

# Effectiveness of Australia's financial services regulatory settings

Report for the Financial Services Council for submission to the Financial System Inquiry



## Contents

Executive summary .....	1
Section 1: Industry innovation, flexibility and efficiency .....	5
Section 2: Competitiveness.....	13
Section 3: Regulatory design and consumer protection .....	19
Section 4: Financial literacy .....	26

# Executive summary

## Background

EY has been engaged by the Financial Services Council (FSC) to conduct a qualitative review of the effectiveness of regulatory settings applying to Australia's financial services industry.

The FSC identified five overseas jurisdictions to observe as context for the review - Canada, Hong Kong, Singapore, United Kingdom and the United States.

Our review is based on information obtained from interviews with financial services professionals across a range of peak industry bodies and EY member firms in the selected overseas jurisdictions. These interviews have been informed having regard to a 65 question diagnostic focusing on key characteristics of financial services markets and industry sectors.

Key hypotheses have been tested regarding how Australia's regulatory settings promote:

- ▶ Innovation, flexibility and efficiency
- ▶ Competitiveness in domestic and international markets
- ▶ Robustness of regulatory design, including balance between market efficiency, industry growth and consumer protection
- ▶ Financial literacy.

## Our conclusion

Australia's financial services industry is internationally recognised and respected, with our superannuation system viewed as key to the domestic market's ability to punch above its weight.

There is an equally strong perception that Australia's historical standing and record of past innovation is not a guarantee of future success, particularly as it relates to increased export growth and penetration of Asia Pacific markets.

Consistent with this position, while Australia remains relatively well placed in terms of its regulatory settings, there is more that could be done to grow the domestic market and capitalise on opportunities provided by the Asian Century.

This is of particular importance given Australia's financial services sector 10.5% contribution to gross domestic product (FSC Policy Priorities 2013 - 2016), and broader structural changes being faced at a macroeconomic level.

In this context, key opportunities for regulatory settings adjustment include:

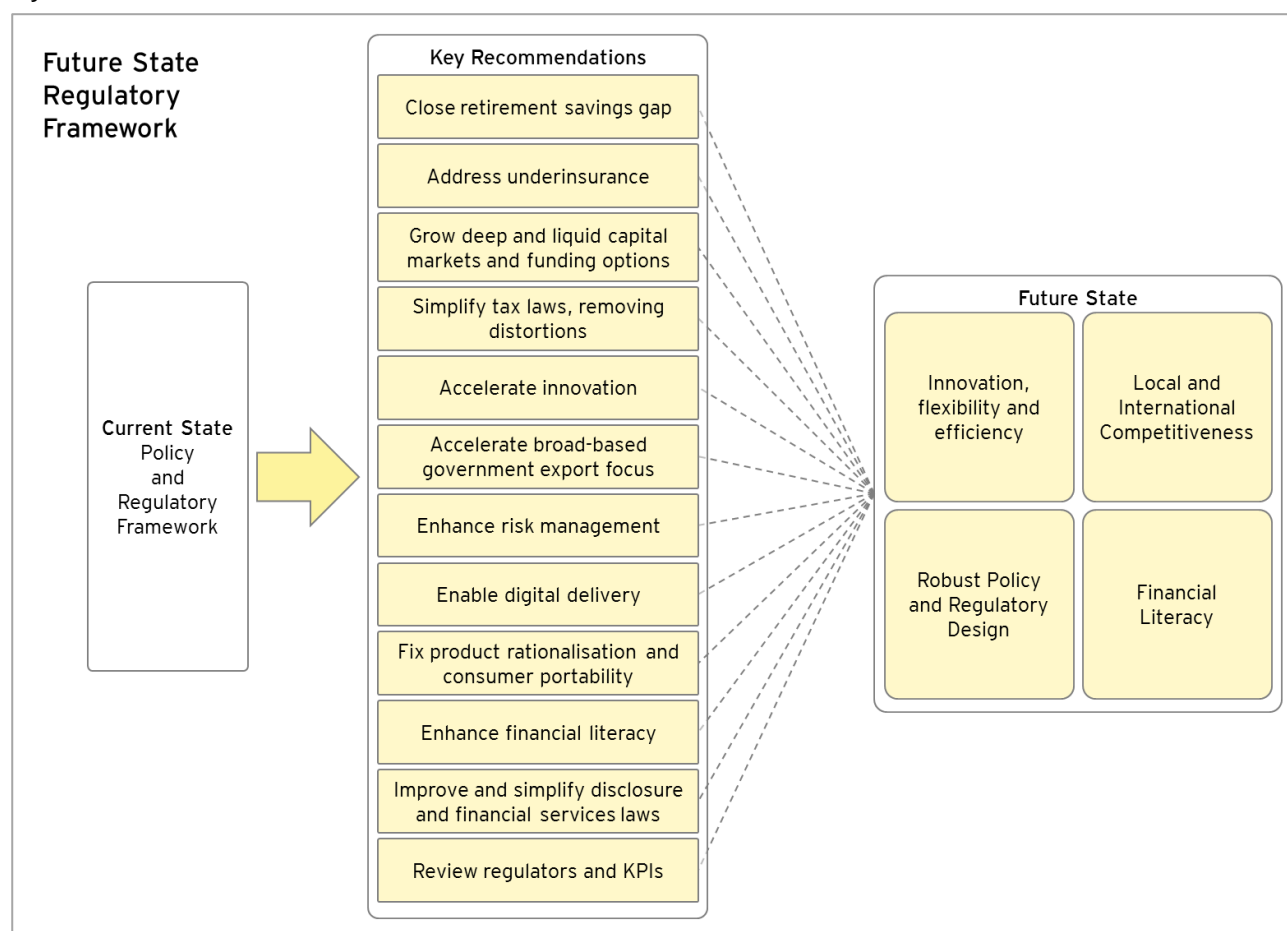
1. Continued phased increases in SGC rates and preservation age. Review of contribution caps, withdrawal rates, aged pension eligibility and diversification of retirement income streams to address Australia's retirement savings gap
2. Measures to address underinsurance. Consideration of private disability insurance options to help minimise forecast National Disability Insurance Scheme (NDIS) and Disability Support Pension (DSP) costs
3. Measures to grow capital markets, including depth and liquidity of bond markets and alternative funding options
4. Reform of state and federal income tax laws that alter level playing fields, investment decisions, capital market development and export growth
5. Rationalisation of regulator, licensing, capital and governance requirements to facilitate level playing fields and product innovation

