Financial System Inquiry — Interim Report presents viable options to improve consumer outcomes

Michael Chaaya *and* ***Corinna Lee*** *CORRS CHAMBERS WESTGARTH*

The Committee led by David Murray that is undertaking the Financial System Inquiry released its Interim Report[1] on 15 July 2014.

Overall, the Interim Report has concluded that the Australian financial system has performed reasonably well, which is reflected in the policy option of "no change" as being part of the spectrum of options considered for the majority of the priority issues and observations identified.

However, the Committee also acknowledged that there are areas for improvement. The Interim Report has made a number of observations and includes a range of policy options for each priority issue. Table 1 (at the end of this article) provides a summary of the observations and the key policy options being canvassed by the Committee.

The Committee has stressed that the policy options are not draft recommendations. It seeks stakeholder input on the observations and policy options in the Interim Report.

The Interim Report is lengthy and covers a wide terrain of topics. Chapter 6 on consumer outcomes focuses on the issues confronting retail consumers (individuals and households). This article explores two observations in ch 6 regarding disclosure rules and financial advice.

In his speech to the National Press Club, David Murray specifically referred to the challenges associated with the disclosure rules in the financial system. He argued that it may be appropriate "to develop a viable alternative approach that is not simply more detailed rules". The Interim Report acknowledges that this problem remains despite several efforts to improve the disclosure regime. The Interim Report also raises concerns with the quality of financial advice available to consumers.

Disclosure rules

The Committee has observed that the current financial disclosure regime, which produces complex and lengthy disclosure documents, does not enhance consumer understanding of the financial products or services and is costly for companies to produce.

Current disclosure regime

The disclosure regime is designed to reduce information asymmetry between consumers and product issuers and to equip consumers with accurate information in order to assist in an informed financial decision-making process.

The mandatory disclosure regime was largely influenced by the Wallis Inquiry, which focused on regulating disclosure as a means of consumer protection rather than regulating the financial product itself. This approach was designed to give maximum flexibility to product issuers, but in practice this focus on disclosure has led to a tick-a-box checking exercise driven by an industry culture of legal compliance, rather than a focus on how best to inform consumers. The result is often lengthy and complex disclosure documents, rather than short, targeted, more useful documents that highlight product features, risks and rewards.

The Inquiry focused on the product disclosure statement (PDS) and credit disclosure regimes, and did not focus on the prospectus regime for fundraising. However, one of the points on which the Inquiry seeks further information is whether there are similar disclosure issues that would apply to prospectuses, and whether there is a need to review prospectus requirements.

Inquiry's assessment — the issues

The Inquiry recognised that while disclosure can be an effective regulatory tool, there are various factors that inhibit its effectiveness. Some are consumer driven, while others are a result of design and structure deficiencies in disclosure documents. These factors include:

- consumer disengagement due to lack of time or motivation, meaning that many disclosure documents are not read at all;
- the complexity and length of disclosure documents, which contain large amounts of information, much of which consumers consider irrelevant — this can make it difficult to compare products, understand risks, and locate and understand the information that consumers do need to make an informed decision;

- consumers have cognitive biases that can lead to poor financial decisions;
- disclosure alone is unlikely to correct the effect of broader market structures and conflicts that drive product development; and
- many consumers lack the financial literacy to understand disclosure documents.

Policy options

To address deficiencies in the effectiveness of the current disclosure regime, the Inquiry has taken the approach that disclosure should only be seen as part of a more flexible regulatory framework to inform consumers in their financial decision-making.

This approach takes from parts of the regulatory regime that have already moved away from the usual disclosure found in a PDS, examples being a shorter PDS regime for a limited number of products and government intervention in the detailed design requirements for MySuper products.

There are two main limbs to the policy options discussed in the Interim Report. The first is to improve the effectiveness of the existing disclosure regime with mechanisms to enhance consumer understanding of product information. The second is to remove some disclosure requirements where they have proven ineffective and adopt alternative approaches to disclosure.

