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Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: fsi@treasury.gov.au

**SUBMISSION ON THE FSI REPORT**
**LIFE INSURANCE ADVICE**
**RECOMMENDATIONS 24 AND 25**

We refer to the final Financial System Inquiry Report (**FSI Report**) and the request for submissions. This letter provides our submission in respect of those parts of the FSI Report directed at the provision of financial advice, and life insurance advice in particular, including recommendations 24 and 25.

We support the broad thrust of the commentary and recommendations of the FSI Report in these areas and in particular the focus on the fair treatment of customers, client best interests and rebuilding consumer trust. However, we believe the recommendations on life insurance adviser remuneration are unnecessary and will, in practice, likely drive undesirable outcomes. This is not to say we see no need for change; on the contrary; but not the changes proposed. Furthermore, in our view, the FSI Report has overlooked some key issues that are distorting behaviours and the market and which should be addressed.

We outline and explain our view in this submission.

### Background to ClearView

ClearView Wealth Limited is a listed life insurance, funds management and financial advice group, which includes a registered life insurer (ClearView Life), a registered superannuation entity (ClearView Life Nominees), a responsible entity (ClearView Financial Management) and two financial advice licensees (ClearView Financial Advice and Matrix Planning Solutions).

As a product provider, ClearView is experiencing substantial growth in the advised product markets in both life insurance and wealth management, but especially life insurance (growth of approx 40% pa). Our advised life insurance products have achieved significant success over the last few years. Our advice licensees support over 200 authorised representatives advising on over $7b of funds under advice and $150m of premium under advice.

We are well aware of, and understand, the issues canvassed in the FSI Report.

**General Observations**

We agree with much of the commentary in the FSI Report concerned with the level of poor quality and less than client "best interests" advice provided by too many life insurance advisers, and with similar commentary in ASIC Report[1] released in October 2014. Indeed, we believe the industry continues to have problems across all financial advice, including where it is struggling to realise the intended outcomes of the FOFA regime. In our view, the advice industry, and those that support it, need to:

- Change into a client focused profession with a "professional" culture;
- Raise education and skill levels;
- Change the dominant advice process and mind set to one that is professional, that starts by understanding the client, determining "the problem", developing the financial strategies to respond to that, then help implement the solutions, including products.
- Adjust remuneration structures and forms, both payments to advisers and payments to AFS Licensees (**AFSLs**), as well as other environmental constructs, so that these do not act to undermine or distort the desired outcomes for customers.

Within the broad public debate over recent years, much attention has been given to part of the last point above - adviser remuneration. Outside recent formal analyses such as the FSI Report and Fawcett Inquiry[2], much less attention has been given to the first three points – raising education levels, becoming a profession, mind set change, culture and the process. Virtually no attention, other than in the Trowbridge Report[3] just released, has been given to the impact, on client best interests and advice quality, of the payments made to AFSLs and a number of other environmental factors and constructs involving AFSLs.

Many seem to think that if we remove conflict from adviser remuneration we will fix the problem. Others seem to believe that moving to "fee for service" is the obvious answer. Few seem to understand that simply changing adviser remuneration structures or levels will not in itself drive the other three changes or address the AFSL driven distortions. Even fewer seem to actually articulate what it is about an upfront commission, other than encouraging some element of undesirable business "churn", that involves material conflict of interest per se.

If one employs staff on a salary but specifies no performance criteria or expectations, and indeed pays a bonus for taking lunch and has rules that stop staff using the best equipment, one should not be surprised by a poor performance outcome. Alternatively, if one specifies performance expectations and criteria, and removes the distorting bonuses and rules, a much better result should emerge. The salary paid at the time of the wrong activities may appear correlated with the poor results but it is not the actual problem in this illustration. Excessive deferral of salary payment as part of a reformed approach would add little to fixing this problem but may well lead to a demand for increased salaries or the exit of staff!

We need to remain focused on the key outcomes we all want to see:

- Ensuring the industry's customers receive quality financial advice in their best interest;
- As many Australians as possible have access to appropriate financial advice, life

[1] ASIC Report 413, Review of Retail Life Insurance Advice released in October 2014.