6. Broad based government action to promote export growth, in particular via Free Trade Agreements (FTA), Double Tax Agreements (DTA), funds passport, investment manager and mutual fund recognition programs
7. Measures to increase the pool of advice. Provision to enhance Enterprise Risk Models (ERM), product suitability and disclosure to address consumer protection needs, advice and distribution flexibility. Consideration of advice tax deductibility
8. Digital enablement of financial products, services and data delivery on a multi-jurisdictional basis
9. Removal of barriers to financial product rationalisation, merger and consumer portability
10. Continued expansion of financial literacy and consumer engagement measures
11. Streamline financial services laws, including robust quantitative impact assessments and mandatory post implementation reviews
12. Review of Regulator KPIs, including provision for increased industry consultation and standard setting.

These issues and recommendations are dealt with in further detail below.

Figure 1 outlines key recommendations to help accelerate Australia's transition to a future state regulatory framework.

Figure 1



## Our assessment

Figure 2 shows Australia's relative international positioning having regards to:

- ▶ Information provided by international peak industry bodies
- ▶ Information provided by EY member firms in Australia and overseas jurisdictions.

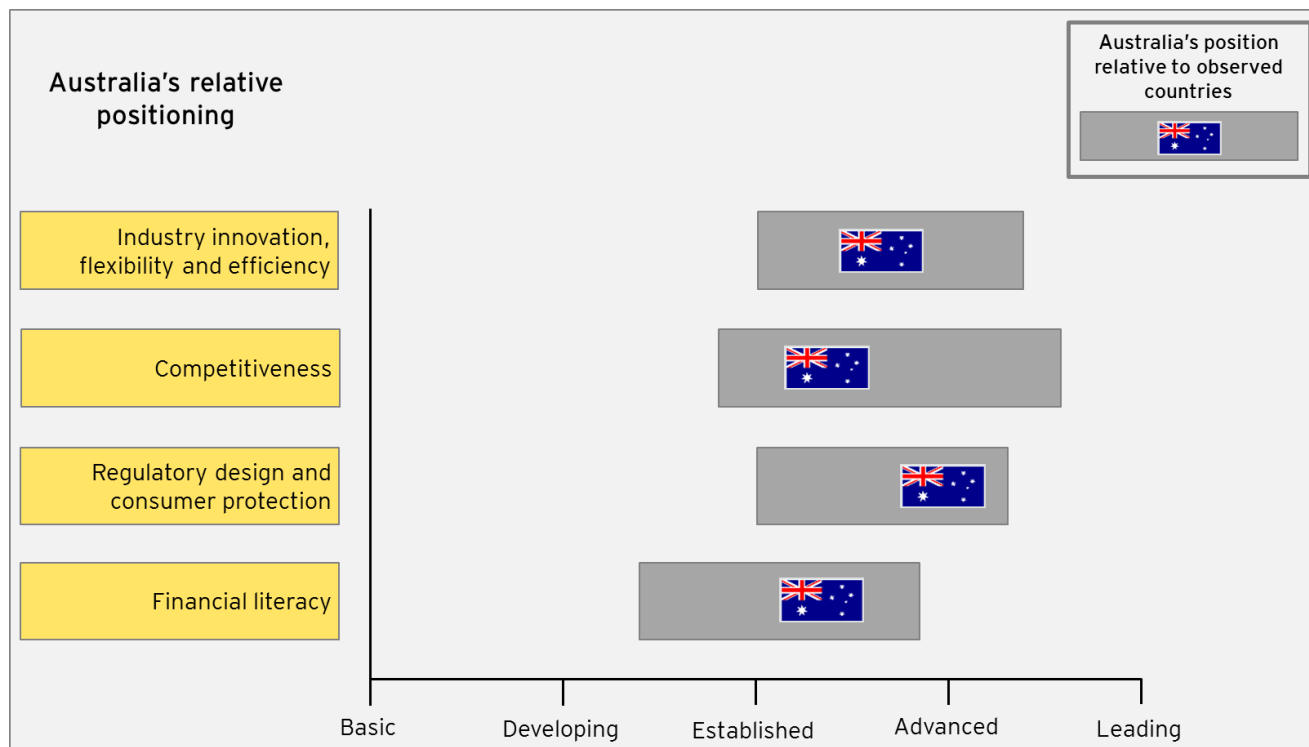
Given inherent complexities and the accelerated timeframe for analysis, the review undertaken is qualitative, rather than quantitative. Based on the information provided, Australia's relative positioning has been determined as follows:

- ▶ Out-performance:
  - ▶ Robustness of regulatory design and consumer protection
- ▶ On par performance:
  - ▶ Innovation, flexibility and efficiency
  - ▶ Enhancement of financial literacy
- ▶ Underperformance:
  - ▶ Competitiveness, particularly when viewed from an export, international market penetration perspective.

While relative performance results suggest that competition should be a primary area of focus, opportunities for regulatory settings improvement exist in all areas, with consequential impacts for consumers, product manufacturing, advice and distribution related activities.

In this context, it is important to note that overseas jurisdictions are actively addressing these issues, including in Asia. Accordingly, a 'do-nothing' approach is likely to result in a future decline in Australia's relative performance.

Figure 2



