

Australian Consumer Law Issues Paper

ISA SUBMISSION

27 May 2016



ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of Industry SuperFunds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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Contents

Australian Consumer Law Issues Paper	ii
Introduction	1
1. Lessons from behavioural economics	1
2. Key issues facing consumers of financial services	1
3. Comments on the regulatory protections for consumers of financial services	5
4. Recommendations	6
4.1 Issue 1 – Stronger regulation of product design and distribution	6
4.2 Issue 2 – General prohibition against unfair commercial practices	7
4.3 Issue 3 – Consumer guarantees	8
4.4 Recommendations in relation to emerging issues	8

Introduction

Industry Super Australia (ISA) welcomes the opportunity to comment on the Australian Consumer Law (ACL) Review (the Review). ISA undertakes policy research and advocacy on behalf of the five million members of Industry SuperFunds to ensure system settings improve their retirement outcomes. As such, ISA is well placed to comment on potential gaps within the current legal framework for financial services, and identify emerging issues which the Review should consider.

This submission will provide a brief summary of key issues around consumer protection in financial services followed by some specific recommendations to improve protections for consumers. ISA welcomes the committee's invitation for a broad discussion of issues, and as such have adopted this approach in our response.

1. Lessons from behavioural economics

A review of consumer protection regulation in financial services should incorporate learnings from behavioural economics into its consideration.

While behavioural economics has been used to analyse the disengagement of members in the default sector in Australia, its lessons have been overlooked in terms of understanding the outcomes of choice sector members.

Applying the lessons from behavioural economics would seem to be equally relevant for consumers perceived to be "more engaged" in their superannuation, who typically achieve inferior outcomes in terms of their retirement savings, than members of Default funds.

In fact, members who exercise choice on average experience worse outcomes than members of not-for-profit default funds. This applies to both members of APRA-regulated choice funds and SMSFs.

While improving financial literacy and engagement is important, particularly for the superannuation industry, the lessons of behavioural economics suggest that like disclosure, member engagement on its own will not enhance consumer protection or deliver stronger returns to members.

Strong consumer protection and default settings will always be needed in superannuation, but they are not needed just for default members – the evidence shows that stronger protections are also needed for those who exercise choice.

It is often noted that there is an absence of demand side competitive pressures in the superannuation industry. Current default arrangements ensures there is a "quality filter" to drive good outcomes for those who do not choose their own super fund. However, stronger consumer protections are required to ensure the same occurs where members depart the default arrangements.

2. Key issues facing consumers of financial services

Since the introduction of the ACL in 2011 there has been significant evidence to support the argument that greater protection is needed for consumers of financial services.

Consumer detriment in financial services is driven in part by:

- Different outcomes across sectors

- Different outcomes across segments
- The information asymmetry between providers and consumers
- The ability to cross-sell financial products via general advice without any suitability requirement
- Unsatisfactory product design and limited controls around product distribution
- The continued existence of some types of conflicted remuneration despite the Future of Financial Advice (FoFA) reforms

Consumer detriment is measured by:

- Financial impact on consumers
- Surveillance of financial advice undertaken by ASIC
- Regulatory action
- Government inquiries into financial advice

Table 1 and Table 2 provide a summary of findings that are relevant to this inquiry.

