BURRELL
stockbroking & superannuation

Kenneth M. Hayne
Commissioner

9th October 2018

Dear Commissioner,

RE: Royal Commission into misconduct in the Banking, Superannuation and Financial Services industry.

The purpose of this letter is to raise matters which the below signed views as not competently dealt with in the Draft Report. In particular, the focus of this correspondence arises from a review of the executive summary, chapters 1, 3, 7 and 8 with a focus on the financial services industry. This submission is set out under the following headings;

- Economic theory of regulation
- Best interests duty
- Remuneration models and financial advisory firms
- Duties and contractual terms in banking
- Ethics and Education

I. Economic Theory of Regulation

The seminal paper on "The Economic Theory of Regulation" was written in 1971 by GJ Stigler. George Joseph Stigler (17.1.1911 - 1.12.1991) was an American economist, the 1982 Nobel Laureate in economic sciences and a key leader of the Chicago School of Economics.
The Economic Theory of Regulation looks at regulation in a micro economic context. When the below signed had the joy of attending business economics classes in 1976 in the University of Queensland Commerce Honours school, this paper and subsequent studies provided an insight into regulation, which has been unmatched by any subsequent contribution. Stigler looks at the players in regulation, the behaviour that might be predicted and also outcomes.
To begin with outcomes, most regulation fails. An example studied during those classes were the indigenous communities in Australia who had for many years lived in communities on properties. They

lived in small temporary shelters called humpies or gunya. People who believed they were working in their best interests decided that the indigenous people who worked on stations, should be paid the same amount as full time non-indigenous workers. The below signed makes no comment on whether this was a socially desirable policy. What happened was that without proper education and a phasing-in period, there were un-intentioned results. Whether because station owners felt that the services were not desiring of equal pay or because they felt that the various amenities were provided to these communities and should be taken into account, the **opposite** result was achieved to what those who initiated the change intended. The station owners replaced indigenous communities with helicopters and machines, and took other means. The opposite outcome is also the likely result of the current Royal Commission.

If the object of this Royal Commission is to achieve more financial advisory services from the banking sector, then three of the four banks have exited or are exiting financial services resulting in no services being provided by those banks to their millions of customers in financial advice. Locally, we've had several discussions with the Bank of Queensland who have advised that their model is to provide no financial planning advice or investment advice whatsoever. Likewise we've seen many of the major financial institutions including Macquarie Bank, Morgan Stanley and the like announce that they will retreat from providing advice to the vast majority of Australians known as Retail Customers and will only advise high net worth individuals.

The Royal Commission may well say this was well underway before they commenced work and indeed this was so. The returns on wealth management advice have been poor for the banks, which stands in rather stark contrast to the findings that the banks were ripping people off and earning high levels of income. The fact is that the return on equity from the wealth management businesses of the banks has been materially less than the returns on their banking business.

The regulatory framework is almost impossible for the banks and the Royal Commission is the nail in the coffin which will result in banks providing almost no wealth management services to the average man in the street.

The Royal Commission has seen several examples of the economic theory of regulation;

- The mortgage broking industry has grown quickly and the below signed was stunned to see that 56% being the number of all borrowers approaching a mortgage broker rather than their bank. Talking to selected borrowers including our own staff, they simply say that the mortgage brokers provide a better range and loans at a lower cost than they can obtain even from their own bank. The banks of course would love to return to the scenario where borrowers went to them directly. By finding some examples of mortgage brokers who may have been driven by unethical behaviour, they seek to cast doubt on an economically important part of the Australian borrowing environment.

  The net result was that even though the mortgage broking industry has had three inquiries and had their practices and business models cleared by ASIC and the government, we saw a number of instances of unethical behaviour before the Commission. We then saw the Commission make

a recurring mistake in terms of seeking to make conclusions about remuneration, dealt with below.

- Another example of the economic theory of regulation is that it is in the best interests of the industry funds, for the main part non-advisory, to seek to damage all advisory service providers. Industry super funds are prescribed under union awards and so the money simply flows in without any need to provide advice.
  Like all sectors within superannuation be it industry super funds, retail super funds or self-managed super funds (SMSF), there will be good performers, poor performers and those in the middle. There have been some appalling performances in all sectors, but the industry super funds appear to have escaped unscathed. Despite instances of dialling up risk and suffering poor returns including the MTA super fund, UniSuper, Australia Post. The top performer for this year HostPlus purports to be a balanced fund, but in fact is properly classified as an Alternative (ALT) fund. HostPlus should not be included in the balanced fund schedule at all.
- An example of the adverse outcomes explained by the 'Economic Theory of Regulation' is the legislation to outlaw charging of fees on group life policies. The industry funds lobbied hard for this attack on the advisory industry. Life assurance is a grudge purchase and the majority of Australians are under insured. Prior to this legislation, an insured representative would be on hand when a person retired or resigned to ensure the life cover from the group scheme was moved under the guaranteed insurability clause to a personal super plan. Those insurance reps are no longer in place – surprise, surprise people won't work for no pay. So we have seen retirees leave work, go on long service leave and return to Australia to see their life cover cancelled after the six week rollover period expired. In one case the letter from the insurer arrived after the six week period.
- A further example of the agents in Stigler's 'Economic Theory of Regulation' is the Commission itself. It is comprised almost entirely of lawyers including counsel assisting the Commission and the Attorney General's department. If what is sought to be achieved is simply to interpret the existing law and give vent for prosecution, then such a composition is fine. But if what is sought to be achieved is to make some recommendations about the financial services industry, then a Royal Commission including three commissioners or assistant commissioners, one of whom has Stigler's background such as a Professor Officer who both understands the economic theory of regulation, understands the financial services advisory industry and understands the complexity of remuneration issues need be appointed. In the absence of such assistant commissioners, the probability of a commission comprised almost entirely of lawyers making value added recommendations to the financial advisory industry is seen by the writer as low. It is much more likely that per the indigenous example above, the opposite result will be achieved.