## Our recommendations

	Recommendation Summary	Innovation, flexibility, efficiency	Competitiveness	Regulatory design and consumer protection	Financial literacy
<b>Industry innovation, flexibility and efficiency</b>					
1.1	Address retirement savings gap measures				
1.2	Review retirement income streams and age pension eligibility				
1.3	Address underinsurance				
1.4	Consider private disability insurance options to offset NDIS costs and welfare entitlements				
1.5	Remove barriers to financial product rationalisation and consumer portability				
1.6	Rationalise regulator, licensing and capital requirements to facilitate product convergence and consumer needs				
1.7	Review capital markets and alternative funding options				
1.8	Align product and service design, distribution and disclosure requirements with digital technologies				
<b>Competitiveness</b>					
2.1	Address arbitrage created by tax and financial services laws				
2.2	Address arbitrage created by licencing, capital, governance and disclosure requirements				
2.3	Address WHT and flow through tax treatment for collective investment vehicles				
2.4	Continue broad based government action to accelerate export initiatives				
<b>Regulatory design and consumer protection</b>					
3.1	Mandate quantitative cost-benefit analysis as part of RIS and robust post implementation reviews				
3.2	Undertake root and branch review of PDS and broader disclosure regime				
3.3	Determine the optimal role for industry in regulator mandates, including standard setting				
3.4	Review and implement advice related reforms				
3.5	Clarify application of wholesale investor tests				
3.6	Assess regulator performance against redefined KPIs				
3.7	Review, harmonise and simplify state and federal tax laws				
3.8	Review, harmonise and simplify licensing, capital and governance requirements				
3.9	Review, harmonise and simplify consumer complaints resolution schemes				
3.10	Review, harmonise and simplify minimum standards of conduct, competency and education requirements				
3.11	Review, harmonise and simplify data collection and publication requirements				
3.12	Incorporate data analytics to aid decision making and preventative risk management				
3.13	Evaluate and manage broader systemic risks				
<b>Financial literacy</b>					
4.1	Embed financial literacy courses and skill development in the national education curriculum				
4.2	Embed consumer behavioural analytics				
4.3	Increase awareness of the importance and value of advice, insurance and retirement income stream products				
4.4	Promote consumer awareness and understanding of digital delivery				