Some of the policy options for improving disclosure include the following:

- **Layered disclosure:** This could include providing different information at important points in time, and most relevant to the consumer's need. It could also include producing key facts documents across all product segments.
- **Better information presentation:** Disclosure could be improved through greater use of shorter disclosure documents, plain English and graphics. In particular, any complex language relating to important information such as fees and charges, risk profiles, term of product, unusual terms or features should be broken down to improve consumer understanding.
- **Risk profile disclosure:** Improve consumers' ability to understand risk. Present information in a standardised manner to allow products to be easily compared.
- **Online comparators and choice engines:** Place more reliance on making financial product and service information more accessible to consumers, including information brought together by third-party providers through online tools and comparators.
- **Financial literacy:** The Inquiry considers that financial literacy strategies are important, although it notes that alone they are not sufficient to ensure adequate consumer outcomes.

Some of the policy options involving alternatives to disclosure include the following:

- **Regulation of financial product features:** Strategic, targeted regulation of product features may be appropriate for cases where certain features are clearly detrimental to consumers or frequently abused. Examples where this approach has been used include banning early exit fees from home loans and introducing caps on interest rates for credit contracts. The Inquiry recognises that the potential downsides to extending product regulation in this way are stifling innovation and limiting competition.
- **Default product design:** A move towards mandated product design with simple features and fee structures, an example being MySuper.
- **Suitability of financial products:** Requiring product issuers to be subject to more positive obligations with respect to the suitability of their products for retail clients. A product issuer could be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of purchasing or investing in the product. Alternatively, the issuer could be required to determine that the product is suitable for a particular individual.
- **Product intervention powers:** The Australian Securities and Investments Commission (ASIC) could be given the ability to prescribe the marketing terminology used for more complex or risky products so as to avoid situations where certain labelling might distract consumers from properly investigating the risk profile of a product. ASIC could also be given the power to ban products or product features. One challenge with this approach would be ensuring regulator accountability. The approach would only be appropriate if ASIC could demonstrate that a significant number of consumers are being caused significant detriment.

Financial advice

Another consumer outcome that the Inquiry examined was the quality of financial advice provided to consumers. Against the backdrop of the government's refinements to the Future of Financial Advice (FOFA) reforms and recent parliamentary scrutiny, this topic is an important and delicate one to balance. The Inquiry observed that affordable quality financial advice can bring significant consumer benefits, but there are currently impediments to achieving this. The Inquiry identified that the main issue with financial advice is variability in its quality. There is also a difficulty in assessing the quality of financial advice received. The Inquiry has observed that comprehensive financial advice can be costly and that there is consumer demand for lower-cost scaled advice.

Regulation of financial advice

Both forms of financial advice — personal and general advice — are regulated under the Corporations Act 2001 (Cth). Under the Corporations Act, financial advisers are required to have a reasonable basis for personal advice, and this has been built upon by the FOFA legislation. In particular, FOFA introduced a "best interests" duty, and a requirement to put the interests of the client ahead of those of the adviser. FOFA also introduced a ban on conflicted remuneration for both personal and general advice to better align the interests of financial advisers and consumers.

The government's recent amendments to FOFA include a general advice exemption from the ban on conflicted remuneration in some situations, such as where the product is issued or sold by the product provider (subject to certain criteria being met). This amendment has been criticised as allowing non-personalised advice to be renumerated through volume-based benefits, including commissions, and it is not difficult to see how a conflict of interest may arise in such a situation.

Conflicts of interest have been a longstanding issue in financial advice, and the Inquiry considers that the principle of consumers being able to access quality financial advice is undermined by the existence of conflicted remuneration structures in financial advice. The conflicts of interest issue is one of the main factors identified by the Inquiry, along with relatively low minimum competence requirements that apply to financial advisers, which result in poor quality personal financial advice. The Inquiry, while recognising the conflicts of interest problem, is silent on targeted policy options to address this issue.

The Inquiry does, however, touch on the related issue of a lack of structural independence leading to lower quality financial advice. The Interim Report outlines that 56% of financial advisers belong to dealer groups that are majority owned by institutions or other wealth managers, or are part of a bank branch network. In contrast, only 15% of advisers are fully independent. The Inquiry asks whether the distinction between independent and aligned advisers should be made clearer, and whether distinguishing advisers in this way would better inform consumers about the potential implications for the range of products offered.

