view. I think that has held us in good stead and I think our regulators have been diligent. Although there have been a number of concerning failures, and part of the committee's work here is to look into those, I think that the regulatory regime has done a pretty good job in spite of some of those things. You are never going to prevent collapses. With issues where clients have been misled or mistreated, the regulators—for example, APRA—have dealt through the crisis, in terms of making sure that they have been around a lot, providing good supervision and keeping the system honest. We are a life company. They are consistent in questioning around stress testing, capital issues and so on. That has been very regular, and appropriately so. I think the regime has held us reasonably well.

The FSR did take us into the next stage in terms of the revolution that is going on around financial advice in this country where I think we do lead the world, but it is time now for us to review, take stock, continue to take that leadership position and challenge and change where we need to. I think the structural suggestions that we have made in here are suggestions for debate which will be debated hotly, but what we have tried to do here is put forward solutions because we all realise that where we are currently sitting the status quo is not an option.

Mr PEARCE—On page 20 of your submission you talk about advice commissions and you say that you do not favour an absolutist regulatory spot such as the banning of advice commissions. However, you believe that the industry should migrate to a remuneration model more befitting of a profession and more acceptable to the customer—a true fee-for-service arrangement. Can you share with the committee how you think the industry might be able to migrate? How do you envisage that happening?

Mr Tucker—We took a strong view quite a number of years ago that the remuneration structure was holding the industry back, that is the commissions system, because it is a hangover from a product sales world and we are trying to move into an advice world where the client is central. At MLC, going back to 2005, we took a view that we should stand aside from the old commission system and move to a fee-for-service model. That meant many long conversations, strong debates and hot discussions with financial planners about what we were trying to do and why we were trying to do it. Our view was that not only would quality differentiate us, but from an industry point of view to move towards a profession where the remuneration was structured around whether or not they sold a product was never going to allow us to get there.

In moving to fee for service we were determined to come up with a model that we thought would be implementable and we set about doing that. A number of years later, NAB Financial Planning, Godfrey Pembroke and most of the advisers in our networks are operating on our definition of a fee-for-service basis. The way we believe fees should operate is that it should absolutely be agreed between the client and the adviser, that is the conversation must take place every year. The client must be able to see the fee; that is, when it is deducted from their account. If it is a percentage fee, which we do support, it needs to come out on their statement every year that there is a dollar amount that has been paid to an adviser for the advice given. That gives the client the chance to review whether they believe they are getting value for that amount, and the client must absolutely have the right to stop paying that fee if they do not believe that they are getting value for it. That is putting the client in control of what they pay for the services they are getting.

The challenge in many legacy products and in history is that there are a lot of payments still being made from products and we cannot change the past. All we have tried to do is put a line in the sand and take a view that we can change going forward.

What has happened since then, as we have taken that stance, is that many advisers have come to us and asked us to help them to manage that change. I am pleased to say that we think we have been very successful in getting advisers to operate on that fee-for-service basis. Beyond that, what has come into the industry is different forms of remuneration, such as shelf space fees and volume rebates.

At the end of the day the reason why commissions are paid is to get products sold. There is nothing wrong with products being sold. It is just the reality of that mechanism. What we wanted to do is move to a different footing, which is where the client chooses what they pay and the adviser and the client have that clear conversation.

Mr PEARCE—In your submission you put a table in which articulated the difference between a fee and a commission. Can you share with us, on the record, what you see as the difference between a fee and a commission?

Mr Tucker—Yes. I should state clearly that we pay commissions. We pay it on old products. Our new product range has been set up not to pay commissions, and that has been in place for a couple of years, but we do pay commissions.

A commission is generally paid by the product manufacturer. It is not necessarily agreed between the client and the adviser, although it is a requirement that it is disclosed. A commission is paid by the customer, the same as the fee is paid by the customer. It is simply deducted from their account. A commission can continue beyond the relationship with the adviser, so if the client and adviser no longer continue doing business together the manufacturer generally has an obligation to continue paying commissions.

Mr PEARCE—Does that happen frequently?

Mr Tucker—That does happen frequently. Finally, the difference is the fee. The client can simply decide to stop paying the fee. They can contact the institution and the fee will stop being paid, whereas the only way to stop the commission being paid in many products is to remove yourself from the product altogether.

With a one per cent fee and a one per cent commission people say to me that it is just a commission by another term. It is not, because the one per cent fee is agreed, but the one per cent commission is not necessarily. The one per cent fee is seen by the client, but the one per cent commission is not necessarily. The one per cent fee can be stopped by the client, but the commission cannot necessarily; and if the relationships falls away the fees stop as well, which is not the case with the commission. It is actually putting the client in much more control.

Mr PEARCE—You have migrated the majority of your business. I think you said earlier some 60 per cent of all your new business is now written on this sort of structure.

Mr Tucker—Yes. It is higher than that, but we will say 60 per cent. We have really turned the corner now. NAB Financial Planning, our bank financial planning network, operates on this model of fees, as does Godfrey Pembroke, which is another network that we are involved with, and the other networks are well and truly on the way and will get there shortly.

Mr PEARCE—Has your business grown?

Mr Tucker—Our business has grown quite nicely.

Mr PEARCE—Has it gone backwards as a result of this change?

Mr Tucker—In the early days when we first took the position there were certainly a number of advisers who were not happy with us. We have taken a lot of time to explain to them that we are an organisation that passionately believes in the value of advice and the success of financial planners, but we believe that we needed to understand that there was a change coming upon the industry, consumers were becoming more aware of these structures and we simply needed to start moving away from that and into this new world, so now we feel like we are in a very strong position to manage through any change that might come.

Mr PEARCE—I know this is an area that is of great interest to you and your business as it is to me, that is the area of financial literacy, or education, for want of a better term. I see it as having two prongs. Senator Mason touched on it before, as you did, about the education of the professionals that are in the sector regarding standards and so on. I know in your submission you have made some recommendations about trying to lift the quality, but the other prong of it, of course, is the education of the consumers and financial literacy. I would like to get your brief comments on what you think can be done better to help both of those groups of people. How can we educate more Australians to be more financially literate about the types of products, what they should be looking for, and in a meaningful, direct way, what do you think could be done either by government, industry or together particularly about lifting the standards? It seems to me that one thing we do need to try to do is to lift the whole financial planning industry to be a true profession, to be one of the great professions of the world. It is not there, is it? What do you see are some direct policies that could be put in place to achieve that?

Mr Tucker—I would like Mr Nunn to talk about the advice aspect. From a consumer point of view, at the end of the day transparency and trust will be the battleground of the next decade in financial services. It is not going to be so much about products, bells and whistles. You cannot have trust if you do not have information and understanding. It is a very difficult issue and one that we need to tackle with a long-term approach. I think we need to do more in our schools. I think we need to accept the challenge that younger people are going to be operating in a world that is very sophisticated and complex, particularly when it comes to financial matters, and we need to take that issue into the schools for the younger people and accept that it will take perhaps half a generation for people to become truly aware in a much more meaningful sense than they are today.

We have a lot of work to do with older Australians to understand the basics around financial services and we should continue our financial literacy programs and campaigns that are underway there.

The big issue and gap that I see that needs to be addressed is the Australian superannuants' understanding of risk and the risk that they are taking with their retirement moneys. What we have seen through the crisis is a lot of people that are approaching retirement or are older and in retirement were probably more exposed to markets than they understood, or at least the impact of the market changes was much greater than they thought. That is a big challenge and it has led to our conclusion that the best way to do it is to get Australians to talk to a financial planner. We know and accept that not everybody will be able to do that or afford to do that so the ability to give general, limited and simple advice in a cost-effective way is a critical issue for our industry and I think it should be high on our agenda.

Mr Nunn—Moving on to improving the standards of advisers, we would agree that financial planning should be seen as a profession. It should be treated equally as clients would perceive an accountant, lawyer and so on. We would also make the point that we have a way to go. The whole tenet of our submission has been about raising standards and professionalism.

We have made some very specific comments around the educational requirements. At the moment the requirements to get into the industry to start to advise clients are reasonably low. You have to be PS146 compliant, and that is not a particularly difficult thing to attain. To do that you can virtually come out and start advising clients who, in many cases, have substantial sums of money.

The tax system and retirement income system in this country is complicated and it requires a level of professionalism and intellectual rigour in order to sit down and understand that and then to impart that to the customer.

What we are saying is that if we really want advisers to be financial planners and advisers to be seen in the same light as an accountant, lawyer and so on, where there are significant educational requirements to attain those professional standards, then we should be looking to have some sort of framework that is similar. I guess what we are saying is that for new people coming into the industry an undergraduate degree is mandatory and then some form of financial planning qualification, over and above that, or a bachelor of business with a financial planning major, as well as say 12 months of experience maybe as a para-planner or working in a financial planning practice before you are actually allowed to get in front of a client and start to give that advice.

There is nothing earth shattering about that. We are simply saying that if we want to be able to go to a fee-for-service model and we want clients to perceive the services they are getting in the same light that they would perceive the service from another profession then we should be matching the same sort of educational requirements.

Mr PEARCE—Thank you.

CHAIR—Senator Williams.

Senator WILLIAMS—Mr Nunn, you were saying to raise the bar when it comes to giving financial advice. Does it need to be raised a long way?

Mr Nunn—Yes. I think PS146 compliant is four modules of the Diploma of Financial Planning or equivalent to PS146 compliance. To go from that to having a mandatory requirement of an undergraduate degree is a fairly significant lift in the standards that we are saying should be obtained before actually being able to sit in front of a client and give advice.

Senator WILLIAMS—Mr Tucker touched on transparency and trust in financial advisers, which I totally agree with. Obviously there have been a lot of people around Australia in the last decade that have put their trust in their financial adviser and a lot of it has gone very wrong. Hindsight is a wonderful thing, but what do we do in that regard? You are saying that we have got to have trust in the financial advisers. When it has all gone very wrong you own the risk—whether it is Opes Prime or Storm Financial. No doubt for those just humble clients, many of them in retirement age that just wanted to be a little bit secure instead of relying on their pensions, they obviously had trust in people and the trust proved to be a disaster.

Mr Tucker—I think we should also be mindful to accept that in the vast majority of cases the trust that has been placed in financial planners has been well placed and that the advice that has been given has been appropriate and clients are better off for it. We firmly believe that and can show strong evidence for that.

Where it has gone badly wrong where clients have been significantly affected is a significant tragedy for them and it is a very poor issue for the industry in terms of our reputation. I think why we are here today and perhaps why you are meeting today is to try to work out whether there are ways of enhancing a system—not throwing the baby out with the bathwater because we have a system that is working pretty well—but what enhancements can we make to ensure that when trust is given it is respected and the clients are looked after.

You have a number of issues in front of you, one of which is structure and clarity around who I am dealing with. The other is how we manage the remuneration issue, which is an issue for the industry and does create conflicts of interest that can create bias. The reality is when large commissions are paid, for example, on a Westpoint product which is sold, whether the right advice has been given does not matter, the perception is that when something goes wrong it has been done in the interests of the adviser, so we accept those things. The role of the licensee and beefing up the governance responsibilities of the licensee to ensure that they are responsible for the advice and the quality of the advice given by them are things that we think are going to continue to take us on the journey towards making sure that these things happen much less frequently than they have. Unfortunately, like in any profession or industry over time, there will always be cases where things do not go well and we know that this industry will keep reforming for probably the next 50 years as we continue to get better. Your points are well made, but there are some things that we can do to change that.

Senator WILLIAMS—When these financial products are out there for sale for people to invest in whose job is it to see that these products can be relatively safe? I know that is a difficult question, but we have all sorts of regulations. Holden cannot sell a car unless the brakes work. We have standards. We have products out there that have gone terribly wrong and caused a tremendous amount of stress to individuals, such as the Storm and Opes Prime products. Who should stress test them? Should it be ASIC? Who should be the regulator to see that the products out there, available for sale for the general public to invest in, are not lemons and cannot go wrong? Obviously what we are trying to do is see that what has happened does not happen for future generations.

Mr Tucker—My comment would be that the product regime that we have in place has not necessarily failed. I suspect in the case of Storm it is the advice that has failed. If you take a margin lending product on its own, it has not failed; it is an appropriate product.

Senator WILLIAMS—Can you design a safe product?

Mr Tucker—If you take an index fund or an investment in equity fund, if you combine these things in a way where the advice is inappropriate and the wrong people are gearing—they do not have income—into products they do not understand where the risk is high—

Senator WILLIAMS—It is not the product. It is the individual circumstances.

Mr Tucker—The advice mechanism is designed to appropriately match the product to the individual circumstances, so we step back from that and say, ‘Of course product design needs to be monitored and we need to make sure we are not creating things that do not work’, but beyond that the role of the licensee needs to be clearer. For example, our approved investment product committee in our business is chaired by an independent director. We have a mechanism that is separate to MLC, in a sense, because of its independence, that makes sure that when we approve products—and we will approve products from time to time that do not work the same as anybody else—there is a very strong process of governance around making sure that we at least put a number of protection mechanisms in place to ensure we do not.

If you look at our organisation, we are a life insurance company. The directors of life insurance companies have obligations to policyholders. We are a superannuation company and we have an independent trustee board that is there to look after the members’ interests. In the licensee world we believe the licensee directors should have an obligation to look after the interests of the advised clients in a similar way. Their job has to be partly to make sure that they have a rigorous process around the products that they allow their advisers to use, which I think we do.

Senator WILLIAMS—I will just take you back to the point I was trying to make. Mr Tucker, you have obviously been around the financial industry for a long time and you are very experienced and knowledgeable of it. I will come back to that question. When there are so many financial products on the market, who should be looking at them to see if they are relatively secure? Who should be not just ticking the boxes on a product, but stress testing them so that, for example, if your investment in the stock market, or the ASX, does fall by 20 or 30 per cent, which it has done many times over the last 30 or 40 years from October 1987 and so on—where we have those fluctuations and, of course, this is one we are in now—who should be carrying out the stress test? Should that be someone like ASIC that should look at what products are available so that there are virtually guards put around those products for sale to protect the people?

Mr Tucker—I do not think we will ever be able to protect people from market fluctuations.

Senator WILLIAMS—Of course not. What I am saying is the highly geared ones where we have the market fluctuation and they virtually lose their life's earnings.

Mr Tucker—I think there are mechanisms in place where we lodge our PDSs with ASIC and there is a role to make sure that what we are saying we are doing and building as a manufacturer of product is what we are actually doing. The role is the licensee and the adviser's role. If you have a highly geared, internal, long, only Australian equity fund, that has a significant chance of losing money in one in three or four years, for example. Is that appropriate in the client's portfolio, given their risk profile as a percentage of their assets and so on? For example, our licensee standards say that if there is a product that has a high risk in it then there is a maximum percentage of a portfolio that can be allocated to that type of product, say five per cent. Why? Because if that does go pear-shaped, and it may well because it is a high-risk product, then only a smaller portion of the assets are going to be allocated to that. There is control through the dealer standards and we believe that is the obligation of the licensee to make sure that those standards are appropriate, in place, and in fact, on the public record.

Senator WILLIAMS—Mr McInerney, in your submission you have one point that was really brought to my attention and I will quote:

> There has been some poorly informed debate around the difference between a fee and a commission. These definitional issues are, at times, intentionally confusing and MLC urge the committee to fully appraise itself on what are the acceptable preconditions for a payment to be regarded as a fee.

What do you mean by 'these definitional issues are, at times, intentionally confusing'? Have I asked the wrong person that question?

Mr McInerney—Not at all. I will give it a crack. There are two gentlemen that I could defer to next to me. When this debate first started three to four years ago, when we say intentionally misrepresented what is a fee and what is a commission, there are those people who wanted to defend the status quo with reference to only selecting some of the criteria which we laid out as what should be regarded as a fee. The criterion that was often left out was that it could be turned off by the customer at any time. There was that issue of selective use of the criteria which we were using. We are not suggesting that there should be a legislative response to that as to what should be regarded under statute as a fee versus a commission but, as Mr Tucker pointed out, it is the transparency and full disclosure. Meaningful disclosure, as the chairman has been mentioning in the parliament last week, has to be easily understood. We were not trying to be mischievous in making that reference to it, but there are some people who were using some of the criteria which we laid out and not all of them.

Mr Tucker—Early on the debate around commissions and whether or not they should continue was centred around whether or not people with less amounts of money would be able to afford to pay a fee. If you look at our definitions it more than likely is the same amount of money. It is not more and not less, but the same. The mechanism for collecting it is the same, an asset-based fee where we can collect it. The difference is the client is either in control or not in control. The fact is that all commissions paid on investment products are paid by the client, so we were just trying to make sure that there was clarity there.

In coming to grips with the debate there were many different discussions around what is a fee and what is a commission, and it got a bit confusing at times.

CHAIR—There are lots of parts to try to improve the system and obviously all the submissions that we have had, including yours, point to a whole range of areas including disclosure, qualifications, remuneration models, fees, structures, identifiability and all of those issues. The one critical part which ties them all in, of course, is the licence, the ability to operate. Is it just one big licence that covers too many different areas and too many different people under one regime? Do we need to segregate or have different entry levels in terms of licensing? Is licensing a key in trying to pull all of this together?

Mr Tucker—Absolutely. I think it is one of the mechanisms that we need to focus on. We were surprised to see how many licences have been granted and how many have been taken away, in terms of the current regime. We believe that the requirements to grant a licence should be more onerous. There is room for differentiation between licences—for example, independent and affiliated licence models. We believe that over time it has become a bit confusing as to the role of the licensee, whether the licensee itself and the company that runs the licences is there to be a distribution business or to stand for the advice given to clients.

We have suggested in our submission some beefing up, if you like, of some of the governance mechanisms around the licence itself, the granting of the licence; the need for capital as well, which is there to protect the clients who are being advised; the need for independence in terms of subcommittees that have specific mechanisms, for example, approval of products; and the dealer standards as to how those products can be implemented in the advice process.

CHAIR—Is the Australian Financial Services licence just too big? Does it just cover too many? As you were saying, there are so many licences granted and it appears to us that it is a catch-all. To operate in any part of the sector you just need this one licence which really grants you the opportunity to do anything you like within it and then all the issues, whether it is a hybrid, affiliated or independent model, all come under the one regime. How do you distinguish which parts work and do not work and where the difficulties exist?

Mr Nunn—I do not think the breadth of the licence is an issue. Having a single AFSL is fine. Under that the AFSL needs to stipulate how broad the advice can be. If the advisers sitting under that licence have not had the appropriate training in, let us say, margin lending, which is a hot topic at the moment, then the licence should not allow the advisers to operate in that part of the market. Selling direct equities is another one or selling derivatives. We need to understand underneath. If the licence is granted the educational standards that have been met by the individual advisers under that licence should dictate what they can then advise on.

CHAIR—I agree with you. As part of that issue is the problem that if somebody has that licence—let us say that they have a full licence to operate under every segment of the market—if they have 100 people working for them under their licence how does anyone really know what qualifications they have?

Mr Nunn—It is up to the licensee to manage that and, through licensee standards, to ensure that is enacted within the day-to-day operations of the business.

Mr Tucker—If you have a licensee board that has independent directors upon it, that has an understanding of its obligations as a licensee which is to ensure appropriate product is selected, that has a separate committee for product approval process, that does not just rely on external research, that does its own due diligence as well—can use it as a basis at some stage—and therefore provides the mechanism to protect the product that goes through to the network, that determines what the standards are for a particular adviser to be licensed to do certain things—for example, we would require people to do margin lending training to understand, abide by and sign off on the dealer standards as it relates to margin lending—if they want to use certain high-risk equity products they must do specific training—

CHAIR—They are not compelled to do all of that. Is that something that an organisation chooses to do or not to do, depending on its own systems?

Mr Tucker—Yes. Perhaps we should compel them.

Senator MASON—Individual financial planners need to perhaps have extra training so they can deal with, for example, margin lending.

Mr Tucker—It is the role of the licensee which needs to be clarified, which is to ensure that the appropriate product is selected and that only advisers are granted the authority to operate not just carte blanche in every way. What are the particular areas of risk and concern? An example is margin lending. We have special training on it. There are also high-risk equity products or dealing in direct shares; they need special training. They need to actually qualify. That is not a requirement under the licensing laws, it is a requirement that we have as a licensee.

What we are suggesting is that there needs to be a mechanism for making it very clear what the obligations of the licensee are and setting out a regime of governance, similar to what we do with trustees.

CHAIR—How would you do that practically? Would you have an annual audit or some sort of reporting mechanism back to ASIC? How would you ensure that a licensee that may have an unlimited number of people operating under their licence would actually have the appropriate people dealing with the appropriate products?

Mr Tucker—We think it should be a requirement that there is an annual audit process, training is documented, dealer standards are documented and lodged publicly and that the requirement is for independent directors to sit on boards of licensees. There are a number of ways you can do it. If you look at the way APRA went through the licensing of superannuation trustees, there were a number of significant obligations from having a risk management strategy which is lodged publicly, right through to the fit and proper requirements of the trustee directors. Those obligations are significant, but reasonable, in terms of what a trustee’s role is with regards to superannuation. I do not think it is dissimilar in terms of the role of a director of a licensee board when it comes to giving advice.

CHAIR—Would that be too onerous for the market generally? Does that add too much cost to the system as it currently stands or is it something that is already being done by the majority and this is just a recognition of what is an industry standard?

Mr Tucker—It is hard for me to speak for the rest of the industry. I certainly know that the larger institutions would not be far away from that type of model. For the smaller licensee the obligations might be a bit more onerous and we would need to work through how they are operating. If the smaller licensees have got a relatively small number of financial planners then it is a lot more easily managed and they can keep a much closer eye on what is going on. When you have a network like ours where we have got well and truly over 1,500 financial planners we have to have pretty rigorous rules and structures around making sure that the advice that is given is under the guidelines that we accept. It is different for the affiliated models versus perhaps the independent licensee.

CHAIR—This one might be a bit of a tough one. How much easier should it be to take someone’s licence away and everybody who works under them in that sort of system? Should it be easier to lose your licence if you do the wrong thing or is it really just the case of the licensee is protected and the more they have people working under their licence then it is those individuals that then become more liable for individual advice or inappropriate behaviour?

Mr Tucker—We think that the obligations of the licensee are serious. We need to have the right structures and mechanisms in place to make sure that those obligations are met. If they are not met then there should be outcomes that might not be in their favour. Obviously, nobody wants to lose a licence and nobody wants to come in with the jackboots on and cause a lot of concern.

Mr PEARCE—There are existing mechanisms at the moment that a regulator can enforce, such as EUs and so on.

Mr Tucker—Yes, and those things have been in force.

CHAIR—There have not been many. It is pretty rare for someone to lose their licence. Last year there were 21.

Mr Tucker—It is pretty rare. It is surprisingly low, probably.

Senator MASON—You mentioned that financial advisers would like to see the profession move to become something like lawyers or accountants. If you do not mind me asking, what do financial advisers charge per hour? It is a difficult question. I know that lawyers charge different rates, but is it comparable to what lawyers or accountants would charge?

Mr Nunn—It is a very hard question to give you a general answer.

Senator MASON—How long is a piece of string, I suppose.

Mr Nunn—Yes. There is a vast array of ways that advisers would look to charge out their time. I would say, on average, that it would be within the realms of going and visiting an accountant and potentially getting legal advice.

Senator MASON—So it is comparable.

Mr Nunn—It is comparable, yes.

Mr Tucker—Some are charging in different ways. What we have not done, as an organisation, is suggest what is a reasonable amount. What we have suggested is a client control model where the client agrees to that amount, sees value and has control, then decides whether they continue paying that or not. That then becomes an issue between the client and the adviser rather than an issue for ourselves.

In our bank financial planning model we have a prescribed set of fees and charges which tends to work out at about $250 an hour.

Senator MASON—$250?

Mr Tucker—Yes.

Senator MASON—That is getting comparable. Thank you.

CHAIR—Just to wrap up, if there was one big thing that you saw as a problem in the sector generally in terms of consumer protection, how do we minimise the possibility of spectacular corporate collapses, the ones that are catastrophic? Even if they might be a small segment of the market, they are still very catastrophic. What is one area that we really need to focus our attention on?

Mr Tucker—As an organisation we have tended to focus on remuneration practices, trust and transparency. We have settled into a clear separation between an affiliated advice model and an independent advice model, and then making it very clear what are the obligations of the licensees in both of those structures. It is the licensee. We have to rely upon them exercising their mechanisms. In most cases, whilst products fail, it is inappropriate advice or misunderstanding the way that the advice is related to those products where there have been problems. I think we can look at the product side and the manufacturing side of things and you can say that financial planners have done the wrong thing in individual cases. In my view, where there have been systemic failures it is the obligations of the licensee that have not been met.

CHAIR—Thank you.

[9.45 am]

MAYNARD, Ms Alison, Ombudsman, Investments, Life Insurance and Superannuation, Financial Ombudsman Service

CHAIR—I welcome the Financial Ombudsman Service and invite you to make a short opening statement.

Ms Maynard—The Financial Ombudsman Service is an approved external dispute resolution scheme which resolves disputes between consumers and their financial services providers. We are approved by ASIC under regulatory guide 139 to conduct this service in Australia. It is a condition of an Australian financial services licence that if you deal with retail clients then you must belong to an approved external dispute resolution scheme such as the Financial Ombudsman Service.

The Financial Ombudsman Service is the product of a merger between the Banking and Financial Services Ombudsman, the Financial Industry Complaints Service and the Insurance Ombudsman Service, and since then Insurance Brokers Disputes and the Credit Union Dispute Resolution Centre have also come into FOS.

My background is that I was the chief executive of the Financial Industry Complaints Service since 2001 before coming in to be an ombudsman within the Financial Ombudsman Service. I have had about eight years experience dealing with financial advice, investment disputes and life insurance disputes. During that time we have had the role of dispute resolution, which is a role that I think we carry out reasonably well, however over that time we have observed that in some instances, although we may resolve a dispute and can make a decision which is binding on a financial services provider, if the financial services providers goes out of business, goes into liquidation, then the consumer is unable to recover in some cases. This was highlighted following the collapse of Westpoint where a lot of consumers had received advice to enter into investments in Westpoint products and in our experience a number of financial services providers went into liquidation, went out of business and therefore consumers who had valid claims were unable to recover. This also exposed problems with professional indemnity insurance policies, which are basically an instrument to protect the financial services provider and, in some cases, do a very good job at giving compensation to consumers, but where there are policy exclusions, limitations on cover, a licensee may have PI insurance cover, however that does not respond to a consumer’s loss.

In addition, there can be problems in circumstances where there are multiple claims and the licensee is unable to meet the cost of the deductible on those claims. It could be problems with policy exclusions and conditions, but also problems with the number of claims, limitations on claims and limitations on coverage given for EDR awards.

Finally, as part of my opening statement, I would like to say that we think there is a need for a compensation mechanism which goes beyond professional indemnity insurance. We would like to see a safety net of a last resort compensation scheme. We have done a lot of investigation and research and come up with a proposal to implement such a scheme which we see as being set up in a similar way to the external dispute resolution schemes, that is that it would be a condition of licensing that a financial services provider dealing with retail clients belong to a compensation scheme and that compensation scheme would be there to meet claims of last resort; that is, where PI has not responded, where other avenues have failed, or where the financial services provider has gone into liquidation or cannot be found, that the compensation scheme would respond in those circumstances.

CHAIR—Thank you. Your organisation covers a whole range of former organisations. In fact, if I read it right, it includes the Banking and Financial Services Ombudsman, the Financial Industry Complaints Service and a whole range of others, so it would be fair to say that you get a really broad cross sectional view of what happens in the sector, where problems arise and obviously complaints. Do you find that the service that the office provides is really more about after the fact where something has gone tragically wrong or catastrophically wrong with a huge failure, or is there something in the middle where you receive early complaints where people get a sense that there is something not quite right with a particular organisation or system?

Ms Maynard—We are more likely to receive complaints after the fact. However, one complaint or one issue can reveal problems. We do have processes whereby information is imparted to ASIC. We do quarterly reports to ASIC where we identify issues in those reports. We also have procedures to look at systemic issues and to take up systemic issues with the members. Often we will get notices served on us by ASIC. If they are noticing some behaviour, they might serve a notice on us to receive information. Also, where things are starting to go wrong it is very likely that the financial services provider is not cooperating with us, perhaps has failed to pay a determination, or even an early sign can be that they are not paying our bills. In those circumstances we issue a notice of expulsion to that financial services provider and a copy of that notice is also served on ASIC.

CHAIR—Expulsion from what?

Ms Maynard—Expulsion from the Financial Ombudsman Service, which has an impact on their licensing and is a mechanism by which ASIC is notified that we are having such a problem with this financial services provider that we are considering expelling them.

CHAIR—How does that impact on their licence?

Ms Maynard—It is a condition of their license when they deal with retail clients that they must belong to an approved external dispute resolution scheme. If we expel them, that has an impact in that ASIC will go in and look at them.

CHAIR—Organisations such as Storm Financial, as an example, would have had to belong?

Ms Maynard—Yes, they did belong.

CHAIR—To get a sense of how these things work in practice, were there complaints? Were there any issues that were raised?

Ms Maynard—We did not receive early warning signs on Storm.

CHAIR—You did or you did not?

Ms Maynard—We did not, no. As you would be aware, we would usually only get disputes when something has gone wrong and the Storm collapse was brought about by the dramatic plunge in the market.

CHAIR—It was very quick.

Ms Maynard—Before that all of the customers were making money, or thought they were making money, so we would not have received disputes.

CHAIR—Is there a mechanism within the ombudsman service to look at inappropriateness or inappropriate advice, models or anything that gives you some sight through to what certain providers are doing, other than just pure complaints that you receive? Is there any other mechanism that is available?

