Lawyers for the People

AUSTRALIAN LAWYERS ALLIANCE

Competition in the Australian Financial System

Submission to the Productivity Commission

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Who we are

The Australian Lawyers Alliance (ALA) is a national association of lawyers, academics and other professionals dedicated to protecting and promoting justice, freedom and the rights of the individual.

We estimate that our 1,500 members represent up to 200,000 people each year in Australia. We promote access to justice and equality before the law for all individuals regardless of their wealth, position, gender, age, race or religious belief.

The ALA started in 1994 as the Australian Plaintiff Lawyers Association, when a small group of personal injury lawyers decided to pool their knowledge and resources to secure better outcomes for their clients – victims of negligence. While maintaining our plaintiff common law focus, our advocacy has since expanded to criminal and administrative law, in line with our dedication to justice, freedom and rights.

The ALA is represented in every state and territory in Australia. More information about us is available on our website.[1]

[1] www.lawyersalliance.com.au.

Introduction

1. The Australian Lawyers Alliance (ALA) welcomes the opportunity to have input into the issues raised by the terms of reference of inquiry into competition in Australia's financial system. This submission addresses the issues raised in Terms of Reference 1 and 4 and comments specifically on vertical integration, asset-based fees and the accountability of professional indemnity insurers.

The level of contestability and concentration in key segments of the financial system and its implications for competition and consumer outcomes

Vertical integration

Vertical integration is a business concept

2. In some businesses it may make sense for the manufacturer to also own the distributor. A couch manufacturer, for example, may own shop fronts for selling their couches to the public. The manufacturer may pursue vertical integration up or down the line in order to own more of the value chain. It may or may not mean that they make more money. Consumers are familiar with going into a store with the same name as the product provider and are not surprised to meet a sales person who will sell them the in-house product. Consumers are equipped to compare products and can shop around if they want.

3. However, for this model to be fair, it is important that consumers are informed about the relationship between the manufacturer and the distributer, and are in a position to judge value for themselves. When it comes to financial services, neither of these criteria tend to be met.

Vertical integration is not good for consumers of financial products

4. Vertical integration is a strategy that has been popular in financial services. Vertically-integrated advice is where an adviser recommends purchase of a financial product (including life insurance) from entities with which they are associated. This is often to the exclusion of more suitable, non-affiliated products.

5. It is often less clear to consumers that the distributor is linked to the product manufacturer so closely. The distributor and the manufacturer will often have different names and branding, offering no hint to consumers that a link exists. Further, due to the complexity of financial services, consumers are less capable of comparing products and determining which one best meets their unique needs.

6. As a result, vertical integration in the financial services industry has been and remains a root cause of poor advice outcomes.

7. Financial products are different to couches or other products. They are often complex and there is significant information asymmetry. Consumers generally do not have high levels of financial literacy, and they rarely have the time or inclination to shop around.

8. Simple market signals do not necessarily hold true in relation to financial service products. The most expensive product may not be the best. Heavily marketed products may not necessarily be the best.

9. Currently consumers have a hard time distinguishing between sales people and advisers. Financial advisers may seem like neutral experts providing advice in the consumers' best interests, but most commonly they are not.

Asset-based fees

10. In financial planning, asset-based fees have long been the norm.

11. A financial adviser will often cite an ongoing advice fee as a percentage of investment funds under management: 'My annual ongoing advice fee is a mere 1 per cent per annum'.

12. On the face of it, this might seems fair. The more money invested, the higher the fee paid, so a person with $1m invested will pay more than a person with $100,000 invested.

13. The argument often put in support of asset-based fees is that it aligns consumers' and financial advisers' interests: if the consumer's investments go up, the financial adviser get paid more, but if the investments go down, the adviser get paid less. On this logic, advisers are motivated to maximise consumers' returns on their investments.