II. **Best Interests Duty**

One of the more common mistakes of regulators is to think they can simplify an industry and propose regulations which add value to the community and to the industry. Regulators also tend to operate in a costless world. At first blush, the "best interests duty" is an example of such regulation.

In a zero cost world, financial planners would earn no remuneration, they would be able to look at the full spectrum of the products on offer (some 600 managed products in Australia in addition to direct investments) and would make perfect recommendations. Notwithstanding that many would be quick to say "well that's ridiculous," the fact is that the Draft Report is consistent in many places with a costless regulatory model.

Wealth management when defined to include investment management and financial planning is a labour intensive and expensive advisory industry. One of the reasons is it involves a large degree of education. Education has one of the highest cost labour intensive workers in Australia – note: universities and others delivering education.

There is a tendency in the Draft Report to adopt the simple model that there are only two types of service delivery; non-advisory and full advisory (which we call wealth management). This is of course a ridiculous proposition. You don't go to a legal firm and ask them to advise you on every area of the law that might impact upon you. You don't go to a dentist and ask for every service that they might be able to provide. In fact you don't go to any professional and say, "Well the model is either non-advisory or full advisory." In fact the whole proposition is preposterous.
Yet that is the model that the Financial Planners Association (FPA) and many regulators have sought to impose upon the financial advisory industry including the banks. In practice, if one is to adopt the mantel of our firm, that we will provide advice to all comers, and to the extent that we are unable to charge for that, then that is part of our social responsibility. A key part of that service delivery is to agree with the client as to what services are to be provided. This is called scalable advice. Scalable advice in the context of the writer's firm is an area that we have spent some time seeking to define and even in this year's 'Triple 6' objectives- being 6 objectives for the firm, 6 for the business segment and 6 for each person, we've again made strides in seeking to segment the advice into areas such as non-advisory, general advice (no relevant circumstances), portfolio advice (sufficient relevant circumstances to determine asset allocation), superannuation advisory and wealth management
Wealth management = investment management + financial planning
Investment management = portfolio management + performance measurement

Regulators and the commission must understand that the financial advice industry is not two polar extremes of non-advisory and full advisory. It is a set of railroad tracks and the important things is to act ethically having agreed with a client the level of service that is to be provided. This is indeed what all professions do, what lawyers do with letters of engagement. The regulators in the financial advisory space have done the professions a great disservice by seeking to simplify what are complex matters.
A non-advisory / full advisory model imposed by the regulators including the Commission on the banks has done the Australian community a great disservice. There is no reason why the banks should not be allowed to manufacture a set of products which are the best products that they are able to manufacture. Having done so they train their people in those products. They then say to their customers that these are the products which we have been able to manufacture and which we are able to offer. We are not giving you independent financial advice and we are not seeking to cover the 600 managed products let alone direct products. The best interests duty has been interpreted so the banks are unable

to make this cost effective offering and the net result is that the banks are exiting the financial advisory space, leaving millions of Australians without any cost effective advice whatsoever. To this extent, the "best interest duty" is a regulatory failure.

III. Remuneration Models in Financial Advisory Firms

Barristers have a failed remuneration model at least as far as it concerns the general public. They charge $7000 - $14,000 per day locally, probably higher down south. No one can afford to consult them other than large corporates, governments, and people who decide to take on cases for principle. Most businesses do everything they can to avoid the courts to settle disputes.

Most financial planners earn fairly meagre incomes. Some of the service fees received are $2- $10 a month on different products. The major accounting firms have been unable to make money out of financial advisory because their charge out rates are $500 - $1000 per hour per partner. They include some financial advice to high net worth clients who can afford these rates, but largely do not advise the majority of Australians in this space.

The writer's firm has for many years offered to provide financial planning advice on an hourly basis. Almost nobody has taken advantage of this offer. One of the reasons is that they have become aware during their lives of hourly rates being charged by professional lawyers, accountants and others and the last thing they want to do is to sign up on an hourly basis for financial planning advice in retirement.