Ms Maynard—No, because we are essentially a dispute resolution service. We are there to look at disputes, but through that there is some information that goes through to the regulator and we do have an obligation to identify systemic issues and take them up with the financial services providers. Sometimes we might see one complaint about an issue and then we go in and make inquiries.

CHAIR—There is no real opportunity for the ombudsman service to prevent perhaps systemic issues outside of really individual cases. Is there a real opportunity for the service, or is it the experience of the service that they can work with ASIC to really try to improve the sector or is it more about trying to fix things at the end?

Ms Maynard—We see that we do have a role in improving the sector. Firstly, we make public decisions and provide guidance for financial services providers, so we try to avoid disputes arising. As I said, we do reports to ASIC. When I talk about systemic issues, when we do have an issue that arises in a complaint that we see may have an impact on more than the consumers that are involved, we will take that issue up with the financial services provider and ask them what they are doing about it, and we may also look at them rectifying the situation as regards the other consumers that are affected.

Senator MASON—You mentioned section 912 of the Corporations Act. Do you see the problem as being the lack of compliance of the financial service providers or is the problem the legislation itself?

Ms Maynard—From my point of view the problems that we have seen indicate lack of compliance with the law. We do not see a particular problem with the section.

Senator MASON—So the legislation is right and compliance is the problem. How do you suggest we seek to improve compliance of the industry?

Ms Maynard—I think that licences need to be harder to obtain. I was interested to hear the discussion that took place before I gave evidence and I suppose the obligations could be made stricter. From my point of view, what I see is ASIC doing a pretty good job, taking away someone’s licence, and then the financial services provider having a right of appeal to the Administrative Appeals Tribunal and at that stage it is very likely to get the licence back or ASIC having to do a deal and get an enforceable undertaking because they can see the writing on the wall. I see there being a problem in that area. I think ASIC has often taken rightful action and then the application by the AAT of the law is not—

CHAIR—If there is a problem with that licensee, can it also be a case where the individual people who may have initiated the inappropriate behaviour are the ones that just go off and work somewhere else or continue to operate in the sector because they actually do not have the license themselves, so they just get another job somewhere else? Is that a problem?

Ms Maynard—Yes, that is a problem as well.

Senator MASON—If that is right—and you know much more about this than I do—that would indicate that there is a problem with the application of the law.

Ms Maynard—I have just realised that I have contradicted myself. Yes, there needs to be some fleshing out of what efficient, honest and fair actually mean, in what is not efficient conduct and what is unfair conduct.

Senator MASON—So fleshing out of the duties and the obligations?

Ms Maynard—Yes.

Senator MASON—What sort of complaints do you generally investigate in the context of financial services? What is a typical complaint?

Ms Maynard—A typical complaint in the financial advice area would be about inappropriate advice. That would be that the advice was not appropriate to the investor's individual circumstances and their willingness to take on risk. Often mixed in with that is all sorts of issues about what level of understanding the client has had about what they are investing in.

Senator WILLIAMS—Could I just add something there?

CHAIR—Yes, of course.

Senator WILLIAMS—You just pointed to the level of understanding that the client has invested in. Is that a major problem or one of the common problems that comes to your department?

Ms Maynard—Yes.

Senator WILLIAMS—What you are saying is that there are products out there that the clients have invested in and then when it has all gone pear shaped they have said, 'Why did I do this? I didn't understand it properly.' You obviously have a sophisticated product that the average Joe Blow, in many cases, does not understand.

Ms Maynard—I am not saying it is the whole financial services industry, but our experience with, for example Westpoint, was that there were about 60 licensees that we dealt with in relation to Westpoint complaints, and what came across in those disputes was that the financial services providers themselves did not understand what they were getting the clients into and, therefore, they were not capable of explaining the risks.

CHAIR—You have opened a can of worms, Senator Williams.

Senator MASON—This might sound like a slightly wicked question, but if people come to you and they are querying the nature of the advice that they have received because it does not relate to their individual circumstances, do people ever complain about the advice that they were given when there is still a bull market? In other words, do people come to you while they are still making money and say, ‘That advice I received was terrible advice because it doesn’t relate to my financial circumstances’, yet the market is roaring ahead and is still making money? Does that ever happen?

Ms Maynard—No.

Senator MASON—We tend to complain when things have gone wrong.

Ms Maynard—We do.

Senator MASON—That is a sort of a rude question.

Ms Maynard—Even when there is a bull market we do get complaints. We do get, ‘This wasn’t appropriate’, or, ‘That wasn’t appropriate.’ There are always other issues that can arise, apart from the appropriateness of the advice. We still get complaints. The number we get drops, but they are at increased levels at the moment.

Senator MASON—That does not mean that the advice is not poor. It is simply that people do not complain because the veracity of the advice is covered up by a bull market, and I understand that.

Ms Maynard—We sometimes get complaints from financial services providers saying, ‘You’re just accepting complaints about performance’, so we do have to explain that really it is only when people make losses that they then go back and say, ‘Were the strategies I adopted appropriate? Did I ever expect to make a loss? Protection of capital was important to me, but it was not taken into account by my adviser.’

Senator MASON—In your opening remarks you spoke about a compensation scheme of last resort. I think that is an interesting policy proposal. How would that work? Is that something like a nominal defendant in the legal system? Is that how you would do it? Are there any precedents for this sort of approach?

Ms Maynard—Yes. There is a financial services compensation scheme in the UK, in particular, and I think there are some in other areas. What we think should happen in such a scheme is that you would come to the scheme with your EDR scheme decision or your court decision that goes in your favour, then the scheme would do some investigation of whether that licensee or former licensee is in liquidation or cannot be located. They would do some investigation to make sure that they are not there and then they would make a payment from the fund.

Senator MASON—How would that be funded? Would the licensees be putting money towards it or would it be the government? What happens in the UK?

Ms Maynard—In the UK there is a model for funding by the industry. What we think should happen is that there may be some assistance needed from government to start it up, but what we would envisage is that it would be a scheme that operates on levies from the industry, that the industry would pay a normal annual levy and that would cover your operating costs and the normal few claims or low number of claims that you would expect in any regular year, and then if you had a large event, like a Westpoint or a Storm, then you would be able to borrow money, fund the claims and do post-event levying on the industry over a period of time. We have done some figures that would support that it would be a viable thing to do.

Senator MASON—That is an interesting idea. Thank you.

Mr PEARCE—Senator Mason has just touched on one of the areas that I was going to talk about. I visited the UK funds when I went to the UK a number of years ago. You talked about the need for some initial government funding or seed funding to establish it. That is what happened in the UK, isn't it? Did the government set it up there and then the industry took it over progressively? Have you had a look at that structure and an application in Australia?

Ms Maynard—Yes, we have.

Mr PEARCE—What sort of funding would be required to establish that?

Ms Maynard—I cannot remember the figures off the top of my head. Can I just refer to my documents?

Mr PEARCE—Yes. You could take it on notice and come back to us.

Ms Maynard—Yes, I will take it on notice.

Mr PEARCE—That would be interesting to know because I cannot remember what it was. The other thing I want to go back to is in your opening remarks and some of the questions that the chair asked you I felt that you underestimated the role that FOS can play in the feedback loop. My understanding is that your experience is very strong and very robust and you actually do play a very important role in going back to the market, to participants in the market, and explaining your experiences.

Ms Maynard—We do. I think I did not finish what I should have said. We have lots of meetings and discussions with industry. We publish circulars and bulletins which help the industry learn. We also play a role in policy development. Obviously we have done this submission to this inquiry and previous submissions that we have done in relation to compensation issues, so we do play a role in the broader community in contributing to the debate around policy. We also have a lot of contact with the industry associations to discuss issues that are coming up for them or coming up for us.

Mr PEARCE—I was interested in your remarks earlier in an answer to Senator Mason. In summary, I think you were saying that you think the law is sound, but it is the compliance to the law that has been the issue in your experience. I think that is a very important comment. The structure of the law is sound, but it is the compliance. How do you think we could achieve greater compliance?

Ms Maynard—Clearly there is an educational aspect to it requiring certain standards of education and training. That needs to be at different levels, depending on the products and type of advice that people are dealing with. At the moment there is the obligation essentially on the licensees and then there are some basic obligations under RG146 about education, but that could definitely be beefed up. I also think it could be made a bit harder to get a licence in relation to having your strategies in place for how you ensure you meet your obligations under your licence.

Mr PEARCE—You talked about FOS in your introductory comments and the bringing together of what were five separate organisations. I think one of the original intents of FOS was to bring one single point of contact for people that were in that situation that needed help from an ombudsman service. Can you share with us how that structure has worked? Has that been successful and has that offered Australians that find themselves in that situation a better, more streamlined solution?

Ms Maynard—We think it is working well so far. We merged only about a year ago. We have been developing single terms of reference and single operational procedures and guidelines, which will hopefully take effect on 1 January 2010. We think that we can be more visible within the community and more accessible. There is one phone number. We also take calls for the other schemes that are not part of FOS through that phone number and also the Superannuation Complaints Tribunal, so consumers only have to get to the one phone number to get assistance. That part of it is working well.

As one big organisation we can do a lot more. We have appointed a new person just to work with community and consumer groups. We did not have the resources for that as individual organisations. We think that we will really be able to improve access to the scheme.

CHAIR—Senator Williams.

Senator WILLIAMS—I would like to follow on from Mr Pearce’s question. You were saying that the laws, as they stand, are not a problem, but that it is the non-compliance with the laws. Can you give us an example of non-compliance with the laws without mentioning names that could simplify the issue?

Ms Maynard—Almost every time we find a dispute in favour of a consumer it is based on the failure to give appropriate advice. Almost every Westpoint decision we made was in favour of a consumer and almost every piece of advice in relation to Westpoint was a failure.

I can give you one example of a consumer that really struck me. That consumer was in a relatively modest but comfortable financial situation. She and her partner were schoolteachers and they had a small amount left to pay on their mortgage. They went to seek financial advice because they wanted to plan for their retirement and be able to take an overseas trip in retirement. It was what every Australian aspires to, to just have that overseas trip and a bit of comfort in retirement. They saw a financial adviser who advised them to borrow money and put it into Westpoint. They borrowed $100,000 against their home to put it into Westpoint, and that woman was devastated. As it turns out, the adviser that she saw—the licensee—went into liquidation and did not respond to complaints, so instead of someone being in a pretty good situation and achieving their goals they are now left with a large debt and, not only that, she said to me, ‘I’ll never see another financial adviser again.’

That is only one story, and there were many stories with Westpoint. Some of them were beyond the monetary limits of our service. We heard stories of people with their whole retirement savings being put in Westpoint and thinking they were diversifying because they were in Westpoint Market Street, Westpoint Ann Street, Westpoint Margaret Street, so they had invested in different schemes and they thought that was diversification.

Senator WILLIAMS—Did you get many complaints from similar investors in Storm and Opes Prime?

Ms Maynard—Generally, the Opes Prime complaints were people with such high net worth that the amounts lost were beyond our limits, so we did not get many inquiries. In relation to Storm, from what I understand of the event, about one-third of the disputes would have been within our limits and about two-thirds were outside our limits. As you know, a large number of those complaints were against one bank, the Commonwealth Bank, and they had put in place a comprehensive internal dispute resolution process to deal with issues which has prevented a lot of complaints coming through to us. We did receive a large amount of initial inquiries, but that bank, in my view, is doing very good early dispute resolution and trying to resolve all of their customers’ issues.

Senator WILLIAMS—One thing that I found quite alarming in your statements this morning in response to a question from Senator Mason earlier on was the situation where financial advisers at times do not understand what they are selling.

Ms Maynard—That is true.

Senator WILLIAMS—Obviously the bar has to be raised enormously so that people who are in a position to give financial advice, are licensed and so on, do actually know what they are selling. If they do not understand it, how can a client understand it?

Ms Maynard—That is what we have been saying to ourselves.

Senator WILLIAMS—I find that alarming.

Ms Maynard—Yes, it is alarming. We were saying, ‘These people didn’t know what they were doing. They didn’t know the risks and they weren’t capable of explaining them to the consumer.’

Senator WILLIAMS—They were just in there for the commission or the fee.

Ms Maynard—Typically we would see a portfolio that said, ‘We’re going to put this percentage in the share market’, and there would be this beautiful explanation of all the risks of equities. You would then have the Westpoint investment with a nice pie chart and a chunk of the portfolio. The Westpoint chunk would be called fixed interest. There would be no explanation of the risks of that product, except there was some sort of material that came from Westpoint itself that described the product in some detail, but in the statement of advice there was no discussion of the risks of that Westpoint product, what the guarantee really meant, what was mezzanine finance, where did the investor stack up as against other creditors of that mezzanine finance scheme and how were the mezzanine finance schemes structured. Even now I do not think that I can give you a clear explanation of how those schemes worked and what their relationship to the parent company was.

Senator WILLIAMS—I will take you back to Mr Pearce’s earlier point about whether the legislation is suitable. As far as members of parliament and Senators are concerned, when we look at the summing up of this inquiry, surely the non-compliance with the law is an issue in the industry; they must comply by the law, but if we have a situation where someone is selling a product and they do not understand that product, would that come back to the legislation? Does the legislation need tightening to say, ‘If you are out there selling a product then you must understand it, know all about it, have certain education and have been in for so long’?

Ms Maynard—I think the legislation is already there that you must be giving appropriate advice. Essentially, the legislation boils down to you must know the product and you must know your client. The legislation is there. The law is there. You must know the product. What we have seen in the Westpoint example, in particular, was that the advisers did not know their product.

CHAIR—Just following on from that, who makes the judgement on what is appropriate and what is not appropriate?

Ms Maynard—When determining a complaint at the Financial Ombudsman Service, we look to what the legislation says, what the courts have previously determined, and there are cases in the courts that guide us. We also look to ASIC regulatory guides and industry rules of professional conduct to look at what good industry practice is. We look to all of those things.

CHAIR—It is arbitrary. It is a judgement call.

Ms Maynard—At some point it has to be a judgement call.

CHAIR—The same case scenario presented to different people may have a different outcome, in terms of a judgement as to whether it is appropriate for somebody else. Is that a problem in itself? Does it really come down to individuals making a call and saying, ‘This product may be appropriate for someone who is 50 years of age in a certain circumstance, but no longer appropriate if they are 60 years of age.’

Ms Maynard—I can only go back to the approach we take. I think the legislation really is termed like this. I do not think that advisers have to be judged on whether it was the best possible advice that anyone in that particular circumstance could have received, what it has to be is whether that advice was appropriate, did it meet industry standards, did it meet the legislative standard and, if so, was that appropriate advice and an appropriate strategy. There can be disagreement. We even see in the media that sometimes a case study will be presented and then a couple of advisers will be asked to give advice based on that case study; you might get two different strategies for that consumer that are published in that magazine, but they will both be appropriate. They will not be the same, but they will both be appropriate. You are really looking for what is below the bar, what is really inappropriate.

CHAIR—Just to be really clear on it, there is no black or white, in or out.

Ms Maynard—There cannot be.

CHAIR—You are right, it cannot be. It is just a big area of grey where people have to be properly qualified, licensed, understand the industry and understand the person. The regulation tries to point to quality and some time spent with the investor, or the client, to make sure they really do understand what that person needs.

Ms Maynard—The licensee must put in the time getting to know the products, doing research, looking at the available research, but also making their own inquiries, and if they cannot find out enough about a product, do not advise on it, and then they have to put in the time getting to know the client.

CHAIR—Is part of the more broader general problem in the sector that because there are so many vagaries to how all this works and there are so many different options and so many different possible outcomes that people intrinsically understand this and that is why perhaps only three out of 10 Australians pay for financial advice or get financial advice because in the end it is just too hard? You do not really know what you are buying. Do you see that as part and parcel through the complaints you get that in the end people really just do not understand what they are purchasing? It is unlike going to an accountant; you completely understand what you are going to an accountant for. You pay a fee because you know what you are getting in return. It could be something as simple as processing your tax return, but you know exactly what the service is, roughly what the price will be and that it is comparable. Is that one of the difficulties in financial services, that there is no sort of bar or comparability between one bit of advice to another or the products?

Ms Maynard—There is a problem. I think that financial services providers, in general, are fairly clear about the service and the products that they are providing, but there is a lot of choice out there in relation to models and what you are getting. It is hard for consumers to differentiate and there is a tendency to say, ‘All advice is the one sort of thing’, when it is actually not. When we boil it down, even if you went to see a lawyer to get legal advice all legal firms are not the same, you are not getting the same sort of service and advice. You might go to a specialist firm when you have a specialist problem. Yes, there is a problem.

One thing I sometimes hear called for and that I would hate to see is a differentiation between advice and product sellers. The idea would be that if you go to Person A they are a person who gives advice and gives you a full service and you go to Person B who is just licensed to sell a product and not give advice. Similar regimes operate in some other markets and consumers just do not know the difference.

CHAIR—Are they intrinsically linked? Is that what you are saying, that you cannot separate them?

Ms Maynard—For consumers it is a really difficult separation and it would be something I would not like to see. We do have providers now who clearly offer, for example, an execution-only service and we see problems where consumers think there is some further obligation on the provider when they have clearly opted for an execution-only service.

CHAIR—I would like to take you back to one of the specifics that you have in your submission in terms of margin lending. You raised an issue that has been raised with us in other areas. It is the issue of an adviser or somebody acting on behalf of somebody else filling out either margin lending forms or loan forms or some other form with a bank or a finance provider and that there may be some errors, deliberate or otherwise, within those. Is this a case of fraud? Is it fraud in the end? Has an adviser the right to do that and then require somebody to sign it on the last page and accept that document?

Ms Maynard—I do not think of itself that it is fraud, but that practice creates opportunities for fraud.

CHAIR—So it is acceptable in the sector for somebody to advise someone to take out a particular debt product or whatever it might be, prepare all the paperwork and just say, 'Sign here.'

Ms Maynard—As consumers we do like service and convenience. Where a product is not a simple standard product there needs to be some way that a consumer acknowledges the risks and the transaction that they are entering into.

CHAIR—People have said to us, 'I didn't even know that I had a loan. I didn't even know that I had a margin facility or something else. I just signed a whole heap of forms based on years of either relationship, service or advice.' In the end they say, 'I didn't know that existed. I don't remember signing it. I signed a whole heap of forms, but I didn't know that that form was there or that I signed a particular debt.' Is that a problem? Is that something that you get lots of complaints about?

Ms Maynard—Yes.

CHAIR—Is that something that people come to you with?

Ms Maynard—We definitely do see that, and it is a significant issue. It is tough because as consumers we do want a certain amount of service and convenience and over a period of time we do build up a certain level of trust.

CHAIR—Is there a particularly distinction, even if it is with the knowledge and agreement of the investor or client, that somebody else fills out the forms for you and says, 'Don't worry about your income, just leave that blank and we'll fill that in later'? Does this pose problems? Do you see this developing into something more than just creative form filling to achieve an outcome or are there significant issues in terms of how that works?

Ms Maynard—It is definitely an issue because you are representing to a lender that these things are true. If the adviser is putting things on the form that they do not have real reason to believe are correct then that is definitely a problem.

Senator WILLIAMS—Just following on from what the chair is saying, the previous witnesses, MLC/NAB, were saying about the issue of trust in a financial adviser. You have made the very point in your submission that perhaps people investing should run it past their accountants for basically double advice. Would you like to comment on that at all?

Ms Maynard—In some circumstances, particularly if you were entering into gearing arrangements and looking at the tax benefits and so on, that would be a prudent course of action to be taking advice from your financial adviser and discussing it with your accountant, who in the end would be looking after your taxation affairs.

Senator WILLIAMS—I find it alarming, if I can put it that way, when you refer to the financial planning company that went out of business and the next thing they are back in the same business in the same premises giving financial advice.

Ms Maynard—Yes. There may be a lag time between that occurring and ASIC catching up with them, but that is a circumstance that has occurred that we are aware of.

Senator WILLIAMS—With regards to the people signing documents for applications, as the chair said we have had many situations brought before us or brought to our attention where people simply had the forms put in front of them, signed them in trust with their financial adviser, whether they be a Storm adviser or whoever, and then find out afterwards, when everything went wrong and they looked at what was on those applications forms, they simply shook their heads and said, 'That's not true and this is not true', yet they were the documents presented to people like the banks for the finance. What comment or suggestion can you add to that?

Ms Maynard—I am thinking on my feet here, but it perhaps has some similarities with when people sign guarantees for other people. We require them to go away and get advice from somewhere else before they sign the guarantee. Maybe some products come into the category of perhaps if you are getting them from the one financial service that you look at some regime that is similar to what we have with guarantees where some other advice or some checking is done by someone on your behalf before you enter into those arrangements.

Senator WILLIAMS—Thank you.

Senator MASON—Disclosure is often seen as the means by which the relationship between clients and their financial advisers can be made more transparent. Some of the submissions even say that it has failed. What do you think and how can we ameliorate the situation?

Ms Maynard—There are some steps that have already been taken in the margin lending area and the retirement savings account area to look at how a good standard form product disclosure works. I think that disclosure is a failure where people are presented with wads of information, so something has to be done to make that more accessible. A good adviser will make that more accessible to their client, but perhaps a key features statement that has the main points up front, the main risks up front, would be helpful.

Senator MASON—This clearly needs to become standard practice throughout the industry.

Ms Maynard—Yes. A good adviser is going to do it well for you.

Senator MASON—The evidence from other submissions is, as you say, where there is a wad of papers it actually does not clarify the situation for a would-be investor at all and, indeed, it just confuses them.

CHAIR—Would you say that all of these issues that arise really come down to behavioural issues; they are not necessarily product issues? Products tend to stand alone and they are not all guaranteed success, but it is really about the behaviour of people in the industry, in terms of how they advise on those products or other products. The compliance is more around the behaviour; would that be a true statement?

Ms Maynard—Again, it is interesting to look at the Westpoint example because we clearly had a regime that regulated certain products and then someone went and found the loophole in the regime that said that a promissory note for more $50,000 is not caught by the provisions of the Corporations Law; you do not need proper disclosure and all of these things.

CHAIR—Is that a product problem or a behavioural problem?

Ms Maynard—In general you want innovative products, products that give people lots of options and that there are lots of choices in how you invest, but when products are so complex that they are very hard to understand then possibly there could be higher bars you have to jump over before they are sold to retail clients.

CHAIR—That makes sense.

Mr PEARCE—If you put those bars in place, in particular, and there has been some suggestion that maybe the regulator should approve products, the issue arises where the liability will fall because, hypothetically, if a regulator was to approve a product as meeting the bar and then something was to happen in the market or something was to happen to that product who holds the liability? Who has the contingent liability?

Ms Maynard—Yes. I agree that puts a big responsibility on the regulator if you look at that sort of system. There is already a regime in place where only certain types of investments are approved for self-managed super funds, so do you have a set of products that are the regular products for retail investors and do get them approved as such and then if you buy an irregular product then that would be flagged? There are some possibilities around that. I would like something like a promissory note that is a mezzanine finance for a property development scheme to just not be considered for a retail client or flagged as such.

I think there were a couple of cases at FOS where we found that an investment in Westpoint had been properly described and was appropriate for someone with a very large portfolio. I guess they are not impossible to have, but they are not the regular product that you want normal retail clients to be looking at. Maybe there could be something developed around that, in that ASIC does not approve all products but maybe there could be some sort of regular type products that are.

CHAIR—Given that it is generally accepted as fact—or whether it is exactly might be a point of debate—that Australia has got one of the most regulated financial services sectors in the world and we have already heard a lot of evidence and have received submissions that say, ‘We don’t necessarily want more regulation, just more efficient regulation that is more effective’, is there an expanded role for ASIC as the regulator? Is there more that ASIC could do, or does ASIC need more power in terms of implementing what currently exists to try to curb bad behaviour or non-compliance?

Ms Maynard—From what I read and hear, it is often an issue of resourcing. They say, ‘We get this many thousand inquiries a year. We have to pick what we investigate and what we go forward with because we don’t have the resources to do it all.’ I think that perhaps it is a resourcing issue as much as anything. If they had greater resources would we be sitting here saying they needed more powers? I am not sure.

CHAIR—There seems to be some disconnect there in terms of licensing where ASIC says, ‘Do we really have the power to prevent someone getting a licence and issues like that.’ Should we take a more proactive interventionist approach early on to try to prevent either bad behaviour or failure, or should it be a case of ASIC allowing the market to operate and then coming in at the end of a failure trying to clean up basically, going back to what it does and then allowing things to go on again?

Ms Maynard—We did talk about some more regulation around efficient, honest and fair. There could be some sort of enhanced requirements there, but it is very hard to tell. A potential licensee could present to you the most beautiful compliance plans, plans for operation and this, that and the other, but it is not until the practice comes into effect that you really know whether they are doing what they should be doing.

CHAIR—There just seems to be some obvious ones. We have heard and seen submissions—I have not got hard data on the numbers—where people have either provided inappropriate advice, been involved in failures, even fraudulent behaviour or misappropriation, and then continue to operate under a different licence, different company, different dealer group or actually been in the industry for a long time and been identified by their own peers as people of concern, and yet seem to continue to operate and provide advice.

Ms Maynard—They seem to be able to get a position somewhere else.

CHAIR—I am not sure whether that is a failure of regulatory power or just, as you say, perhaps a failure of resourcing.

Ms Maynard—It is about whether you drop down a layer in the licensing and look at whether there has to be some sort of licensing of authorised representatives. That is a huge undertaking and I wonder whether that would have significant benefits. You might be better off putting the resources somewhere else, because you can set up licences until the cows come home. Maybe putting the resources into being able to follow up more of the issues they identify through their information that comes into them, and also it might be cheaper for you to put the resources into something like a last resort compensation scheme and say, ‘We’re going to do the best we can on licensing. Most of the time it works pretty well, but when someone falls through all the cracks there will be a bit of a safety net there at the bottom.’

CHAIR—Licensing is essentially the only check we have. That is it. That is the bar. You either have a licence or you do not. Once you have a licence it is more reliant upon your goodwill and self-regulation that you actually comply. Whether a licence is too easy or not too easy to get, once you have got it you really have jumped through all the hoops and that is it?

Ms Maynard—I have heard some people in the industry say, and I have some sympathy with the view, that maybe if there were more requirements as to the financial resources of the licensee that would have two effects. One is that they have more skin in the game and the second is that there is a more realistic prospect of recovery if there is a claim or an event that happens down the track.

CHAIR—If we were to make one big change within a sector where, let us say just broadly for argument sake, we say, ‘Regulations are doing a reasonable job and ASIC, given its resources, are doing a reasonable job’, and there are catastrophic failures from time to time, where is an area that we can have the most impact? Where can we curb behaviour for those people out there that will act outside of what legislation intends it to be?

Ms Maynard—My one big thing would be to have a last-resort compensation scheme.

CHAIR—Would that necessarily help or would that just make matters worse. People could say, ‘If it all falls over, don’t worry because we’ve got a good compo fund and somebody else will pay for it all’? Does that just add more costs to the sector? Somebody has to pay for these things regardless.

Ms Maynard—Yes. We think the design should not be 100 per cent recovery of losses. You would take away that sort of moral hazard by having limits on the compensation that is available. However, I see it as being something that can provide consumers with confidence in that when they deal with a licensed adviser there is a compensation regime in place. Also, I do see the industry having an interest in maintaining its own standards because they are paying for the last-resort compensation scheme, so it has an impact on industry standards. Just on that very human ordinary retail client level in our community, they are assuming the responsibility for their own financial wellbeing. The days of the defined benefit scheme are gone and therefore they do need to be using the financial services industry, obtaining advice and looking after their own finances. In a regime like that a last-resort compensation scheme is necessary.

CHAIR—Finally, from your experience in terms of your service, is it the case that all failures that come to you in the end have attached to them some sort of inappropriate behavioural issue or some other wrongdoing, or can it just be the case where it is just pure commercial failure where something just did not work? All the advice and mechanisms were appropriate, there was complete compliance, but it was just the case, as in life, that sometimes things just do not work?

Ms Maynard—We certainly have disputes that come to us where consumers have suffered losses. We have looked into it and strategies have been appropriate, advice has been appropriate and it is just that markets have gone down or an investment has failed. That can happen.

CHAIR—Thank you. We really appreciate your time.

Proceedings suspended from 10.47 am to 11.02 am

COHEN, Mr Geoff, Managing Director, Investment and Insurance, ANZ Banking Group

HODGES, Mr Graham, Deputy Chief Executive Officer, ANZ Banking Group

NASH, Ms Jane, Head of Government and Regulatory Affairs, ANZ Banking Group

SANTAMARIA, Mr Bob, Group General Counsel, ANZ Banking Group

CHAIR—I welcome representatives from the ANZ Banking Group and ask you to make a short opening statement in relation to your submission.

Mr Hodges—You have our submission, and I will just make a few brief opening comments. The terms of reference require the committee to investigate the involvement of the banking and finance industry in the provision of financial advice more generally and, more specifically, providing finance for investors in and through Storm Financial and Opes Prime. I will touch on each of these briefly from an ANZ perspective.

Firstly, Opes Prime—ANZ's relationship with Opes Prime was solely as financier, primarily through ANZ's securities lending and equity finance business. ANZ also provided some general banking facilities, including small working capital accounts. ANZ did not have any direct relationship with Opes Prime customers. Customers of Opes Prime are understood to have signed agreements providing for the transfer of ownership of securities right at the outset. This had consequences for them when Opes Prime went into administration. Opes had in the meantime disposed of some of those securities to ANZ. To recover in part the funds advanced to Opes Prime ANZ sold the securities at the best price it could obtain. This is quite different from margin lending, where customers retain ownership of the securities and may sell them to recover their loan obligations. This difference was not widely reported and ANZ suffered considerable reputational damage as a result.