14. There are, however, many reasons that asset-based fees are not fair, or in consumers' best interests:

    - a fee expressed as a simple, small percentage usually sounds modest and reasonable. However, it can add up to a significant total, which can be higher than what is fair;
    - financial advisers cannot control markets or determine market outcomes. It is unfair that their pay is based on something that they cannot control;
    - advisers' workload may not vary depending on the amount of money invested. It may instead vary depending on the extent of the task at hand, the complexity of the issues being considered, etc; and

- having a percentage based fee may encourage advisers to maximise their pay by maximising the amount of funds under management, when this might not be in their client's best interests. For example, good advice may be to pay off debt rather than to invest, but the former will not increase the adviser's fees.

15. For these reasons, the ALA believes that asset-based fees should not be permitted. They are based on an out-dated understanding of what a financial adviser does. A modern financial adviser cannot accurately predict the future movements of the share market and should not be paid on the basis that they can.

16. Instead, consumers should pay financial advisers for following the financial planning process – for understanding their client's needs and circumstances, for understanding their risk profile and then conducting research to determine suitable strategies and products to support their client's objectives.

17. This sort of modern financial planning (mandated by both statute[2] and the common law) is sensible, takes time and needs to be provided diligently by an adviser with appropriate skills and knowledge, who prioritises the client's best interests over their own.

18. Benefits for consumers and advisers from a ban on asset-based fees include:

    - consumers would know what they are actually paying in dollar terms;
    - consumers would be less likely to be over-charged;
    - advisers would be paid for their time and expertise;
    - advisers would be under less pressure to give advice that results in more funds under management;

[2] *Corporations Act 1995* (Cth); *Australian Securities and Investments Commission Act 2001* (Cth).

- advisers would still be able to charge more or less depending on what is required;
- the managers of advisers would be encouraged to develop adviser technical skill and expertise rather than sales skills; and
- the focus would be less on selling products and more on quality advice.

Barriers to and enablers of innovation and competition in the system, including policy and regulation

Vertical integration

Government policy needs to support consumers

19. Government policy has long supported the dominance of big banks and insurance companies. In exchange, these institutions have long been trusted to do the right thing to help consumers – they have been granted a social licence, in effect.

20. The public mood has changed, however, as the banks have used their privileged position to increase their profits at the expense of consumers' interests. Vulnerable people have been taken advantage of – over-charged and sold products that do not meet their needs – and in some cases they have been left worse off as a result of seeking expert advice.

21. The Australian Securities and Investment Commission (ASIC) has described the vertically-integrated advice model as being inherently conflicted, and lacking in customer transparency. For example, ASIC's submission of December 2014 to the Scrutiny of Financial Advice Inquiry noted:

> 'The inherent conflict of interest created by vertical integration may not be readily apparent to clients, particularly if the product manufacturer and advice parts of the business operate under separate licences and business names. Roy Morgan Research found that 55% of surveyed consumers receiving financial advice from an entity owned by a large financial institution, but operating under a different brand name, considered it to be independent—in contrast, only 14% of consumers considered financial planners working under the brand of the same financial institution to be independent. This was also an issue identified by the Financial System Inquiry, which recommended that advisers be required to disclose ownership structures of the advice firm to consumers.'[3]

22. Consumers need good financial advice that is in their best interests more than ever, but there is now a trust deficit in the industry. Consumers need help navigating this highly complex industry, otherwise they remain vulnerable to the unethical advisers who prioritise sales over client interests. For this reason, the ALA believes that there is a need to move toward fiduciary duties for financial advisers.

23. Interestingly, we see that product manufacturers are starting to recognise that vertical integration may not deliver big dividends for shareholders. Some manufacturers are selling their distribution arms.

24. Also, financial advisers are increasingly wanting to be able to give un-conflicted advice. This is essential if they are to be seen as competent professionals with skills and knowledge, acting in the public interest, and not mere salespeople.

25. The vertically-integrated players are predominantly owned and controlled by the ANZ, Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac (the big four banks), AMP (including AXA) and Macquarie Bank. These

[3] Submission No. 88, at [245].

dealer groups collectively account for around half of the total market share in the financial advice sector, and their stake is increasing.

26. Dealer groups utilising a vertical integration model are not obliged to have any retail life risk insurance product on their Approved Product Lists (APL) other than their own affiliated product.