[2] Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry, December 2014.

[3] Review of Retail Life Insurance Advice, Final Report, by John Trowbridge, 26 March 2015 sponsored by the FSC and AFA.

insurance advice and life insurance products; and

- The advice and life insurance industries be exposed to vibrant competition to drive innovation, efficiency and effective outcomes for their customers (existing and future).

A fixation on adviser remuneration structures will not, alone or even substantially, fix the historic problems. Again, we emphasise we are not saying that there are no issues with aspects of current life adviser remuneration structures but rather, simplistic, "slogan based" solutions about level commissions and the like are well wide of the mark.

**Professionalism, Culture, Education, Advice Process Standards**

The FSI Report has made a number of recommendations aimed at improving the quality of advisers, their professionalism and related environmental factors, including:

- Various changes to issuers' "design and distribution" obligations;
- Lifting adviser education standards (relevant tertiary degrees, competencies, CPD);
- Introducing an enhanced ASIC adviser register;
- New regulator powers to ban "bad apples" from financial firm management; and
- Improving financial firm ownership transparency.

We support these recommendations (subject to accommodating practical transition).

However, we suggest one important item in this area was not considered in the FSI Report. If there is a desire to see financial advisers transition into a profession, then explicit action to implement a professional framework should be pursued. Most professions are associated with membership of professional bodies, where there is an element of co-regulation/liaison between industry regulators and the professional bodies.

- A prerequisite for industry licensing is membership of an accredited professional body;
- Such a prerequisite then gives the professional body meaningful teeth (the ability to sanction and even suspend or terminate unsatisfactory members); and
- This then means the professional body can issue enforceable professional standards.

Such a construct would help drive a professional mind set, enable codes of ethics to be implemented, assist the development and driving of professional, client best interest advice processes, and ultimately drive the sort of professional "culture" we would all like to see, cornerstoned by advisers with a robust fiduciary understanding. Looking like other successful professions is a big step in the direction of acting like them.

We believe this would be a much better and effective model than a model where ASIC is the sole regulator. ASIC regulation will not generate the same professional pride and attitude.

Such a model should include incorporated AFSLs as "affiliate" members of the bodies.

We note the recent Fawcett Inquiry made recommendations similar to our comments above. We very much support the thrust of the Fawcett Inquiry recommendations, subject to some debate around some points of detail and transition which is beyond the scope of this letter.

The comprehensive implementation of such a framework, together with the FOFA "best interests duty" as it becomes ingrained and fully understood, would substantially address the adverse financial advice issues that we are currently concerned about.

We are concerned that regulatory policy does not "over-correct" the current advice and remuneration policy settings of FOFA. A great deal of the current focus on up front commissions arises from the sole empirical source of ASIC Report 413. That Report sampled adviser files from the first weeks after the new laws commenced in 2013. The Report found (Paragraph 151) that post FOFA files had higher pass rates than pre FOFA files.

The history of financial services regulation is one littered with the policy circumvention and avoidance, especially where the policy focus has been on remuneration to the exclusion of other critical environmental factors. For policy reform to be effective in relation to recommendations 24 and 25, it is vital that the broader perspectives in this submission are addressed.

Before leaving this area of discussion, we would raise one final "professional" point. It is common for other professions to be sensitive to their members operating within structures that may have ethical/professional perspectives inconsistent with that expected of their members. In this context we question the legitimacy of financial advice businesses within large vertically integrated groups reporting via the head of distribution of the group's product provider and/or governed by a puppet Board. Yet this has been a common structure to date and represents one of the many "environmental distorters" we referred to earlier that the FSI Report has overlooked (although the issue was alluded to in the recent Fawcett Inquiry). In our view, such conflicted management structures should be prohibited.

**AFSL Behaviour Distorters**

As noted above, there has been much focus on the behaviour of the individual financial adviser and their remuneration structures, but little consideration of AFSL remuneration structures and the restrictions they impose that limit or distort best interest advice.