ANZ undertook a review of the securities lending business, chaired by ANZ CEO Mr Mike Smith, who was assisted by respected company director David Crawford. I will table this review for the committee. The review found that at times there were deficiencies in ANZ's identification and management of risks within the securities lending business. A remediation plan was instituted and six staff and two senior executives left the bank.

Secondly, Storm Financial—ANZ did not have a formal relationship with Storm Financial, nor did we provide margin loans to our customers to invest through Storm. We noted in our submission around 160 customers who may have borrowed from ANZ, mostly via mortgages, to invest through Storm. We are continuing our review of the Storm related clients and expect we will find additional customers who may have some connection with Storm through this review.

From the reviews completed so far we have identified a small number where lending decisions did not comply with ANZ's policies. We are contacting those customers and will treat them fairly. Our approach will include assessing hardship on a case-by-case basis and rectifying detriment that resulted directly from action on ANZ's part. We are also contacting the other customers to encourage them to talk to us about their position. So far we have contacted 64 customers by phone and sent around 50 letters.

Finally, I will make some broader comments. The collapses of Opes Prime, Storm and other similar businesses followed 17 years of strong economic growth and booming equity and property markets. Cycles turn and people tend to lose sight of the fact that asset prices fall regularly as well as go up. Regulation will not change that. However, there is room for improvement and refinement. ANZ has more than 300 financial planners. We think a good reputation is key. We support professionalism of the industry through raising standards. We also support the shift in the industry towards fee-for-advice. Legislation should establish that financial advisers owe a fiduciary duty to their clients.

In raising the bar for advice giving we suggest the committee also consider how best to ensure continued access to cost-effective wealth solutions for all those Australians who require something less extensive than holistic financial advice. That concludes my opening statement. My colleagues and I would be very pleased to answer any questions from the committee.

CHAIR—Thank you. We will perhaps attempt to break this into three parts, given that we want specifically to have a chat about Opes Prime, a little bit about Storm, and then maybe some questions and comments in relation to the financial services sector. Interestingly, you said that after 17 years of growing markets and a housing boom people lose sight of the fact that markets can turn. Would that apply equally to banks, financiers and other people involved in the sector, not just investors?

Mr Hodges—If you look around the world the evidence of that is quite clear. Everyone gets caught up in the environment at the time. At times it is very difficult to see where the next shock is going to come from.

CHAIR—Would that apply equally to your organisation as well?

Mr Hodges—It would apply to our organisation, every other financial service provider and probably most businesspeople. One always is looking for those trends and sometimes we miss them.

CHAIR—In terms of Opes Prime, you have clearly stated in your submission and again in your opening remarks that you had no relationship with Opes Prime; you were the finance provider to the business model and scheme and therefore there was no direct connection. Given that fact, how much research and due diligence do you do, though, in terms of providing that finance? Obviously a relationship is developed through financing. How much due diligence do you do in the actual model itself to ensure that your clients' funds and the bank's funds are properly invested in schemes such as Opes Prime?

Mr Hodges—You used the word 'scheme' such as Opes Prime. Opes Prime as a business was part of a business that we funded. We had a wholesale funding relationship with it. There would have been a due diligence process done as part of developing a lending relationship with Opes Prime as a business. I will defer my comments to Mr Santamaria, who has more extensive knowledge of the particular case, but my view would be that, while we did do due diligence on this in the normal way we would with any customer that we lend money to, I think we found subsequently that our understanding of that business was less than it should have been within the bank, and therefore that was part of the issue that ANZ faced in terms of dealing with the Opes Prime issues.

CHAIR—You call it a business and not a scheme. I understand that Opes Prime was actually a stockbroking firm of some description, but in the end you could almost say it was a scheme because it really had only one product. It really had only one type of thing that it did. The business was based around what it did, its scheme as it were, rather than a business that did a range of things. Is that not the case?

Mr Hodges—No.

CHAIR—How would you describe what it did?

Mr Hodges—There are many one-product businesses. As a business, its product was to provide finance to individuals who were looking to invest in equities. The model it used, though, was more a securities lending model as opposed to, as I mentioned in my opening submissions, a margin lending model. The model is quite a different one. Perhaps I will ask Mr Santamaria very briefly to explain the difference and why this was a specific model. There are not many examples of this in the market except generally at the wholesale market level.

CHAIR—Just to make sure I am clear on what you are saying: the whole business was predicated on just one model?

Mr Santamaria—It was a stockbroking firm. As with a lot of stockbroking firms, they provide finance to their customers. They chose to use the equity finance model as opposed to perhaps a more conventional margin lending model that others use. As Mr Hodges explained in his opening statement, there are significant differences between margin lending and equity finance or securities lending. At the end of the day, when Opes Prime went into administration, it had serious consequences for the customers of Opes Prime. Would you like me briefly to explain that?

CHAIR—Yes.

Mr Santamaria—As we discussed previously, with margin lending you never lose fundamental ownership of your shares. With a home loan you retain ownership of your home. You pay off the loan and you get your home back unencumbered. With margin lending you pay off the loan and you get your shares back unencumbered. With securities lending or, as it was known here, equity finance you actually dispose of the entire legal and beneficial interest in those shares to the broker, who then uses those very same shares as security for the loans from ANZ. When Opes Prime went into administration, customers of Opes Prime understood they were still their shares, and hence the—

CHAIR—Did you believe they understood or did understand?

Mr Santamaria—To be honest, I do not know what was in their mind. They thought ANZ was selling their shares. When you ask about our experience with this, it is summed up in one of the central conclusions of our published securities lending review; we are out of that business. We are not continuing to provide funding to that sort of business.

CHAIR—Why?

Mr Santamaria—We believe it is not the sort of business that a bank should be in. We have admitted very publicly that it was not. It was a type of model that was always, in retrospect, prone to misunderstanding. We have admitted we made a mistake there and we have quit that business. To the extent that we acted sloppily, we have imposed sanctions on the people who were involved in that and the sanctions were very serious right up to two of the direct reports to the managing director.

Senator MASON—I have some other issues relating to financial services.

CHAIR—Yes, that is fine. Just to finish off in terms of Opes Prime, you have now put in place a model within the bank to deal with customers or specific issues and you are working through any leftover matters that have arisen out of that?

Mr Hodges—We have looked at how that arrangement was put in place. We have examined where we felt that we could improve our internal standards in terms of understanding our clients. But we have always had a process where we want to really understand the client's business. One of the challenges with the Opes business was that it was difficult especially when the clients say they did not understand what business they were signing up for. Therefore, the reputational issues that the bank gets left with certainly outweigh the benefits of doing any business with a client like that. As part of that broader process the bank has had a much higher focus within the bank on what we might call reputational risks. This would be a good example where the sort of business we were doing carried more reputational risk than we understood at the time we did it. Therefore, we have a much higher standard or threshold around examining reputational risks and how they might impact on the bank, and not just the normal issues about doing credit. It has actually had a fundamental impact through the bank, and that is very much reported in our public report.

CHAIR—Aside from the commercial failure are there any other failings or shortcomings that you can now see in retrospect in terms of Opes Prime? Was it a disclosure problem? Did it meet all of its obligations? Did it have all of the processes in place or not? Where was the gap that you have identified which now cause you concern looking back and which leads you to the path of saying, 'It's not a business we really want to be involved in anymore'? I can understand reputational issues and that maybe it is something the bank does not want to do anymore, but what can you now identify that would help us to have better regulation?

Mr Santamaria—You mentioned the disclosure problem in your question. We do not know exactly what disclosures were being made between Opes Prime and its customers. There is no evidence to suggest that we knew anything of that sort. To go forward, you also mentioned the reputational risk with this particular form of business and I mentioned that we have quit this form of business. But there are broader things we have tried to learn from this. For instance, on page 3 of the securities lending review there are the 13 remediation actions adopted and published as a result of the review. Action No. 9 is product management, which will involve a full review of the product approval process in ANZ. If we had really thought through the potential impacts of securities lending in this sort of situation with the market dropping and share prices dropping, then we should have thought a lot longer about being in that sort of business.

CHAIR—Hindsight is a wonderful thing. Obviously after the fact you can always say, ‘We lost money. We shouldn’t have done that.’ But at the time was it outside of the norm? Was it unusual in any particular way or was it really just one other business using a particular model that may have been aggressive or not?

Mr Hodges—It was more a niche type of business, as I said, with the benefit of hindsight. The real issue was that when the business went into administration it really crystallised the difference between the equity finance model and the margin lending model. If it had not gone into administration, those differences would not have come to light as they have.

From the bank’s point of view, as Mr Santamaria said, it requires quite a thorough due diligence on the process and how a model will work in both good and bad times. Our judgement is that these more niche businesses are things that we will either avoid entirely or will undergo a very thorough review within the bank before we will do those.

CHAIR—You are not saying there was a failure of compliance with regulation specifically in any particular area?

Mr Hodges—No.

CHAIR—Perhaps there was a failure of disclosure to the bank itself? I read in your submission there were issues that became clear only after problems had arisen and you appointed KordaMentha as auditors.

Mr Santamaria—There were various factors that led to Opes Prime’s collapse. One was that the market was going down along with the value of the shares tendered as security. There were also perceived to be some irregularities within the Opes Prime business. When these started to cascade and then the Opes Prime directors appointed their own administrator it was at that moment that ANZ appointed a receiver. I am not sure whether that is answering your question.

CHAIR—I am just wondering whether there was a gap between either compliance with regulation, and you are saying not that you are aware of, but perhaps also compliance in terms of you as the financier.

Mr Santamaria—I am not sure that we can express—

CHAIR—Whether they were fully open and disclosed to you all the information they had or whether they were not disclosing all of the information that they had.

Mr Santamaria—The exact state of the business in those closing weeks is perhaps not fully known to us, but that often happens when a company gets into trouble. That often leads to a series of actions where you, as the financier, try to work out whether you can save the business, which is in the interest of the business, in the interest of the bank and of the other third parties, the customers. That process went into place. It happens very quickly. Various arrangements were entered into in an effort to save the business, but that did not succeed.

Mr PEARCE—I noticed in your submission on page 2 something that I would like to clarify for the *Hansard* record. You state that ANZ is not aware of any evidence that the collapse of Opes Prime stemmed from a deficiency in the regulatory framework. You obviously stand by that?

Mr Santamaria—Yes. We are not aware of that. The chairman asked whether there was compliance with regulation. We are just not in a position to say one way or the other. There were cases that have been initiated against Opes Prime and against other parties such as ANZ and Merrill Lynch. If those cases had proceeded to go to trial with discovery/cross-examination, we may well have found out the truth as to what happened in those disclosures by Opes Prime to its customers. As you are probably aware, a scheme of arrangement has now been overwhelmingly supported by the creditors of Opes Prime, and approved by the Federal Court, which will terminate all of that litigation and lead to distributions to those creditors.

Senator MASON—As to what you argue was the fault with respect to Opes Prime, was it the bank's established procedures or the individual incompetence and malfeasance of individual officers?

Mr Santamaria—That led to the collapse?

Senator MASON—No, that led to your admitting fault.

Mr Santamaria—Our internal processes were inadequate. What were those internal processes? It was the review of the product at the outset and, as Mr Hodges explained, the way in which that product would play out in all different sorts of markets. I do not think we properly studied and appreciated that in, say, a falling market this product would operate differently from margin lending.

Senator MASON—You are not trying to say it was just a couple of bad apples within the bank at all, are you?

Mr Santamaria—No. I am saying there was a failure to appreciate the workings of the product, but there were also some behaviours within the bank where, for example, we have admitted there was not proper follow-up on the level of exposure to the bank. We have said all of that in the report.

Senator MASON—So, it is both really?

Mr Santamaria—It is both.

Senator MASON—Thank you.

CHAIR—In essence, you are saying, though, that the product, in your view, was either too risky or not appropriate or the product or model itself was not suitable for what you would deem—

Mr Hodges—There are two things. One is that it was purported to be more a business that took on general investors. These sorts of models do operate at the very sophisticated end of the industry. Investment managers and superannuation funds do equity finance or other sorts of things, but they obviously have more substance to them. The real issue that crystallised here was the collapse of the business, which effectively crystallised the problem of losses for both the bank and unfortunately for investors. There will be a part of the market where this model could work and work quite effectively, but not as it was in this case.

CHAIR—We might move on to Storm.

Senator WILLIAMS—I would like to ask a couple of questions.

CHAIR—Yes, Senator Williams.

Senator WILLIAMS—As to the submission put forward by Mr Robert Fowler, he stated that ANZ financed Opes at a loan to valuation ratio of up to 90 per cent. Is that correct? Do you know what LVRs you went up to with this lending?

Mr Hodges—Do you mean Opes?

Senator WILLIAMS—Yes.

Mr Santamaria—I do not think we can answer as to whether we went to 90 per cent. What we have said is that we took stocks as part of our lending security that were not appropriate to take as security. By way of explanation, a well run business would have taken only stocks in the ASX200—good-quality stocks, stocks that are well traded and stocks that are less liable to big fluctuations especially in a falling market. ANZ took stocks outside and below the ASX200, and that was something that we realised later on was a mistake. I cannot answer whether we went up to 90 per cent LVR.

Senator WILLIAMS—That is a claim in Mr Fowler’s submission, that ANZ Bank was financing Opes on a loan to valuation of 90 per cent on securities lending contracts. That is his claim. Can you take that on notice and let us know?

Mr Hodges—I will.

Senator WILLIAMS—The point where I am coming from is that we have seen the collapse of Opes Prime and Storm, which is very damaging to many mum and dad investors as well, who were obviously involved in these investments. If they are going to go in too deep, if I can put it that way, even if the market fluctuates by 10 per cent to 20 per cent, obviously they are going to be in trouble.

Mr Santamaria—That is exactly right.

Mr PEARCE—You were not involved in that process.

Mr Hodges—No.

Mr PEARCE—Correct me if I am wrong, but your relationship was a commercial relationship with the business.

Mr Hodges—I was going to say that. We actually funded the business. Presumably this submission was saying how much funding they got via Opes for their shares, which would be nothing to do with the bank per se.

Senator WILLIAMS—So, you were not responsible for the highly geared borrowers in Opes, because that was obviously them doing that?

Mr Hodges—That was their model and what they were doing with their clients—not to do with the bank.

Mr Santamaria—To supplement that and also to refer partly to the chairman's last question, throughout we were told by Opes Prime that the model they were operating they were providing to sophisticated investors. We never got the names. It was not the practice of our customer to give us their names, and we would not go to that level of detail.

Senator WILLIAMS—But you found that not to be the case; that they were not all sophisticated investors?

Mr Santamaria—Yes, that is right. We accept that. ANZ runs a margin lending business. In a sense, we were competitors. In those circumstances it is not the client's practice to give you their own clients' details.

Mr PEARCE—You operated your own channel as well, your own direct business?

Mr Santamaria—Yes.

CHAIR—We will now move to Storm. Storm is obviously very different, and again you claim no relationship with the Storm model or business.

Mr Hodges—I think we said 'formal relationship'.

CHAIR—Yes, formal relationship.

Mr Hodges—We do have clients who have invested through Storm. We have ANZ customers who have borrowed from the bank generally as a mortgage and then they have taken those funds and invested with advice from Storm.

CHAIR—You offered no margin lending facility? You offered basically a home equity-type loan or some other loan facility where people required that?

Mr Hodges—We had three broad types of loans. The vast majority were home mortgages. There was a small number of business loans where people would have borrowed in the business name, and I presume that may have been for tax reasons. Then we had a very small number of personal loans, where people have borrowed. Typically personal loans are unsecured and the amounts involved in those were very small. The customers have come to the bank to borrow funds and then those funds have been used, presumably at the advice of Storm, to invest in a Storm related investment plan.

CHAIR—Can you clarify for us that all of the applications that came through ANZ in terms of Storm were done directly by investors/clients themselves, or were some of those representations or applications, if you like, made on behalf of clients by a Storm representative or a Storm officer?

Mr Hodges—We have a small number of customers who effectively were Storm customers and Storm sent the loan applications to the bank. Those loans were processed and we do know of a number of loans that were approved that way. We had one loan officer who operated in one of our branches in Queensland who had an informal relationship with Storm as a referral arrangement. We found out about that. When I say 'we' did, the loan officer's supervisor found out about that. That approach was not in keeping with ANZ's normal operating procedure. That loan officer was investigated for her lack of compliance and ultimately was disciplined. We had our internal investigations people go through the files there and we found that a number of those files were processed in a way that was not consistent with ANZ's normal operating procedures. That individual, as I said, was disciplined and ultimately resigned from the bank.

CHAIR—Is this bank policy/common practice in the sector—or maybe we should stick just to ANZ—where you do not formally set up a relationship with anyone outside of the bank; that all customers applying for loans do so directly themselves? Is that the case?

Mr Hodges—Yes. Subsequent to that individual loan officer leaving the bank, we had an approach by Storm to the bank more formally to set up a more formalised relationship. We were sent details of their model. We reviewed that model. At the bank we went through our model and their model and found that they were incompatible. There were four broad areas of incompatibility, if I could refer to those.

CHAIR—When you are talking about the model you are talking about their business relationship model and not the investment model?

Mr Hodges—The business relationship model with the bank, yes. I will refer to those four areas. We found that the approach Storm wanted to adopt with the bank was that they effectively were the central manager of the client relationship. They requested the bank to respond to their requests for loan approvals or renewals and for the bank to take Storm's advice directly around 100 point checks and so on, which are part of our normal procedures, and that they would manage the customer interaction. The bank has a procedure where we will not do that. Our approach is that we have to contact our customers direct to do 100 point checks. We typically do that within a branch, but we have to do that with a direct ANZ person. We also have to have direct contact with the clients. We do not believe that we can do that through an indirect relationship. When customers have a letter of offer, or a loan document, we also expect customers will come in and meet a bank officer and that the terms and conditions of the loan documents are explained to the individuals. Therefore, in the Storm model that would not have been the case. They would have had a Storm person explain the terms and conditions of the ANZ documents and that, again, was against our model.

We were also not prepared to act on Storm's instructions around rollovers or account maintenance. We need to contact the client. Finally, when we do loan offers we expect to do a quote as an indicative offer and then we have follow-up offers, where again we would expect to deal with the client direct. Those things were not consistent with the way Storm wanted to work with us. Having had a meeting with them, having gone through this, the bank declined to have a formal relationship with Storm and Storm said that they would not deal with ANZ.

CHAIR—It seems like a pretty sensible approach that as the financiers you would want to have a direct relationship with each customer so that you understand and know who your customers are. Is that common practice across the sector or is it really an in-house policy decision?

Mr Hodges—They are our own procedures. I could not talk about the sector more broadly.

CHAIR—There are no regulations in this area that stipulate you have to do anything like that?

Mr Hodges—Around the 100 point checks and a few other things we have a 'know your customer' approach. That is consistent with areas such as anti-money laundering, fraud and so on. You need to understand who the client is you are dealing with. On top of that, at a level that is more consistent with customer service, you want to be able to understand the client's needs and what they are doing with the funds that they are borrowing. That makes sense from a bank point of view. We would say there is a broader responsibility to the client to make sure that we do not give clients funds where we do not think it is appropriate.

CHAIR—You would say you are meeting your responsible lending compliance-type requirements; you would have to do that?

Mr Hodges—Yes. Our bank has a customer charter, which we publish and which we can table if the committee would like. The customer charter spells out the bank's approach to responsible lending and how we like to approach that, which is consistent with our procedures.

Senator MASON—This is the same question I asked in relation to Opes Prime. In relation to Storm are you arguing that the bank's—to use your words—standard operating procedure was satisfactory but that the individual officers were negligent, reckless or did not comply with procedures?

Mr Hodges—Yes, in this particular case there was an individual who did not comply with procedures. A compliance check was done.

Senator MASON—This is more the bad apple scenario?

Mr Hodges—It was an individual, and she was—

Senator MASON—What you are not doing is claiming that there was any problem with your standard operating procedures?

Mr Hodges—No. In fact, the standard operating procedures found that she was in breach of our normal procedures. The compliance checks were done. The supervisor ultimately was unhappy with this. The person was disciplined. An investigation and file review was done and the person, after being on stress leave, actually left the bank.

Senator MASON—That was quite different from Opes?

Mr Hodges—Yes.

Senator MASON—Thank you.

Mr PEARCE—I wanted to follow on from the comments you were making about the offer that Storm made to you and that you were able to refuse. You talked about all the front end work that they wanted to do. Did they also want to manage the back end? If there was a problem did they also make an offer that you would not have to deal with the customers, they would not call your customer care service and that they would look after them with any problems?

Mr Hodges—I am not aware that they made that offer, but the implication was that they were the ones who were driving the relationship. In their letter to us in terms of presenting the model they did suggest that if there were mistakes made—and banks do make mistakes at times in terms of dealing with their clients—that we talk to the Storm people first before contacting the customer, because it may have been something that they had made a mistake with in the management of the relationship. It was essentially, to some extent, outsourcing some of our customer relationship to Storm, which again was not consistent with the model that we wanted to run as a bank.

Senator WILLIAMS—This person on the Sunshine Coast was obviously issuing some loans against securities for Storm investments?

Mr Hodges—The person was a loan officer effectively approving mortgages, and then the loan funds would have been used by Storm as part of their financial advisory advice that they were giving to that client. The person was effectively doing mortgage lending.

Senator WILLIAMS—A lady by the name of Kay Wright wrote:

I have no idea why my loan with the ANZ would have been set up at a branch on the Sunshine Coast of Queensland when I live in New South Wales. I have requested copies of my loan application and am waiting for these at the moment.

So, that would be why that happened?

Mr Hodges—That was one of the issues that flagged the supervisor's concern. It would appear quite unusual that you would have someone who lives so far away from the branch where this happened that they could actually be doing the normal procedures, and so that was one of the flags that came up. We found there were a number of customers who were being effectively domiciled in a different branch, but the loan approval was being done in that branch in Queensland. That is one of the issues that flagged us to investigate that and obviously to stop that. That is consistent; that issue is something we would not want to have happen in the bank.

Senator WILLIAMS—For the record, how many loans did ANZ lend for Storm investments?

Mr Hodges—We are still reviewing this, because we did not have a formal relationship. We put in our submission that we had 160 loans. We will probably expect to see more of those loans. We were provided by ASIC with the Storm database of customers of the bank who may have had a Storm relationship. That was a higher number, but a number of those customers just had credit card relationships. In other words, they had an ANZ credit card but no loans with the bank. We have gone through the ASIC database that was provided. They have subsequently sent us a second database, which we have not finished going through. We are also doing what I might call an internal forensic through our transaction accounts where we look to see whether there was any evidence of customers making payments into the Storm BSB and so on, which might also identify or flag other customers who may have been making payments to Storm. As one of the largest banks in the country we clearly have some customers who have an ANZ and a Storm relationship. Some of those we obviously were not aware of. Some of them we have actually made loans to and it is clear that there has been some relationship with those.

Senator WILLIAMS—When you say 'we weren't aware of them,' are you saying yourself at the management or at the branch level?

Mr Hodges—No. I mean that the bank officer may not have been aware of those. They may have borrowed some money and not mentioned that they were investing through Storm.

Senator WILLIAMS—Would that be rare?

Mr Hodges—Yes, it would be.

Senator WILLIAMS—If I owned a home worth $400,000 and I went to an ANZ Bank and said, 'I want to borrow $200,000', would it not be normal practice for the loans officer to say, 'What do you want the $200,000 for?'

Mr Hodges—Yes. And they might say they are investing the funds. They may not have said they are investing it via Storm Financial. You are right; we would have known that they were investing it. We would have looked at whether they could afford to borrow the funds and do the loan approval, but we may not have known—

Senator WILLIAMS—You would have also looked at whether they could repay the funds?

Mr Hodges—Yes. Typically, as you would look at any loan, while the loan to valuation is one of the issues that you would look at as whether a person can afford it, as important or probably more important is the ability of people to service the loan and pay down the loan. Cash flows would have been part of the assessment of whether a loan was appropriate or not.

Mr PEARCE—Would there not also have been potential cases where a particular customer of ANZ has a mortgage, you have given them a mortgage limit of, call it, $300,000, they have paid off some of that mortgage and so they have some equity in that? They could draw down up to that $300,000 just by calling you and saying, 'How much have I got up to my limit?' You might say they have $100,000. They could draw down the $100,000, because that is a preapproved limit.

Mr Hodges—We do have a redraw facility.

Mr PEARCE—In that case you would not know where that $100,000 was going?

Mr Hodges—No, but if a customer had come in and said that they wanted to use some of those funds for investment, we may have asked that question.

Mr PEARCE—You may have.

Mr Hodges—They may not have. If they said they were going to redraw, we typically would ask the question and we would understand what they were going to do. What I am saying is that we may not have known it was a Storm related issue. It may have been that they were investing in Macquarie Bank or another bank doing such and such, and that may not have been something which we understood was driven out of advice by someone else.

Senator WILLIAMS—As Mr Pearce says, with redraw facilities is there any limit? For example, if I had a $200,000 loan and I reduced that to a $100,000 home loan and I had the redraw facility, if I wanted to redraw the $100,000 would I have to seek permission from the bank or can I simply just do it?

Mr Hodges—I stand to be corrected, but I would expect that you would need to seek approval to redraw the facility. There would typically be a process that you would go through with the bank officer to redraw that facility.

Senator WILLIAMS—Certainly on many of your loans when you leant them, if they were not on the redraw facility or whatever then the bank officer would have asked, 'How are you going to repay it?'

Mr Hodges—Yes, exactly. Some of that would have been through salaries, investment income and other sources of income as well. Some of it might be from a property they get rent from. We would normally go through the process of understanding where the sources of funding are going to come from to repay the loan and what is the purpose of the additional funds that they have taken. That would be a normal part of the standard procedure in terms of advancing facilities.

Senator WILLIAMS—Would your loan officers have understood the Storm plan? I suppose that is a difficult question to ask you.

Mr Hodges—The individual loan officer that we talk about who was effectively, as we understand it, the only person who had that sort of referral relationship in the bank would, I think, have had some understanding of the Storm model. We understand that individual was also a customer of Storm. As a customer, they may have understood that they provided financial advice. Just exactly what advice or what range of advance I am not able to say. More generally, our financial advice is done in the bank through our financial planning teams. Storm Financial was not an organisation on our approved list.

Senator WILLIAMS—It was not on your radar every day?

Mr Hodges—No. We had very little knowledge of Storm until obviously this hit the radar screen.

Mr PEARCE—If we just step back again to the question of our responsibilities as legislators to look at the law, we talked earlier about the Opes Prime situation; that you believed that was not a reflection on a gap in the regulatory system. In ANZ’s experience, does the same thinking apply, that there is no evidence of a regulatory framework problem and that it was more a particular consequence and circumstance in a particular isolated case? Is that your view or do you think this implies further—

Mr Hodges—I actually think there is enough regulation out there around knowing your customer and responsible lending. There is quite a bit out there. It is something that I cannot really offer a view on, but the question is: what was the advice given to the Storm investors as to how they invested their funds, under what circumstances they did this, what stage of life were they at and what risks they took. Clearly, those issues are quite relevant for your inquiry in order to understand the nature of that sort of advice and how it was structured.

CHAIR—Just following on from Mr Pearce’s question, you state in your submission in regard to Opes Prime that ANZ is not aware of any evidence its collapse stemmed from any deficiency in the regulatory framework. You do not particularly say that in the area you cover under Storm. Do you have a different view?

Mr Hodges—We have a different level of knowledge. My sense would be that we do not really understand the Storm business at all. We had very little to do with them.

CHAIR—Again on the same subject, if there is no deficiency in the regulatory framework how would you define it? Is it a deficiency in compliance? Is it a deficiency in behaviour? Is it a deficiency in the model? Is it a combination of all of those things? How do you see it? I am not asking for a definitive answer.

Mr Hodges—In the Storm model?

CHAIR—No, in Opes Prime or Storm—both. How would you define it in your own mind? How do you see the situation?

Mr Hodges—I will ask my colleagues to say something as well. My broad observation would be that clients of both Storm and Opes were very much caught up in the times and people were generally seeing everything going up and nothing going down in terms of value. I suspect people lost sight of the fact that markets are volatile, economies do go up and down and did not appreciate the risk they were getting into. In that sense, as I said at the very opening, they were not alone. The world was caught up in that to a large extent.

CHAIR—Were they being advised poorly?

Mr Hodges—You would need to look at the individual customer advice that happened with both and the individual circumstance of their ability to absorb risk and take on risk. Given the fallout, you would clearly say some people were advised poorly. You would definitely say that. Was that done without due care, given the time that the advice was given? That is a harder judgement to make, because hindsight does offer insights that you do not have at the time when you do this.

CHAIR—Are there any other views?

Ms Nash—Yes. There are two aspects to this that you have identified. Mr Hodges has given a very important context here about the times, what the markets were doing and so on. Mr Cohen would probably want to make some comments about the standard of advice in the industry and what might occur there, which is outlined in our submission. Of course, the other side of it that you have been talking about relates to banks, for example, with their lending practices and standards. One of the things that is relevant here is the responsible lending obligations that are on their way for lenders. Those obligations will formalise some of the things that we have been talking about. For example, we will be obliged to ask our customers, ‘For what purpose do you want this loan?’ We will have to establish that a product is not unsuitable for that customer’s needs and will have to make what the legislation describes as reasonable inquiries of the customer around their capacity to repay the loan. Those things build on and formalise the practices that I see inside reputable banks at least. Mr Cohen might make some more comments about financial planners.

Mr Cohen—I will defer the broader comment on financial planning until we get to that topic. I would reiterate the comments made about understanding of risk. It is important to understand that the fact that a share or a fund may fall in value does not mean that poor advice has been given. A key role for a planner is to help the customer understand their own risk profile, and it is around that that we place great importance in our delivery of advice. That has to be a key element to remember. I think people’s appreciation of their own risk profile before the event and after the event can often be clouded.