27. This inherent conflict has given rise to much litigation in recent years,[4] the most notable case being *Commonwealth Financial Planning Ltd v Couper* (*Couper*).[5] In *Couper*, the late Mr Stevens was advised by a CBA adviser to cancel his existing Westpac life insurance policy and replace it with a vertically-integrated CommInsure product, which he did. The subsequent claim made by his estate for his life insurance benefit was declined and the policy avoided on the basis of non-disclosure under s29 of the *Insurance Contracts Act* 1984 (Cth) (ICA). The Court of Appeal found that the financial adviser was negligent and engaged in misleading and deceptive conduct. The Court noted that while the Statement of Advice (SOA) did disclose the risk of avoidance for non-disclosure, it failed to disclose the 'three year rule', namely that:

    - because his Westpac policy had been on foot for more than three years, it could not be avoided by the insurer except by proving fraud; and
    - the CommInsure policy could be avoided for 'innocent non-disclosure' within the first three years from inception, and was therefore an inferior product.

28. The three year rule was, in the adviser's words, "news to me".

[4] See also *Swansson v Harrison & Ors* [2014] VSC 118.
[5] [2013] NSWCA 444.

29. These inherent conflicts were highlighted by Roy Morgan Research which stated that over a three year period, these dealer groups allocated an average of over 70 per cent of their sales to their own products.[6]

30. Because the big vertically-integrated players have such vast distribution channels to sell their in-house products, they do not rely on other advice firms to do it for them. That means they are disinclined to take the lead on product design, which is anti-competitive and leads to inappropriate or defective products being paid for by the client, and often results in the insurer denying liability because of those defects.

31. Recent controversies have exposed stark examples of this, such as CommInsure's retail trauma policies, which contained medically-obsolete 'heart attack' and 'severe rheumatoid arthritis' definitions. Despite knowing the definitional flaws, CommInsure relied upon them to decline claims. It took a media exposé to prompt CommInsure to update its obsolete clauses.[7]

32. Legislative reform is needed now to require financial advisers to demonstrate that they consider and recommend both affiliated and non-affiliated products. Specifically, that could be achieved by making the following improvements:

   - Requiring that APLs include a balance of affiliated and non-affiliated products, and/or a minimum proportion of non-affiliated products from a reputable provider.

   - Requiring that, if a SOA produced for a customer recommends an affiliated product, that should be disclosed and the SOA should show a comparison with

[6] Roy Morgan Research, *Superannuation has become a political football but a new report shows what the members think*, 27 May 2015, http://www.roymorgan.com/findings/6262-superannuation-political-football-but-new-report-shows-what-members-think-201505270222.
[7] Joint Fairfax/ABC 4 Corners investigation, *Money for Nothing*, March 2016, http://www.abc.net.au/4corners/money-for-nothing-promo/7217116.

one or more non-affiliated products to demonstrate that the affiliated product is more appropriate.

33. These measures would provide prescriptive requirements to support compliance with the Future of Financial Advice best interest test reforms. These measures are also directed towards achieving the recommendation of John Trowbridge, the author of the *Review of Retail Life Insurance Advice: Final Report*,[8] that APLs be reformed to 'ensure competitive access and choice for all advisers and their clients'.[9] These improvements are necessary because the expansion of APLs alone will not necessarily be effective in practice if the advisers in question consistently recommended just the one insurer's products despite being officially permitted to recommend others.

34. Requiring advisers to give customers disclosure of comparative non-affiliated products in the SOA, will help achieve a range of important outcomes including:

- Increase competition;
- Improve the quality of products as designers know that consumers will see the terms compared with those of competitors;
- compelling advisers to genuinely source a reasonable range of available products on the market to best suit their client's circumstances;
- help avoid the presently common situation whereby the product most appropriate for a consumer is in fact a non-affiliated product that the consumer is never told about and cannot access through his/her adviser;

[8] Released 26 March 2015, http://www.fsc.org.au/downloads/file/MediaReleaseFile/FinalReport-ReviewofRetailLifeInsuranceAdvice-FinalCopy(CLEAN).pdf.
[9] *Ibid*, recommendation 4, p 9.