Policy options

In relation to personal advice, the focus of the policy options was on increasing adviser competence and accessibility to lower cost, better quality financial advice.

Options for increasing adviser competence discussed in the Interim Report include the following:

- Strengthening education and training requirements for advisers in a move to further professionalise the industry. Options discussed include raising the minimum education requirements and recognising higher educational standards through introducing concepts such as "accredited adviser".
- Introducing a national exam for advisers. This approach has been taken in other jurisdictions, such as the United Kingdom and the United States, though the Inquiry expressed concern that consumers may place too much reliance on the regulator guaranteeing the competence of advisers who successfully complete the exam.
- Introducing specific training requirements for advisers who advise on complex products or arrangements, such as self-managed superannuation funds (SMSFs).
- Introducing an enhanced national public register of advisers, including employee advisers, to help raise competence standards in the industry by providing transparency about an adviser's qualifications and employment history.
- Enhancing ASIC's powers to include banning individuals from managing a financial services business.

In terms of accessibility of personal advice, the Inquiry recognised the challenge of both increasing the quality of financial advice and making it more affordable. Options for increasing accessibility include the following:

- Advisers could provide more cost-effective scaled or limited personal advice, confined to a single topic or particular issues.
- Technology could be used to offer consumers more cost-effective advice through automation or mass-customisation techniques, and could open up new business models such as scaled or automated online advice.

Finally, in relation to general advice, the Inquiry focused on whether it should be renamed as sales information, advertising or guidance, and whether this labelling better reflects the nature of such advice, being recommendations made in general terms.

Conclusion

There is a strong argument that informed consumers would better stimulate effective competition and drive efficiency in the financial system.

The Inquiry has rightly questioned the reliance on disclosure as the primary means of consumer protection, and whether financial literacy could be improved in part by increasing access to quality and affordable financial advice.

The policy options in the Interim Report examine the current regulatory framework and draw from many sources, such as emerging trends, the use of technology and guidance from other jurisdictions, and they present many viable opportunities for improvement to consumer outcomes.

Following the Interim Report, the Committee is inviting submissions and feedback from interested parties to gather further evidence, check the validity of observations and test potential policy options. The closing date for submissions is 26 August 2014.

The Final Report of the Committee is due in November 2014.

Table 1: Nine priority issues at a glance — observations and policy options

	OBSERVATIONS	POLICY OPTIONS
1	**Competition and contestability**	
(a)	The banking sector, dominated by the big four banks, is concentrated but remains competitive.	
(b)	Large banks derive some of their cost advantage by using internal ratings-based (IRB) risk weights, allowing them to assign lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs).	Reduce the risk weight margin for mortgages through means such as increasing minimum IRB risk weights or allowing smaller ADIs to adopt IRB modelling for mortgages only.
(c)	The cost of residential mortgage-backed securities (RMBS) funding has increased since the global financial crisis (GFC).	Provide government support for the RMBS market, or change the class of the asset to a high-quality liquid asset for the purpose of the liquidity coverage ratio.
(d)	Differences in the structure of payment systems (for example, credit cards, debit cards) have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.	A spectrum of policy options has been outlined, including no change, lowering or removing interchange fee caps, capping merchant service fees, and a broadened ban on "no surcharge" rules.
2	**Funding Australia's economic activity**	
(a)	Foreign funding has allowed Australia to sustain higher growth than would otherwise have been the case. Risks associated with foreign funding (such as integration with international capital markets) can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.	
(b)	Structural impediments for small and medium-sized enterprises (SMEs) to access finance, including information asymmetries (ie, lender will have limited information about a new borrower's financial position), regulation and tax.	Facilitate development of SME finance database to reduce information asymmetry.
(c)	A range of regulatory and tax factors has limited the development of, and participation in, Australia's domestic bond market. Companies that want to issue bonds face impediments in making public offers to retail investors in particular.	• Allow listed issuers to issue "vanilla" bonds directly to retail investors (no prospectus). • Review the size and scale of corporate bond offerings limited to a value of $2 million.