# Section 1: Industry innovation, flexibility and efficiency

## Background

Promotion of industry innovation, flexibility and efficiency is critical to maximising private sector savings and adequate insurance outcomes. In order to achieve these policy objectives, key regulatory settings need to reflect:

- ▶ Measures that encourage the growth of new financial products and services
- ▶ Consumer choice, portability and mechanisms to rationalise inefficient products
- ▶ Distribution channel diversification
- ▶ Digital enablement of financial product and service delivery.

## Australia's relative positioning

The importance and strength of Australia's superannuation system is internationally recognised, as is the relative sophistication of the domestic financial services market.

In broad terms, domestic success in navigating the global financial crisis, robust twin peaks regulatory model, compulsory superannuation system, investment product choice and platform based distribution model is perceived to have allowed Australia to 'punch above its weight' in terms of industry growth and innovation.

As a counterbalance, Australia is viewed as a relatively complex, high tax and heavily regulated financial services market, particularly in comparison to Asian countries.

These characteristics, when added to compulsion and past success, raise questions as to Australia's future growth, in particular the challenges of growing a sustainable export base in a rapidly changing digital environment.

In this context, in addition to regional passport and investment manager initiatives, innovative policy and regulatory settings that deliver capital market growth and funding alternatives, diversity of retirement income stream products, increased insurance and advice uptake and digital enablement are important for domestic and international market positioning.

Further, regulatory settings that encourage private sector investment to support 'big picture' nation building and risk mitigation objectives (for example, including infrastructure, exports, housing and the flow of capital to sustainable enterprise) are likely to further improve Australia's economic position and potentially be a source of industry growth and competitive advantage.

Innovation, flexibility and the effective engagement of investment and capital markets is viewed as critical given forecast structural changes in Australian industry, increasing globalisation and fiscal pressures faced at a state and federal level.

Solutions to these issues are not driven by directing investment mandates.

Rather, focus needs to be on how policy levers and regulatory settings can be adjusted to mobilise the various pools of capital that exist in the Australian market.

These issues are discussed in further detail below.

► **Maximising private sector savings and addressing Australia's retirement savings gap.**

The superannuation system has been subject to much analysis and review. Most recently the Super System Review ('Cooper Review') looked at the governance, operation and efficiency and structure of Australia's superannuation system. A number of significant recommendations are being implemented as part of the Stronger Super response, including MySuper and SuperStream.

Continued action is essential to adequately address the nation's demographic challenges and ensure more self-funded retirement is generated than age pension dependency.

Australia has gone some way to addressing its retirement savings gap by increasing compulsory superannuation contributions (SGC) on a phased basis to 12%. The gap is the difference between the amount required to be saved for to maintain a comfortable living in retirement less the amount likely to be accumulated at retirement.

Rice Warner estimate the retirement savings gap as \$836 billion. While this figure will fall as SGC moves to 12%, the gap will still be significant.

While industry commentators view the SGC rate as needing to rise beyond 12% to fund adequate retirement savings, the equity of the system should be considered. This is particularly the case for lower income earners and those with interrupted work patterns, including casual workers and women. Higher SGC rates should be considered alongside potential opt-out arrangements for low income earners that exist in overseas jurisdictions.

By way of example, increased flexibility of compulsory arrangements is reflected in the auto-enrolment pension regime instituted in the UK in 2012 and the introduction of Pooled Registered Pension Plans (PRPP) in Canada in 2013.

Further measures to encourage contributions, such as flexible contribution caps and age-based work tests, should be considered. From an international perspective, 'catch-up contributions' have been a feature of 401(k) plans since 2006. In Canada annual contribution limits (RRSP 'deduction limits') may be increased to the extent prior year caps have not been utilised.

Regulatory settings applying to contributions are only part of the equation. Post retirement settings need to be examined, including withdrawal rules.