- help reduce conflicts of interest;
- help preserve the integrity of the advice given through openness and transparency; and
- help restore consumer confidence in an industry beleaguered by misconduct and controversy.

Separating manufacturers from distributors would benefit consumers

35. Adoption of the above recommendations would offer a sensible separation between product manufacturers and distributors. Such a separation would enable more competition.

36. Manufacturers would compete on price, quality of advice and service, rather than seeking to over-service existing clients to maximise their own profits. Such a reform would introduce space for innovation and competition in the industry, meaning more products would become available to meet consumers' diverse needs. This would lead to greater choice for consumers, reducing the cost and increasing the quality of products available.

The accountability of professional indemnity insurers

37. There are strengths and weaknesses of the existing compensation arrangements contained in the *Corporations Act 2001* (Cth) and *National Consumer Credit Protection Act 2009* (Cth).

38. Under the existing external dispute resolution (EDR) framework, there are situations where an EDR body orders that a claimant be paid compensation, but that compensation is not paid.[10]

39. As at 2 May 2017, $13,909,635.50 (excluding interest) and $399,862 (excluding interest) in determinations made in favour of complainants by Financial Ombudsman Service (FOS) and Credit and Investments Ombudsman (CIO), respectively, had not been paid.[11]

40. There is a lack of clarity regarding the number and size of cases where the FOS or CIO declined jurisdiction. FOS and CIO only accept disputes against financial services providers (FSPs) that are registered members. When an FSP loses its Australian Financial Service (AFS) Licence or no longer provides financial services, its EDR scheme membership ceases. Hence these determinations are from matters where the FSP ceased trading or became insolvent after the dispute was lodged, and any statistics of those entities do not include cases where the FOS[12] or CIO declined jurisdiction.

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[10] Australian Securities and Investments Commission 2015, Report 459 *Professional indemnity insurance market for AFS licensees providing financial product advice*, page 11. Quoted in The Australian Government the Treasury, *Review of the financial system external dispute resolution framework,* Supplementary Issues Paper (May 2017) [42] https://static.treasury.gov.au/uploads/sites/1/2017/08/c2017-t185463-SupplementaryIssuesPaper.docx.

[11] *Ibid*, [43].

[12] Over $13m as at February 2017: https://fos.org.au/fos-circular-28-home/fos-news/unpaid-determinations-update/.

41. While ASIC ensures that an FSP has professional indemnity (PI) insurance, it does not approve PI insurance arrangements for FSPs and it does not have 'data about the renewal of advice licensees' [PI] insurance cover'.[13]

42. This is problematic. A monitoring and approval regime should be introduced.

43. These arrangements would ideally include claimants being able to access direct recourse to PI insurers through EDR schemes including the Australian Financial Complaints Authority (AFCA) when it commences operations from 1 July 2018.

44. This recommendation is contrary to ASIC's December 2015 report *Professional indemnity insurance market for AFS licensees providing financial product advice*,[14] which said that PI insurance 'is neither intended nor designed to provide compensation directly to consumers'. However we would assert that ASIC's position taken on that point is contrary to the common law doctrine of 'direct recourse' and the statutory regimes which grant claimants the right to look beyond the insured wrongdoer and seek recovery directly from the relevant PI insurer.

45. In that regard, we refer the Commission to the recently introduced *Civil Liability (Third Party Claims Against Insurers) Act 2017* (NSW), s4(1): 'If an insured person has an insured liability to a person (the claimant), the claimant may, subject to this Act, recover the amount of the insured liability from the insurer in proceedings before a court.'

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[13] Australian Securities and Investments Commission 2015, Report 459 *Professional indemnity insurance market for AFS licensees providing financial product advice*, page 11. Quoted in The Australian Government the Treasury, *Review of the financial system external dispute resolution framework,* Supplementary Issues Paper (May 2017) [59] https://static.treasury.gov.au/uploads/sites/1/2017/08/c2017-t185463-SupplementaryIssuesPaper.docx.