CHAIR—Even without the benefit of hindsight there are some activities that are just inherently risky.

Mr Hodges—Yes.

CHAIR—You can design a product to be as risky as you need it to be or want it to be, and therefore it really does come down to the appropriateness of the advice.

Mr Hodges—An example of that is, say, the margin lending business. If you have all of your investment in one individual stock as opposed to having your investments across 15 stocks, you are going to run a lot more risk with a single stock investment. There are quite sensible and obvious issues around not just the product design but actually how you utilise a product in terms of an investment product like that.

I agree with you. Some of the risks are reasonably straightforward from the start and you would expect that normal advice would be very clear about those sorts of levels of risk that you run and would steer people away from taking risk that is not appropriate to their financial circumstances. Some people want to take risk for reward, and I guess it is all about that risk/reward spectrum that they are on, but most people, in the norm, would want to take a moderate or reasonably conservative approach, particularly where they do not have substantial means.

CHAIR—Mr Santamaria, would you like to add anything?

Mr Santamaria—I agree with what others have said here. I think the fundamental rules are fine. You asked whether it was that or whether it was individual behaviours. Again with Opes Prime, we did not cover ourselves in glory. We took stocks as security that were outside ASX200. Another one of the financiers to Opes Prime, Merrill Lynch, was able to liquidate the stocks it had as security much more quickly, as we believe, because they confined themselves largely to ASX200 stocks. It got down to individual practices at least insofar as the Opes Prime story was involved.

Mr PEARCE—Are you happy to move to broader questioning?

CHAIR—Yes.

Senator WILLIAMS—I have one question.

CHAIR—Senator Williams.

Senator WILLIAMS—You obviously solved the problem with the person who was doing the lending in Queensland. There was stress leave and a resignation. Did you have other situations where brokers were coming to you to borrow money for Storm investments?

Mr Hodges—I do have a few facts around the Storm loans and Storm investors. Broadly, of those investors who we now know had some relationship with Storm, about 60 per cent came in through the branch network. They borrowed money through the branch network. Twenty per cent came through third-party brokers.

Senator WILLIAMS—So, you did have other brokers?

Mr Hodges—They are effectively mortgage brokers. Typically we did a mortgage lend. ANZ and most other banks have a relationship with brokers. So, we had about 20 per cent from them, and then 20 per cent came from our personal mortgage managers. Those numbers are not inconsistent with the way we would normally acquire mortgages in the market. It is broadly consistent with the way we would acquire business in the market. There would be some through our own individual specialist mortgage managers, some people just coming into the branch, and others through the broker network.

Senator WILLIAMS—Everything has gone pear shaped and a lot of people are in distress. I have concerns for those people in the twilight of their life, if I can put it that way, and who are concerned about losing their house and their security. What is the attitude of the bank in handling these people who are really desperate? Where do they go from here?

Mr Hodges—That is a good question. We have had seven customers complain to the bank around this, and so we are obviously dealing with those. We have six customers who are currently in arrears. That means that they are not currently meeting their repayments. We have 13 customers who are on hardship, have made hardship requests, and we are dealing with those as individual customers. For example, we have 13,000 customers who have some sort of account where they have some issue that they are managing through. It is a small number, but it is actually quite important for these particular customers because, as you say, their financial position has been impacted quite substantially through this. Our intent is to work through with each of these customers on a case-by-case basis to look at managing their circumstances and to ensure that no-one loses their home as a result of this.

Senator WILLIAMS—That is very good.

CHAIR—We will move on.

Mr PEARCE—I have some questions for Mr Cohen. We have had lots of submissions, advice and evidence about the financial planning industry. Lots of people have ideas about lifting the thresholds to get licences, and training requirements. Give us your 60-second appraisal of how you see the Australian financial planning sector?

Mr Cohen—There is a general push for the lifting of the standard of the provision of financial advice. As set out in our submission, we are supportive of doing that. When customers or clients come seeking holistic financial advice the quality should be good. By and large in the industry today one does get good advice. I do not want to suggest the industry is broken, but I do think there are ways to continue to improve it.

As noted in our submission, there are three broad areas where we see scope for improvement. The first relates to professionalism generally. We could have a professional body overseeing the financial planning industry with probably greater powers around misconduct and greater scope for individuals who do wrong to be appropriately dealt with under a professional banner.

The second area is around educational standards. Again, there are educational standards and we obviously meet the minimum standards but encourage our planners to be above the minimum standard. We are seeking to lift that standard within our business, but there is area for improvement there.

The third area is around confirming or establishing the relationship between the provider of financial advice and the client as a fiduciary relationship—again, reinforcing the status. I think those three elements and some of the other items we speak to in our submission would help lift the standard.

I will comment on the question of commissions versus fee-for-advice, which is clearly part of the debate. Again, we think that the industry should move to a fee-for-advice model where customers are seeking holistic financial advice. We are doing that in our business. We think it will take a bit of time. Just the practicalities of moving from a business model that revolved around commission to an advice model takes time in training people and providing the products. We see a need for transition, but we also see the end state being there. That is in relation to provision of holistic advice.

We would also note, as mentioned in the opening statement, it is vital that access to what we call cost-effective wealth solutions are still available. There are people who do want holistic financial advice and we think it is important to get that right. We also think there are a lot of people who have modest sums of money or relatively simple needs and, if there is no way they can get cost-effective wealth solutions, they will miss out on receiving advice or sensible counselling in the entirety. We would see those two things as going hand in glove in terms of any changes.

Mr Hodges—The latter point around ensuring there are simple products that are still very effective, easy to understand and at a reasonably low cost continuing to be available in the market for the less sophisticated and smaller investor is really important. People should start to invest and plan early on in their working life, which helps them build the nest egg they need for retirement. That is what we are all hoping people will do. They do not have a lot of money at that stage. Giving them the opportunity to invest reasonably simply in a straightforward lower risk sort of product does make a lot of sense.

Mr PEARCE—You are actually doing that. You mentioned in your submission about this new thing you are piloting called My Advice.

Mr Cohen—We have a number of initiatives. For some time we have been focusing on finding convenient, simple and responsible solutions for the mass customer. Clearly that is the ANZ customer base. We do mention two initiatives that are underway within the bank. The first is My Advice. That is a simple advice model where people who have a basic financial need are able to, through a telephone inquiry, receive some advice of a limited scope and then take out investment product.

Mr PEARCE—Do you need to be an existing ANZ client to access that?

Mr Cohen—You do not need to be, but in practice we find that virtually all customers of our financial planning business are originally ANZ customers, because it is the relationship of trust that they have with the bank that causes them to seek out financial advice from us.

Senator WILLIAMS—Your point on the understanding of investment is a very valid one. The Financial Ombudsman Service stated here earlier that the people actually marketing products did not understand some of them. It is obviously a very scary situation when the person selling the product does not understand it. The investor must understand what they are doing.

Mr Hodges—Both the people who are selling the product and the investor need to be able to understand what they are getting into. Some of the more sophisticated product is quite challenging and difficult. You need to make sure you understand that. That is part of the issue about raising standards at the more holistic level. But at the simple level you can still have quite effective simple products that offer solutions for people who have smaller sums and who cannot afford to pay thousands of dollars for special advice.

Mr Cohen—Just to complete on that point, the people providing advice over the phone under our simple or light advice model are trained to meet the minimum standards for financial planners as well.

Mr PEARCE—Do they provide just general advice?

Mr Cohen—No, they provide personal advice. People receive a statement of advice electronically. We have processes in place. It is very clear that, if their needs are broader—and that emerges during the conversation—they will be referred to a financial planning process.

CHAIR—How often would that happen?

Mr Cohen—At the moment this initiative is in its early days.

Senator MASON—My question might be for you, Mr Santamaria. This is a legal question.

Mr PEARCE—You are basically all lawyers.

Senator MASON—I am not a very good one. Mr Santamaria is. If we seek to impose a fiduciary duty on the relationship between an investor and a financial adviser, which is a change to the law, is that compatible with the payment of commissions to financial advisers?

Mr Santamaria—I think it is so long as there is proper disclosure.

Senator MASON—Some people describe it as a failure, as you know.

Mr Santamaria—I think I understand the essential concern that, when you are a fiduciary, you have to be seen to be acting in the best interests of your beneficiary—your client. The fundamental thing with commissions is: is there not an thing there to sell more and more product? Is there an inherent conflict of interest? That is one of the fundamental issues that your inquiry is looking at.

Senator MASON—I do not disagree with what you are proposing at all, but if we do wish to impose a fiduciary duty I suspect that would have implications for the payment of commissions and so forth. I do not know that, but I suspect it would.

Mr Santamaria—It would have to be reconciled. That is true. Again, under our submission, in terms of our thinking as a business, with the provision of that holistic financial advice that we would see evolving into a fiduciary relationship our model will see a payment of fee by the client and really the rebate of all commissions.

Senator MASON—I understand that.

Mr Santamaria—The simple solutions that we are talking about may not be a fiduciary relationship. It might be something different to meet that simple need.

Senator MASON—Could you comment on MLC's proposal—your competitors from NAB—to the committee that there should be a division between affiliated and independent advisers. In other words, independent advisers were advisers that received no commissions and no payments whatsoever from the sale of any particular product, versus affiliated ones that do. Do you think that is a useful bifurcation of the industry? You can speak freely here, Mr Cohen.

Mr Cohen—It is an interesting proposal. The reality is that the numbers are something like 80 per cent of planners in today's market work for dealer groups that are owned by either banks or major wealth businesses. We should not shirk away from that reality and should not try to cloud it. As to whether or not the delineation and what might attach to that delineation is probably as important a question as to whether we should make the delineation in the first place—in my own view a lot has been made about 'independent' in terms of independent financial advice. A bank is a very good place to go to to get financial advice, because you have the credibility and stability of a large organisation behind it. That sometimes gets a bit lost. There is a focus on the end product—this product versus that product.

We were speaking earlier about risk profile. The provision of good advice is a lot more than: should I buy product A or product B? It is providing advice to help the customer understand their risk profile, their risk at the time and their goals. If I were to give any general thought it would be to understand how we get good advice rather than undue focus on product A versus product B.

Mr PEARCE—Correct me if I am wrong, but in your submission you advocated a two-pronged approach. You might give them different titles. When I read that I actually interpreted it to be somewhat aligned to that.

Mr Cohen—That is why I am saying a solution is being affiliated versus independent, which is from the MLC submission. Another delineation is holistic financial advice versus product based or solution.

Mr PEARCE—You might call it something else.

Mr Cohen—There is a solution in there. For instance, as we go forward, ANZ will have both advisers who provide this holistic financial advice on a fee-for-service basis and we will also want to, and need to, have within our model this other solution.

CHAIR—You made the point a number of times, including in lots of submissions, about understanding the risk profile. That seems to be quite important. How do you do that at ANZ?

Mr Hodges—Mr Cohen has brought one of the tools we use inside the bank to do that.

Senator MASON—Is it a questionnaire/survey style—

Mr Hodges—No. I will get Mr Cohen to explain it.

Senator MASON—That would be great.

Mr Hodges—It is a process supported by the tools we have to help people and the adviser work through the right approach.

Mr Cohen—It is actually quite an extensive process. Firstly, it starts in the branch, where there is a conversation typically between a member of the branch and the customer. The branch member is encouraged to have a discussion with the customer about their needs. It is a needs based discussion really about understanding where they are in their life stage and what their needs might be. As was mentioned, we have a tool that is used by our bankers, who will sit down with the customer and take them through, ‘Where are you in your life? Are you starting out saving for a home? Are you at a stage where you’re consolidating your position?’ You might be taking out a mortgage and so you need some protection. You could be well on the way, paid off your mortgage, looking towards retirement or you could be post retirement. We are encouraging, at the first instance, a discussion between the branch staff and the customer. If emerging out of that discussion we identify a possible need, at that point the customer is asked whether they would like to speak to a financial planner. If they say ‘yes’, an appointment is made.

We then have a second step where we have a service centre. Between the time the appointment is booked and the appointment actually occurring we will have someone ring up the client and say, ‘You’ve got an appointment booked with a financial planner. Do you understand what it is about and the scope of the discussion? These are the materials that you might need to bring.’ That makes sense, because sometimes along the way the client’s needs have been misinterpreted, and so it does not help us if they end up having the appointment with the planner on a misconception. It is very helpful to make sure, again, that the customer understands what to expect from the meeting with the planner.

Then when the first meeting with the planner occurs it is largely about understanding their needs. In addition to the piece of paper and the materials that the branch staff would work through, the planner again sits down with the customer and spends an hour going through a more detailed fact find. It is not so much, ‘Tell me all the facts.’ It is actually a process where they are asked, ‘What are your financial goals? What are your financial needs? What is your risk appetite?’

CHAIR—How would you describe that process? What would you call it?

Mr Cohen—It really is an opening conversation to understand the customer. We spend a lot of time educating our planners to have rich discussions.

CHAIR—It sounds like a professional judgement.

Mr Hodges—It is an exploration of the client’s expectations in life and what is important to them. If you have someone who says, ‘I want to be secure in my retirement’ or ‘I want to make a lot of money’, then you have very different sorts of conversations.

CHAIR—Doesn’t everybody want to make a lot of money?

Mr Hodges—No, I do not think they do. Some people just want health and happiness. It is about getting behind what motivates the individual or the couple and, typically, it is about exploring their needs and what they are looking for. From that you start to take the conversation further.

CHAIR—Do you have a tick sheet or a survey?

Mr Hodges—We will table this. This is what the branch uses—Your Financial Solution. I will open it up. You can see a funny little squiggle here, which is their journey in life and what they are hoping to do within ‘life events’, and the things that might be important to them. They work through this with the client and it is used as a tool to help them think about these issues. From that you get an idea. This is the first conversation. Then the financial planners use a much more sophisticated tool.

CHAIR—I am assuming most people will have roughly the same goals. If you took 1,000 people then roughly you will end up in the same places. Everyone wants to own a house. How do you distinguish? Is there a thousand different ones and, therefore, you have a thousand different solutions?

Mr Cohen—In terms of risk profiling we actually ask questions such as, ‘How willing are you to lose money, with what frequency and what’s your time horizon?’

CHAIR—Not at all.

Mr Cohen—Some people do say not at all and some people say absolutely, because of risk and return. We use a range of these questions to actually profile someone under five risk categories from conservative, moderately conservative, balanced—

CHAIR—And then direct them into specific products or plans?

Mr Hodges—It is actually more than that, though. You have someone who is maybe in their mid-forties. They want to put children through private education and so they need to have funds available for that. You do not want to lock them into necessarily an equity portfolio where they have a 5- to 10-year horizon; they might need funds earlier. You have to understand what their intent is over the next five to 10 years in terms of what they are going to do as a family, what they want to spend their money on, and therefore that will dictate what their investment profile might look like and what funds they might need around them. Do they want to upgrade their property? Have they got a new family that is coming on and so they will need to find a new house or do an extension? All of those things are individual issues and people are trying to work through, ‘How am I going to get through the next 10 years and what is going to happen?’ It is not just, ‘Will I have a bucket of money when I turn 65?’ It is actually helping them through a whole range of issues. Unless you have a clear understanding of what the individuals or the families are doing you cannot really help them plan this out sensibly. The exploration process is a really important part of it.

Mr Cohen—And for completeness, when the advice is provided it is important that the adviser plays back the understanding of that exploratory conversation and has it recorded in the advice.

CHAIR—That is fine. Thank you. I appreciate that. To pull all of this together, from your experience—obviously collectively you have a lot of experience in the financial services sector—what typifies some of the bigger issues as to corporate collapses, the problems we have seen and the failures? What are the identifying issues that you see as being the problems?

Mr Hodges—That is a wide question.

CHAIR—I will give you an example. Is it double gearing? Is it poor advice? Is it compliance issues or behavioural issues?

Mr Hodges—I would say one of the issues that has had an impact on collapses around the market and the experience that individual investors have had has clearly been the very long period of strong growth where people have lost sight of the inherent volatility of asset markets, financial markets and the economy overall. That is an aspect of what we have gone through. We have seen that in business. We see that in very large business, small business and in individuals. I think that has been across the economy. That sits behind it as an environmental issue.

We have seen within that environment people who have looked to build business models that are inherently more aggressive or more risky than other people have had, and so you have had a range of new business models emerge through that period. That has enticed people either to take higher risk or to take risk they did not understand, in part because they have been very good at selling a model and selling a dream or a vision about what it was going to deliver them. That is very hard to legislate against. People will make mistakes and will make poor judgements.

We have probably seen examples of where there has not been proper compliance or proper disclosure around some of these things, and so at the edges we have seen examples where we can tighten up around governance, disclosure and regulation across the financial services industry and I am sure in other industries as well. I might say that it is more at the margin where we have seen these sorts of issues, and it is the marginal areas that tend to get more out of control as you go through the sorts of booms that we have had. It is about making sure that the regulation is bringing us back to understanding where those excesses are emerging and getting some quick correction on those. The regulators need to be alert to those sorts of issues and have corrective actions around them in a timely manner.

CHAIR—Given that a lot of the issues have stemmed around gearing and margin lending, which obviously multiplies a person’s risk, what would you regard, from a financial perspective, to a lender as a safe percentage for an LVR?

Mr Hodges—It depends on the asset. If you are borrowing for a mortgage, it is your family home and you have steady income, I think you can go to a higher loan to value ratio, and particularly if you have the income to support your repayments, than if you are investing in a product like a margin loan. Again, in a margin loan, as I said earlier, are you a single-stock margin loan investor or do you have a wide spread of stocks? I do not think you can answer that question. We quite safely lend 90 per cent LVR on owner occupied homes where individuals have steady jobs and they can afford the 95 per cent LVR on that loan. There are other examples where people cannot afford that, and so therefore you would pull that LVR down. For example, for a different product, a low-doc loan where we have less disclosure, we will lend 60 per cent. Why? That is because the clients, for whatever reason, wish to disclose less to us as a financier. We will tolerate that to a point, but that becomes more, what I would call, an asset lend where you are lending with good security; the investor or the owner of that property is not giving you sufficient disclosure for you to make sensible judgements about aspects of their financial position, including their statement of position, and therefore you will have a lower risk appetite around it, both for our purpose and for the client’s purpose as well.

CHAIR—I appreciate that in terms of real estate it is quite different, but with margin lending, the equities market, somebody wanting to come in and borrow today, what are you comfortable with?

Mr Cohen—As was mentioned, it does vary by stock.

CHAIR—ASX200.

Mr Cohen—Even with the top highly liquid stock it will be 70 per cent to 75 per cent. Others are at 40 per cent and then there is other stock against which we will not lend at all. I would say far more significantly than the LVR on individual stock it is about diversification. This has been something that we have identified through our own analysis. We have been at the forefront as a margin lender in terms of development of new product. We encourage investors, when they are taking a margin loan, to do so on a diversified portfolio. That dramatically reduces the risk profile for both the lender and the borrower in margin lending.

Mr Hodges—The other part of that is that we do know stocks will go up and down, and so it is about having the processes in place that give the investors enough warning that they are reaching the thresholds where they can either put up more equity to support that loan or to make an orderly exit from the facility.

CHAIR—All of that makes sense and it is really simple in normal market conditions, up or down, because everything is orderly, but when we have seen crashes—and they do happen regularly—there is no order, there is just panic. LVRs, buffers and ability to sell go out the window. Margin calls do not happen in time and, even if you can sell, it is all too late because there is no-one to buy them. Even at 75 per cent how does that make any sense when there is an event? Is there any consideration taken of events?

Mr Cohen—There is consideration; as you rightly point out, the events have occurred. And it does work. The events do occur and we notice it, because the level of margin calls, as was mentioned, or the trigger events dramatically increased during the period of the equity market gyrations, and so you need to have good processes in place to act in an orderly but quick way.

CHAIR—What is ‘quick’?

Mr Cohen—If someone has their LVR limit breached they are notified of that.

CHAIR—Is that just under an orderly normal movement? If there is an event, you can forget about it being breached, because it is going to fall so quickly that you are not going to get to your first hurdle before you are at your third. You are not going to be able to make the phone call in time.

Mr Hodges—Our experience with our stock—and we lend against liquid stock—has been that while it drops and, yes, people have lost money, the value of their equity has fallen but they are able to get out. It is important to understand that while the market does drop—and it did drop over 50 per cent from its highs—it did not drop over 50 per cent in one day. One could exit and take a loss. It is vital for the customer that when a margin call event occurs you either get the money or you sell out and limit their loss. Our experience even during these tumultuous times is that our customers were able to exit. They either took a loss or reduced the accumulated gain.

CHAIR—So, is that based either on your process or on the ability for them to meet the margin?

Mr Cohen—That is correct. We often had that process, but often people had their margin. So, I am reinforcing that it is critical to have strong processes.

Senator WILLIAMS—You said that you run your own margin lending program?

Mr Hodges—Yes, we do have a margin lending business.

Senator WILLIAMS—When you have a downturn in the market do you notify your clients before you sell their shares?

Mr Cohen—Yes. There is a notification process. As was mentioned, people are given the opportunity to put additional moneys in or to take action themselves. That process may be done by way of phone call, SMS texting or otherwise.

Senator WILLIAMS—I ask the question because many Storm clients have said to me, 'We didn't know what was going on. We just got a letter.' That is obviously not your issue, because you were not running Storm.

Mr Cohen—I cannot comment.

Senator WILLIAMS—I just wondered, for interest's sake, whether you do notify your clients if there is a margin call.

Mr Hodges—Absolutely.

CHAIR—Thank you very much. We appreciate your time and your submission. We will adjourn for lunch and return at the appropriate time.

Proceedings suspended from 12.31 pm to 1.34 pm

DAVISON, Mr Michael, Senior Policy Adviser, Superannuation, CPA Australia Ltd

DRUM, Mr Paul, General Manager, Policy and Research, CPA Australia Ltd

CHAIR—I welcome representatives of CPA Australia to the inquiry and ask you to make a short presentation on your submission or any additional comments you would like to make before we get into questions.

Mr Drum—I will open with some short comments about our organisation for the record. CPA Australia represents the diverse interests of more than 122,000 members in finance, accounting and business in 100 countries throughout the world. About 85,000 of those members are in Australia. Our members work in many diverse areas, including industry and commerce, public practice, government, the not-for-profit sector and also academia. Our vision is to make CPA Australia the global professional accountancy designation for strategic business leaders and we welcome the opportunity to present to this committee hearing today.

We made a submission to the joint parliamentary committee on 31 July 2009 and there are two points that I would like to raise as part of this hearing today for further discussion. The first one is about the role of ASIC. We believe that ASIC’s focus should be on increasing the effectiveness of the existing regulation. They should have a proactive approach in regulating and implementing more effective approaches to increase the effectiveness of existing regulation. By that I mean they should look to introduce an AFSL annual return, which would cover key information about the business to identify AFS licensees who may be at risk of breaching their obligations due to their business practices and, secondly, using the information that is already collected by ASIC when an applicant applies for an AFSL to assess the risk that they may breach their obligations once licensed.

The second point we want to raise is about financial planner remuneration. CPA Australia is an advocate of fee for service and we believe that third party benefits should be banned. By third party benefits we mean soft commissions, trailing commissions and those types of things. Both of these points are covered in our submission. Thank you.

CHAIR—Just as a matter of clarity and for the record, you state in your submission that you cover 122,000 members in 100 different countries in the areas of finance, accounting and business. Can you describe the area of finance, in particular? I am interested in how somebody qualifies or is able to join CPA in the finance sector?

Mr Drum—By finance we mean it in its broadest possible sense. It will be about financial reporting, as well as the finance sector. To join CPA Australia you have to historically have done an approved range of accounting, legal and other subjects at the undergraduate level and then do the CPA program. That is basically the background, and then if somebody is going to work in, for example, the financial planning sector they must follow the normal RG146 educational requirements.

CHAIR—So it is on top of being a qualified CPA and administered and so forth?

Mr Drum—Yes. In that regard, we have our own RG146 pathway. We offer a course that is compliant and on the list with ASIC as an approved course and our CPA program, historically, has had a unit that looked at finance and superannuation that qualified and was registered with ASIC as well that enabled people to get some exemptions under the RG146 educational requirements.

CHAIR—Can you give us some idea of how many people across Australia would actually have that full suite of qualification, be it a CPA under your program, that would have that minimum entry requirement of the RG146?

Mr Drum—Not off hand. I mentioned that we work in a broad range of areas and one of those areas is public practice. Those members of ours that are in the financial planning space would also have a public practice certificate or be working for someone who has a public practice certificate. We understand that we have about 3,000 members that are in financial planning and would be compliant with RG146 one way or another.

CHAIR—They come in only one particular way and that is they are fully qualified and they are a CPA and then they would obtain the RG146. Would it happen in the other direction?

Mr Drum—No, because the way our bylaws are constructed and the way the organisation operates to give advice in the public domain you have to hold a public practice certificate with us and to get that certificate you must have successfully completed the CPA program and all the things prior to that. If you went and did RG146 outside CPA Australia obviously you do not have to apply with our own rules, but a CPA has these other degrees of integrity, qualifications and experience that they must have before they can actually give advice in the public domain.

CHAIR—Would you say that is a fairly high standard or high bar, in terms of entry, qualification and everything that follows with that?

Mr Drum—It is certainly a higher bar than RG146. As I said, that also carries with it other exposure to discipline and sanctions of our own where members are found to be in breach of some of our own rules. It is a higher bar than just a person going straight in and doing an RG146 course.

CHAIR—From the community perspective, the CPA is always held in high esteem and regard and there is a fair bit of trust and good standards in people that have a CPA qualification. How do you find that in practice? Is there a really high ethical standard? Do people adhere to codes and compliance? Do you find that within your own sector people that you represent or are qualified to be members have really high standards?

Mr Drum—Certainly. They have to meet our standards, so yes. Some of what you are talking about is certainly aspirational, but the evidence is that our brand is well recognised and held in high regard in the market from our marketing research and those types of things and again, as I said, to remain a CPA requires a certain amount of study per triennium. It is not just do it once and then you have got it for life, it is something that you have to make an ongoing commitment to and be able to demonstrate that. It is about keeping up to date. The example I was going to give is even with myself, as the General Manager of Policy and Research, I have just been through an audit with the organisation about how I keep up to date per triennium, have I done the hours that are required every three years and the types of appropriate formal training, rather than just reading late at night and that type of thing.

Mr Davison—Our members, not just CPA members, but members of the accounting profession generally, are regarded as a trusted adviser and certainly research suggests that people still go to their accountant in recognition of that level of trust. Research that we have done recently in relation to self-managed funds and advisers, both CPA and non-CPA, suggests that the industry as a whole, so financial planners, sees CPAs as held in high regard. Importantly, consumers who have self-managed funds see CPAs as the leading trusted adviser at least in the self-managed fund space. The work that CPAs have to go through to get their designation holds them in high regard.

CHAIR—In your submission you talk about the need to increase the effectiveness of the existing regulation. By that statement it is your view that the FSR, the current Corporations Law and so forth, is adequate to meet needs in Australia, that there are enough regulations and that it is just a case of compliance.

Mr Davison—Overall the vast majority of advisers and licence holders are doing the right thing. The level of abuse or people breaking the rules is relatively small. Admittedly, we have had some pretty high, public incidences where advisers, business models or products have fallen over, with Storm and so on, but I think there are 800 licence holders and we are seeing serious issues with a handful. The vast majority of our members are doing the right thing.

Storm is an example which obviously is of interest to the inquiry. On the whole you would say Storm was operating within their requirements of the regulation. The big issue would appear to be that Storm was giving the same advice, irrespective of the client circumstances. It was often margin loans which possibly exceeded their capacity to pay or even their need for the underlying investment. It would appear Storm were doing a one-size-fits-all approach to advice. Everyone was doing the same, getting the same advice and clearly, whilst they might have been doing the right thing around disclosure and so on, that is not in line with section 945A of the Corporations Act where there has to be a sound basis for the advice. I guess we fail to see if someone was looking at a licence holder, I would have thought serious questions would have been asked earlier as to how a one-size-fits-all advice model works for all their clients.

CHAIR—Whose job should it be? Obviously it is ASIC, as the regulator, but you have sort of said as a contradictory statement that your view is that Storm was not in breach of the Corporations Law. If it was a one size fits all then that would be a breach, because you are supposed to know your clients.

Mr Davison—If you look at everything they are doing around disclosure, SOAs and so on, they are operating within the law. The one section where they were not was in knowing the client and having a reasonable basis for the advice, section 945A. I am surprised that was not picked up, considering they were doing it for everyone.

What we have seen anecdotally and talking to ASIC over the last few years since the FSR has been in place is that quite often when questions are raised, or if we ask ASIC if there is going to be a particular issue whether it is going to cause concern with ASIC, their response has been that they will not or cannot act until they have complaints. From the recent collapses it appears that their response has been very much reactive, based on complaints. Even looking at their submission to this inquiry around Storm and some of the complaints they received, if there was not substantial evidence they did not follow them up. That is as far as what they have said publicly; I have not seen what they have said confidentially. The indication to an observer is that they act reactively. As we have suggested in our submission, if they actually were to rely on the information they receive in the licence process to start looking at risk factors concerning licence holders or licence applications, as to what risk they may pose when providing financial services or providing advice, we do not suggest that ASIC should be approving business models. We do not believe ASIC or anyone is properly equipped to do that. Certainly, they could start flagging practices, as far as risk is concerned. Having access to annual information would enable adjustment of those risk factors, as appropriate, and they should be monitoring those practices or those licence holders that are in the high-risk categories. That would suggest if you are looking at someone, for example, whose business is built around margin loans and everyone is getting the same advice, then you would hope that would be putting up red flags earlier before the events reach a crisis.

CHAIR—Has CPA got internal systems where they do similar activities or where they monitor their own members?

Mr Davison—We have a quality assurance process.

