CONSUMER OUTCOMES
of the 2014 Financial System Inquiry

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This paper reviews the eight recommendations of the 2014 Financial System Inquiry relating to consumer outcomes. These include strengthening product issuer and distributor accountability, providing specific product intervention power to the Australian Securities and Investment Commission (ASIC), and facilitating innovative product disclosure. They also include better aligning the interests of financial firms and consumers, raising the competency of financial advisers, and improving guidance and disclosure in general insurance. The response by Australian industry and consumer groups has been generally favourable despite the expected difficulties and lack of detail associated with the product design and distribution obligation, and concerns about the substantial product intervention powers extended to ASIC. Some unease also exists about the apparent inattention to key issues in the general insurance industry, especially underinsurance and noninsurance in home and contents insurance relating to natural disasters.

In November 2014, the Financial System (Murray) Inquiry (2014b) released its final report on the Australian financial system. Only the third such inquiry in more than three decades, the inquiry built upon the 1979 Australian Financial System (Campbell) Inquiry, which led to the floating of the dollar and the deregulation of the financial sector, and the 1996 Financial System (Wallis) Inquiry, which invoked further changes in financial services regulation, including the creation of the current regulatory authorities. At its inception in November 2013, Commonwealth Treasurer Joe Hockey tasked the inquiry with:

> examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth [and with providing recommendations] to foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users (Financial System Inquiry 2014b, p. vii).

Unexpectedly, the inquiry's resulting terms of reference were broad, and included commenting on developments in the financial system since the previous inquiry and the recent global financial crisis (GFC), as well as their implications for Australia's capital needs, the level of domestic competition and international competitiveness, and the cost, quality, safety and availability of financial services and products for users. The terms of reference also included directions to 'refresh' the philosophy, principles and objectives underpinning a well-functioning financial system, including the balance of competition, innovation, efficiency, stability and consumer protection, the nature and management of financial and systemic risk, the effectiveness of financial regulation, and the role of government and financial regulators. Lastly, the inquiry was to identify any emerging opportunities and challenges likely to drive change in the financial system, including the role of new technologies, market innovations, and consumers, changes in the sources and uses of capital, and the nature of corporate governance structures in the financial system and their effect on stakeholders.

In addressing these terms of reference, the inquiry focuses on and makes recommendations across seven themes: strengthening the economy by making the financial system more resilient; improving the superannuation system; driving economic growth and productivity through innovation; enhancing confidence and trust in the financial system; developing regulator independence and accountability; and minimising the need for future regulation. These objectives largely corresponded to the themes (and report chapters) of resilience (Ch. 1), superannuation and retirement incomes (Ch. 2), innovation (Ch. 3), consumer outcomes (Ch. 4) and the regulatory system (Ch. 5) (Financial System Inquiry 2014b).

The purpose of this paper is to comment on the fourth of these themes, namely consumer outcomes. I first summarise the background to the themes which the inquiry uses in making its recommendations. I then review the recommendations themselves. Finally, I discuss some of the responses to the recommendations, both from the Interim Report (Financial System Inquiry 2014c) and the Final Report (Financial System Inquiry 2014b).

Background to recommendations

In terms of consumer outcomes, the view of the inquiry (Financial System Inquiry 2014b, p. 197) is that the financial system should deliver five outcomes. First, consumers should have access to products and services that help them meet their individual financial needs. Second, consumers should have access to the information, advice, and education necessary to make effective decisions about financial products and services. Third, consumers should have confidence and trust in the financial system and be protected by effective regulation that minimises misconduct and promotes fair outcomes. Fourth, financial services and products should be accurately described and perform as described. Finally, consumers should have access to timely, low-cost, and efficient dispute resolution and remedies when problems arise.

In viewing the current system governing consumer outcomes, the inquiry believes that the current regulatory framework, with its focus on disclosure, financial advice and financial literacy, is necessary but not sufficient to achieve these desired outcomes. In particular, the inquiry suggests that while product disclosure plays an important part, it is not sufficient to allow consumers to make informed financial decisions. Likewise, while financial literacy implies more informed and engaged consumers, and strategies in this regard are of benefit and should continue, this is also not sufficient to ensure fair outcomes. Consequently, the inquiry believes that the current arrangements are generally working well, and that any changes are intended to be low-cost, not unnecessarily increasing the existing regulatory burden, and can be accommodated within the current regulatory authority structure, with some strengthening of ASIC.

In terms of the balance of regulation, the inquiry also seems to suggest that while industry self-regulation could meet some of the recommendations described in the next section (including raising industry standards, and levels of disclosure and professionalism) increased government regulation may be required at the sector level. This may be necessary where competitive pressures mean that some desired consumer outcomes come at a cost to individual firms and industries.

