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**Submission**

# Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

26 October 2018

**ABOUT ADVISER RATINGS**

Adviser Ratings launched in October 2014, in the wake of the Future of Financial Advice reforms (FOFA), the Financial System Inquiry (FSI) and financial planning scandals of the time. Adviser Ratings' vision is to improve the penetration of advice amongst Australian consumers. There are more than 24,000 financial advisers on its independent platform, enabling consumers to browse and search for an adviser suited to their needs, rated and reviewed by other consumers.

Adviser Ratings has evolved into a data and technology company providing services to the wealth management industry including advice Licensees, super funds, life insurers, fund managers, investment platforms and software providers.

Adviser Ratings has teamed up with researchers from the UNSW Business School led by Professor Jerry Parwada, to develop an evidence-based methodology of assessing the quality of financial advice in Australia.

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**INTRODUCTION**

Adviser Ratings welcomes the opportunity to make a submission in response to the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

In its Interim Report, the Royal Commission acknowledged the financial planning system needs to be looked at in more detail - the Commissioners and the market are in general agreement that a self-policing regime rather than new legislation is the way to go. Our submission is based on a proposal we have crafted for a system to systematically rate the quality of financial advice, initially at the Licensee level, and subsequently targeting individual advisers (Adviser Ratings, 2018). Adviser Ratings proposes to establish a new rating system for Licensees designed to align the quality of advice to customers with the institutional attributes of those institutions and to enhance the clarity and consistency of information used by clients to select financial advice providers. Our proposed Licensee rating system represents one way for the industry to demonstrate that it is serious about ongoing self-introspection to safeguard against the return of past excesses and misconduct.

The proposal reflects insights gained from extensive consultation, including roundtable discussions and semi-structured interviews of practitioners, regulators and policymakers held during 2018. We believe that a well-constructed, evidence-based rating methodology will lead to greater discrimination across purveyors of financial advice based on quality and risk. The submission reflects our experience and previous research. The proposal incorporates plans for scientific validation of the key drivers of our rating model as well as its ongoing maintenance, stress testing and development.

Most of what follows is a summary of Adviser Ratings' earlier research work. We specifically respond to questions raised by the Commission in its Interim Report that pertain to the financial advice industry. That is the focus of the present submission.

**ADVISER RATINGS' LICENSEE RATING SYSTEM**

The focal point of the Rating System is to predict actions within a Licensee that are detrimental to clients' interests. At stake is the threat to retail customers' willingness to access financial planning services. It has been argued in theory that a key function of financial advisers is to convince households to trust the financial system (Gennaioli, Shleifer and Vishny 2015). However, recent studies demonstrate that even indirect exposure to misconduct destroys trust and results in non-participation (Georgarakos and Inderst, 2014; Giannetti and Wang, 2016).

Smith (2010) shows that the prevalence of unethical conduct in Australian financial planning groups should be identified by the Australian Financial Service Licensee's risk management and compliance systems but are not. Our approach to assigning ratings will employ a sequential analysis, comprising:

- An assessment of the executive and governance strength of the Licensee
- An assessment of the advisers under the Licensee
- The third set of factors represent assessments that are overlaid over the largely quantitative first pair of assessments. We combine these assessments, stage-by- stage, to generate ratings for each Licensee.

By utilising machine learning and academic rigour, a scorecard will be built based on this framework. The components of the platform will bring together a cross collaboration from specialist technology firms and researchers at UNSW led by Professor Jerry Parwada. The scorecard will provide the structure to express the analysis that determines the Licensee Ratings by capturing and communicating in a systematic fashion the following:

- Historical performance based on authenticated data;
- Expectations for future trends in determinants of quality of advice;
- Qualitative adjustments to the model-driven scores, capturing other relevant qualitative information as well as broader considerations that the metrics do not necessarily capture.

The platform will consume both structured and unstructured data from a range of sources (Adviser Ratings, UNSW, ASIC, Licensees and procured data from sources such as Equifax).