Mr Drum—In answer to the question, we do not monitor how our members operate their businesses. The short answer is no. Our point about the regulator and the role of regulating in this space under the regulation is do more sets of words change much or are the sets of words and the powers already there to enable the regulator, ASIC, to be a bit more proactive and look at things a bit earlier? I really think that is the nub of the issue. For example, if you look at the Australian Taxation Office and annual tax returns, the tax return is full of data collection about things that have nothing to do with the determination of the taxable income of that taxpayer. Similarly, we are suggesting that ASIC collect information from the AFSLs, who do not actually have an annual return at the moment, but that is one of the things that needs to be done; they need to look under their existing powers to require AFSLs to lodge annual returns that would disclose certain types of information and that information would enable them to see, regularly and perhaps early, business approaches, so are there very high sales of margin lending products. You can learn more about the demographic of their client base, what it looks like and whether it is in accord with the information that was originally provided to ASIC or not. If it was not it enables them to then make inquiries similar to what the tax office does. They monitor data, they crunch it through the computers and that type of thing, and then that will lead with letters, follow-up inquiries and those types of things. Whereas we might find as part of this voyage of discovery in this inquiry that those types of things happen, but again, as Mr Davison was saying, we are not seeing it so we have the perception that it is not happening and it is all after the event that they go in and say, ‘There’s a mess here. What do we do?’ That is our concern.

Mr Davison—Following on from Mr Drum’s comments about the tax office, the tax office whilst being the revenue collector, as far as self-managed funds are concerned it is also a regulator. As the regulator it collects a lot of data on self-managed funds and audits of those self-managed funds and it uses that data to assess risk factors in relation to funds or auditors as to how well they are going to comply with the superannuation law or breach the superannuation law. Based on that they structure their surveillance program around the higher risk funds or auditors and review them appropriately. That is an ongoing process.

Mr Drum—They also provide information to the professional bodies, like CPA Australia, about members where they think that they might be at risk for us to follow up on as well, so we have an exchange of information in that regard in respect of self-managed super funds.

CHAIR—If there was enough data collection and you saw some things that were at risk, but not necessarily breaching law, practically what could you do? If somebody is offering very high geared products, aggressive products and all the rest of it, not necessarily outside the law, how do we deal with scenarios like that?

Mr Davison—ASIC probably does it more with the shadow shopper, for example, when they do go out and look at quality of advice. I know that ASIC has put programs in place to look at quality of advice. Storm is an example. If ASIC had the information and you could see a licence holder was recommending a lot of margin loan products and it just turned out that a large proportion of their client base was retired, then that would warrant grounds to go in and have a closer look, look at the basis for advice and whether it is appropriate or not.

Senator WILLIAMS—Was that the case with Storm?

Mr Davison—It was. Being an observer, it would appear that in a large number of cases the advice would appear to be inappropriate, considering the demographics of their clients.

Mr Drum—We do not know whether Storm was warned or alerted, or whether ASIC knew early enough and did anything about it.

Mr Davison—It comes back to the perception.

Mr Drum—If I could just continue on with the theme of comparative analysis between ASIC and the tax office, as I said the tax office goes through and looks at all this data and then it will determine what action it needs to take, if any, and some of that might be, in the case of the tax office, writing to the taxpayer. Some of it might be that it feels as though it needs to do some kind of public alert. They have taxpayer alerts to say that these alerts might be something less than an interpretation of the law, like their ruling system, but it is just, 'We've seen this practice. We don't like the look of it, so we're just flagging that it's on our radar and we're going to watch it.' It is like an all points bulletin that is then out in the market and it is more information for people to be able to determine, 'Am I in this situation or not? Does this reflect the discussions that I'm having with my adviser?' It is not just about direct communication with the AFSL business, it is about putting information into the public about this. I know we have got FIDO and other things.

Mr Davison also mentioned the shadow shopper initiative, but shadow shopper is something like 30 entities every two or three years, it is not like the way the tax office approaches these things. We have been critical sometimes about how vigilant the commissioner is on some things, but in this regard he is much more thorough in his checking for the benefit of the revenue in that case and here we are unsure about how proactive ASIC are in this regard.

CHAIR—There is probably a huge difference between the size of the ATO and ASIC. ASIC has only just recently doubled the number of commissioners from three to six and has had some expanded resources. It is a phenomenal task in terms of checking nearly 20,000 people who have an AFSL licence or work under one. There is probably some resource issues, in terms of just how much can physically be done regarding checking. If you do go down that path of closer scrutiny and more monitoring, is it more of a concern that the CPA has in terms of products or is it more towards advice and behaviour? Which area would be of most significance?

Mr Drum—I am not sure that we can pick one over the other.

Mr Davison—I would lean towards the advice because the products range from a simple bank account term deposit through to some very sophisticated structured products. Those sophisticated structured products may be appropriate for particular sophisticated investors who have advice. Whilst there are questionable products and structures out there, it is really about whether or not people are being put into those or recommended those products appropriately or not. It is a question of appropriate advice.

Senator MASON—Just to recap, it is not so much a failure of legislation, but a failure of compliance. Is that right?

Mr Davison—Yes, I think so. The vast majority of the legislation is appropriate. The industry, as a whole, complains about the disclosure and so on, but it is compliance.

Senator MASON—In relation to compliance, ASIC should take a greater role, and as the chairman said, resources may be an aspect of that.

Mr Davison—Yes.

Senator MASON—I will move on. You said that Storm was acting within the law, except potentially with respect to section 945A of the Corporations Act. Is that right?

Mr Davison—Yes, that is right.

Senator MASON—Is that the only section that you think Storm may have been acting contrary to the law? Is that your understanding?

Mr Davison—As an observer, without being across all the facts, the most obvious thing that stands out is that Storm adopted a one-size-fits-all advice model.

Senator MASON—It would seem that way.

Mr Davison—It would seem that way. We do not know all the facts, but as an observer that is what it would appear to be.

Mr Drum—Part of our thinking on this is influenced by the fact that we understand they had been subject to an ASIC review not long before the whole thing went tail up. They have been checked and their paperwork is apparently fantastic, all recorded nicely, but was there any action taken about the types of products they were selling? Not that we can see.

Senator MASON—It really shows that there is a problem with enforcement or compliance.

Mr Davison—That is right.

Senator MASON—There has been a review and ASIC has given Storm the all clear. On the face of it that would suggest that something is a problem.

Mr Drum—Or there is silence.

Senator MASON—Fair enough, silence. That would seem to indicate there is a problem, would it not?

Mr Davison—We do not know what the all clear was for.

Senator MASON—We will ask about that later on, of course. I know that is a topic that has raised its head before the committee before, but we will be pursuing that. This morning both MLC and also the ANZ developed models where there were, in effect, two tiers. I do not know if you heard the evidence, but MLC said that financial advisers should be split into both affiliated and independent and then ANZ Bank, in their submission, said that there should be two groups. One group of financial advisers, in a sense a more senior one, would have a fiduciary duty to act; in other words, more comprehensive than section 945A, and perhaps to ensure that no one missed out on financial advice, it would be a lower order duty for other financial advisers. What do you think of that two-tiered approach?

Mr Davison—I have not seen the detail of their submissions although I am broadly aware of what they are proposing. I understand that it would mean that the second or lower tier is pretty much selling house products or linked products somehow.

Senator MASON—Indeed. It may be potentially based on commission and the other one based on fee for service.

Mr Davison—Our first response was that it would be difficult to delineate between the two based on product or the experience, education or qualifications of the adviser. A broader qualification may well be linked to what control the adviser has with the product they sell. It is whether they are only selling a house product, like the tier two as they are calling it.

Senator MASON—Yes.

Mr Davison—If they are only selling house product then obviously they are not independent. If you did not have independent control over what was on your recommended product list, then there would be a suggestion that you are still not independent. If these tier one or independent advisers—whatever you want to call them—had total control over what products they sold through to the point of what is on their recommended list or not—if recommended lists continued to exist—then it has some merits.

Senator MASON—Would you link independent or tier one, to use your terminology, to the application of a fiduciary duty? If you wanted to really tighten it up.

Mr Davison—You could.

Senator MASON—Your evidence before was that the only breach of the Corporations Act by Storm, on the face of it, is 945A. Would it not be a good idea to link tier one and the independent financial advisers with some sort of fiduciary duty? Would that make sense?

Mr Davison—I still have a question over the benefit in as far as the tier two. From the consumer's point of view, someone approaching the tier two product adviser is going to get house product or a linked product. The question is whether that is in the best interest of the consumer or not.

Senator MASON—You are right.

Mr Davison—There is no fiduciary duty. If you walk into a bank you will be sold that bank's investment or superannuation products.

Senator MASON—That might be fine, although it may not fit a fiduciary duty.

Mr Davison—No.

Senator MASON—Not if someone is getting commissions and so forth, it may not. I would have thought it would be grey.

Mr Davison—The question is whether the consumer is getting the best products for their needs and getting the best advice or any advice by approaching those tier two advisers.

Senator MASON—Tier two would not be subject to fiduciary duty, but it would still be subject to 945A.

Mr Davison—Yes. The tier one advisers may very well become quite a niche market. The question then is whether the public, as a whole, is going to have access to affordable advice.

Senator MASON—You are right. That is right for a policy issue. I just want to scheme out in my own mind how we are going to go. You can see where the evidence this morning has led us. You can see that you have two tiers, one with a fiduciary duty—fee for service—and then the other one. Do you follow this?

Mr Davison—You are going to have a full independent financial adviser who gives you financial advice independent of product and the second group will be product advisers that will sell you a product for your need.

Senator MASON—Without a fiduciary duty that still would meet the current Corporations Act.

Mr Drum—We are happy to have a look at the *Hansard* regarding what was said this morning and follow up with some written comments. We can take it as a question on notice if you like because it is from the hip, off-the-cuff remarks at the moment without understanding the detail.

Senator MASON—Yes, for me as well. From the evidence this morning there was a couple of threads one could pick up and I think I am doing the right thing in trying to reflect those threads back to you. Thank you.

CHAIR—Senator Williams.

Senator WILLIAMS—You appear to be quite critical of ASIC in your report. Do you agree with that? Are you hinting that they need more muscle and manpower to carry out their duties?

Mr Drum—I would say all of the above.

Senator WILLIAMS—Just hypothetically, imagine you were the boss of ASIC and you had the free reign to do what you wanted to do to see that regulations or amendments to regulations are in place and to see that these sorts of things do not happen again, what would you do?

Mr Drum—Some of the things we have already touched on. Some of it is about beefing up the shadow shopper; some of it is about more resources into FIDO and market alerts on things. They can only really do those things in the way that we have been discussing if they get that information earlier. Some of it is about an annual report and you can get people to lodge annual reports, but then someone needs to have a look at that data. I think they are some of the things that need to be done. They really need to toughen up on the proactive, doing things earlier, and if that means more resources, and it would seem as though it would, then that is where the energies should be, because at the moment the basis of our submission is that they seem to come in either after the fact or when they go in early we do not see anything actually happen that changes the course of events that subsequently follows. In this case it has ended in tears on more than one occasion. We are not expecting these are one-off issues. History will repeat itself. It will happen again unless ASIC or some other regulator does something. This is ASIC's baby. It is something that they should be looking at.

Senator WILLIAMS—There are many financial products out there for sale. Are you saying ASIC should be having a good, close look at those products, perhaps stress testing them and calculating what would happen if, for example, with a margin loan related to the stock market, if the market were to drop 30 per cent, and perhaps being more proactive in that way?

Mr Drum—I am not sure about that. Products that are good for one person may not be good for others. We are not talking about them actually regulating the products. As Mr Davison said before, we are talking about advice and whether we have situations where people are getting holistic, independent advice or whether they are getting a one size fits all, 'This is easy to sell. We get a good commission off it, so let us just push this product as hard as we can until year end or into the next year.' That does not seem to be in the best interests of consumers, investors or whatever you want to call them.

I do not think that it is about giving a Nike swish, if you like, to the product that is in the market, it is really more about monitoring what those in the market are actually doing and issuing the market with advices from time to time.

Senator WILLIAMS—What is your opinion of the way the bar is sitting as far as financial advice goes? Do you think the bar should be raised as far as professionalism?

Mr Drum—Are you talking in terms of general financial experience or qualifications?

Senator WILLIAMS—Exactly. Do you think it is too easy to become a financial adviser?

Mr Drum—It is not that difficult. RG146 is a commencement point rather than the end story. If you look at the pathway that a person who wants to go into financial planning takes, they can be partially compliant with elements of RG146 and giving advice on pieces without being fully RG146 compliant on every unit that is on offer. Yes, we think there is scope to improve that over time. As I said, it is the benchmark, the standard and commencement point and needs to be viewed as such.

Mr Davison—Following on from what Mr Drum said, professional accountants in financial planning have an overlay on top of education requirements in that the three professional accounting bodies have a professional statement for financial services, so any member operating in the space has to comply with our professional statement APS 12, which sets high standards around professionalism, how they interact with clients, independence and remuneration. The accounting profession, as far as financial planning is concerned, has actually put the bar at quite a high level regarding professional expectations.

Senator WILLIAMS—Thank you.

CHAIR—You have obviously got a very large membership. Would you cover off on most accountants? How do you define the coverage that you get out into the community?

Mr Davison—As Mr Drum said, we have about 122,000 members worldwide, with 85,000 in Australia.

CHAIR—That is pretty substantial in terms of coverage.

Mr Davison—Off the top of my head, the Institute of Chartered Accountant has about 60,000 members. Between those two bodies we would cover the majority of accountants.

CHAIR—It would be pretty fair to say that you have got a large coverage.

Mr Davison—That is right.

CHAIR—I am just trying to understand how it would work. Let us say that people get financial advice separately to their own accountant or somebody who is qualified—and we might take the Storm example—at some point in time they would go back to their accountant obviously at some point in the financial year to work through their financial affairs. The accountant would be aware that they have invested in Storm or other products. Again, in terms of knowing what your client does, is there any responsibility or any effort that you would see where an accountant would then look at that particular investment and say, ‘Give me a look. What type of investment have you got?’, or is it completely separated out from the work that an accountant might do?

Mr Davison—You could argue that an accountant has an obligation to the client to advise on that. Unfortunately or fortunately, however you look at it, under the Corporations Law an accountant cannot give that sort of advice on the appropriateness of an investment or financial plan unless they are licensed.

CHAIR—I am just wondering at what point. We are talking about so many thousands of people. There must have been a few, maybe a lot, maybe lots, who would have at least looked at that.

Mr Davison—I would not be surprised that individuals seek that advice and get it from their accountant.

CHAIR—I am wondering how that works. If that is the case, why would the accountant not have said, ‘This is inappropriate for you. This is too risky.’

Mr Davison—I would suggest that the accountant is hamstrung by the law, that they cannot.

Mr Drum—I would also add to that and suggest that quite often the accountant sees it after the event. It is at the year end when they come in to do their tax—wash up, mop up of their annual compliance tax obligations—that they find out.

Similarly, at a different inquiry we were talking about agribusiness and agricultural investments. Quite often if the accountant is not RG146 compliant or a registered adviser in that regard they only find out after the event: ‘By the way we invested in this.’ Then, if they are not the adviser, how can they give advice to say, ‘Unravel it. Get out of it.’ It is not within their bailiwick.

CHAIR—Since you have raised MIS, it is another inquiry that we are doing concurrently with this one. The evidence that we have received in that inquiry is that a lot of MIS schemes are actually sold through accountants. They were basically under an authorised representative type selling a single product or advising on a single product through the MIS scheme. Again, how does that sit in terms of the profession? Are there any CPAs that were involved in the selling of MISs?

Mr Drum—We actually gave evidence at that and said yes there were. I came in by phone so you may not recognise me.

CHAIR—Now I remember you. We might get it on the record for this inquiry.

Mr Drum—I understand that in the case of Great Southern, for example, there was 1,100 people who sold the product. I think 300 have been identified as accountants. Of those 300 there were about 75 that we have identified as CPAs. Do we have a concern about that? We have a concern about agribusiness in the context that, just as we have been talking about holistic and independent advice, rather than just selling one product, we certainly have a concern about that because we do not think it is in accordance with holistic advice just to be a licensee or an authorised rep of a licensee to sell one particular product.

CHAIR—It was one of your recommendations that ASIC provide some guidance on this area, whether they sell one or two or a limited number of products.

Mr Drum—Yes.

CHAIR—That would apply equally across whether they are an accountant, a CPA, a financial adviser or anyone.

Mr Drum—Correct. In respect of the accountant issue, they said there were 300. It is really an issue about whether it was 300 accountants of people that call themselves accountants or that Great Southern said, ‘These are accountants’? We said at the time that we thought that issue was actually a bit of a red herring because at the end of the day the people were all authorised reps. That is about AFSL and, again, RG146 and whether you are an authorised rep under the law rather than what else you do in your spare time, so to speak.

CHAIR—There are some people that are suggesting that one way to minimise the impact of some of the issues around failure or inappropriate advice would be to get a second lot of advice. You might initially get your advice from the financial planner or whichever organisation it was from and then you would have a checking mechanism where you would probably go off to either your lawyer, solicitor or perhaps your accountant, which might be the most appropriate place, and get some sort of secondary advice in terms of how well suited you are to that particular product. Do you think that is workable or a good idea? Are there regulatory changes needed to maybe effect something like that? What are the advantages in that?

Mr Davison—It obviously has merit to have that second opinion. There are two issues. Firstly, there is the cost to the client because they are going to be seeking another piece of advice. Financial advice, in general, is quite expensive and a large chunk of that is compliance cost to the adviser. Secondly, we do not have enough members of the general population seeking advice now. I think a requirement to seek a second piece of advice may actually scare more people off.

Mr Drum—The third issue would be whether two people could ever agree on what is the correct advice for somebody.

CHAIR—That is an interesting thought if one could agree on what was appropriate or not. That might lead to some other issues. Thank you for your time and your submission.

[2.16 pm]

BLACK, Mr Stuart, Director/Board Member, Accounting Professional and Ethical Standards Board

DAY, Mr William, Director/Board Member, Accounting Professional and Ethical Standards Board

WIJESINGHE, Mr Channa, Technical Director, Accounting Professional and Ethical Standards Board

CHAIR—Welcome. I invite you to make some opening remarks in addressing or adding to your submission.

Mr Black—Firstly, thank you for the opportunity to appear before the committee on behalf of the APESB. The board's charter is to publish, in the public interest, professional and ethical standards that apply to members of the accounting profession in Australia. That is the three main accounting bodies—the Institute of Chartered Accountants, the CPA of Australia, from who you just heard, and NIA Australia. Rather than summarise the contents of our detailed submission, which I am sure you have already read, I intend to take this opportunity to address some of the fundamental issues that we think highlight shortfalls in the framework of the existing regulatory regime and the areas that we consider need to be addressed.

Let me start by saying that the focus on banning commissions, which we have seen a lot of in the press, no doubt is important, but it is only part of the problem. It is not the solution. I want to make that point quite clear as we go through. The real problem lies in the framework of the existing legislation, which in our view is structurally unsound and unlikely to be fixed by playing around the edges. Unfortunately, the existing legislation has been shaped by the investment planning industry, which you could say is controlled by the product manufacturers, and I could say with the intent of locking in a product distribution network. As a result, many of the traditional trusted advisers to the public at large have really been blocked out of the industry, principally by the strict licensing regime and the associated costs of compliance and administration. There are very few truly independent small professional advisers who have chosen to obtain a dealer's licence. Most have been forced along the route of an authorised representative, and in many cases some could be described as salesmen. In my view, and in our body's view, the public is the poorer because it is unable to seek advice from those people it trusts on their investment or wealth management affairs.

Many of these authorised representatives are restricted to recommending a product list of the product manufacturer's product. They lack the necessary skills to advise the more sophisticated investors, in particular, in a holistic manner. They are remunerated on a contingent fee basis that creates a basic conflict of interest with the client.

The first thing that must be done is to recognise the fact that the investing public is not a homogeneous group. The $10,000 investor's wants and needs are quite different from those of the $1 million investor, which are different again from those of the $10 million investor. One piece of legislation is unlikely to work for all of those investors. Perhaps the legislation should be focusing on the mums and dads that really do need the protection, and consideration should be given to letting professional advisers or investors opt out of the scheme. There is a precedent for this now because professional advisers can opt out of certain areas of legislation.

The second thing is to recognise that there are different roles that the adviser takes of the client. The first one is what I would call the broker agent salesman. This is where the adviser is authorised to act on behalf of another. The adviser clearly has a conflict of interest and he must fully disclose that. The second role is the steward, which is probably what many of the investment advisers are. In this case the adviser has agreed to act on another's behalf. There is a basis of trust and confidence, and the interests of the adviser should be aligned with those of the other party. You then have a third higher level, which is a fiduciary relationship. In that case the adviser has accepted a legal responsibility to act on another party's behalf. The adviser can have no conflict of interest whatsoever, which is typically seen in a trustee relationship, a director or a power of attorney.

The current legislative framework misleads the public by not clearly differentiating these three roles. It enables the salesman in a profession effectively to pass themselves off as a licensed investment adviser, which enables them to gain the trust of their client.

Thirdly, the consumer should be given freedom of choice to consult with their trusted adviser, such as an accountant—provided they have the knowledge and experience—and they should not be forced to deal with a licensed financial adviser with whom they may have no pre-existing relationship and to whom they do not wish to divulge their personal affairs. We are talking about very private matters here.

Fourthly, the legislative framework needs to be refocused on the adviser providing financial advice irrespective of the product, unlike the existing focus on selling financial product. In this regard, the current definition of 'financial product' and 'financial advice' is far too wide and encompassing. Equally bad is the call from some sectors of the industry, which are effectively asking to legislate the term 'financial advice' and restrict its use to licensed investment advisers. 'Financial advice' is a pretty generic term. I think accountants and many other advisers provide financial advice every day. The term has a far broader meaning than a small subset of investment advice. It is a very small part of it.

Prior to 2001 we had the rewrite of the financial services legislation. Prior to that time accountants without a licence were able to provide incidental investment advice to their clients as part of their overall services that they provided. I think consideration needs to be given to opening the pool of qualified advisers, not necessarily licensed, who can provide appropriate investment advice to break the grip of the product providers over the financial services industry.

Fifthly, recognise that the only true protection of the investor comes from a good investment process, as legislation has had limited effectiveness in protecting investors wherever it has been introduced in the world. There is no shortcut to procedural prudence. RG175 sets out a reasonable basis for advice rule, but from what I can see it is pretty much ignored. Where is the due diligence of the adviser other than to read the report of the product promoter? Incidentally, I have yet to see one report which does not recommend their products.

Investors who purchase a business or a property will always undertake a significant amount of due diligence, yet time and time again we see investors investing in financial products with only the most cursory review of the investment and due diligence. Typically we have seen this in Opes Prime or the MIS schemes, where people just did not understand or look at what they were buying into.

Finally, introduce full transparency, particularly in regard to fees and expenses, and ban contingent fees that create a conflict of interest. Fees must be unbundled so that consumers can clearly evaluate the reasonableness of each of the different components of that fee. There is the money paid to the money manager, the broker, the consultant, the custodian or the administrator. If one of those is under-representative you know you are not going to be serviced there. To move away from a commissions based structure to a fee-for-service structure it would be necessary to change the tax act to put commission for service and fee for service on the same tier. I commend the board’s submission to the committee and ask that you consider our recommendations with an open mind. Thank you.

CHAIR—Thank you for that full explanation of some of the points. I appreciate what you are saying in terms of trying to differentiate between the different types of advice and what advice might look like. That is pretty complex. A lot of the submissions that we have received in evidence are that there almost needs to be two types of models—affiliated or independent-type models. Is that just too simplistic? Does that not really delve deeply enough in terms of trying to provide clarity?

Mr Black—In our view that is a little bit simplistic. It comes to the fact that we are trying to legislate a product range which is from that wall to this wall and in between. It is not as simple as saying, ‘There’s the simple and there’s the hard.’ I think it is really a refocus of legislation. It is the role that the adviser is taking. The adviser can take a different role in different circumstances.

I was talking to Mr Day earlier today and he said, ‘How would you classify my 80-year-old mother who goes along to seek investment advice from a licensed investment adviser? Are they a steward or is there a fiduciary relationship?’ Normally it would be a steward, but in that case, that 80-year-old is probably putting their full trust and benefit in that person and it is more from a steward to a fiduciary relationship. It is very hard to put a black and white rule as to what fits in.

The two-tier proposal that you have mentioned is easy to do for the first stage of probably saying, ‘This is an agent broker salesman who clearly works for the product provider. It needs to be clear that they are not.’ Someone said I was far too emotive saying, ‘They are a wolf in sheep’s clothing’, but effectively they have to be seen for what they are. You then have the steward. In many cases it is a question of the relationship that you have with the person. That becomes a harder one to define.

CHAIR—Are you effectively saying that, rather than narrowing by more clearly defining what each person does, which would be a narrowing of the market, as it were, in those particular areas, you are really saying the opposite? You are saying: open it right up, allow more people to give advice and create more checks and balances?

Mr Black—People need to state the role they are performing. Clearly, at the beginning of the engagement they need to make it quite clear. Are they acting in an agent broker salesman role? Are they acting as a steward or are they acting in a fiduciary role?

Mr PEARCE—Are you saying that those people need to be licensed?

Mr Black—Not in all cases. What I would argue personally is that we need to protect the mums and dads and the less sophisticated investors.

Mr PEARCE—In what case would they not be licensed?

Mr Black—If a person came to see someone in a very highly structured investment scheme that fitted into their affairs, and they had $50 million in assets invested with a very complicated structure, the investment adviser is not going to be able to help them in regard to that.

Mr PEARCE—Would it depend on who the adviser was?

Mr Black—That is quite right. They need to make sure that they are speaking to an adviser who has the expertise to do that.

CHAIR—You would not know if that adviser had those qualifications, would you?

Mr Black—It is a little different from going to a tax accountant and knowing someone who does a simple salary wage tax return or BHP tax return. You have to make that judgement.

Mr PEARCE—The question I was asking, following on from the chair's question, was that you are advocating for a widening of the licensing, if you like, to allow other people to offer advice without a licence. Is that not what you are saying?

Mr Black—It is slightly different from that. What we are effectively saying is that possibly there should be a safe harbour for certain people to step within where they fall and have the safety net of the system, but the more sophisticated investor, as we do now for prospectuses, has the opportunity to opt out of that and say, 'I'd rather go and get my own advice from a person I believe who can help me here.' They may not be licensed. I was listening to the question earlier. Why should they have to go to a licensed person and then get a second opinion from their accountant or their lawyer, who then says, 'I can't give you that advice'?

Mr PEARCE—But is that not like saying, 'Why do I have to go to an accountant or a tax agent to do my tax return?'

Mr Black—You do not have to go to an accountant to do your tax return. You would have to go to a tax agent, which is a registered tax agent.

Mr PEARCE—Why?

Mr Black—The act requires you to use a registered tax agent.

Mr PEARCE—And you would be supportive of that?

Mr Black—Not necessarily so. That is the way it is. I do not necessarily support that.

CHAIR—Are you referring perhaps more to secondary advice? Perhaps you initially seek advice from a particular area or somebody is giving you advice?

Mr Black—I would certainly agree with your comment about the availability to people to go and get secondary advice. At the present time they cannot. If someone comes and sees an accountant after they have been to an investment adviser and says, 'What do you think of this recommendation?' you actually cannot give a recommendation. Then the client says, 'What do you really think?'

Mr PEARCE—There is a reason why that accountant cannot give that recommendation.

Mr Black—Because he is not licensed.

Mr PEARCE—That is right, and why are they not licensed?

Mr Black—Mainly because they choose not to be in many cases.

Mr PEARCE—That is right.

Mr Black—It is too expensive and it is not worth it.

Mr PEARCE—There are many that are licensed.

Mr Black—There are quite a few that are licensed, but many of those are in an authorised representative capacity rather than holding their own dealer's licence.

Senator MASON—I congratulate you on a conceptually creative submission. I thought it was very interesting. You said before that one size does not fit all; it covers many parts of our discussion this morning. Getting back to the question that Mr Pearson and our chairman touched on, we have this term 'financial adviser'. There has been some evidence from MLC and the ANZ Bank that we might, in fact, want two tiers, and now you are suggesting three tiers. Is that right?

Mr Black—I am suggesting three different roles they should be playing. I am not necessarily suggesting that they all should be legislated.

Senator MASON—No, but you are suggesting that there may be different legal duties attached to that.

Mr Black—Yes, definitely.

Senator MASON—You do think there is a role for differentiating the legal duties attaching to different sorts of advice?

Mr Black—Yes.

Senator MASON—Thank you.

Senator WILLIAMS—We have heard over the past several months sad stories about people investing in Storm, Opes Prime and various other things. If we took someone who got some advice from a Storm broker and said, ‘This is the way to invest in the future’, do you think if they had then taken that plan to their accountant they would have been better off as far as secondary advice?

Mr Black—The simple answer is that it depends on the quality of their accountant. Not all accountants are equal and nor are all investment advisers equal.

Senator WILLIAMS—The reason I am asking this is that it went disastrously wrong for so many, and I question: was it just a case that they put faith and trust in their broker and perhaps should have sought more advice, whether it be from an accountant or some other planner?

Mr Black—It is made difficult by the fact that accountants have drilled into them that you cannot give investment advice otherwise you have no PI cover or anything else, particularly at the lower level. Certainly when you get into a more trusted adviser relationship I think a lot of people end up giving advice even though they are not supposed to. It is very hard to have a relationship with someone for 30 years where you know more about their affairs than they do and then tell them, ‘Sorry, I can’t give you advice on that.’ Effectively a lot of advice gets given.