	OBSERVATIONS	POLICY OPTIONS
(d)	Australia’s tax system distorts household savings towards housing, both for home ownership and investment, and encourages people to take on higher levels of debt. The increase in housing debt and banks’ more concentrated exposure to mortgages mean that housing has become a significant source of systemic risk.	
3	**Superannuation efficiency and policy settings**	
(a)	Operating costs and fees in the superannuation sector appear high in comparison to those in other Organisation for Economic Co-operation and Development countries. There is little evidence of fee-based competition.	• No change and review effectiveness after the impact of MySuper regime can be assessed. • Consider mechanisms to improve services for MySuper members, such as auctions for default fund status.
(b)	Growth in direct leverage by superannuation funds (especially SMSFs) may create vuln erabilities for the superannuation and financial systems.	Restore the prohibition on super funds borrowing money on a prospective basis.
(c)	Superannuation policy settings lack stability that will add cost and reduce long-term confidence in the sector.	
4	**Stability and the prudential framework**	
(a)	Australia should reduce perceptions that some institutions are “too big to fail”. This would involve presenting options for the financial market that do not involve government support or bailouts in times of economic stress.	The options discussed consider increasing the risk burden on financial institutions (by increasing capital requirements) and creditors (by increasing the ability to impose losses on creditors of a financial institution in the event of its failure). The options also consider strengthening regulators’ resolution powers for financial institutions and ring-fencing critical bank functions, such as retail activities.
(b)	Other jurisdictions have enacted macroprudential toolkits to assist in managing systemic risks, though their effectiveness in Australia is uncertain.	• Introduce specific macroprudential policy tools. • Establish a mechanism to adjust the prudential perimeter to apply heightened regulatory oversight to institutions or activities that pose significant risk to the stability of the financial system.
(c)	Australian banks’ capital ratios are around the middle of the range relative to other countries, though differences (for example, definition of capital) and national divergence from some baseline international standards limit international comparability, and potentially create real costs for industry.	• Calibrate Australia’s prudential framework, in aggregate, to be more conservative than the global median. • Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the aim of increasing transparency.
(d)	Regulatory focus has confused the delineation between the role of the board and that of management in corporate governance and managing risk appetite within financial institutions.	• Review prudential requirements on boards to ensure they do not draw boards into operational matters. • Regulators continue to clarify their expectations on the role of boards.
5	**Consumer outcomes and conduct regulation**	
(a)	The current disclosure regime for financial products is complex, lengthy and expensive and often does not enhance consumer understanding of financial products and services, and imposes significant costs on industry participants.	Potential solutions to move towards producing more targeted disclosure documents include: • online competitor analysis and risk profile disclosure; • removal of ineffective disclosure requirements; and

OBSERVATIONS	POLICY OPTIONS
	• additional powers to ASIC to increase oversight and intervention.
(b) Comprehensive financial advice is expensive, and there is consumer demand for lower-cost scaled advice.	The options considered are focused on: • increasing the minimum competency levels of financial advisers, particularly those providing personal advice (for example, through raising competency benchmarks); and • increasing regulation and public awareness of poorly performing financial advisers (for example, enhancing ASIC's power to ban individuals from providing financial advice, and introducing a public register of financial advisers which includes a record of each adviser's current status in the industry).
(c) Underinsurance may be occurring for a number of reasons, including affordability and lack of adequate information or advice on the level of insurance needed. Improved technology may lead to streamlined products and increased competition.	
6 Regulatory architecture	
(a) Australia's financial regulatory framework could be re-examined in a number of areas to ensure that each can capture emerging risks.	Suggested areas for re-examination include regulation of the superannuation industry (prudential versus conduct regulation), simplified and transparent regulation of retail payment systems, and the introduction of market integrity rules to securities dealers.
(b) Australia's regulators are generally well regarded, but improvements could be made to increase operational and budgetary independence and accountability.	Suggested improvements include moving ASIC and the Australian Prudential Regulation Authority to a more autonomous budget and funding process and clarifying the metrics for assessing regulatory performance.
(c) During and after the GFC, Australia's regulatory coordination has been effective, and the Council of Financial Regulators (CFR) plays an important role in coordinating financial regulation and stability issues, though there is room for greater transparency.	A few options are being considered to increase the role, transparency and external accountability of the CFR, including: • formalising in statute the role of the CFR; • adding the Australian Competition and Consumer Commission, the Australian Taxation Office and the Australian Transaction Reports and Analysis Centre to join the CFR; and • increasing reporting by the CFR.
(d) Regulators' mandates and powers are generally well defined and clear, though they could place more emphasis on competition matters. In addition, ASIC has a broad mandate and the range of penalties available to it is low in relation to that of comparable peers internationally.	• Strengthen competition considerations through mechanisms other than amending the regulators' mandates. • Refine the scope and breadth of ASIC's mandate. • Review the penalty regime in the Corporations Act.
(e) Regulators need to be able to attract and retain suitably skilled and experienced staff in order to perform their roles effectively in accordance with their legislative mandate.	Review mechanisms to attract and retain staff, including terms and conditions.