Table 1 - Drivers of consumer detriment in financial services

	Evidence
Different outcomes for members across segments	<p>Superannuation consists of three broad industry segments: Not-for-profit APRA-regulated funds, for-profit APRA-regulated funds, and SMSFs. Between these segments, there are clear differences in the net performance delivered to members. Over the long term, not-for-profit funds have consistently achieved superior net performance compared to the SMSF and for-profit segments.</p> <p>Over the 10 years to June 2015, for-profit funds underperformed not-for-profit funds by an extraordinary 1.73 per cent per year.¹ Over the seven years to June 2014 average returns for SMSFs were 3.09 per cent, compared to 1.93 per cent for retail funds and 3.57 per cent for not-for-profit funds.</p> <p>The compounded aggregate cost of underperformance across the whole system is significant. If for-profit funds had generated the net returns of not-for-profit funds over this time, our pool of retirement savings would be \$76 billion more than it is, an increase of more than 4 per cent. Including SMSF sector underperformance in this analysis (using the longest reliable data available), increases the cost of sectoral underperformance to \$111 billion.²</p>
Existence of conflicted remuneration	<p>Despite the FoFA reforms' 'ban' on conflicted remuneration, carveouts for life insurance commissions on individually advised life insurance within superannuation and grandfathered conflicted remuneration mean that commissions will continue to compromise member outcomes in the Choice and SMSF sector for many years to come. Grandfathered commissions are a powerful incentive for advisers to leave clients in underperforming products.</p>

¹ Source: APRA (2015) Superannuation fund level rates of return (see Appendix 1, Figure 1)

² APRA (2004) Supertrends; APRA (2016) Quarterly Superannuation Performance; ATO Self-managed superannuation funds – A statistical overview 2011-2012; 2012-2013; 2013-2014. The actual retail fund assets is a projection. It does not precisely reproduce current APRA data on retail assets since the projection includes pre-2004 data where the APRA reporting of fund returns used a different methodology. Not-for-profit returns are the average simple average returns of industry, public and corporate sectors. SMSF projection starts from 2004 due to data availability.

Evidence

The information asymmetry between providers and consumers

The current regulatory system does not adequately address the information asymmetry between advisers and consumers. Independent analysts agree - based on an analysis of 622 products across MySuper and Choice options, in 2015 SuperRatings concluded that 'fee disclosure amongst funds still remains varied in the absence of prescriptive legislation that stipulates the degree of disclosure required from each fund along with the determination of materiality³'. While it has been widely acknowledged that on its own disclosure does not enable informed decision-making, it is still important that there is consistent and comparable disclosure. The fragmented and incomplete nature of the current disclosure regime limits the ability of informed commentators and consumers to compare products and exempts providers of platform-based Choice products from disclosing underlying investment costs deducted from investment earnings. Retail Choice superannuation products, the majority of which are distributed through platforms, benefit from lower levels of disclosure than the rest of the market which results in reduced comparability and less protection for consumers.

The ability to cross-sell financial products via general advice without any requirement to ensure that the product is in the consumer's best interests

Consumer protections in general advice are considerably lower than in personal advice. Sellers are not bound by an obligation to act in their client's best interests and may therefore sell a product that is unsuitable or detrimental to consumers. In the general advice environment, conflicted remuneration continues to be permitted in the form of balanced scorecards, which include a component for revenue, to remunerate staff. For example, a number of banks reward tellers for measures which include successfully cross-selling superannuation under a general advice model.⁴

Unsatisfactory product design and limited controls around product distribution

Product designers and distributors are subject to limited obligations in terms of the design and distribution of products. This can lead to risky products becoming available on the market without any consideration of their target audience or complexity, as well as distribution that undermines the best interests of consumers. ASIC's report on Regulating Complex Products recognises that consumers will often not have a sufficient understanding of the risks associated with a product to make an informed investment decision.⁵ It can also lead to products remaining on the market that are delivering little or any consumer benefit.

Poor product design and lack of ongoing oversight is particularly apparent in relation to legacy products,⁶ which comprise a substantial proportion of assets in the retail segment of the superannuation system. There is no publicly available data on the returns delivered by these products and exit fees are typically high. Independent analysis has demonstrated that legacy products are more costly than current products.⁷ Furthermore, advisers can continue to receive commissions from clients in legacy products under the FoFA reforms.