Beyond the governance observations noted immediately above, other issues include:

- AFSL volume rebates, i.e. rebates and fee payments based on percentages that vary with sales volumes, or similar "low lapse rate" bonus payments. These all focus on single insurer product "sales" and detract from client best interests servicing and advice.
- Unreasonably narrow Approved Product Lists (**APLs**)[4], or "shelf space fees" charged by AFSLs for insurers to get on their APLs. How an adviser can even give best interest advice with access to only a narrow range of products is highly questionable. Single or narrow product menus may be acceptable under "general advice" direct sales channels, but are not acceptable for client best interest, strategic and product "personal advice".
- There has been much commentary on placing requirements on advisers, but little on the way AFSLs should structure their business models, training and competency models, and their monitoring and supervision models, to support and drive these outcomes.

An AFSL within a vertically-owned financial services group, with a narrow group product focused APL, reporting via group "distribution" must almost inevitably have a sales based culture that will swamp any adviser remuneration structure or client best interests duties.

These AFSL related matters and concerns have been completely overlooked by the FSI Report and many others, yet we see them as a large and core part of the problem.

[4] Narrow APLs are a common feature of advice businesses operating within large, vertically integrated financial institution groups, where the institution's products are prominent on the APL.

Most critically in our view, it should be noted that the "self employed", personal advice market for retail life insurance is already heavily concentrated in the hands of vertically-owned institutional groups. An outcome from restricting or limiting adviser remuneration that drives further concentration of "advice" being provided via such AFSLs, via narrow or even one product APLs, will fundamentally fail to meet the reform objectives.

It is one thing for an adviser to join an AFSL owned by a group with products, services and a culture they regard well and willingly recommend to many of their clients. It is an entirely different thing to force advisers into "aligned" AFSLs with narrow APLs simply to survive.

We note that some of these issues were tackled in the most recent Trowbridge Report. In particular the Trowbridge Report made recommendations on banning shelf space fees and limiting AFSL remuneration and volume bonuses.

However, we do not believe the Trowbridge Report has got the balance right:

- Trowbridge recommends requiring APLs to have at least half the insurers in the market on them. As the whole market involves only 13 life insurers, this means at least seven. We believe the requirement should simply be to have an open APL. Allowing APLs to be restricted to seven insurers provides continuing opportunities for vertically-owned AFSLs to play restrictive games. Any claimed costs of having 13 insurers on APLs are nonsense – most APLs have 100's of investment managers on them without issues.
- Some proposed restrictions, such as banning insurers support to AFSLs for education costs seem to go beyond FOFA limitations and seem to go too far.[5]

**Life Insurance "Churn"**

One of the life insurance adviser behaviours loudly complained about by many is inappropriate policy replacing, AKA "churn". This is typically portrayed as a clear indicator of issues with upfront commission payment. However, we would observe:

- While it is right to be concerned about inappropriate replacement, we must equally recognise that replacing policies in a client's best interests is entirely appropriate.
- The impacts, costs and prevalence of churn should not be overstated. There is clearly some churn, but at a macro level it is difficult to distinguish churn from appropriate policy replacement. There are no reliable industry statistics that distinguish between the two. Furthermore, analyses such as that set out in the ASIC Report comparing lapse rates and patterns by commission structure are quite flawed relative to the conclusions ASIC inferred. By our analysis, the ASIC Report analysis demonstrated only that advisers and their clients are broadly rational in their financial decisions, nothing more and certainly not any inference of the quantum of replacement business in total, let alone "churn". Detailing our analysis of this is beyond the scope of this submission, but we have provided it to ASIC and to the FSC/AFA Trowbridge process, and would be pleased to provide it to you on request.
- Care is needed not to allow those who have a commercial interest in discouraging all policy replacement (e.g. large, non-growing insurers), to use this issue as a stalking horse to reduce industry competition and/or argue for reduced (non-salaried) adviser remuneration to drive further advice industry consolidation (into their vertically-owned AFSLs).

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[5] Although we note the Trowbridge Report is somewhat unclear from our reading as to its exact intentions in this general area.

- One of the key client disadvantage elements of replacement business is the restarting of a client's exposure to the "non-disclosure" period. However, this exposure is confected by the life insurers themselves. The industry could remove this exposure if it chose to.