OBSERVATIONS	POLICY OPTIONS
7 Retirement income and ageing	
(a) The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.	Various policy options are aimed at encouraging retirees to use income streams with longevity protection in retirement, including: • providing policy incentives to retirees; • introducing a default option for taking retirement benefits; and • mandating the use of particular retirement income products.
(b) There are regulatory barriers to setting up new superannuation products with risk management features that are in the interests of retirees.	• A flexible, principle-based approach to, and streamlining administrative arrangements for, assessing tax concession eligibility and Age Pension means-test treatment. • Longer-dated government bonds could support the development of retirement income products.
8 Technology opportunities and risks	
(a) Technological advances can drive efficiency and competition, but regulators and the government need to mitigate any potential risks while promoting flexibility and innovation.	Various policy options focus on promoting technological neutrality in financial services regulation, such as by removing provisions in relation to specific technologies. Other policy options focus on facilitating technological innovation. One of these options is to establish a new (potentially public–private sector) body to advise the government on technology and innovation.
(b) Growing amounts of consumer information can be used to improve efficiency and competition, but this also raises privacy and data security risks.	The policy options considered are focused on protecting the privacy of consumer information, such as: • implementing mandatory data breach notifications to affected individuals; and • reviewing information storage and privacy requirements, in particular those that impact on cross-border information flows.
(c) The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions.	The government has a role in facilitating industry coordination in this area and the options provide for government-driven policies in consultation with the private sector, financial institutions and stakeholders. The options include: • reviewing and updating the 2009 Cyber Security Strategy to reflect changes in the online environment and progress public–private sector collaboration; and • developing a national strategy for promoting trusted digital identities.

OBSERVATIONS	POLICY OPTIONS
9 International integration	
(a) The government should seek to enhance the integration of Australia's financial system with those in Asia, to benefit from opportunities to access capital and be involved in financial services exports and imports. The integration of Australia's financial system could be more effectively coordinated with growing Asian financial markets with the removal of impediments to international capital flow.	
(b) Domestic regulatory processes could be improved to better consider international standards and foreign regulation.	Domestic regulatory process could better consider international standards and foreign regulation (which since the GFC increasingly extend to activities occurring in Australia) by including processes for: • consultation about international standard implementation; and • mutual recognition and equivalence assessment processes.
(c) Coordination of Australia's international financial integration could be improved across the government, regulators and industry.	Amend the role of an existing coordination body to promote accountability and provide economy-wide advice to government about Australia's international financial integration.

Michael Chaaya
Partner
Corrs Chambers Westgarth
michael.chaaya@corrs.com.au
www.corrs.com.au

Corinna Lee
Graduate Lawyer
Corrs Chambers Westgarth
corinna.lee@corrs.com.au
www.corrs.com.au

Footnote

1. Financial System Inquiry *Financial System Inquiry Interim Report* Commonwealth of Australia, July 2014, available at www.fsi.gov.au.