I would suggest in answer to your question that a lot of the people who went into Storm were not the sophisticated investors who had a strong relationship with their accountants. In many cases, they were more uneducated investors who were driven by returns and did not consider the risks fully. There were some figures that the CPA put forward on the numbers. We do not know whether they were accountants, members of professional organisations or people who called themselves accountants, but it is interesting that a much lesser proportion may have sought some secondary advice.

Senator WILLIAMS—You have hit on the point that I am getting at. These people are not sophisticated investors and they were driven by perhaps the very good returns proposed and so on. As we look forward, if something similar were to come up again in Australia with those same types of investors, how would we keep a check on this?

Mr Black—I have no doubt that it will happen again. I have already seen in the last six months that people have withdrawn, but now suddenly the market is going up and they are going out again. It is remarkable how short people’s memories are. I will just put this forward. Years ago we had the concept of authorised trustee investments, which we still have of course. Possibly people need to be told that, if you want a safe investment where you are not putting your money at risk, you can invest in these areas, they are protected and there is a very high level of assurance on it. If you choose to go outside of that, buyer beware. We cannot legislate against greed.

Senator WILLIAMS—That is right. Or stupidity.

Mr Black—Yes.

CHAIR—What do you see as the core of the problem here? You raise a range of issues. It is not just about the giving of advice. Obviously there are some models that are more appropriate and tailored to some people, less appropriate to others and there are issues of disclosure. There is a whole range of issues at the edges that create problems and, therefore, the collapses and losses. What is at the core of all of these? How do all of these connect up?

Mr Black—I summarised them in the six points.

CHAIR—Yes, I am trying to get a sense of this. Is it more focused on the licence provision or is it more of a compliance and monitoring role? Which one gives you the most access?

Mr Black—The biggest concern I have is the framework that the legislation is written in, in the sense that it is focused very much on giving product advice and having a licensed dealer as the only person who can recommend on the product. The definition of that is so broad that it cannot help but bring in conflict all along the way. Our standards in the professional ethical standards board are all about the code of ethics. We deal with this in auditing and all these other areas, where independence and conflict cannot be touched.

CHAIR—It is institutionalised.

Mr Black—They are institutionalised. They become what we think about. They are supported by ASIC. I listened earlier to the comments about ASIC, but there is no way ASIC could ever have the resources to do what is being asked of them.

Senator WILLIAMS—We hear cases of many shire councils, for example, investing in AAA credit rated investments and they have effectively done their backsides. We come back to looking at safe and secure investments. Here are things that are AAA rated. You would have confidence to say that is a safe investment, but in the end they were hopeless.

Mr Black—I would refer to the question about due diligence. ‘Due diligence’ does not mean looking at what someone else rates them as, particularly when you have rating agencies where people are paid to rate things. Due diligence is about getting into the prospectus and understanding what is underneath it. That is what does not happen. It is very rare to see any real due diligence done on investment products.

Mr Day—As you were saying earlier to me, people think that cash management trusts are cash, but it is not, it is securities. The principal actually fluctuates day by day in the marketplace, but do people really understand that as compared with a deposit?

Mr PEARCE—I want to understand what your key propositions are a little bit more, because I have to declare that I am not entirely sure that I understand exactly where you are heading. You just made a remark a short time ago to Senator Mason about dealing with the conflicts as auditors do and all the rest of it. Auditors have conflicts every day of the week. That is why we put in place CLERP9, largely to help that process along. You are not suggesting to the committee, are you, that there are no conflicts that exist in accounting or auditing?

Mr Black—Certainly not. In certain areas there is quite happily a bit of conflict. I am saying that in the case here that it is quite acceptable for a broker agent salesman to have a conflict as long as everyone knows that. You cannot work for someone and not have a conflict.

Mr PEARCE—There are many accountants in Australia that are also AFSL holders. There are many organisations that provide a full service offering to their clients. They do accounting practising, auditing, financial planning advice and so on. There are many financial service advisers who are accountants, and many of those accountants are members of the professional bodies that make up your board. I get the distinct feeling from your submission and from your remarks here that you are somewhat separating financial advisers as being a distinct group in their own right when in fact they are made up of many disparate groups, including accountants. I get the feeling that you are requesting that the legislation be altered to affect financial advisers, but a lot of that will flow on to the accountants as well, won't it?

Mr Black—Where an accountant acts as a licensed financial adviser, most certainly. But that is not the basis of what I am arguing here. I would rather see the scope of the licensed investment advisers restricted and other people having the ability to give advice. What is happening now is that the only people who can give advice are so-called licensed people, and in some cases they are not necessarily the best people to give the advice or, as the point was made earlier, to give a second opinion.

Mr Day—A question that was raised earlier was the example of Storm and whether a qualified accountant have given a different answer. The answer was maybe yes, maybe no, but query whether the accountant would have looked at the broader picture, the whole of the assets and liabilities of the investor and whether they would have done a true financial picture of their income and expenses. Maybe that fits into the second opinion regime as well. But if the accountant can give financial advice in the broader sense, maybe a particular product or structure would be picked out that was not in their best interests.

Mr PEARCE—Are you suggesting that in that case that accountant would not need to be licensed to give financial advice?

Mr Day—That is right. They would be able to give financial advice in a more general sense.

Mr PEARCE—But they might not be qualified to do that.

Mr Day—They might not be qualified as in a licensed investment adviser or a licensed dealer, but they would be qualified in the broader sense of financial literacy, financial understanding and they would have worked with that client, quite probably, in their taxation affairs or in setting up their business, and so there is no reason why they could not give a more holistic piece of advice or even a second opinion advice.

Mr PEARCE—Without being licensed?

Mr Day—Without being licensed in the current terms.

Mr Black—Under APS 110, which is the code of ethics—the Australian version of the international one that applies to all accountants—one of the fundamental rules is that you cannot give advice in areas that you are not qualified to give it. In the case where you had an accountant who was not qualified to give that advice he should be saying, 'Sorry, I'll have to get a second opinion elsewhere.'

Mr PEARCE—Does the opposite work? Does the reverse work? Could financial planners give accounting advice?

Mr Black—They can now.

Mr PEARCE—Do they have to be licensed? Do they have to be an accountant to give accounting advice?

Mr Black—Presently anyone can use the term 'accountant' in Australia.

Mr PEARCE—What is your opinion on that? Would you be happy if licensed financial advisers felt that they had the competencies to be able to offer accounting advice?

Mr Day—No, I would not. They should only be allowed to call themselves accountants if they are qualified in one of the three professional bodies.

Mr Black—But that is not the case at present. At present you can have anyone call themselves an accountant.

Mr PEARCE—Yes, I know that.

Mr Black—They just cannot provide tax advice and they cannot be an auditor or a liquidator without registration, but they can call themselves an accountant.

Mr PEARCE—So, you would not be happy with it going one way, but you are happy with it going the other way, that accountants could offer the financial advice without being licensed?

Mr Day—That is right.

Mr Black—It would not worry me.

CHAIR—What you are effectively saying, though, is that the licence requirements in themselves are no guarantee of anything because the entry is so low in terms of qualifications?

Mr Black—Yes, in the investment area. But if you take the professional bodies that Mr Day is talking about, all of their postgraduate programs are at a much higher level. They are an undergraduate entry and a postgraduate program, which touches on a fair proportion of what we are talking about. There is a continuing professional development requirement. If you are going to give advice in that area you have to keep up to date. In fact, under the institute's requirements, if you provide specialised advice in any area you have to do a minimum of 20 hours each year in that particular area.

Mr PEARCE—The same applies in the financial advising area. You have to do professional development, don't you?

Mr Black—Yes.

Mr PEARCE—Again, it is exactly the same.

Mr Black—Yes, and some of them are very good, the same as some accountants are good and some accountants are bad.

Mr PEARCE—It is still unclear to me exactly what your proposed model would be. I cannot speak for the rest of my colleagues, but I think it would be quite a substantial step for us to move to advocating for a certain sector in the community to offer advice without being licensed to do that. That is a big step.

Mr Black—I appreciate that is a big step and that is why we have raised it, because it is a fundamental change in the framework that is in place now.

CHAIR—You are also suggesting to us, though, that financial advice is given all the time by a whole range of people.

Mr Black—Yes.

CHAIR—That happens anyway in real life.

Mr Black—Yes.

CHAIR—It just draws me to think about the Storm case, in particular, where we have certainly got plenty of evidence and submissions to say that in fact the majority of advice that was given to Storm investors was actually from their friends or neighbours. That is how they actually got in. It was not from an adviser. The adviser's role was more just to sign them up. Is that your view?

Mr Black—It is very much my view of what happens in the industry, yes.

Senator MASON—I think your oral testimony was that the legislation should really reflect the grounds in which mums and dads operate. That is your view?

Mr Black—We should protect the people who do not have the opportunity to protect themselves.

Senator MASON—I think that is right. That is sensible policy. Your purist policy approach is interesting but difficult for politicians to contemplate.

Mr Black—I appreciate that.

Mr PEARCE—It might be difficult for you in the Senate to contemplate. You state in your submission:

We also consider that as a matter of principle the Australian financial services legislation should be reviewed and, if possible, should be written in a manner that the overarching principles are in the legislation and the rules relating to particular matters are in the regulations.

That is how our financial services legislation is written. It is a principles based regime.

Mr Black—It is principles based. What we were getting at—and it may not have come across as clearly as it possibly should have—is that the legislation is written as being all encompassing; to get out of it there needs to be an exemption, rather than the other way around of saying, 'Everything we want to catch we should put in.' We have such a volatile changing environment that when you have to write legislation which is trying to catch every single thing you can ever think of, you end up catching a whole lot of things you do not necessarily feel you have to catch. I agree that it does not read as well as it should. It should be written such that we add in by regulation the areas we want to catch. As a new scheme comes out we can then add it in and not have to rely on it being exempted out. To get something taken out of the legislation is extraordinarily difficult. It just does not happen. It just stays there. It is a lot easier to keep monitoring and adding in things you want to catch. Someone commented on the tax system, which is a little bit more where they tend to put out rulings, add in things and change it more often. It is more the way that it is written and how easily it can be amended that we are trying to get the message across on.

CHAIR—If we focus on Storm as a case study, do you see it as just that there was inappropriate advice, the advice was just not suitable, and it was not necessarily the product, or is it a combination of products and advice or just schemes that really were never going to succeed long term; they just succeed while markets are heading skywards?

Mr Black—There is a high proportion of investments out there that are probably never going to be viable in the long term unless the markets continue to run that way, and they offer very high returns. There is an element of pyramid schemes in some of them. You talked about managed investment schemes. If you pay out X proportion in commission you need to retain sufficient to continue to do the development of the agricultural land, and you cannot do that unless you continue to get money coming in. You have a hiccup, a drop in the market and it falls. There are a lot of investments out there like that. They promise high returns and people are attracted to high returns, but no-one makes any comment that return and risk must always be traded off. If there is a problem in the legislation it is that it is easy to measure returns—and I think Mr Day was talking about having benchmarks published and comparisons on returns—but there is a real risk that you will focus people's attention on return being everything. It is not return. Some people would be far better suited with a lower return and a low-risk product. No-one ever sells risk.

Mr Day—Taken at its most simplistic level, when a person gets a statement about their investment, do they see the opening balance, the movements and the closing balance both in dollar terms and in percentage terms? Very few product providers actually present to the investor what has happened to their money over the relevant period of time. It may be that it is a low return or a high return, but do they ever compare that truly to a government return plus the rate of inflation and really point out to them that anything above that is actually higher risk?

In other words, even at the mum and dad level there is what I would call insufficient clear reporting of both actual returns in absolute and relative terms for the period over which that person has invested. That is an amazing gap in the requirements of product providers.

CHAIR—Would you say that most advisers, at least at entry level, would have that sort of capacity, to understand those concepts and theories and be able to onward explain that?

Mr Black—Not at the lower end of the market.

Mr Day—What if I were to ask you: what is a risky return today? The answer is: three per cent real return plus inflation at two per cent. Anything above five per cent today is a riskier return than a government security. Do people really understand that? Yet they are talking about double digit returns. When structures are added in, as is the case with Storm, that structure is leveraged to provide a higher return on equity that is absolutely inconsistent with a base level return of five per cent or six per cent of low risk. But that kind of information and education is not required to be put in front of the mum and dad investor, or if it is it is rather sold in terms of a way to get a higher return rather than to get a sensible return.

CHAIR—With that in view, is there a need to separate out in some legislative manner what is a retail-type investment or a wholesale-type investment—sophisticated? Is there a need to really start to distinguish between broad product categories?

Mr Black—I think there is. There needs to be almost a safe harbour where you can say, ‘These investment categories, which could be authorised trustee investments, are safer. They are never 100 per cent safe.’ Commonwealth bonds are not 100 per cent safe. ‘But they are considerably safer. They will have a lower return because they are safer.’ We can possibly legislate those ones very well. But if you opt to step out of that—you cannot force someone to—for a higher return they have to accept the higher risk profile, and it will not be appropriate for some people. Advisers should be very clear to point that out.

CHAIR—What is your view in terms of margin lending and gearing in the general community and people getting into trouble?

Mr Black—My personal view on margin lending is that it can be very dangerous for people who do not understand it and who do not have the capacity to do it. Margin lending can be fantastic for people who have the resources and the income stream to weather the troughs and not be forced to sell. For anyone who is an unsophisticated investor who does not have the resources to back it up when the troughs inevitably occur it is an absolute disaster. As much as it leverages as you go up, it leverages as you are going down.

Mr Day—That goes to an earlier issue that Mr Black raised verbally about product providers and bundling together different pieces of the product. Having Storm backed by a particular financial institution it then effectively accelerates that kind of product through their distribution network. It is quite staggering the way in which that distribution network is owned and is force fed by the players.

Mr Black—On the question of due diligence—you get an individual investor who leverages their investment into an investment which is leveraged, you then have leverage on top of leverage.

CHAIR—In those cases that you are describing is there any real advice or is it really just people selling a product?

Mr Black—In those cases it is mainly people selling a product, made worse by the fact that where they charge with funds under management they get a greater fee by leveraging the investment, which is definitely unethical. But there are cases where for some people that is a good answer. As an experienced trusted adviser you need to know your client well enough to know their circumstances, and in some cases, as silly as it sounds, you have to be able to make a decision for them as to whether that is reasonable or not, because they do not know. They are relying completely on you. This is where the fiduciary relationship comes in. If you are in such a state that they are really relying upon you and they cannot make their own decision, you are shifting towards a fiduciary relationship. That is distinct from someone who really understands your advice and makes their decision based on the advice you have given them. They say, ‘Yes. I choose to ignore your advice and I do that.’

CHAIR—How many people currently holding an AFSL or working under a licence as an authorise rep would really have those sorts of qualifications at the fiduciary level to be able to advise someone properly and fully understand the products they are dealing with?

Mr Black—I do not have the figures, but my expectation would be that it would be pretty low, based on the people I have met and the people I have dealt with. I have certainly met some very good people, but as a rule it would not be particularly high.

CHAIR—You have made some very interesting comments. Obviously, transparency of fees and expenses is very important, and we agree that there needs to be some clarity in terms of who gets paid what and by whom. I think that is agreed right across all of the submissions we have received. How important is that for individuals to understand how their adviser is remunerated, whether it is a commission, fee for service, hourly rate or a commission? What difference does it make to somebody who is being advised on a product?

Mr Black—In regard to a person advised on a product by a broker agent salesman I do not think it makes any difference. It is no different from buying something at Harvey Norman and negotiating the best deal you can get. You know the person is conflicted. You know they work for someone else and you know they are trying to sell something to you to get the best profit they can get. I do not see a major problem, as long as people do not hold them out as being independent advisers. Once you move into the stewardship, where you are seen to be acting on the customer’s side, then it is a problem. If you are just a bank teller, most people should recognise that the bank teller is working for the bank, getting paid on a commission structure and will sell you whatever they can sell you. As long as you point that out and people are very clear about that.

CHAIR—Is there enough disclosure in that area as the law currently stands?

Mr Black—As the law stands, if you are a licensed and authorised representative you are assumed to have the same ability and skill level as someone advising someone on $10 million. You could argue that they should be aware of that, but that is not the way the legislation is written.

CHAIR—How would you effectively separate your three levels, being the broker, the steward and the fiduciary? How would you see that distinction being made that would work in practice?

Mr Black—In practice, right up front when you do the engagement letter you have to specify in respect of that engagement in what role you are acting. That sets the ground rules on how you act for that client.

CHAIR—Would that extend as far as to what role you can act in, so not just what role you are playing but what you are qualified to actually advise on?

Mr Black—Certainly. It goes back to the codes of conduct that professionals have. Likewise, one of the rules should concern the qualification to advise. I do not think you can actually say, 'You've got to pass this, this and this.' It is a subjective test; are you qualified to give that advice? If you are not qualified, you should go and seek the advice from someone else and you should be prepared, if you get it wrong and you are not qualified, to be sued. That is the ultimate protection for the investor. If someone gives them advice they are not qualified to give and they have held themselves out to be qualified, they should have their PI policy to pay it. In fact, the market will then start to drive what ASIC itself cannot do, because the person's premiums will go through the roof if they have claims.

CHAIR—Thank you very much. We appreciate your time and your submission.

[2.59 pm]

BROWNING, Mr Steven, Executive Manager, Guardian Financial Planning

CARTER, Mr David , Executive General Manager, Advice Solutions Suncorp, Guardian Financial Planning

CHAIR—Welcome. I will give you an opportunity to make some opening remarks.

Mr Browning—Thank you for the opportunity to present on behalf of Guardian Financial Planning. You have a copy of our submission, and rather than repeat the contents this afternoon my colleague Mr Carter and I would like to focus on a key issue for the industry that is in danger of otherwise being lost in the detail of arguments about remuneration and conflicts of interest. Australia has benefited from FSR and other legislation. Our compliance, disclosure and advice obligations are arguably at the forefront of consumer protection globally. However, in the context of that, there is little doubt that consumer confidence in the financial services industry has been damaged badly by the high-profile collapses in the last 18 months and the reduction of asset values generally. We acknowledge the devastating human toll that the collapse of Storm has had on their customers and regional communities. We must work together to restore confidence in the financial services industry.

Guardian Financial Planning believes that the key elements that have most damaged consumer confidence are ethics, or the lack of ethics in dealing with other people’s money; supervision or the lack of supervision of riskier licensees who are typically not the largest by adviser numbers and typically not backed by an APRA regulated institution; and capital backing or the lack of capital backing of failed operators. The boom market conditions of the last 15 years created an environment that accelerated consumer desire to rapidly create wealth. It was also relatively easy to become a financial adviser and relatively low cost to establish an AFSL.

The industry is made up of around 17,000 practitioners who fall into two broad camps—non-institutional operators, known as independent financial advisers, and those that are backed by a financial institution, often referred to as aligned or tied advisers. The majority of advisers are said to be aligned to institutions such as AMP, AXA, the banks or businesses such as ours. Historically, they seem to have been the focus on media, professional bodies and regulators. However, it is a small number of non-institutional operators who have been at the forefront of the highest profile collapses. Those operators represent a small minority of advisers. For example, as best we understand the details, Storm Financial had around 13 advisers. The industry has some 17,000 advisers. The cost to consumers of the collapse is estimated at over $3 billion.

We acknowledge some distaste for vertical integration where the manufacturer of the product owns the distribution channel to the end consumer. We would point out, though, that the businesses that caused the greatest losses were typically not vertically integrated. Vertical integration cannot be all bad; after all the industry super fund movement is a vertically integrated business.

Financial institutions have the structures in place to ensure compliance with regulations, legislation and other internal checks, including business values. The outcome is that institutions tend to look after their brand and their customers. That sees advisers aligned to institutions protected and governed by explicit policies around hiring practices, supervision and compliance, education and professional development.

The other critical element is capital backing. In those instances where the checks and balances fail institutions stand behind their mistakes. Having deep capital reserves adds another layer of protection for consumers. We also acknowledge the discussion raging over fees versus commissions. However, our position is that these are not the big rocks that led to the high-profile collapses and the loss of consumer confidence. Because competition and consumer choice is so vital to a healthy industry, let us see what we can do as an industry to extend those institutional systems and frameworks to non-institutional operators so the end result is better consumer protection.

To borrow from a sporting metaphor, we suggest a goalkeeping net to be applied to non-prudentially governed operations, with ASIC as the goalkeeper. The argument is that if Storm, for instance, had to put up, say, $5 million in capital in order to operate, then perhaps $3 billion in life savings would not have been lost by Australians. The capital required to support $5 million in funds under advice or insurance cover under advice can be the same as that required to support $5 billion in funds under advice or insurance cover under advice. Capital obligations imposed on banks and insurance companies by APRA vary with the size of their balance sheet and APRA supervises and monitors these closely. Therefore, we believe that similar checks and balances should be applied to AFSLs; explicitly, that they are continually monitored for financial strength and solvency, probably by ASIC. To avoid duplication ASIC would be entitled to rely on APRA’s supervision and monitoring of financial soundness of APRA regulated groups. The amount of capital they hold should also vary with the scale of their funds and insurance premiums under advice. All AFSLs should have to submit financial statements to ASIC at least annually.

In closing, we believe that we should, firstly, put in place standards at adviser and licensee level to discourage unethical and risky behaviour. Secondly, implement a risk based approach to supervision and monitoring to detect early warning signs. Thirdly, the industry must work closely with regulators to insist on a combined approach that weeds out those advisers who through reckless or self-serving actions risk tarnishing the whole industry’s reputation. We must restore consumer confidence in the financial services industry.

CHAIR—Thank you. Turning to your executive summary, you make three points about factors that influence the situation in terms of collapses such as Storm, Opes Prime, Lift Capital and others—inappropriate advice, a one-size-fits-all approach, a lack of prudential regulation and not enough review of AFSL licensees and processes. You say in particular that a conflict exists between some advisers in particular with remuneration largely driven off the large upfront fee model, which is what Storm had, but then a few paragraphs further on you actually say that commissions did not play a factor in the collapse of Storm and that the Storm adviser remuneration model was based on an upfront fee. You have stated, ‘It is important to note that the commissions did not play a factor in the collapse of Storm.’ Is that your view?

Mr Browning—It is, as we understand the situation with Storm. We believe that upfront fees were the issue rather than the commissions.

CHAIR—Is it one and the same thing?

Mr Carter—I understand Storm was charging a percentage amount, which was a fee on the amount of advice. They were not receiving a product commission of seven per cent. Our further understanding would be that they were then charging seven per cent again on margin lending amounts and seven per cent on margin calls the whole way through. When we reflect on that, the debate at the moment is about commissions or fees. That is actually not going to prevent that sort of behaviour in future. It is possible to be charged a fixed flat dollar fee independent of a product and still, through the unethical actions of an adviser, be ripped off or cause people to suffer a loss. Our concern would be that the focus on fees and commissions is not going to prevent this. We could outlaw commissions tomorrow and have everything as a flat dollar fee. Will that prevent another Storm occurring? No it will not.

Senator MASON—It will make it less likely.

Mr Carter—Storm was not owned by a product manufacturer. That seven per cent was not being paid out of the proceeds of the product. Indeed, from what I understand of the product, it was quite a reasonable product. It was an indexed managed fund in equity. It was very diversified and very low cost. It is fair to say that the high commissions on some products—and some of the managed investment schemes are a good example; there were instances of 10 per cent or eight plus four—and those models do potentially encourage a sales oriented culture for those products. There is a mix here of outcomes that are required, but it is still possible to do the wrong thing by a consumer or a customer no matter what the remuneration model is or the ownership structure.

CHAIR—Could you say, though, that Storm was the product manufacturer; it was their own funds? They structured their own funds. They had set up their own systems. They were the manufacturer in the end. Is that not the case?

Mr Carter—I understand Colonial was the issuer of the product and it was a white label product for Storm. It is one of these challenging questions around whether that is the product or who is the product in that case. There are various models that permeate this industry. A number of the independent advice businesses, for example, run white label platforms and product offers that are backed by another manufacturer. Does that make them independent or who is the issuer of the product in that case? That is hard to discern.

CHAIR—You also mentioned that Storm had 13 advisers. That seems like a low number considering they had something like 14,500 clients—at least 1,000-plus for each adviser. Is that possible? Can an adviser possibly have over 1,000 clients each and meet all of their obligations and duties of knowing their client and be able to carry out all of their responsibilities in terms of their licence?

Mr Browning—That is a good question. I think it depends on your definition of ‘client’.

CHAIR—They had to be somebody’s client; they only had 13 advisers.

Mr Browning—A client, typically for most advisers, would be someone that they have a close working relationship with where they are doing reviews and have a service arrangement. They would be clients. Those that sit in the database, if you like, of a practice perhaps at the other end are less clients; they are perhaps more people in a database than they are serviced clients.

CHAIR—As to somebody who puts themselves out as a financial adviser in any form that that might take, how many people could they realistically have as clients?

Mr Carter—I need to continue a theme that has been coming through in a couple of recent presentations. It does depend on the nature of the clients, the offer and the proposition that the client is after. We would argue that, from what we know about Storm, it is this appropriateness of advice issue which, in our view, is well covered by the current legislation. Unfortunately, it just has not been picked up early enough in the case of that particular business. There is this one-size-fits-all approach that people characterise that business with. In a business where clients are into fairly sophisticated strategies, such as a relatively highly leveraged gearing strategy, where the consumer is a relatively uneducated and financially less literate consumer, that requires a very low client to adviser ratio. There would be other models where it is relatively simple advice and a relatively low need for ongoing detailed month-to-month or quarter-to-quarter relationships. That allows for a greater ratio of clients to advisers. Advisers who focus on life insurance, for example, might see their clients once every two years to see if their circumstances have changed. They can quite reasonably work a number that goes to several hundred to one adviser. Someone who is offering very bespoke, tailored, customised advice in fairly sophisticated areas—it may well be high net worth clients—might run a ratio closer to 30 to one. Unfortunately, it does come down to this issue of trying to work out where the consumer, the adviser and the business fit on a continuum. It is very hard just to say that the number is 100 to one or 500 to one. It is a horses for courses approach.

CHAIR—Is there enough in the regulatory framework to be able to determine the level of advice and the appropriateness of advice which then gives distinction to the number of people a so-called adviser could actually have? Would one person having 1,000 people on their books, advising all of those and claiming them all as their clients be something that is commonplace or practical?

Mr Carter—If you look at advice businesses that have been around for a long time that ratio would exist, and that would more likely be life insurance oriented advice. That in itself is not unmanageable, depending on the support structure the adviser has in their business. They might have two or three support staff to help them get to that point. A ratio of 1,000 to one, were it that high—my understanding of Storm is that maybe there were 13,000 clients of Storm, but 4,000 or so had been Stormified, as it was reputed to be, and so the ratios might have come down a little—in that model with that quite complex and sophisticated advice and product offer is unlikely to ever work.

CHAIR—This one-size-fits-all just keeps coming up in all of our submissions and inquiries. How do we get around that? How do you make distinctions in that area, because it appeared to a lot of people that it was not just one product and that there was diversification? There was a range of products, but in the end it really was just all the one thing.

Mr Carter—It appeared to be the one strategy. It appears to be that, anecdotally, whether a person was 40 years of age, high income earner with quite a good financial backing and quite literate or whether they were potentially 75 years of age, no longer working and perhaps not that financially literate, the strategy seemed very similar. That is our understanding.

Gearing in itself as a strategy is not a bad strategy, as was articulated by the previous group. I suspect that what happened is people may have started with relatively low levels of gearing, perhaps $100,000 of income and $100,000 of debt. As markets moved up they were, for whatever reason, encouraged—or they chose or a combination of both—to keep increasing the amount of debt. That works well when markets keep going up and you capitalise the interest because your loan ratios are staying below the minimums. Unfortunately, when the market takes a break, which it clearly did in quite a severe way, if you wake up and you still have $100,000 of income but you now have $800,000 of debt, your chances of servicing that debt from your income and still continuing to be able to eat and buy clothing are fairly low. Your chances of making a significant margin call, in dollar terms—10 per cent of $80,000—is much less likely than it would have been if you had kept the debt at $100,000 and you had to find $10,000.

Most adult Australians gear. Most adult Australian end up buying a house and most people do that through borrowing to buy that house. People borrow to buy investment properties. Investment properties go up and down in value. They rarely evaporate to zero, but they do go up and down in value. It seems that people do not understand—and this may well have been the fault of the advisers—that continually increasing debt and leverage, if your base income or underlying financial position has not changed, can be very dangerous.

Senator MASON—You state on page 4 of your submission:

Unfortunately too many salespeople are taking the title of financial planner or financial adviser without appropriate accreditation, qualifications or experience.

You go on to state:

There is an urgent need to upgrade financial adviser accreditation and make clear to the client exactly what an adviser is authorised and qualified to give advice on.

Are you saying that there should be a division in roles for financial advisers, on the one hand, having salespeople and, on the other hand, having so-called financial advisers? Is that what you are seeking?

Mr Carter—Not quite. We have assessed this in practical terms for consumers. We are really talking about the less financially literate consumers, the mums and dads market. They are the ones who need the most protection, which is a point that you probably raised earlier. Their ability to discern the difference is something we would be concerned about. What does this concept of independent, affiliated, aligned or whatever really mean?

Senator MASON—That is right; independent, affiliated and so forth.

Mr Carter—Yes, what does that mean?

Senator MASON—Yes, MLC.

Mr Carter—Yes. We would suggest that the legislation currently encourages a licensee—and as a responsible manager I feel this—to make sure that advisers are not authorised to advise on things that they are not competent to advise on, that their qualifications back that up and that their continuing professional development is targeted towards the competencies they need to discharge their duties to their client base. I would suggest most licensees probably operate in a very similar fashion, because the personal liability that one takes as being a responsible manager and an office holder of the licensee is fairly significant. I think most people take that very seriously.