Recommendations

The inquiry makes eight recommendations pertinent to consumer outcomes (Financial System Inquiry 2014a), as shown in Table 1. Recommendation 21 indicates that the government should introduce a principles-based product design and distribution self-regulatory obligation. The stated purpose of this obligation is to ensure that product issuers and distributors consider and agree upon a range of consumer-related factors in designing and distributing any product, and that a periodic post-sale review be undertaken to ensure that the product objectives are still being met. The belief is that this positive approach would effectively match consumer needs with appropriate products and would thus avoid the existing heavy reliance on product disclosure, which have failed on a number of recent occasions (Storm Financial, Opes Prime, Westpoint etc.). However, this would still leave this requirement with product issuers and distributors best placed to understand the features of the product and its targeted market. This process is already operating in some best-practice firms and should be encouraged as an industry standard. The thinking is that this solution would be more effective, less costly, and less prone to manipulation than the alternative of individual appropriateness tests at point of sale which are used in the European Union, Japan, Hong Kong and Singapore.

Recommendation 22 is that ASIC be provided with product intervention power as a last resort to protect consumers. This ranges from amendments to marketing and disclosure materials, warnings to consumers and labelling of terminology changes, and restrictions to product distribution, all the way to outright product banning. In making this recommendation, the inquiry points to several specific instances where ASIC was powerless to intervene. This includes mortgage managed investment schemes (MIS) prior to the GFC where the expectation of consumers was of greater liquidity and unlisted debenture investments, as in the case of Banksia Securities, where the consumer perception was that this was a bank term deposit. The inquiry indicates that this approach would neither stifle innovation nor involve unnecessary regulatory costs for firms with robust product design and distribution practices, and that these powers should be carefully used, limited, and subject to review, with the overall aim being to rebuild consumer confidence in the financial system.

TABLE 1: Consumer outcome recommendations

No.	Description
21	Strengthen product issuer and distributor accountability
22	Introduce product intervention power
23	Facilitate innovate disclosure
24	Align the interests of financial firms and consumers
25	Raise the competency of advisers
26	Improve guidance and disclosure in general insurance
40	Provision of financial advice and mortgage broking
41	Unclaimed monies

Recommendation 23 aims to remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risks and fees are conveyed to consumers. In making this recommendation, the inquiry takes the view that the existing mandated product disclosure requirements, with their heavy focus on form and content, have inhibited the ability of issuers to communicate with consumers. It also indicates that through opening up this process to innovation, particularly through 'new media' rather than the existing paper-based disclosure, consumers could be more effectively engaged.

Recommendation 24 is that the interests of financial firms and consumers could be better aligned by raising industry standards, enhancing the power to ban individuals from management of financial firms, and ensuring remuneration structures do not affect the quality of financial advice. The inquiry suggests that the financial services industry has suffered from poor standards of conduct and professionalism, and that while this should be principally improved through industry efforts, ASIC should be given powers to bans persons form the management of financial firms. The inquiry also argues that the remuneration structures in the life insurance and stockbroking businesses do not act in consumers' best interests. In terms of the former, the inquiry recommends an amendment to the law such that the upfront commission for life insurance advice is no greater than the ingoing commissions, thereby reducing the incentive for churning and improving that for quality advice. In terms of the latter, the inquiry recommends a review to focus on the effect of remuneration structures on the quality of consumer outcomes which, depending on the outcome, may result in the removal of the sector's current exemption from the ban on conflicted remuneration, particularly 'grid' commissions where commission-based remuneration is received soon after the advice is given.

Recommendation 25 is that the Commonwealth Government should continue its current efforts in raising the competency standard for financial advisers. The inquiry notes that despite the consumer benefits affordable and quality financial advice could bring, training standards are still too low, particularly in relation to the complexity of many financial products. The inquiry considers that such efforts may increase the cost and availability of advice, particularly as existing advisers may leave the industry and that the higher standard may act against entry (but with some transition arrangements). Nonetheless, the inquiry remains of the opinion that it is in the interests of consumers to maintain a high standard of advice, even in relation to Australia's peer jurisdictions. The inquiry also recommends the establishment by ASIC of a register of employee advisers beyond the existing system of financial advice licensees and notification of authorised representatives.

Recommendation 26 specifically targets the general insurance industry, and particularly, home insurance, indicating that the industry should enhance the existing tools and calculators used to guide consumers as to the likely replacement value for homes building and contents. (It includes the proviso that a lack of progress would prompt government attention.) In part, the inquiry declares that this is the result of inadvertent underinsurance and the lack of awareness of insurance policies, including key features, caps and limits and exclusions, primarily as a result of recent experiences with high-cost insurance in natural disaster prone areas (including floodplains and cyclone-prone areas) leading to noninsurance and underinsurance.

Recommendation 40 is that 'general advice' be renamed and that there be a requirement for financial advisers and mortgage brokers to disclose ownership structures. This results from the inquiry's opinion that there is value to consumers in making ownership and alignment more transparent, certainly more broadly than that currently required. Finally, Recommendation 41 is that unlike the existing requirements where bank accounts and life insurance policies are deemed to be unclaimed monies and transferred to the government if they are inactive for three years, this be extended to seven years, principally as a means of reducing the number of claims.