"Churn" is an issue. However, we do not believe it is the top issue nor "root of all evil" some infer, and it needs to be considered relative to advisers' ability to properly service their clients and recommend appropriate policy replacement.

Restricting adviser reward for replacement business so that it is not excessive relative to effort is sensible to reduce the encouragement of churn. However, great care is needed that we do not undermine the reward for advisers to acquire new clients or properly service their existing clients, or to drive other anti-competitive outcomes as above. Nor is it appropriate to create new barriers to new advisers entering the industry. We do not want a cure that has an outcome that is worse than the disease itself.

**Adviser Direct Remuneration**

This brings us to the matter of adviser remuneration.

Any restrictions on adviser remuneration models should be considered in the context of an industry model reflecting the changes set out in the FSI Report, Fawcett Inquiry and as further proposed in this submission. The question should be "allowing for all the education, professional and ethical changes now proposed, what is the remaining conflict or behavioural bias within the adviser remuneration model that demands to be mitigated".

We raise two elements to consider in this context:

- The positioning of the remuneration as to its intended character/purpose;
- Any relevant limitations that should apply.

***Positioning of Remuneration (The Language Used)***

The significance of the language used in respect of adviser financial support and payments has not been directly considered by the FSI or many industry commentators. We regard this as very important and it needs to be addressed. We see it as critical in moving the financial advice industry to become more professional in its attitudes and behaviours, and for the whole industry (advisers, AFSLs and insurers) to be clear on the intention of the financial reward provided to advisers and AFSLs by insurers. This includes clarity of the language used. Financial payments received by advisers (and AFSLs) must be seen to support the target outcome, whether they be payments received directly from the client or from an insurer (including payments amortised via the insurance premium).

We believe the industry should drop the term "commission". Retaining terms such as "commission" and "incentives" perpetuates the wrong mind set and implies a product and sales focus. A term such as "client service payment", paid from an insurer engenders an entirely different mind set directed towards a professional advice relationship.[6]

***Reform of Adviser Remuneration***

If we are to be frank and logical on this matter and avoid self-serving slogan responses, we need to recognise and focus on three key issues:

[6] In making this point, it remains important that the legal structure and form retains appropriate tax treatment. We note that "adviser service fees" under FOFA for investment products are treated as "commission" for tax purposes, so this is not a new or necessarily difficult issue, nor any impediment to a change in language.

- That all remuneration structures, of any of us, involve some conflict;
- There are few retail business models where isolated "advice" is adequately rewarded;
- If we are to change remuneration levels/forms, then we should be clear on our objectives, which means we should have some clear principles to guide the design.

We contend, that despite perceptions, those advising retail customers are primarily paid for "implementation", not for their "advice" per se. If one considers the engagement of, say, a surgeon, dentist, lawyer; the advice content involves discussing the situation, problem and the strategic direction. However, the retail customer primarily pays for the implementation: conducting the legal case; installing the braces; the knee operation.

When consumers are given the option of separating advice from implementation, they will seek to avoid paying for the advice and arbitrage the cost of implementation. We see this increasingly with retailers versus online shopping and medical advice versus travelling oversees for cheap "implementation". The Dunning-Kruger[7] effect is important here. Retail customers will, en-masse, a-priori undervalue advice in fields they are not expert. However, they value and pay for "activity" and "implementation". This is before we even introduce the issue in life insurance around the effort in acquiring and "selling" clients on the need to act to manage their longevity and disability risks.

The key issue here is that enforcing a business model that separates payment/reward from the advice and the point of key activity/implementation, is dangerous and will be open to gaming and arbitrage by clients and/or other attackers. Indeed, we are already seeing activity such as businesses which seek to takeover insurance customers post policy implementation to capture the servicing commission. Some of these offer to "split" the renewal commission with the customer, and use the customer's share to reduce the premium. Excessively deferred adviser remuneration that can be simply avoided by clients or attacked by others will undermine the advice industry's economics.