Moreover, financial planning advice requirements vary dramatically from year to year. Across an individual, there will be periods of requests for large amounts of financial planning advice in years where retirement, a property settlement or a decease in the family occurs. The highlighting of the fees charged when people decease in the Draft Report is ridiculous. When people decease, large amounts of financial planning advice are given. For example, a couple of months ago we had a client who had a small portfolio come to see us after her husband deceased. He was an NAB manager. Her allocated pension product provided that the funds were to be paid to her upon decease. We were able to work with the large insurer to arrange for the allocated pension to be reversionary. This was a material advantage to the client in achieving this outcome, despite the fact that the PDS appeared to the contrary. A death benefit pension is now in place. There's then a question of how to charge for this – is it an upfront consultation fee, an upfront service fee or the majority of people would prefer that there was a service fee charged over a period of time, notwithstanding that the bulk of the work is done upfront. Again the interim report fails to understand that just as judges and lawyers like to be paid regularly, so do those in the financial planning industry. So it is quite common for service fees to be paid over a period of years rather than for an amount to be paid upfront and there is nothing wrong with this as an industry model. The key issue to understand from the Perpetual studies is that the more time invested with a client upfront, the greater the probability of a long term value added relationship. Studies show on a time cost basis, an investment of $3,000 - $7,000 is required. Many clients won't pay this, so the dilemma is whether to provide no service or our preference, which is to provide the service and negotiate a fee model with the client that they are agreeable to.

It is dangerous for regulators and the Royal Commission to be making statements about remuneration, when the underlying theme seems to be that financial planners should earn no remuneration or that they should only be allowed to charge on an hourly basis. Neither of these models is particularly practical for other than high net worth individuals and a small group of clients and financial planners who wish to pursue this pricing model. For most everyone else, there will be cross subsidies across a person's lifetime with some years being high demand and others low demand and there will also be cross subsidies between charging a fee on assets and charging for financial advice. Finally there will be cross subsidies across clients with some requiring large amounts of advice when they can least afford it, for example on marriage breakup, whereas others in that particular year may not require much advice. Regulators and the Commission interfere in a complex industry with a likely result being sub-optimal outcomes and less advice provided rather than more.

IV. Duties and contractual terms in banking

When the writer studied law (he wasn't much good at it), the duties of bankers were high including duties of confidentiality, duties of disclosure etc. One area where the Royal Commission should be able to make headway is in considering what has happened over time ie that the banks have utilised the services of lawyers to severely reduce their legal responsibility for duties to clients and to include in contracts unconscionable clauses allowing them to act without a proper investigation of client circumstances and to bring good businesses into administration or to wipe out large amounts of equity when all they are focused on is recovering their secured debt. This contractual whittling away of the duties owed by banks to customers has led to a culture where they do not necessarily act in their client's best interests. Given the negative comments on the best interest duty above, any "best interest duty" that might be recommended for the banking sector needs to have some significant caveats for it to be at all workable. In fact the reading the writer has done indicates there is no best interest duty under current law for the banking sector and so some of the behaviour before the Commission is hardly surprising.

One other aspect is to comment upon is the over-emphasis given by the Commission concerning the bank industry assessments of customer expenses. In the costless world that regulators and Commission like to operate in, then obviously you would require a full set of expenditure from each customer, suitably audited and the banks would be able to make individual assessments. This costless world does not exist. Most individuals have bank accounts for personal expenses which are a shemozzle. Some of the worst belong to barristers, some of them spend all they earn and still have no money for tax.

Common sense would indicate the banks would use benchmarks to reduce the cost of assessing individual's expenses. To the extent banks are precluded from using benchmarks, banks will increase the disclosure duty on customers, costs will increase, speed of lending will decrease and a number of potential borrowers will be refused funding.

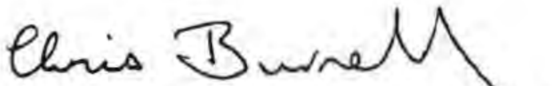
V. Ethics

Ethics is **right thought, right action.**

Ethics define a profession and responsibility falls to the professional firms and professional bodies. This is the legitimate function of such professional bodies. It is often said that one can't legislate for ethics. Education is important, likely via on the job training and life experiences as well as formal education. The education requirements for financial advice are already high and regulations are tough – almost impossible to comply with. FOFA has raised the bar dramatically and is working well.

The Economic Theory of Regulation might predict regulators and politicians demanding more and more education. It might also predict politicians have no requirements to even undertake a week course on macroeconomics and microeconomics before they take their seat in the Australian Parliament. Traditionally existing practitioners of long standing are grandfathered into education changes. That this is not proposed under the most recent changes is appalling. It amounts to discrimination against older workers.
And then there's the fact that barristers are not liable for negligence. But investment advisors and planners can be held liable for market changes which weren't foreseen or foreseeable. It may be that those who require the most education in financial advice aren't the financial advisors at all.

Yours truly,



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