The challenge is that, if you have people who have basic levels of qualifications and experience as an adviser, they should not be giving advice on sophisticated products and strategies. In our business we run a range. We have four levels of accreditation for advisers. Those who are accredited at A level cannot give advice, for example, on gearing. That is not allowed. Your supervision and monitoring practices need to be there so that you can check that they are not doing it.

Senator MASON—This is an in-house scheme?

Mr Carter—Yes.

Senator MASON—You would not want this reflected in legislation?

Mr Carter—No. As I say, I believe the legislation encourages you to do that today. I suspect that certainly the larger groups would all be following a very similar approach. They are all very conscious of the consequences of getting it wrong.

Senator MASON—If the committee is to recommend to the executive to put forward to parliament legislation to change financial planning—and it seems to have been put to us in evidence this morning and this afternoon that perhaps we can divide financial planners into different categories; there has been a bit of advice to that effect today. Part of it will be education, I accept that, and experience in certain areas, but part of it might also be upping the legal duty/fiduciary duties, which we just touched on. It also might be that in certain contexts perhaps you cannot take commissions, because there might be inherent tension between taking a commission and a fiduciary duty. Do you see my point?

Mr Carter—Yes.

Senator MASON—Do you think that is fair? Is it an appropriate way for legislators to go or not?

Mr Browning—Potentially it adds complexity to the existing regime, and I am not sure whether that is what we all want to be doing here. I understand the reasons why you might choose to do that. I think we all want to see the bar raised, clearly, and I think the fiduciary duties need to sit and rest largely with those who are dispensing advice at the licensee level, as much as it is for those who are dispensing the advice at a face-to-face customer level. Generally speaking, we can raise that bar. Do we need to segment and change the legislation accordingly? I am not completely sure of that.

Senator MASON—You probably suggest that we should raise the standard overall, but not necessarily in two or three tiers.

Mr Browning—At the end of the day this is about protecting the consumer better. If we can do something that improves that it would be good. The industry and the products have become very complicated, and maybe what the consumer would like to see is a little bit more simplicity and transparency. How do we get our statements of advice down from 60 and 80 pages? Do people really read 80 pages? Probably not. Again, if we use Storm as an example, my understanding is that they had 106-page documents, with every page initialled by the customer. That did not help them better understand what they were doing, and I bet that they fully disclosed in dollars and percentage terms what the adviser or the advice licence was going to earn from it.

Senator MASON—This committee has heard both publicly and also in private session a lot of evidence about disclosure, that it has not really worked. Some think it has failed. That has been the evidence we have received. Having a 70, 80 or 106 page document does not solve the problem, does it?

Mr Carter—No. The other thing we would say is that when the legislation as it currently stands was written it really raised the bar quite significantly for the industry, put some major changes through and was good. From a consumer point of view it was good. Since that time products have become far more sophisticated and new products have evolved. The legislation, as it is currently written, contemplates how you might advise or distribute certain products. It does not necessarily contemplate how you give advice, generically speaking. In the case of, for example, recommending margin lending into a managed fund, you have a very clear obligation on how you give advice on a managed fund, but the margin lending product was not included in the scope of that structure because it was not defined as a tier 1 product at the time. Steps have been taken to change the rules around how margin lending might be sold in the future, but we do not know in three years time what the next margin lending product will be that does not fit into the scope of a tier 1 product definition.

That would be our suggestion. How can the legislation be framed going forward to talk about advice generically as a concept? Our view would be that consumers go to people they see as experts for advice. They do not appreciate the difference between tier 1 and tier 2 or personal advice, general advice or no advice. We would suggest that people who go into the bank and ask about a home loan feel they have probably come away with the person on the other side of the counter giving them some level of advice about that. We do not advocate putting statements of advice in place for home loans, but our point is that the consumer is thinking they are getting advice. How do we make sure there are no loopholes that say, ‘I’ve given you advice on this particular piece, but actually I didn’t have to give advice on this product over here because it was not countenanced by the legislation.’

Senator MASON—Thank you.

Senator WILLIAMS—In your presentation at the start you commented about a lack of ethics in dealing with other people's money. Could you just expand on that a bit? We were talking about the whole financial industry and you said in the past there has been a lack of ethics among some people.

Mr Browning—I think that is perhaps best illustrated by the Storm example. I suspect that the advice that was given in that particular example was driven by a number of factors. Ethically, if you start talking about fiduciary duties, that is a very clear and concise role and responsibility. One of the things we need to do is think about advisers and how they deal ethically with clients. That goes to a broad range of things. How you test ethics is a very interesting concept. But at the end of the day businesses such as ours and the industry need to have layers where ethics become a very important part of the whole process that we call advice. One of the things that we are keen on is to make sure, going forward, that the advisers we have out there in the marketplace do have and do share that fiduciary responsibility, because that is important and vital in most cases.

I think the ethics thing is something we really need to have a look at in totality and it is something that we probably have not spent a lot of time looking at previously as an industry. We can start to think about things like whether we call it the bad apples or whatever you want to call that group of advisers out there in the past who have brought the industry into some disrepute. What are some of the remedies that we can start thinking about collectively, both from a government or regulatory perspective. And for the purveyors of the advice, how can we all get involved in raising that ethics bar and making sure that we do not see repeats of what has happened? Legislating against greed, fraud and some of the other nefarious aspects of human nature is very difficult, but I think we can do more than perhaps we have done in that ethics area.

Senator WILLIAMS—Surely many of those Storm clients had long-term relationships with their Storm broker. They knew them personally and had confidence in them and trust had been built up. You probably would not blame the Storm client for trusting the broker if they had known them for many years.

Mr Carter—Absolutely not.

Senator WILLIAMS—We come back to the model and how it worked, and hence the reason for the collapse.

Mr Carter—And the issue of this appropriateness of advice. With respect to the legislation today, how do we turn the focus to that? Perhaps the focus in surveillance activity historically is around whether the disclosure was correct or whether the replacement product schedule was correct and things like that, which is really technical compliance. It is not unimportant, but it is technical compliance. How do we turn the focus to: was that advice appropriate for that person given their circumstances? That is our challenge.

Senator WILLIAMS—What have we learnt out of the past 12 months and will it happen again? That is my big concern. We had the 1987 crash. We can go back decades and similar things have happened, where people have been burnt and lost their life's savings. But to try to legislate to prevent this would be absolutely impossible. It must come back to financial advisers or financial planners perhaps being more conservative.

Mr Carter—That is why when we considered this we said there were three components. It is the ethics of the advisers and the licensees who support them. It is the supervision and the risk based approach to supervision. If, for example, ASIC had received a report each year that showed the growth in the funds under advice of a licensee, the growth in the number of advisers in a licensee, and the growth in the revenues of the licensee, and that was well above the norm that would potentially have been a trigger to say, ‘We might go and focus on that group of 13 advisers’ and perhaps lessen the focus potentially on the group of 1,500 advisers, which is 10 per cent of the industry. At one level you would say that is a smart thing to do, but when was the last time one of those groups cost $3 billion? The answer is: never.

How do we get that balance? ASIC cannot do it if it does not know what the situation is. There is a lot of anecdotal around whether ASIC was or was not informed about Storm. I do not know; you would have to ask ASIC. If, as a requirement, you had to lodge certain information, key metrics, with ASIC on a regular basis it would certainly help them determine their surveillance program for the next period of time.

Senator WILLIAMS—Thank you.

Mr PEARCE—I would like to get your response on the *Hansard* if I can. I am going to quote from your submission where you state:

Unfortunately the industry reputation has been badly affected by the recent corporate failures, Storm, Opes Prime, Lift Capital, but we don’t feel that is due to systemic issues within the profession or the industry.

What was it due to?

Mr Carter—Given the quantum of the losses it does not seem like isolated instances, but we would put it down to isolated instances where the ethics of the promoters were not aligned appropriately to the needs of the clients. Secondly, there is again this issue around a risk based approach to supervision so that early warning signs are detected. Thirdly, the other aspects that we talked about today is whether the financial consequences, the amount of money you have at risk, is a sufficient inhibitor to taking dumb risks as a licensee or a product issuer. Our perspective would be that currently to operate a licence you might need only $50,000 of capital, whether APRA is in your group regularly having a look at your solvency and other issues—which in the last 18 months has been good—or whether you are not and no-one sees it. So, as your business grows rapidly and you still have only $50,000 of capital, if your business is throwing off dividends of several million dollars a year to you, but you have $50,000 of capital sitting in your licence entity then maybe you are not worried too much about the risks you are taking.

CHAIR—Is that more of a balance sheet issue, though, or is it something else?

Mr Carter—The typical licence entity does not have a big balance sheet. It is run in a way that does not require a lot of working capital; it really is just holding the equity. If the equity required to start a licence is set at $50,000 or $20,000 and there is never a requirement to increase that or scale that for the size of your operations then you can grow a very large business without having to put any more money at risk.

Senator WILLIAMS—Just going back to Storm, you said there were 13 advisers and thousands of customers. Who was responsible for monitoring their level of debt, their LVR, in your opinion? Obviously the 13 could not, unless they had some magic computer program. I ask the question because I have spoken to people who had their shares sold up at an LVR of 143. That is way over any equity whatsoever.

Mr Carter—It is hard to know how it got to an LVR of 143 per cent. On any given day the share market did not drop that far to get from 80 to 140. Without knowing what happened it is very hard to comment. It just does not seem right that that could happen.

Senator WILLIAMS—No, it does not seem right. Perhaps we had a situation where the money was being leant, the money was being invested and then a blind eye turned to it, and obviously not enough management in process, whether it be those managing debt levels, whether it be the bank, the broker or the customer to manage it so that when it did get to desperation times some action was taken. But obviously the horse had bolted long before they shut the gate on many of those.

Mr Carter—We had a 15-year bull run and, yes, we had a bit of a dip through 2000 and 2003, but essentially we had this amazing environment. Consumers were keen to get on that bandwagon and not miss out.

Senator WILLIAMS—It would go up forever.

Mr Carter—It would go up forever. Twenty per cent a year in a three per cent inflation environment sounds pretty good, and if you gear that up you are getting 50 per cent. Sometimes it is hard to prevent people from wanting to jump on that bandwagon, but then it really comes to the adviser to be able to say, ‘I appreciate you want to do that. I’m not prepared to recommend that to you. I can’t work with you.’ That is quite challenging, but that is where people need to get to from an ethical point of view.

Senator WILLIAMS—That is a very good point.

Mr Carter—In terms of the margin lending question, who should have been talking to the consumer and who should not, I just do not know the nature of the relationship between the margin lending product provider and all the other parties involved. It just does not seem right that you can get to 143 per cent all of a sudden.

CHAIR—Thank you very much. I will adjourn the committee.

Proceedings suspended from 3.33 pm to 4.02 pm

RESNIK, Mr Aaron Paul, Chief Executive Officer, FinaMetrica Pty Ltd and Worcester Consulting

WORCESTER, Mr Peter Alan, Managing Director, Worcester Consulting Group Pty Ltd

CHAIR—We will resume the proceedings. I welcome the witnesses and invite you to make an opening statement.

Mr Worcester—I would like to talk for about two minutes about the first paper, which is about the product, Mr Resnik will talk for a couple of minutes about the people who use the product and then throw it over to you for questions. Is that okay?

CHAIR—Yes.

Mr Worcester—I want to give you a history lesson on markets gap. In 1987 Wall Street fell over on 19 October. The Australian market opened 20 per cent down and closed that day 25 per cent down. What that meant was that any stock loss systems failed and any margin loan calling systems failed. Even if people tried to use their margin loans or the bank tried to close them out, there was no liquidity. Therefore, our premise is that, while margin loans work nine years out of 10, every tenth year or thereabouts it crashes, and it crashes through the floor, so it is a totally unsuitable product. Furthermore, margin loan systems fail. The banks get overwhelmed because they have to make so many margin calls and they have not got a hope because too many people are in the chain.

Secondly, we have demonstrated that margin loans themselves do not add value of any reasonable value over the cycle of the market. We have shown they add about one per cent per annum after tax for a person on the top marginal tax rate, which is the best set of assumptions for margin loans and, furthermore, we have ignored all expenses, so therefore it is going to be worse.

We feel that Storm has failed every part of the Corporations Law. Firstly, knowing your client, because they used the one size fits all; secondly, knowing the product—they did not do the research that we did, and that is not very hard; and, thirdly, ensure that the advice is appropriate for the member, which they did not do. We believe, moving forward, that people need to stress test client portfolios under certain black swan scenarios and we believe that margin loans should be banned for retail clients or, if they are used, the bank doing the margin loan must guarantee liquidity at a certain level. For example, if you are going to borrow $200,000, the bank must guarantee to take that portfolio out at, say, $160,000. I will pass over to Mr Resnik.

Mr Resnik—My perspective is to look at what I would call informed consent. One of the obvious points when reading through many of the submission that everybody seems to have missed is that there was no informed consent to the risks that many of the Storm people and I suspect 98 per cent of customers in the financial planning world took on. What is informed consent? It is basically understanding the risks that you have taken on and the consequences. In the case of Storm it is fairly simple. If things went bad you could lose your house. If I said to Senator Williams, 'Here is this great dream, but you could lose your house', what is the likelihood that we would have 6,000 people saying, ‘I’ve lost my house or close to it’? It is putting things into context. An informed consent is saying it is not just a product. The easy way to confuse people is let us just talk about the product, particularly if you are numerate. You can create any sort of numbers that you like. I have been in an industry for a long time and you can do that.

We have argued that one of the ways of differentiating to get an informed consent is that you have got to understand people’s risk tolerance. You will have seen from my submission that we have been working on risk tolerance for about 15 years. Understanding an individual’s risk tolerance gives a basis for a discussion. The discussion goes, ‘You’re more likely not to have a risk tolerance that is consistent with 100 per cent exposure to growth assets, but that’s what I would like to sell you.’

I will invite each of you afterwards, if you are interested, to do your own risk tolerance and to see what it means. I will not look, I promise. It will take you about 15 minutes, but once you have actually got a report and you see how you are different from other people, the greater likelihood is that you will not find yourself a victim of smart selling. From what I have heard today these are external systems. Do we licence them this way? Do we give authority another way? In the end individuals live the outcomes of their decisions in life and we have got to give them some tools. My belief is we have got to make them more financially literate. Doing that generally is really hard, but you can start with something really simple. The really simple thing is what is your risk tolerance. If you know your risk tolerance you have got a starting point to look at the likes of Storm, MIS and Westpoint.

The next part is knowing your risk capacity, which is the stuff about whether you could lose your house. ‘Yes, but I’m going to inherit four others.’ That is okay. That is contextually rich, but you could say to someone, ‘You could lose your house because of the way these things work.’

Basically, my submission at it simplest—and you would have noticed that I put in three because this, for me, was the most important opportunity in my 15 years that I have been focused on client process to try to get the story out—everybody should robustly have their risk tolerance assessed in a way that is scientific and not the nonsense risk profiles that you would have seen. Every super fund has them. Every women’s magazine has one. Basically, they are two questions: how old are you and what is your risk tolerance? They will say the classic, ‘You’re an Aquarian. You like liquid investments, holidays by the sea and new flats.’ That is what prevails.

ASIC and the FPA just sit and watch. I have been writing about this and talking about it for 10 to 15 years. I published a book six or seven years ago with a guy you know, Noel Whittaker. We wrote a book called *Borrowing to invest: the fast way to wealth?* What did it show? It said margin lending is the last resort when all else fails because it is the dumbest thing to do. It is the dumbest thing to do. Why? It is a high interest rate with no long-term horizon that you can control, for not necessarily the appropriate level of diversification. It is the last resort of good advice. It is certainly where you get the maximum amount of commission, though.

CHAIR—In your submission you talk about the three things that you just mentioned, particularly know your client, know your product and ensure the advice is appropriate. Obviously that is what is contained in the act. That is what FSR is about and the Corporations Law. It is about consumer protection. How well does that work in practice? It is one thing to have it in law and have it there, but whether there is or is not market failure, how well does that work?

Mr Worcester—With Storm, it failed totally. One of the issues that people who have licences have to do is that they have to have their own compliance committee. However, if you are working on that compliance committee you work for the boss of the firm and, therefore, you are likely to believe the firm's story. If the boss at Storm says, 'Here's my great idea', he is going to get somebody running his compliance committee who believes in that story. Therefore, one recommendation I would have is to say that the external auditors of that financial planning work should have to look at some of the financial plans of the financial planners. There should be an external audit or spot check on the actual business model of a firm.

Secondly, I would say that, having read the ASIC submission, their response is, 'We did everything we could within the law.' That may well be true. However, there is another part of government called the tax office, which we all know and love, and they take a stronger view. They say, 'We think there's a leakage of revenue here; therefore, we'll go and tell the Treasurer and make a press release saying to back date the law today to stop this leakage.'

I would recommend that part of ASIC's role is to say that where they think there is a problem in the industry that they do not just ignore it and say, 'We're doing our job by the law', you have to go to somebody, the minister or whoever, at least once a year to say, 'Here are the systemic problems in the industry and here's how you can fix that by changing these rules.'

CHAIR—Is it a change of law? Is it a gap or a weakness in regulation, or is it an application of the regulation that currently exists?

Mr Worcester—If you read the submission by ASIC, they imply that they are frustrated by the AAT. I have never been there, but the AAT tend to take a very different view to that of regulators. If they are frustrated by the AAT, that means that there is a problem with the law governing either ASIC or the AAT.

CHAIR—Again, just on those three major points that you raised, which are all encompassing in terms of advice that is provided, are you distinguishing at all between just pure advice and pure product or should there be some distinction made between the product and a model or just the advice that is provided?

Mr Worcester—If you look at the history of ASIC and its predecessor, the ASC, everything was product focused. Individual products had to be approved. I remember back 20 years ago you had to get your PDS or the actual prospectus, as it was, vetted by the ASC before you could sell it. Now they just do spot checks. I think there is still a culture of: is this product good and is that product good? Personally I believe that the whole thing needs to be client focused. For that client is that total mix of product appropriate? If you think about it, who cares whether you buy share fund A, share fund B or share fund C? It is not going to make an actual material amount of difference. But if you are geared 200 per cent in share fund A versus having 50 per cent in share fund A and 50 per cent in cash, then your starting focus is on the client issue.

CHAIR—Thank you. One of the questions that has come up has been the issue you just raised regarding appropriateness of advice. Again, one of the big issues for us is how do we get to a position where regulation works in terms of what is appropriate? How does ASIC monitor appropriate advice?

Mr Resnik—I do much of my stuff internationally, not by choice but just because of the way the market has gone, so I spend a fair chunk of time in the UK. The thing that has been interesting there is this notion of treating customers fairly, which is a very generic obligation on advisers to be able to justify how they go about doing business. It is not very prescriptive. It does not give you lots of tick boxes, which is one of the problems we have here. It has been in the UK now for three or four years. I talk about it a little bit in my third submission, which you may or may not have seen, but what it does is that it changes the culture. It creates an environment of saying, ‘This is how we go about it. We’re actually treating customers fairly.’ If, when the audit comes, it is not clear that is what is working its way through then there goes the licence. Apply that into the Storm case, which is the one that we are talking about today. It would not take very long. Every client got the same outcome. It seemed to be predominantly towards the benefit of Storm principals. There was no justification.

From the very simplest numbers, the equity-risk premium historically is three to four per cent over cash and that is the cost of margin loan plus what they charge you plus fees. That is why it is a zero sum game. It does not require any sophistication. What you will see is a whole bunch of people that are called educators that have come out from fund managers who will show you different sets of numbers.

That is what treating customers fairly is about. It is finding sources of information which are not people with vested interest to promote it. The vast majority of stuff in margin lending will be researched out by somebody who is employed by a margin lender. TCF is a starting point to getting a better culture.

Senator MASON—In conclusion 4 on page 4 of your submission you say:

Double gearing, we argue, is immoral and probably fails to meet the adviser’s duty of care obligations.

Do you think double gearing is a breach of the Corporations Act?

Mr Resnik—It is a failure to behave as a humanoid. I think it is immoral.

Senator MASON—You are speaking as a lawyer, but as a humanoid.

Mr Resnik—Yes. I sleep with a lawyer. That is as close as I get to being one. That is pretty close. Our argument would go that most people are too innocent to know the difference between the risks of margin lending and we try to separate it, so sophisticated people should be allowed to take risk. Unsophisticated people should not be subjected to things that they do not understand. Our final proposal, as we worked our way through this, was let us guarantee the margin call price. That will fix it really fast, because what will happen is that the banks will go, ‘We won’t lend on that. We’ll only lend on this. We have to have our margin in place. It affects our APRA stuff and it affects this.’ What will happen is that it will get boxed really quickly because it has to work. It is the gapping, the systemic failure that sits, the inherent risk that sits in there.

Senator MASON—What you are saying is providing the liquidity and guaranteeing the liquidity in terms of margins?

Mr Resnik—Yes, so we do not have this 128 per cent thing you were talking about.

Senator WILLIAMS—Can you just explain that in shearers' terms please?

Mr Resnik—When you are sitting there and the margin lender says, 'Look, when the price gets to here you either have to put some more money in or we'll sell you.'

Senator WILLIAMS—You might have a deal of say 80 per cent with a 10 per cent buffer, so when it gets to 90 per cent they are going to say, 'You're in trouble. When your LVR is at 90 per cent you're going to have to cough in more or we're going to sell you up.'

Mr Resnik—Yes.

Mr Worcester—Or we will guarantee you get 90 per cent, but if we sell you up you get less. That is what we are saying.

Mr Resnik—What we are saying is instead of it being sold on to the market the bank buys it. They take the risk on.

Senator WILLIAMS—Instead of selling you out at 97 per cent or 116 per cent, they guarantee you 90 per cent. If they lose, they suffer the loss.

Mr Worcester—Exactly.

Mr Resnik—We are transferring the risk to the people that understand the risk.

Senator WILLIAMS—They will be keen to take that on!

Mr Resnik—They will be very pleased to take that on! But that will fix the problem. You can look at one of the interesting little bits of graphics that we showed you.

Mr Worcester—Do you have this graph here?

CHAIR—Yes.

Mr Worcester—Basically what we have got is two lines. The blue line is an all ordinaries accumulation index and the red line is your actual amount of margin loan outstanding at the end of every quarter. If people were doing margin loans correctly, that is timing them, the actual red line should start high when the market is low and then come down as the market goes up. People should get out of margin gearing if they think they can time the market.

Senator MASON—They do not.

Mr Worcester—This demonstrates the chooks following the herd and therefore, when you get three good years they say, ‘This is easy money. Let’s chuck some more money at it.’ Then along comes this dirty great big black swan and splat.

Mr Resnik—Who takes the risk? Who has made the money? You have 300 and something submissions from people that took the risk. Who took the money? It just seems to me that it is an inequitable social outcome and that is why we call it immoral.

Mr PEARCE—Who took the capital?

Mr Resnik—No, who took the margins. There are two bits. We can look at Storm because Storm is a very interesting one. You have got the margin rates, the loans that went to Storm clients, and then the index funds. I had a quick look at that index fund. For what it is worth, it has got a seven per cent upfront fee and it charged 50 per cent more than the standard CBA Commonwealth Financial Services index equivalent.

Mr Worcester—And that is a shocking product.

Mr Resnik—Of that, a chunk of it—0.45—went back to somebody who said, ‘I invented this idea’, which was Cassimatis. You poke around in that stuff for a few minutes and you go, ‘This is, I think, immoral.’ It does not require you to read a piece of regulation. You sit and make the judgement. I have watched for 40 years the laws getting harder and softer, and in the end, as many people have argued, we need to find a way of bringing some morality back into the process. One is around TCF. Another is a real recognition that this stuff is toxic, it does blow up and we need to protect people that are innocent. We need to make them literate. My core position is that I want people to make an informed decision, not be victims in their lives or their financial lives, and that is where our investment should go.

Senator WILLIAMS—On this whole investment in Storm, you talk about stress testing a product in your conclusions. We have three players. We have the investor who you could say is an ordinary mum and dad, perhaps a bit ignorant on a complicated margin loan and how high it is geared. We had Storm inventing and marketing the product. Then we had financiers lending into the product. The two people at the greatest risk will obviously be the investor and the financier with the way it has all panned out and who is going to lose what. Do you think the financier should have stress tested and perhaps had a decent look at it? It is all right to tick the boxes on something, but what if the market falls 30 per cent? What if this happens? If I was a bank and I was lending money out, the first thing that I would want is my money back.

Mr Resnik—To be fair, they are probably protected. The margin call would be whatever price. The Guardian people were saying that people have no skin in the game. When you are a margin lender you are just a margin player. Theoretically, you have got no risk. You will lend to everybody as long as you can get them out at some price that covers you. They do not have skin in the game. It is just a margin call. If I can get more people holding my paper then I will make a profit. That is why our proposition is for those people to put some skin back in the game. You are the ones with the balance sheet; you are the ones that can do the calculation; you are the ones that can impose some standards on advice; you are the ones that can impose people to do risk tolerance and get informed consent; you can afford to do that.

Senator WILLIAMS—'You' being the bank?

Mr Resnik—Yes. You have all the facilities there. At the moment we have 99 per cent financial illiteracy in this stuff and the numbers suggest that black swans happen, people will be annihilated and they will buy at the top of the market, so there is a duty of care, which is the broader term. That comes from not going to box ticking. 'Yes, we did this and we did this so now just get on with growing the book.'

Senator WILLIAMS—Would you say there is a desperate need for something which you might call lender liability or something like that, or just a more cautious, more conservative approach?

Mr Worcester—Yes. I would like to use the idea of when you go to your doctor and he is going to operate on you. He gives you a two-page informed consent. He says what it is going to cost, what the procedure is, what might go wrong and what is the probability of it going wrong. I tend to believe that we should chuck out those 50-page statements of advice and have a two-page document that says these are the assets that we are putting into it—

Senator WILLIAMS—In shearer's language.

Mr Worcester—In shearer's language, 'These are the bloody things we're putting you into.' Then say, 'This is the long-term expected return—shares doing cash plus five per cent or CPI plus five, probably four, or whatever.' Then have an actual grey swan effect to say, 'If you get a moderate swan hitting the portfolio, you're going to lose 30 per cent. If you get a big fat ugly black swan, you lose 50 per cent.'

Senator WILLIAMS—Just thinking about it, if you were highly geared in a margin loan then you are relying on the franked dividends coming from investment in shares to pay your interest to the financier.

Mr Worcester—Yes.

Senator WILLIAMS—On a commercial lend you expect your interest to be seven or eight per cent, perhaps nine per cent. I do not know the figures that you would expect. A home loan is 5½ per cent. An investment loan would be more expensive. Mr Resnik, you have been around the game for a long time, what is the chance of getting a dividend return year in, year out from your investments that will cover the interest?

Mr Resnik—Zilch. The numbers are in our submission. I think we said one per cent over 28 years and then we looked at it for cycles and chose a rolling five years. To make money you had to get in at the right time and get out at the right time, which is a less than one in four chance. To put the proposition to you again, if I said to you, 'Senator John Williams, you could have your farm gone or you can make $5,000 a year on $100,000 of borrowed money and you would do that less than one in four times.' Would you take on that proposition?

It is all about the context of how it is offered. We could dress it up another way. I have worked it at all ends. Forty years does not mean that I spend all my time on this. I am like a reformed smoker. I have worked in the various parts of this for a long time. It is very easy to stop. I used to use the line, ‘It doesn’t matter how scenic the trip is if the destination is Wollongong.’ You can dress up almost any part of this to make it look really attractive. The net result is that there is the likelihood of a black swan every 10 years.

CHAIR—Under those same circumstances and what you have just explained, how is it dressed up? How are those figures explained to people in terms of a margin loan? Can you give us the opposite example?

Mr Resnik—An example will be that it will not look at the volatility. It will be very smooth. We will not see the markets move in various ways. It will invariably presume that the margin call will go in at the price on the day.

Mr Worcester—They also do not tell you what the cash shortfall will be on the plan even before the black swan. To answer your question, if you go to page 16 of our submission we show once you have borrowed $300,000 on the house and $600,000 on the margin loan, we say that even though we hope you will make one per cent a year after tax on that, you are still going to have a cash flow shortfall of $31,000 per year after tax because, as you say, the banks are charging you nine per cent on the margin loan, seven per cent on the housing loan and you are getting five per cent dividend a year, so that is a shortfall. They do not explain that to you. Usually they will say, ‘You can just go and borrow a bit more at the end of the year. We will re-Stormify you to do that shortfall.’

Senator WILLIAMS—When it came to the Storm clients paying their interest, did Storm actually pay the bank the interest or was it the actual client who paid the interest to the bank? Do you know?

Mr Resnik—I have the same access as you have, which is where people send me stuff to look at. My reading of it was that Storm was so panicked at one stage they were trying to make some repayments for people.

Senator WILLIAMS—Before the disaster hit was Storm paying the interest to the bank or was it the client?

Mr Resnik—I am not too sure.

Senator WILLIAMS—If Storm had to pay the interest to the bank, if that was the case, and they could not earn enough dividend to pay the interest then they probably thought, ‘The more we sell, the more seven per cent up front; we can use that to pay the interest.’

Mr Resnik—There is a whole series of interesting things in the business model. A quick lesson; prior to ‘87 all the financial products had a very high fee and no ongoing cost. Then after the ‘87 crash we sort of worked out that as an industry we wanted to have longer term relationships. We brought the fees down and we started charging ongoing fees. You will be very familiar with the argument; the ongoing fee just eats in every year.

If you just think about it very simply, one per cent per annum over 10 years is the equivalent of 10 per cent up front, and one per cent over 30 years is 30 per cent. They become quite large numbers. What Storm did was said, ‘Let’s go back to a pre-87 modelling and look at it.’ From their business model, if you were a long-term investor you paid less going to Storm. The break-even was about year eight or nine, because they charged less ongoing. It was very seductive, but they were short. It was under capitalised business and an under capitalised business always has to look for new business, and that caused them to churn.