Taking into account these observations and the target outcomes desired, we would suggest adviser (and AFSL) per policy remuneration design principles such as:

- Support quality advice provision and client best interests.
- Adequately support new client acquisition (increase advice and insurance penetration).
- Take account of upfront referral and lead generation costs of advisers.
- Not encourage over "selling" or a fixation on advising on "big premiums".
- Encourage client servicing, appropriate product replacement, but not "churn".
- Financially efficient, cost effective and not exposed to client gaming/arbitrage.
- Provide sound support for the typical range of life insurance business issued. Advisers can always negotiate additional fees for particularly large/sophisticated cases/clients.
- Must not hinder industry competition for customers (existing and new).
- Must not hinder new entrants into the financial advice industry.

Based on consideration of these principles, this suggests remuneration/reward that:

[7] Dunning-Kruger have written papers and articles on, essentially, "we don't know what we don't know, and the less we know the more we underestimate our knowledge weakness". The fundamental consequence is the less someone knows and the more they need advice, the less they will value the advice (at least until after they have received it), but if the apparent price "appears" too high, they wont buy it.

- Provides some appropriate upfront payment at the point of client acquisition and product placement. Excessive deferral (levelisation) of reward will expose gaming/arbitrage, increase remuneration costs and reduce client acquisition effort. An appropriate responsibility period would be reasonable (e.g. 2 or 3 years).
- Payment (as a % premium) that may be higher for smaller premiums, but capped, limited or tiered for larger premiums.
- Payment that encourages genuine review of client needs every 2 or 3 years.
- Financial support that covers the costs incurred for the marginal additional effort for a product increase or replacement (beyond the support suggested immediately above), but doesn't provide excessive windfall gains for advisers/AFSLs for "churning".

These principles and features suggest some modification to current common "commission" structures, but a simple "level commission only" rule would be highly undesirable.

***Trowbridge Report Proposals***

The Trowbridge Report was only very recently released. There is much in that report we support. For example, for reasons similar to those discussed above, the Trowbridge Report concludes that a level only commission structure would not be appropriate or realistic to be adopted. It proposes a capped "Initial Advice Payment" in addition an ongoing level commission payment. The Trowbridge Report therefore supports our view that a level commission structure should not be legislated by government or regulators.

Nonetheless, there aspects of the Trowbridge Report we are quite concerned about:

- Continued usage of the term "commission";
- The very low cap of $1,200 applied to the proposed Initial Advice Payment (**IAP**), and a fixation on "churn" via limiting the IAP to be paid only once in five years per client.
- The potential, as we discussed above, for the overly restrictive proposals to drive further advice industry consolidation into the hands of the large, vertically owned institutions.
- No consideration of the treatment of salaried advisers or their bonuses, what seem to be throw away proposals for direct (general advice) remuneration without regard to the economics of that sector, and little consideration as to how scaled advice is treated.

**Conclusions & Other Key Matters**

We support the FSI Report recommendations aimed at quality of advisers, professionalism and related environmental factors. However, we recommend additional items, such as those recommended by the Fawcett Inquiry, concerning membership of professional bodies would strengthen the outcome.

We recommend that aspects of AFSLs' business models be addressed, including banning narrow APLs (i.e. all 13 retail life insurers should be on all APLs), (leveraged) volume rebates, shelf space fees, and certain reporting lines and governance models within conglomerates.

The term "commission" should be dropped in favour of "client service payment".

Adviser remuneration models should be permitted based on principles such as those outlined in this submission. Legislated "level commission only" rules would be inappropriate.

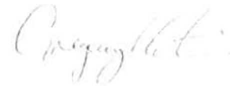
Change to adviser income structures must be carefully assessed in terms of their likely

impact on incomes (both in aggregate and by different business models), and how advisers can or will likely respond. Adequate transition allowance for any changes will be critical.

The FSI Report and other public commentary tend to focus on the "full advice" and "personal advice". Careful consideration is needed of how any rules and limits introduced here may impact "scaled advice", "execution only advice" or direct "general advice" only businesses.

We would welcome the opportunity to discuss our submission with you.

Yours faithfully



Simon Swanson
Managing Director

Greg Martin
Chief Actuary and Risk Officer