³ SuperRatings, Australian Institute of Superannuation Trustees Fee and performance analysis, December 2015, p 21

⁴ Despite FoFa's selective ban on commissions and conflicted remuneration, commissions and other forms of conflicted remuneration continue to be permitted for general advice in certain circumstances

⁵ Australian Securities and Investments Commission (ASIC) 2014, Report 384: Regulating complex products, ASIC, Sydney

⁶ Legacy products are products provided by the retail sector that are closed to new members

⁷ Rice Warner, Superannuation Fees, 2014

Table 2 - Measures of consumer detriment in financial services

Evidence	
Financial impact on consumers	The financial impact on consumers of financial advice is difficult to quantify, but the report of the Financial System Inquiry (FSI) has observed that collapses involving information imbalances, exploitation of consumer behavioural biases and poor financial advice have affected more than 80,000 consumers, with losses totalling more than \$5 billion. ⁸ This did not include the financial impact of subsequent advice scandals at CBA, ANZ and NAB.
Government inquiries	<p>There are a number of outstanding issues from past government inquiries which need to be addressed to improve consumer outcomes.</p> <p>The 2014 Financial System Inquiry identified conflicted remuneration in insurance as an important issue to be resolved if public trust and confidence in the financial system is to be restored. These issues are yet to be dealt with, and the Bill which was presented to the recently dissolved Parliament represented a very weak response, which left conflicted commission structures in place.</p> <p>The final report of the Inquiry stated:</p> <p>In terms of fair treatment for consumers, the current framework is not sufficient. The GFC brought to light significant numbers of Australian consumers holding financial products that did not suit their needs and circumstances — in some cases resulting in severe financial loss. The most significant problems related to shortcomings in disclosure and financial advice, and over-reliance on financial literacy.⁹</p> <p>To strengthen product issuer and distributor accountability, the Inquiry also recommended the introduction of a targeted and principles-based product design and distribution obligation and a new temporary product intervention power for the Australian Securities and Investments Commission (ASIC).¹⁰</p> <p>The 2009 Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in 2009, emphasised that the regulatory regime (i.e, pre-FoFA) was ‘failing to protect consumers from poor financial advice and its consequences.’¹¹</p> <p>The same Inquiry found that ‘the major criticism of the current system is that licensees’ minimum training standards for advisers are too low, particularly given the complexity of many financial products.’¹²</p> <p>Similarly, the 2014 Joint Committee on Corporations and Financial Services’ Report of the Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry noted that product design and the design of remuneration structures in both vertically integrated and independent settings has the potential to adversely affect the cultural realities of the respective workplace within the financial services industry.¹³ These recommendations are yet to be implemented.</p>
Regulatory action	In 2014 ASIC set up its Wealth Management Project which focusses on the conduct of the largest financial advice firms. To date as part of this project, ASIC have banned a number of advisers from financial services. There has also been a number of enforceable undertakings entered into and penalties imposed upon financial advice firms.

⁸ This estimate includes losses involving Storm Financial, Opes Prime, Westpoint, Great Southern, Timbercorp and Banksia Securities. – FSI Final Report, p 199

⁹ Financial System Inquiry, Final Report, November 2014, p. 27

¹⁰ Financial System Inquiry, Final Report, November 2014, p. 27

¹¹ Parliament Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, November 2009

¹² Parliament Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia*, November 2009

¹³ Joint Committee on Corporations and Financial Services’ Report of the Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry, 2014