The intriguing part of a capitalisation is—when I look at the wind-up—they owe a bank $27 million. That is the only one that is visible, which is CBA all the time. I said to myself, ‘What’s going on here? Who was funding this?’ There were two bits of funding. Either you borrow money from somebody or you take it from clients if you do not have it yourself.

All I can say is that Storm is a very unusual case and it goes back to conflicts of interest and lack of duty of care, that we do not have a clear line. One of the lines that I certainly put is Storm is just a front for CBA. I am putting the proposition that I have heard. Here is the line; let me put it to you. A major part of funding in the wind-up was $27 million from CBA. The major product going through is home loans from CBA. The margin loans are from CBA. The major product being promoted is a CBA on steroids. What is true to label in the marketplace? Is that an independent organisation? It is not a question that I am asking; I have to say this as an innocent.

Senator WILLIAMS—It has been a disaster and unfortunately many people have suffered. I ask the question again: what is this product doing out there? It is like a car without brakes. Who did the stress test? Whose job is it to see that these products perhaps are not available to the public so people cannot get in this mess if it is such a mongrel, as you say?

Mr Worcester—I would say that since we published the actual paper about how you do not make money out of margin lending so many months ago, nobody has contradicted it. It has been in three publications. Why has ASIC not been knocking on the door of these product providers saying, ‘We’ve seen this report. Do you disagree with it? Can you disprove it? If not, what are you turkeys doing having this product on the market for retail investors?’

Senator WILLIAMS—This is what it is about. Unfortunately, we cannot turn the clock back.

Mr Worcester—Yes.

Senator WILLIAMS—This whole inquiry is about what needs to be done, or if anything has to be done, as far as legislation et cetera to see that Australians do not get their fingers burnt so severely again in the future. My son is 28. If he worked hard and he got to 58 or 65 and found that he lost his life’s earnings, it would be a terrible disappointment.

Mr Worcester—There are certain classes of product which, if they are misused, are toxic and therefore should not be available for retail investors. Westpoint is another case in point because they had this thing called debentures. I hate that word ‘debenture’ around a product because basically it is raising money, lending to property developers who do not have enough skin in the game. You put the word ‘debenture’ around it, because there is an actual trustee, and people think it is as safe as a bank. Really the company has got $5 million skin in the game and $95 million of debentures, so when the property market falls over they are stuck.

One thing that I would suggest that you could consider is to stop the use of that word ‘debenture’ unless there is significant equity in the game. I am not sure what rules you would have, but I think it is a misleading name which gives people a sense of false security.

Senator WILLIAMS—We do have debenture issues in companies. I know people like the Provic group in Victoria where people invest with them and they lend the money out on to real property, farms and so on, with real security just like a bank does. Is it a whole different game with debenture issuing companies like that?

Mr Worcester—The issue becomes if you are having debentures then the person you are lending to, that is the farmer, must have enough skin in the game. If your farm is worth $10 million I do not want you having a $9.5 million loan from the debenture holder because that is not secure enough.

Senator WILLIAMS—Exactly.

CHAIR—Mr Resnik, you made an interesting comment right at the start where you said that you had been around the industry for about 40 years, but you do most of your business overseas. Is that a reflection on the Australian regulatory system?

Mr Resnik—It is, yes.

CHAIR—Can you explain that? We are interested in that comment.

Mr Resnik—Yes. About 15 years ago I started on what seemed to me to be a very obvious exercise, which was whether I could figure out the better matching of products to clients so that everybody won. It met my ideological position and it met my commercial position. I had set up a life company, asset management company and financial planning business. The trick of profitability is consistent clients who stay with you, do not take their money away and invite their friends to join you. It seems so simple. We launched 11 years ago saying, ‘One of the really important things was to understand how clients think and make decisions’, and one of the bits that we got to was understanding their risk tolerance. We did a swag of research, which is summarised in our submission, to show that risk tolerance is an enduring trait, it does not change very much and it is a good basis for all forms of conversation. The Australian response was basically, ‘We don’t like psychobabble.’ The net result is that most of our business is in the UK and US. We are in 12 countries. I am just going on a two-month world tour to visit places. We are launching in Germany in two weeks’ time. The Australian response is, ‘I don’t like this sophistication. It sounds too academic.’

I have not been able to have a serious conversation with a member from ASIC for 10 years and the FPA is worse. The professional standards are a laughing-stock and a joke. So, my response is yes, Australia is a backwater. I do not know why. You would have to ask them. In terms of the two parts that I am looking for, which is a warm feeling that I am having some impact upon the world, it is not in Australia and it is certainly better to feed my children by working internationally than it is locally.

CHAIR—It runs counter, perhaps, to a lot of the submissions we have had and evidence which basically says that Australia has got one of the most highly regulated financial services sectors in the world. Is that the case or not the case? Is it a bit of both?

Mr Resnik—The answer is yes. You can do anything with this item. I was in New Zealand a few months ago and they said, 'We're about to be regulated in financial services. What can you share with us from what you have seen?' I said, 'The US is well regulated and look how appallingly things have gone.' At its bottom line you say, 'It was a lack of professional ethics.' Why? It is because you could do a job. You could tick a box. If you did not tick the box somebody showed you the door. That was the way the process went. When we have KPIs in large businesses they determine you get rewarded for doing this and you get punished for having an alternative view. The US is an abomination. We have gone through that and it has been saved by ransoming several other generations that will pay for it.

The UK has had a whole batch of regulation and we have some of the worst forms of stuff going through. In Australia we are terribly conceited. I hear these stories that we are so well regulated. Yes, it is not too bad, but Storms will happen and they will happen again and again in our current environment because people are intellectually lazy and do not want to take up the challenges of there being better ways.

My sense is that we are conceited and when I come back I often get the sense of it being the lucky country. It is the right description. We feel like it is going to come through, and it has come through again.

I opened the *Australian* last Wednesday and there was an article on gearing. It could have been two years ago. Now is the opportunity. Around the bottom, the 93rd paragraph, there was this little thing from a planner saying, 'It's toxic, you know.' We just forget. It is changing that culture. That is why I think treating customers fairly is a good thing to think about.

CHAIR—Thank you very much.

[4.45 pm]

ARMSTRONG, Professor Anona, Private capacity

SMITH, Ms June, Principal, Argyle Lawyers

CHAIR—Welcome. Would you like to make some opening remarks in terms of your submission?

Ms Smith—Thank you for the opportunity to appear before you today and give evidence. Our evidence will focus on only some of your terms of reference—Nos. 1, 2, 3, 5, 6 and 9 in particular. Those terms relate specifically to some recent empirical research that we have conducted during the course of a PhD study. That study relates to ethical decision making of financial planning participants, namely, financial planners and compliance managers, and also how ethical decisions are made within the financial services organisation itself.

Whilst our evidence will focus on that empirical evidence, we wish to add at this initial stage that, in our experience, the collapse of recent financial products and companies, such as Basis Capital, Lift Capital, Australian Capital Reserve, Chartwell, Opes Prime and Storm, together with investment schemes such as Timbercorp and Great Southern, really mean that the committee should also be focusing on the regulatory issues related to product manufacture, credit and research house sectors, as well as the responsible entity sector, in addition to the advisory arm. No doubt the committee will receive evidence from other witnesses on those issues. That is not to detract from the critical role that financial advisers played in relation to recent collapses at all. Rather, our view is that the issues faced by this committee mean that it goes deeper than merely a discussion of whether or not to additionally regulate what is ostensibly the last rung in the financial product distribution system in the hope that recent collapses will not be repeated.

We believe our research may assist the committee in its deliberations because we have identified factors at an individual and corporate level that we believe significantly influence the decision making that is happening in the provision of financial advice to consumers. We believe that the patterns and trends we identified in our research reflect the experience and conduct also associated with the recent collapses. We are confirmed in this belief due to our day-to-day experience in the provision of advice to participants at all levels of the financial services sector, so our aim today is to impart our research to you and provide you with the benefit of the regulatory and policy implications, as we see it, arising from the research.

We wish to add the following additional points. We think the current regulatory model is not working if its goal is to protect consumers from inappropriate practice and to ensure the provision of individual and tailored advice to consumers that meets their objectives and circumstances. We think that is because, in part, the current regulatory system is premised on the assumption that compliance with the system is the key determinant when decisions are made by advisers and AFS licensees. The system has also generated a reliance on what we call legal compliance frameworks at a corporate level that reassure the licensee and the regulator that the licensees are providing advice pursuant to what is ostensibly a statutory process. The focus is therefore on the protection of the licensee from breaching the act. There is no emphasis within those frameworks on the quality or the nature of the advice that is given to the client, or the integrity or governance of the financial advisory participants that take part. In any event, our research identified numerous instances of breaches of the act, even with the current legal compliance frameworks, so it is not even achieving this basic aim.

In our opinion, the regulatory system currently encourages a tick-the-box approach to compliance, without promoting an ethical or integrity foundation within financial services for the provision of advice. The evidence associated with the recent financial product and advisory collapses suggest to us that existing legal compliance frameworks alone are insufficient to pick up and identify systemic instances of unethical conduct within financial advisory firms.

Our research shows there are many factors that influence the decisions made by financial advisers, compliance officers and within financial services organisations, only one of which is the regulatory environment in which the decision is made and only then if the participant receives a message from the organisation that compliance with regulation is, in fact, an important factor to be taken into account when making decisions between different courses of action. We understand from our research that individual attributes are quite key to decisions made by advisers and others within the organisation and this includes their level of ethical reasoning, which our research indicates is in turn related to, and influenced by, their age, their experience, their education level and whether or not they hold a professional designation. Hence our emphasis in the submission on competency and education levels for all individuals across the financial services organisations. We found that the minimum competency levels that exist within ASIC Regulatory Guide 146 at the moment are completely inadequate to allow advisers, for example, to position themselves to deal with the complex ethical issues they face when giving advice, and the younger and more inexperienced they are the more likely they are to make the wrong decision and the more likely they are to be influenced by peers and superiors to take the wrong action. That is why we have called for this committee to consider increasing specific ongoing training in ethics for financial advisers and new entrants into the industry as part of ASIC Regulatory Guide 146 and also, if consideration is given to the restriction of the term ‘financial planner’, that there be a significant increase in the competency levels that would be associated with that term in addition to conduct and other requirements.

We have also recommended that organisations’ responsible managers have training and experience in governance and ethics before they are appointed. That would require an amendment to ASIC’s current policy on organisational competencies. We say this because we think that ethics and competency should be a mandatory component across all levels of the organisation, from advisers and compliance staff, to responsible managers and directors. It seems inconsistent to us that only advisers would need to be trained and competent in ethics to provide overall advice to consumers in circumstances where those who are supervising the advice, those who are responsible for the day-to-day management of the licensee, in fact do not have to meet those requirements.

Indeed, our research indicates that compliance managers and responsible managers are currently dealing with far more complex ethical issues than advisers are and they are mostly associated with the conflict associated with the commercial imperatives of the organisation, as opposed to giving advice in the best interests of the client.

We have attached some evidence from a focus group that we ran that provides you with significant evidence as to what compliance managers and advisers are currently thinking in relation to the key ethical issues they face in terms of professional advice and conflict of interest within the organisations themselves. That being said, there are also many contextual factors that are influencing decision making within financial services, and we have focused on ethical leadership as a factor and on the ethical climate and culture of the organisation as well. Our research suggests there is a significant statistical relationship between ethical leadership within an organisation, the commitment, therefore, of the employees to that organisation, and their commitment to ethical conduct. We believe that you will have evidence before you that suggests that gaps in ethical leadership in those organisations that collapsed may well have contributed to the systemic unethical conduct and also the investor losses that have been associated with those companies.

Interestingly, in terms of remuneration structures, which is another contextual factor influencing ethical decision making, our research did not show that the receipt of commission by an adviser is linked to their level of ethical reasoning. That is, whether or not an adviser receives a commission payment is influencing whether they will or they will not take an unethical action. What is happening, though, is that the adviser is being influenced by the remuneration structures and the commercial relationships that the dealer group or the licensee has with product providers, responsible entities and credit lenders. If the message within the organisation is that these commercial relationships are a primary matter to be taken into account before a decision is made as to where to place a product, for example, or as to which lender is to be used in relation to either a margin loan or a housing loan, then our research would indicate that the advisers are significantly influenced by that and then remunerated through sales targets, bonuses and other incentives. This is the basis for our argument on simply banning commissions at adviser level. We are totally in support of that and I have written papers for the APESB on financial standards for accountants, as well as other papers for the FPA on this point. I have been on record as saying that since 2006. What we are really saying however is that if you only ban commission at adviser level you may miss a gap in terms of current conflicts of interest and how they are currently managed within this industry at the moment. Our research would indicate to you that it is those conflicts of interest and their mismanagement that is really influencing advisers to act one way or the other in the provision of financial advice to consumers.

Storm is the classic example where you will have evidence before you that suggests Storm advisers were not in fact in receipt of commission but rather received fee for service and other remuneration benefits. Individual commissions, in that instance, may not have influenced the adviser conduct, but the commercial relationships between Storm, the credit lenders and the margin loan providers may be a completely different story. I am sure you have heard evidence from a number of witnesses on that point.

We want to tell you that our research indicates that the ethical climate and culture of the organisation are very significant in terms of whether or not advisers act ethically or unethically. ‘Culture’ refers to the formal and informal systems and procedures that the organisation has in place. ‘Climate’ refers to the messages that the organisation sends its participants about what factors they should take into account when making decisions. They are significantly related to the level of ethical conduct within a financial services organisation. Yet our research indicates that even though these systems and procedures are articulated in the ASX corporate governance principles and other Australian standards on governance, such as the Australian standards on the

Fraud and Corruption Control and the Corporate Social Responsibility codes of conduct, very few AFS licensees who took part in our survey have all of the systems you would expect to see for an effective ethical culture and some had response rates as low as 21 per cent, in terms of some of the systems you would expect to see. Hence our emphasis in our submission on considering whether or not there should be a shift from a focus on legal compliance frameworks, and compliance with the regulation using those frameworks, to an integrity based model where licensees are encouraged and in fact it is made mandatory that licensees must have in place systems and procedures related to the Australian standards on governance so as to, firstly, effectively integrate governance, ethics, risk management and compliance systems across the organisation and, secondly, to ensure that decisions within those organisations are based on values, integrity, trust and transparency.

We are happy to take any questions that you might have for us based on the submission and also to impart further information to you about the research that we have conducted, if that would be of assistance. Thank you.

CHAIR—Thank you. You referred to ethical conduct. The legislation does not specifically talk about ethical conduct. It talks about appropriateness of advice, knowing your client, knowing your product and a range of other things. What is the big difference in terms of how you would get legislation to affect ethical conduct in those terms?

Ms Smith—Our research calculated instances of unethical conduct based on the codes of ethics of the CPA Australia, the Institute of Chartered Accountants, FPA, the Australian Financial Advisers and the STIA.

Mr PEARCE—Did you ask all of them to provide you with information?

Ms Smith—I got their codes of ethics off the websites. My PhD was done in conjunction and with the endorsement of the Financial Planning Association of Australia as well. CPA Australia and the Institute of Chartered Accountants has also had access to the data. What I did for you, in terms of the appendices, was once I had identified the unethical conduct in terms of principles, such as integrity, diligence and competence, I then transposed that into the Corporations Act requirements for advice, and so the appendices you have talk about a breach of the obligation to give a reasonable basis for advice or a breach of the obligation to have done adequate research.

Our focus for today, in terms of ethical conduct, is more on the systems and procedures that the licensee should have in place to ensure conduct is improved. I think it is quite an easy process to map the existing regulatory obligations to give advice, including the obligation that advice be suitable, the obligation that you take into account objectives and the like, to the ethical principles that are currently in place in the codes. That is how we did it for you.

CHAIR—You are saying that there is a gap between what the regulations state in terms of what ought to happen and between what actually takes place in terms of the actual standards, and you can measure that within an organisation depending on how they behave or their internal compliance. How do you do that? Do you know that through the research you have done compared with failures or even successful organisations? Is that what you are saying?

Ms Smith—Yes. You can in fact measure it. We did it in four different ways and then we compared it across. To make sure that our research was consistent we then reviewed all decisions made by external decision makers for three years and had a focus group also give us some evidence, so we know that it is consistent. As I said, what we looked at was whether or not within the decisions made by ASIC, Australian courts and FOS in 2006 and 2007, the decision maker had said there was a breach of the act. We then transposed that to an ethical principle and then back again to a section of the act. I think you can do that. If you are asking me can you regulate or can you insert a section within the Corporations Act that says all advisers will act in an ethical way, the answer to that is, no, but what you have is a mirrored provision that ostensibly says the same thing. I think section 945A is the classic example of that—know your client is acting in the client’s interest. It is about understanding who your client is and giving advice that is not only suitable to their needs and objectives but it is in their interest.

I think there is a way you can mirror a minimum legal standard of conduct to match an ethical standard, but as you have seen we have gone further and also suggested that it is probably time that Australia consider the professionalisation of one element of the advice market, hold it to higher standards of conduct and then either regulate that in a coregulatory way through a professional standards board, in conjunction with ASIC, or through the existing professional associations, and in that way impart a higher standard of ethical conduct on those individuals. The submission we have given to you is how you might implement systems and procedures within the licensee framework, assuming you are going to stay with licensing of only corporations and not going back to an individual registration of advisers.

Senator MASON—I should call you Dr Smith.

Ms Smith—No, that would be extremely premature. I am happy to just be called June.

Senator MASON—The chairman has just raised this question. When you are looking at what you could call an ethical deficit is the best way to do this through legislation or through codes of conduct? It is likely to be the latter, is it not? I am a lawyer. Basically, our ethics are governed by common law and by codes of conduct rather than by legislation, because it is more malleable. You would know this, Professor Armstrong. It changes, does it not?

Ms Smith—The Corporations Act already has some ethical principles enshrined in it. For example, the obligation to act efficiently, fairly and honestly ostensibly is an ethical obligation. As I said, you can in fact mirror some of the provisions to ethical conduct. I think what we have is a system where if you are going to license the licensees or the corporations that provide advice you really do need some level of individual accountability at a different level for the advisers and others within the industry, and I think the way to do that is to have a dual system whereby the individuals are regulated through a series of ethical standards or professional standards and those that hold the licence, if that is the system that the committee determines it will go forward with, are licensed at a legal standard but based on an integrity framework rather than the one we currently have, which is simply processed driven—aka, ‘Have I sent a financial services guide out? Have I sent a statement of advice?’

Senator MASON—You ticked box A, B, C, D and E?

Ms Smith—Correct, yes.

Senator MASON—I follow that. What you are suggesting would go at least some way to addressing some of the issues raised by the previous witnesses.

Ms Smith—Which you have had the benefit of seeing.

Senator MASON—It was very entertaining.

Ms Smith—I am quietly confident I know what Mr Resnik said.

Senator MASON—I have one last question. Today we have heard a lot about disclosure and you speak about disclosure not being sufficient. Is that a specific example of your more general point; you tick the box about disclosure but in fact you are not necessarily acting transparently to the client?

Ms Smith—I think compliance documents that currently exist have become a mechanism for the licensee ensuring that it has met the act and will not breach the law rather than providing consumers with the ability to make an informed decision and make choices. The classic example of that is the statement of advice, which is 125 pages long and that nobody is going to read.

Senator MASON—We have heard a bit about that today.

Ms Smith—The other example of that is simply disclosing that you have a commercial relationship with a margin lender, a credit provider and a product manufacturer, and that in some circumstances this will mean a pecuniary benefit. That does not mean anything to a consumer and it certainly is not managing the conflicts of interest that arise. Our point is, firstly, written statements of advice are not working and they are not working for two reasons. The first is that they are too long, unwieldy and they are a legal compliance document.

Mr PEARCE—Lawyers keep on getting involved.

Ms Smith—I am all for bowing out and letting someone else take over. The second reason is that there is a blurring currently between the personal advice and the general advice definitions, that is, in circumstances where advisory firms have worked out that they can subvert the law by disclaiming the fact that they are giving personal advice and either giving general or execution-only advice. That makes a mockery of the statement of advice in any event. I spent last week reading one file trying to work out what the disclosure statements were trying to tell me about the commercial relationships, the fees, commissions and benefits flowing back to the organisation from a series of investments that my client had. It took me a week and I still did not get there. I am about to, one hopes, be imparted with another degree. I just wonder, in that context, if the whole legislative purpose is to put a consumer in the position where they can make an informed decision, what does that tell you?

Senator MASON—Thank you.

Mr PEARCE—There are two schools of thought generally. One is a principles based approach and another is a prescriptive black-letter law approach. Which school do you advocate?

Ms Smith—We are from the principle based approach, because we believe that is the way integrity based systems and frameworks work. One then has to have mechanisms in place that are actually going to assist in picking when those integrity based frameworks are not working. The black-letter law approach is not currently working. You have numerous instances where even an approach that is currently based on that is not being followed.

Mr PEARCE—Our financial services regulation act, essentially chapter 7 of the Corporations Act, is actually principles based.

Ms Smith—It says that and everybody says that, which is the rhetoric, but what it has generated is, in my opinion, a legal compliance framework that is strictly just about compliance with the prescriptive nature of each and every provision within that act, and that is all it does. Have I sent out a financial services guide? Have I sent out a statement of advice? Does it comply with the 13 or 14 requirements in the provision? Have I disclosed fees and commissions? I am saying that, whilst it is principle based, people do not treat it that way. They treat it as if it is a mechanical or a process based system.

Mr PEARCE—You accept that it is principles based. I think it is principles based. What you are saying, therefore, is that it is the practical implementation of that.

Ms Smith—Correct. That is what I am saying.

Mr PEARCE—I made a comment earlier about lawyers getting involved. Why do you think that has broken down, if in your view it has broken down? If it has gone from a principles based regime but yet has broken down in terms of the implication, why is that?

Ms Smith—I think it is because when FSR was first introduced there was very much a focus on how do we comply with this new set of provisions. I think what that generated—and no doubt you have had significant evidence to this effect—is a regulator who then issued numerous policy guides that everybody took as black-letter law, and every policy/regulatory guide that came out was ostensibly the bible on how to do something. Then everybody went around implementing systems that did exactly that. They articulated, in step form, processes and the mechanics of financial product advice. What was missing from that system and what our submission suggests is that that has nothing to do with the quality of the advice that was given, the integrity of the conduct on which that advice is given, but it has everything to do with whether or not, in a stepped or formatted mechanical process, all steps have been ticked off. That is why, I think, with some of these recent company collapses the issues have not really come to the fore until and unless there has been a catalyst for it—aka, the global financial crisis—or a collapse in a particular product. In fact, I have had people argue until they are blue in the face that a statement of advice from Storm Financial of 125 pages was perfectly compliant with the law and that, in fact, the consumer had signed every page, thereby rendering it a document that they understood. We both know, firstly, that document probably did not impart the advice that it was supposed to give. Secondly, it certainly did not explain the risks associated with the products and the strategy. Thirdly, it certainly did not have anything to do with the quality of the advice that was imparted through it.

Mr PEARCE—It may or may not. It would depend on each circumstance, would it not?

Ms Smith—In the circumstances where you have collapse such as Storm, Opes Prime and where you have advice firms under significant pressure—Lift Capital, Basis Capital and others that I see before me—what you usually see is a business advisory model that has been set up to generate or facilitate the distribution of funds under management through particular mechanisms, and that is all it is. Therefore, that means that the disclosure documents are set up through template, often written by a para-planner, not the adviser, or somebody else to simply ensure that the licensee is not seen to be breaching the act while doing that.

Mr PEARCE—Professor Armstrong, we have met, haven't we?

Prof. Armstrong—Yes. You were my guest speaker.

Mr PEARCE—At the university?

Prof. Armstrong—Yes.

Mr PEARCE—In Flinders Street?

Prof. Armstrong—Yes.

Mr PEARCE—I remember. That is right. What is your view of all of this?

Prof. Armstrong—I think Ms Smith is spot-on. Her thesis and the results that she has put forward were very carefully and very reliably reflected. I think you can rely on it. There are two things the chairman brought up about the ethical climate in an organisation. It is no good trying to influence the person giving the advice at the bottom of the chain. If you think back to Opes Prime and the ANZ Bank, the board said they did not know what was going on. That is another factor. It really has to come from the top of the organisation. I think the ASX is conscious of that, but there are a lot of companies that are not listed, anyway, and so on. There are a lot of issues there.

Senator Mason mentioned the code of conduct. I think those sorts of principles have to be supported right through an organisation right from the top. I keep coming back to ANZ because it is one of my favourite examples. Here they are with all of their corporate social responsibility charters trying to do the right thing, and yet unless you have a climate in the organisation that actually rewards good behaviour and does not reward bad behaviour or unethical behaviour then you are in trouble.

CHAIR—It is an interesting proposition and you are not the first. We have had other submitters that have talked about this tick-the-box approach. How do you get around that? Whatever you put in place in terms of black-letter law or regulation to try to ameliorate for deficiencies in a system, human nature might be that people will just attempt to comply and if they have systems in place in the end they will just formulate a template and a system to comply, and not necessarily to provide quality? Quality might be at the forefront of rhetoric, but in the end it skews towards ticking boxes and saying, 'We'll comply first and then we'll worry about quality second.'

Ms Smith—If we assume—and we will—that is a correct assumption, we would say you have the wrong systems in place. We have given you an appendix that actually articulates 10 systems or procedures that we would have expected to see in any Australian organisation, and our results show that they were either not there or they were lacking—completely deficient. If we are going to assume that human nature being what it is that a lawyer or a compliance officer is always going to come up with a system, what we are saying to you is that we think the current systems and procedures that are being generated are looking for the wrong thing. They are focusing on the wrong thing and they are not picking up on the right conduct.

CHAIR—Again, just to explore that a little bit further, in the areas where ethics and good standards of corporate governance work it is not so much black-letter law ethics, it is more where there is perhaps peer review, where there might be corporate governance structures and professional bodies?

Ms Smith—There are myriad examples. If you are going to have an integrity based system, the first thing you would do is you would implement a system where you had client feedback forms. You would implement a system where you had not only the values of the organisation espoused but then communication, training, induction, recruitment mechanisms and performance management mechanisms that linked to the values of the organisation. Every one of those will have systems and procedures attached to it, but the outcome of those systems and procedures should be more about trust, transparency, integrity and the right messages in relation to conduct than what you currently have at the moment, which is mechanisms and systems set up to address, 'Have we got sufficient human resources? Have we got sufficient organisational capacities? Have we got templates in place to ensure that advisers are adequately researching the law?' Those systems and mechanisms that are currently set up are far more about the mechanics of the financial product advice. We are saying the systems and procedures that should be set up are about the values on which the decisions are going to be based, and then the communication, training, induction, recruitment, disciplinary and performance management systems will link back to those values, rather than what they do now, which is link back to the process of giving financial product advice.

CHAIR—We have heard a lot of evidence about trying to separate out very complex products that may be more suited towards wholesale sophisticated-type investors who at least have more understanding of the risks they might be taking compared with unsophisticated mum and dad investors. Do you think we need to move down a path that really does separate out the more complex world of advice to the more simplistic pay your house off-type advice?

Ms Smith—There are a number of things to say on that. The first is that you will have evidence before you about the UK FSA and what they are doing. They say that the issue is there needs to be clarity for a consumer about the nature of service to be offered. They are looking at these notions of independent versus restricted advice. We have almost got that in terms of personal general advice and execution-only advice. One of the things we identified was that there is a lot of mismatch of financial product with retail investors, and you will have seen that. One of the problems we are seeing, though, is to get around the wholesale investor rules four clients might be linked into a self managed superannuation fund and then those funds are being used through wholesale investment vehicles to subvert the fact that each of the individual members or trustees of the self-managed super fund may not on their own meet the test.

I think there are certainly some financial products and managed investment schemes, in particular, to which particular client bases should not be exposed. We would say that you need to look at not only regulating the nature of the services that are being provided and the types of products that can be given in relation to that; there also needs to be some regulation around different levels of advisers, in other words, a shift up in the competency and professional standards of certain types of advisers, in addition to looking at the nature of the services.

We have been down this route before with only certain financial products being allowed to be exposed to wholesale investors. We have been down the track of sophisticated versus wholesale client definitions. There are always ways around these definitions. That is why we say, rather than this focus on legal compliance frameworks and how we get around that, let us look at something completely different.

CHAIR—From the evidence that we have heard, there tends to be a trend in these sorts of reviews that you want to tighten up and make more difficult the application of who is allowed to advise on certain products. That seems to be the most obvious course. We have also heard that maybe the counter to that would be to open it up, to have more people able to advise so that you are not restricted to just those people who have a specific licence and that you could go off, check or get other advice. You make it broader. You allow perhaps accountants or others to give you some advice on particular products as well. Do you have a specific view on that?

Prof. Armstrong—I have a view about that, because I feel that if you open it up to anyone to give advice you are really not looking after your investors, and especially the small ones, who are the most vulnerable.

Ms Smith—What our submission really says and what our PhD results show is that there is significant confusion already in the marketplace about who can give advice, who is licensed and the terms ‘financial adviser’, ‘financial strategist’, ‘wealth management adviser’. I think if you were going to go down that path you would want to be very careful about just creating more confusion for consumers. In fact, our submission would go the other way. It is really saying it is time to delineate boundaries around certain advisers, make them more accountable and link a fiduciary standard to any advice they give—not just if it is personal advice, but any advice. I think our submission would run counter to that argument.

CHAIR—I just wanted your view and what your research is showing as to how that would work.

Ms Smith—I do not think it would.

CHAIR—Thank you very much for a very complete submission and presentation. I thank everybody for their assistance today. We will close the proceedings.

Committee adjourned at 5.22 pm