[14] Australian Securities and Investments Commission 2015, *Report 459 Professional indemnity insurance market for AFS licensees providing financial product advice*, pp 14-15.

46. This law represents the best practice benchmark for facilitating a fair and effective direct recourse regime.

47. We also refer to the New South Wales Law Reform Commission's report, *Third Party Claims on Insurance Money: Review of s6 of the Law Reform (Miscellaneous Provisions) Act 1946*,[15] which catalysed that Act. That report confirmed that the new provisions would ensure that a PI insurer:

    - would not be liable for more than it would have been liable to pay under the insurance contract; and
    - can rely on the same defences that the insured could have relied on in an action brought by the claimant.

48. Hence it cannot be said that PI insurers are prejudiced by this form of 'direct recourse'.

49. We also point to s601AG of the *Corporations Act 2001* (Cth) and s51 of the *Insurance Contracts Act 1984* (Cth) which allow the plaintiff to litigation to proceed directly against the PI insurer when the insured defendant is absent because it is a deregistered company, or he or she is a dead or missing individual.

50. However, these statutes relate to litigation through the state, territory and federal courts, and lack consistency across jurisdictions. That may encourage forum shopping which is undesirable. Further, litigation is obviously prohibitively daunting and costly for most victims of financial wrongdoing. That is why EDR schemes such as the FOS, CIO and the Superannuation Complaints Tribunal (SCT) exist. What is therefore needed is a right of direct recourse by consumers via an EDR forum.

[15] Report No. 143 (November 2016): http://www.lawreform.justice.nsw.gov.au/Documents/Publications/Reports/Report%20143.pdf.

51. One option for reform may be to establish a condition of licencing that FSPs' PI insurers are registered and contractually bound by EDR decisions in relation to which the PI insurer is on risk (we accept that such an arrangement could only function prospectively as the PI insurer would not have been party to a previous EDR decision). At the very least, EDR schemes should include in their register of FSP Members the name and details of the relevant past and current PI insurers. This will help deserving claimants to receive compensation and lessen the burden on compensation schemes of last resort.

52. The 2012 report prepared by Mr Richard St. John, *Compensation arrangements for consumers of financial services*, recommended that licensees provide additional assurance to ASIC that their PI insurance cover is current and is adequate to their business needs.[16] We support this recommendation.

53. Finally, there are inadequacies in the *Corporations Act* that are worth noting in this context.

54. For instance, it is our experience that, in pursuing a financial adviser who is in liquidation, it is very difficult to work out who the PI insurer is and the liquidator typically will not disclose that information. Again this is an issue that potentially could be monitored by the Commission and reported to the regulator and/or subject of legislative reform via the *Corporations Act*.

55. Furthermore, direct recourse to the relevant PI insurer would provide a mechanism to receive compensation.

[16] The Australian Government the Treasury [Richard St. John], *Compensation arrangements for consumers of financial services: Future of financial advice,* Final Report (April 2012) https://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_report/downloads/Final_Report_CACFS.pdf, recommendation 2.1.

Recommendations

56. The ALA makes the following recommendations:

    a. Ensure necessary information regarding comprehensive remunerate structures are in place and APLs are available to stakeholders at the earliest possible opportunity;

    b. APLs must include a balance of affiliated and non-affiliated products, and/or a minimum proportion of non-affiliated products;

    c. If a SOA produced for a customer recommends an affiliated product, that should be disclosed and the SOA should show a comparison with one or more non-affiliated products to demonstrate that the affiliated product is more appropriate.

    d. Asset-based fees should be prohibited in relation to financial services;

    e. A monitoring and approval regime should be introduced for FSP PI insurance policies, including enabling consumers to directly access PI insurers through EDR schemes. The laws in NSW represent best practice in this regard, and should be emulated across all Australian jurisdictions;

    f. Licensed FSPs should be required to provide additional assurances to ASIC in relation to their PI insurance cover;

    g. Reforms should ensure that, where a financial adviser is in liquidation, liquidators make the PI insurer’s details available to former clients; and

    h. Clients should have direct recourse to the PI insurer and a mechanism should exist to ensure compensation is available from them.