Critique

Most of the recommendations in the interim and final reports concerning consumer outcomes have been well received and largely expected, as with other themes covered by the inquiry. Clearly, the intention is that these recommendations complement the existing Future of Financial Advice (FOFA) and product disclosure reforms, with a key objective being to improve overall consumer trust and confidence in the financial system. This naturally leads to a focus on professional standards, competency, and conduct by individuals and financial services firms. However, Ernst and Young (2014) argue that '... in a significant philosophical shift at the regulatory level, the recommendations include a greater focus on product suitability requirements and regulatory intervention across the value chain. In particular, the inquiry has acknowledged the fundamental role product providers (rather than just distributors alone) play in impacting consumer outcomes. As a result, integrated product design, advice and distribution approaches will come under greater scrutiny'.

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PwC Australia (2014) similarly points out that this '... paradigm shift away from the reliance on point of sale measures like disclosure, financial advice, and consumer financial literacy' is one of the defining and radical features of the recommendations. Barton Deakin (2014), Byrne (2014), Gilligan (2014), Inside Publishers (2015), Minter Ellison (2014) and Shapiro (2014) have made similar supportive comments, with Deloitte (2014) declaring that in adopting a pragmatic outcomes-based approach and avoiding overly prescriptive statements, the inquiry has taken 'the right approach'.

Of the eight recommendations, Recommendations 23–25, 40 and 41 have been most well received and perceived as fairly benign and consistent with existing developments. For example, the CFA Societies Australia (2014) and Financial Planning Association of Australia (2014) have both come out in support of Recommendation 25 (Liew 2014) with PwC Australia (2014) arguing that this is likely 'to be relatively easier to implement, given the support these measures have received from ASIC and the industry more broadly'. Similarly, most industry and consumer groups have also endorsed Recommendation 23 on enhancing and allowing innovation in disclosure, and this appears to correspond closely with industry submissions to the inquiry (ANZ 2014). Choice (2014) has particularly welcomed Recommendation 24 regarding the advanced powers to be given to ASIC banning individuals from financial firm management and the disclosing of the ownership structure of firms providing financial advice so consumers understand advisers' or mortgage brokers' association with the financial product issuers. However, the Financial Planning Association of Australia (2014) points out 'the incentive to improperly manage conflicts of interest is exacerbated by low consumer engagement, the complexity of disclosure documents, and widespread financial illiteracy [and that] positive change can only occur through a mixed strategy of reform aimed at creating a critical mass of behavioural change'.

As discussed, even though Recommendation 21 is one of the more radical consumer outcomes of the inquiry, most have welcomed it. This is because of both the expected ease of implementation, in that existing controls can be simply scaled up to the new standard, and also that the more costly prospect of individual appropriateness tests at the point of sale for complex products (suggested in the interim report and found in other jurisdictions) has not been pursued further (Herbert Smith Freehills 2014). The main objection to this recommendation mirrors Allens (2015) concerns in that while the inquiry's recommendation is less prescriptive to the alterative 'the difficulty with a "principles based" obligation is that while it can be simply stated, what it requires is likely to be unclear — and abstract norms are much easier to weave into claims by consumers'.

I cannot say the same of Recommendation 22 which confers specific product intervention power to ASIC. Allens (2015) acerbically notes that: 'The inquiry appears to have accepted ASIC's ambit claim for a product intervention power without any critical examination of its merits or its basis (or otherwise) in fact — and product intervention could make FOFA feel like a beating with a peacock feather.' Likewise, King and Wood Mallesons (2014) accept that the product intervention power is to be only used as a last resort or pre-emptive measure where there is risk of significant detriment to a class of consumers and would be temporary and subject to a judicial review and prior consultation with the Australian Prudential Regulatory Authority (APRA) where necessary. However, King and Wood Mallesons (2014, p. 1) notes that:

> [M]any industry stakeholders expressly did not support a power of this kind in their submissions to the inquiry and there are concerns that it could create uncertainty, constrain innovation, increase costs, detract from consumer accountability and increase reputational risk. However, the inquiry did not accept these concerns.

The remaining significant issue with the inquiry's recommendations on consumer outcomes relates to Recommendation 26 concerning consumer guidance and disclosure in the general insurance industry. Foremost among these, the Financial Rights Legal Centre (2014) contends that the insurance industry still 'requires urgent review and regulatory reform [and that the] failure to undertake that review in the context of climate change leaves consumers, the Government, the insurance industry and other financial services providers (and the economy as a whole) at serious risk'. Clearly, the inquiry's view that the general insurance industry should be left to 'complete its recent work on reducing complexity and facilitating consumer understanding of key features and exclusions' does not go far enough toward what it refers to as the alternative of 'a prescriptive regulatory regime'.

Summary

In its Final Report, the Financial System Inquiry (2014b) into the Australian financial system makes eight recommendations relating to the theme of consumer outcomes coincident with its stated aim of 'seek[ing] to strengthen the current framework to promote consumer trust in the system and fair treatment of consumers.' (Financial System Inquiry). Overall, these recommendations have been welcomed and are largely consistent with existing regulation and industry efforts and expectations. However, three of the recommendations are more contentious, with some highlighting the lack of detail concerning the product design and distribution obligation, the substantial, albeit temporary, intervention powers extended to ASIC, and the relative inattention to pertinent issues in the general insurance industry, including underinsurance and noninsurance relating to natural disasters.

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