Evidence	
Surveillance of financial advice undertaken by ASIC	<p>Shadow shopping surveillances undertaken by ASIC have consistently showed (a) inadequate consideration of clients' needs; (b) inadequate justification or lack of credible reasons for recommending clients switch products; and (c) the impact of conflicted remuneration structures on the quality of advice.¹⁴</p> <p>ASIC's 2014 review of retail life insurance advice found that 37 per cent of life insurance advice did not comply with the minimum standards in the Corporations Act.</p> <p>ASIC's 2012 investigation into retirement advice found that scoping of advice was only adequately disclosed in half of all advice examples where limited advice was provided, while in 'several instances, particular topics were excluded from the scope of the advice, to the potential benefit or convenience of the adviser, and to the significant detriment of the client.'¹⁵</p> <p>ASIC's 2012 review of the quality of advice given to investors in relation to SMSFs, Report 337, found issues in the following areas: advice was not sufficiently tailored to the needs of the investor; replacement product disclosure was absent or inadequate; suitable alternatives to an SMSF were not considered; and there was inadequate consideration of the investor's long-term retirement planning objectives.¹⁶</p> <p>ASIC's 2011 review of the top 20 advice licensees found that the majority indicated that they 'remunerated their advisers based on the volume of financial products sold,' with 90 per cent of total licensee remuneration paid as commissions and asset-based fees from product providers and only 10 per cent paid directly by clients. The same survey found that despite all licensees using relatively large approved product lists (the median number of products on the Approved Product List (APL) was 400) 'there remained a tendency to concentrate product recommendations into a few key products.'¹⁷</p>

3. Comments on the regulatory protections for consumers of financial services

It is ISA's submission that the current regulatory framework contains some weaknesses which means it does not always adequately protect consumers of financial services from unfair practices such as commission-based selling and defective products.

Since the 2009 Inquiry into Financial Products and Services, the Government has implemented a range of measures with the objective of strengthening the protection for consumers of financial services.¹⁸ However, many of these measures contain significant loopholes or concessions (including the exemption of most life insurance commissions and balanced scorecard arrangements), leading to weaker protections where consumers arguably need it the most. These loopholes were strenuously opposed by ISA and consumer groups.

¹⁴ Page 9, ASIC submission to the Inquiry on the Scrutiny of Financial Advice, December 2014

¹⁵ ASIC (2012) *Report 279 Shadow shopping study of retirement advice*, p 12-13, and p 36

¹⁶ <http://download.asic.gov.au/media/1344218/rep337-published-18-April-2013.pdf>

¹⁷ ASIC (2011) *Report 251 Review of financial advice industry practice*, September 2011, p 7

[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep251-published-13-September-2011.pdf/\\$file/rep251-published-13-September-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep251-published-13-September-2011.pdf/$file/rep251-published-13-September-2011.pdf)

¹⁸ The FoFA reforms as legislated contain a number of carveouts on the ban from commissions, The Life Insurance Package of reforms currently before the Senate does not remove commissions from the life insurance sales environment despite the considerable body of evidence supporting their removal

While ISA recognises the need to strike a balance between addressing consumer harm without imposing unnecessary burdens on business, too often has the regulatory pendulum swung in favour of business than consumers of financial services.

The importance of strong consumer protection for consumers of financial services is heightened by the compulsory nature of superannuation, the evidence that choice within super does not lead to better outcomes and a well-established lack of engagement by consumers.

While it is not the Review's task to solve these problems, the following recommendations may go some way in delivering meaningful outcomes for consumers of financial services.

4. Recommendations

4.1 Issue 1 – Stronger regulation of product design and distribution

Under the current law, there is no obligation in relation to issuers and distributors of financial products which requires that the products are suitable for purpose.

Stronger regulation around financial product design and distribution could help prevent consumer losses arising from cases such as Storm Financial, Opes Prime and TimberCorp where poor product design and inadequate protections around distribution resulted in millions of dollars of loss to consumers.

Section 12ED of the ASIC Act imposes an obligation that financial products and services are 'fit for purpose', however the test is limited in scope, lacks certainty and does not provide sufficient protection.

The protection offered by 12ED is inadequate for the following reasons:

- The implied warranty is only applicable to the contract between the provider and the consumer, and does not give the regulator any power to act where a breach of 12ED arises.
- The fit for purpose tests in 12ED does not require a product provider to investigate the personal circumstances of the consumer.
- The obligation is limited to circumstances where the person expressly or impliedly makes known the particular purpose, or the desired result that he or she seeks to achieve - unless the consumer does not rely on, or it is unreasonable for the consumer to rely on the supplier's skill or judgment.