The platform will integrate with an emerging artificially intelligent data extraction platform provided in collaboration with partners. Given the ingestion of sensitive data, the platform will be built secure by design, anticipating cyber vulnerabilities and malicious attacks. With the amount of superannuation at stake and the ability for malicious cyber activities to undermine the system's stability, a key weighting will also be applied to the cyber security of these licensees.

Key outcomes are both broad and massively beneficial, given the $2.6 trillion in Australian superannuation funds under management alone at stake.

**The outcomes of quality of advice rating system for Licensees?**

1. Improved adviser-client relations
2. Improved regulator relations
3. Increased awareness of customer welfare issues
4. Greater focus on preventive compliance and early problem detection

**The outcomes of quality of advice rating system for advisers?**

1. Greater practice focus on clients' access to advice
2. Focus on preventive services for early detection and risk compliance that matches their individual needs
3. Access to a reference / differentiation / risk defining focal point when an adviser is considering switching Licensees

**The outcomes of quality of advice rating system for customers?**

1. Access to an independent aggregator of data on Licensee quality
2. Ability to identify changes in Licensee quality for use in determining whether to switch advisers
3. Increased ability to learn about the quality of past and future decisions regarding choice of advisers

**The outcomes of quality of advice rating system for other stakeholders?**

1. Superannuation funds would gain a tool for recommending advisers to members
2. General insurance companies would have access to metrics for risk assessment (e.g. for professional indemnity insurance)
3. Financiers would have access to metrics to help with due diligence screening in advance of providing funding to licensees, or to assist with surveillance of their credits
4. A range of vendors to the advice industry, including fund managers and platforms, will be able to leverage the information for counterparty risk assessments and ongoing surveillance
5. Regulators and government would have a secondary source of macro and micro intelligence to augment their own industry surveillance, supervision and policy decision making.

The rating system will create an enduring legacy for the participants in the market, where information asymmetry is profound and where greater trust and transparency is required.

**What has been the market's response to the proposed rating system?**

The proposal received resounding support during roundtables and semi-structured interviews. We subsequently invited comments to the proposal. Admittedly, there has been a minority of industry participants who have opposed the idea of a rating system. In the interests of full disclosure, we summarize the major concerns of such parties as follows:

- Rating systems (e.g. in the corporate credit markets) have failed to predict market failures such as the Global Financial Crisis.
- A rating system fails to incorporate the failure of regulators to police and sanction misconduct among financial advisers.
- A rating methodology developed by a private entity is potentially conflicted due to its own profit motive.
- The proposed rating methodology does not sufficiently incorporate the internal incentive structures of financial planning firms and groups such as conflicted remuneration models that induce financial misconduct and unethical behaviour.
- Being at the Licensee level, the rating system does not accommodate the diversity of roles performed by Licensees that includes activities that do not require knowledge or oversight of individual advisers (e.g. in corporate advisory services).

The criticisms are well taken and will inform the final outcome. Our White Paper provides details of solutions to some of the issues, including the management of conflicts through independent oversight of our rating methodology as summarised below. An industry shared ownership model of the system is also under discussion. As data availability improves over time, we hope to incorporate greater inputs reflective of conflicted incentives and individual adviser-specific metrics. Our overall view is that the benefits of a transparent rating system make it imperative for the industry to embrace quality assessment disclosures as a partial solution to the dearth of attention to the implications of bad advice on retail clients.

**Governance framework for managing conflicts of interest**

In order to mitigate conflicts of interest, we will take a number of steps:

- In terms of internal arrangements, these measures include, for example, a clear separation of function between those who negotiate the business terms for the ratings assignment and the analysts who conduct the analysis and provide the ratings opinions.
- Another safeguard is the rating committee process that limits the influence any single person can have on ratings opinions. The role of the committee is to review and assess the analyst's recommendation for a new rating or a rating change as well as to provide additional perspectives and checks and balances regarding adherence to the ratings criteria. Executives and managers, who respond to applicants' ratings requests and deal with commercial matters such as pricing, contract negotiations, and maintaining client relationships, do not participate or vote in rating committees.
- A further safeguard is the appointment of a Ratings Committee with a compliance officer as an ex-officio member that has access to all documentation of the company she/he deems necessary to carry out his controlling and supervisory role and can independently report likely conflicts of interest.

- Finally, the Board of Directors establishes clearly defined policies and procedures. To ensure maximum level of independency, the Board is not involved in the issuing rating process but appoints the compliance officer and the rating committee.

**Business model**

The business model envisaged is akin to the widely-accepted approach taken by global credit rating agencies and Australian investment and superannuation research houses. This comprises a combination of subscription revenues driven by the licensing of research to interested third parties, and the charging of fees to rated entities for solicited ratings. Importantly, in relation to the latter, Adviser Ratings recognises the potential conflict of interest in charging rated entities and for that reason will implement the governance framework described previously. Furthermore, we will explore two alternative fee models for solicited ratings:

- flat fees charged annually to prepare and maintain a solicited licensee rating, with full rights to the licensee to market that rating publicly at no additional cost;

- no fees payable by the licensee for preparing and maintaining a solicited licensee rating, unless the licensee should wish to market the rating publicly, for which there would be an annual licensing fee.

In all circumstances, the fees charged would be entirely independent of the rating outcome and established before the rating engagement.

**RESPONSE TO THE COMMISSION'S INTERIM REPORT**

In the following, we respond to the Commission's additional questions (see pages 156-158 of the Commission's interim report). We cite the relevant questions in bold and provide our comments in italics.

- **"How does a financial adviser's employer encourage provision of sound advice (including, where appropriate, telling the client to do nothing)?"**
- **"How do advice licensees encourage advisers aligned with the licensee to provide sound advice (including, where appropriate, telling the client to do nothing)?"**
- **"Can conflicts of interest and duty be managed?"**

*In our view the existence of a rating system that is underpinned by analysing the contribution of each adviser to the aggregate quality of advice at the Licensee level represents one way of developing a shared culture of individual advisers taking responsibility for their actions. Licensees who embrace disclosures of the quality of their advice develop a culture of shared ownership of actions that affect retail clients.*

*The knowledge that misfeasance by an individual would harm other associated advisers through the rating of their Licensee would, for the first time, publicly align the employers' and advisers' incentives to encourage the provision of sound advice. This would be equivalent to the fine tradition of shared tips in the Australian hospitality industry – an employee that mistreats a customer is committing a similar action to 'raiding' the tips jar to the detriment of co-workers.*

*To the extent that a Licensee rating takes into account conflicts of interest, our methodology provides a gauge against which such conflicts are managed.*

- **"Should all financial advisers (including those who now act as authorised representatives of an advice licensee) be licensed by ASIC?**"

*Once the market becomes familiar with a Licensee rating system we would be ready to add the rating of individual advisers who take up their own licenses as anticipated by this question. We believe that individual licensing would bring the issue of organisational reputation closer to the individuals who make up the industry. Moving to individual licenses accompanied by a transparent quality of advice rating system aimed at individuals would represent a big step towards professionalisation of the industry, in line with contiguous professions such as accounting and medicine.*

- **"Are current product and interests disclosure requirements sufficient to allow customers to make fully informed choices?"**
- **"Should the period after which a client must positively review an ongoing fee arrangement be reduced from two years to one?"**

*It is our view that there will always be a grey area between insufficient information disclosure and excessive requirements. The Commission has already identified problems with the current regime for the review of ongoing fee arrangements as implied by the second question immediately above. One way to resolve these problems is for an independent party to assess and publish its findings about the quality of disclosure. Indeed, this would be one input for the proposed Licensee rating system.*

- **"When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee inform their clients of the reason for termination?"**
- **"When an employee or authorised representative is terminated for fraud or other misconduct, should a licensee review all the files or clients of that employee or intermediary for incidents of misconduct?"**

*Although this is a complex matter that intertwines with Australia's strong privacy laws, we concur, in principle, with the view that past misconduct and the movement of tainted individuals through the industry, sometimes congregating at the same employer, are predictors of future misconduct as documented by the literature we cite in our White Paper (see page 11). As such, having a Licensee rating system that contains aggregate data on the misconduct records of advisers employed by a Licensee helps individual customers to digest information on this dimension of quality of advice that would otherwise be almost impossible to distil from a confusing myriad of information sources.*

**REFERENCES**

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