These recommendations are particularly relevant in the general advice market, where sellers are not bound by an obligation to act in their client's best interests and may therefore legally sell a product that is unsuitable or detrimental to consumers.

4.1.1 Proposed recommendations:

ISA recommends consideration of the introduction of a targeted and principles-based product design obligation upon issuers as recommended by the final report of the Financial System Inquiry.

The obligation would consider the following factors:

- The type of consumer whose financial needs would be targeted by the product
- The type of consumer whose financial needs would not be addressed by the product
- The best distribution method for the relevant product – for example personal advice, digital advice or general advice (or all)
- Ongoing reviews throughout the lifecycle of the product

To complement the product design obligation ISA recommends the introduction of a suitability requirement upon distributors which would require:

- An assessment of whether the client falls within the target group identified in the product design phase
- Full disclosure of any attached commissions or fees in relation to the sale of the product
- This obligation would apply to product sales through individual general advice

These recommendations would have the effect of minimising instances where:

- Products are designed without consideration of the type of consumer in mind
- Products sold are underpinned by complex arrangements which consumers do not understand
- The distribution of products undermines the best interests of consumers (particularly through general advice channels)
- Products sold have complex exit fee arrangements detrimental to the consumer¹⁹
- Consumers remain in poor-performing products due to high exit fees (eg Legacy Products)²⁰

4.2 Issue 2 – General prohibition against unfair commercial practices

The Issues Paper notes that the ACL does not contain a general prohibition against unfair commercial practices. This raises the issue of whether aggressive commercial practices or business models are not adequately addressed by the ACL through the unconscionable conduct or other provisions. The Issues Paper cites the example of business models based on ongoing fees, or fees that are significantly disproportionate to the cost of providing the goods or service, where businesses have little incentive to adequately inform consumers about fee structures as an area for consideration.

The vertically-integrated model of distribution prevalent in the retail sector has created a situation whereby products distributed through general advice channels may undermine the client's best interests. It has also enabled banks to capitalise on pre-existing business banking relationships with employers to persuade them to take up the bank's default super.

4.2.1 Proposed recommendation

The ACL should contain a general prohibition against unfair commercial practices, with a specific mention of business models based on ongoing fees, commissions and anti-competitive exit fees.

This recommendation would have the effect of:

- Strengthening consumer protection against mis-selling and cross-selling of superannuation through general advice
- Enabling consumers to switch from inferior products without facing significant exit fees (potentially capturing legacy products)

¹⁹ The review should consider whether such exit fees could be recovered under the unfair contract terms of the ACL

²⁰ The review should consider whether such exit fees could be recovered under the unfair contract terms of the ACL

4.3 Issue 3 – Consumer guarantees

The Issues Paper requests feedback on whether the consumer guarantees should be extended to goods and services currently excluded including financial services. Under the ACL, services must be performed with proper care and skill, be fit for a particular purpose, or achieve a result agreed between the supplier and the consumer, be delivered within a reasonable time, or by the end date set in the contract. The ASIC Act's consumer protections differ from the ACL in that it provides an implied warranty that services will be provided with due care and skill and does not include a positive obligation on the seller that the goods are fit for purpose.

4.3.1 Proposed recommendation:

The consumer guarantees provisions should be extended to include financial services. There should be capacity for regulators to have broader powers to take representative action where a breach has been established. This is particularly relevant in the general advice sector where legal protection for consumers is limited and staff may earn commissions from sales of financial products.

4.4 Recommendations in relation to emerging issues

The Issues Paper highlights emerging issues in relation to the ACL, however does not comprehensively cover issues related to financial services. ISA would like to raise the following emerging issues to the Review's attention:

- Unsolicited approaches by retail funds to consumers with multiple accounts to encourage switching without considering the consumer's best interests (often via email or text message)
- The practice of bundling super with home loans and other products without providing comprehensive advice
- The need for greater transparency in relation to the assessment and handling of life insurance claims