Recent research has questioned the appropriateness of the minimum 4% withdrawal rate in pension phase, in particular the implications for longevity risk. Provision for greater flexibility and alignment of withdrawal strategies with cash flow and consumer lifecycle stage is important to minimise mismatches between asset and liability management in retirement.

While the above measures are directed at contribution and withdrawal flexibility, preservation age increases should be considered.

When the retirement age was set originally at 65, male life expectancy was 55. Today, Australians can expect to live well into their 80s, with health and medical advancements expected to give rise to ongoing increases in life expectancy. The OECD found Australians' life expectancy increased by 6 years to 81.5 years in the 25 year period between 1993 and 2008.

Increasing the access age for superannuation would encourage a longer savings accumulation phase better suited to our longer life spans. An increase in the preservation age is consistent also with broader policy goals related to increasing workplace participation and productivity of older generations. Such proposals are consistent with measures being taken in overseas jurisdictions.

In addition to increasing retirement savings through innovative and flexible regulatory settings, many jurisdictions use tax policy and distribution channel innovation to increase broader savings options outside of superannuation.

Tax examples include UK ISAs, Canadian TFSAs and exemptions for capital gains and other investment income. Distribution examples include listing of bonds, mutual funds and ETFs, and funds passporting,



► **Review retirement income streams and core elements of age pension eligibility.**

In addition to raising the preservation age, measures to align this with age pension eligibility should be pursued.

Ensuring tax, pension and social security rules treat retirement income stream products on a consistent basis is important to expanding consumer choice and effective competition in the pension market. While such measures have bipartisan political support, legislation to facilitate, for example deferred lifetime annuities, is yet to be enacted.

Further measures to broaden the retirement income stream market and provide active disincentives to lump sum withdrawals of accumulated benefits are needed. Such measures include:

- Streamlined and consistent approval processes for longevity products, incorporating APRA, ATO, Centrelink and ASIC
- Provision of exemptions for longevity products from means testing, particularly when access to funds is deferred
- Improving knowledge and awareness of longevity products via better advice and education programs
- Consistent tax and SIS Act treatment of annuity/longevity products, including provision for distribution by SMSFs
- Review of surrender values impacting product development costs.

► **Measures to address underinsurance.**

Insufficient life and income protection insurance remains a significant issue in Australia.

Rice Warner estimate that the average Australian is covered for only 14% of their TPD needs and 42% of the amount needed to maintain the standard of living of dependent family members. Research by the FSC and MetLife values the underinsurance gap at \$1.1 trillion (\$800 billion premature death and \$304 billion disability).

Root causes of underinsurance include lack of consumer understanding of life and TPD cover, complexity of products, a perceived lack of value, increasing price of premiums, and a lack of engagement with superannuation which is where most Australians source their life and TPD cover.

Recent increases in claims and policy lapse rates foreshadow further rises in premiums that may exacerbate underinsurance, fiscal and welfare pressures.

In this context, measures to raise awareness and motivate consumers to take up appropriate coverage, including co-funded education campaigns, access to financial advice and digital engagement are extremely important, as are measures that address market constructs placing pressure on premium costs.

► **Private disability insurance options to reduce NDIS costs and welfare entitlements.**

Recent research in Australia found that the level of underinsurance is estimated to be \$304 billion per annum, with Australians employed in the 45-64 year age group being the most underinsured. Adequate insurance arrangements have been forecast to reduce social security and welfare benefits by a minimum of \$340 million in the first year.

The NDIS and DSP are government funded schemes, with policy debate continuing regarding the long term financial risk and sustainability of these measures. Treasury estimates forecast the annual costs to government for these schemes to be approximately \$14 billion each.

Innovative life, TPD and private disability offerings, supplemented by government incentives, could transfer welfare costs and fiscal risks posed by underinsurance, NDIS and DSP schemes to the private sector. That would leave NDIS and DSP to operate as an important safety net.

This would be analogous to the role private health insurance plays alongside Medicare, to address rising health costs for an ageing population.

Similarly, private pensions help reduce adequacy, longevity and public sector funding risks associated with provision of the aged pension.

► **Barriers to product rationalisation.**

Industry estimates there are over 6,000 legacy products which are closed to new members, obsolete and being maintained on outdated systems. The value of these legacy products is forecast to be approximately \$200 billion (FSC estimate, Treasury Product Rationalisation Issues paper 2007). The trade-off for product innovation is an inevitable tail of legacy products. This tail represents a challenge for institutions who must maintain systems and processes to manage legacy products and for consumers who are trapped in often higher cost and lower value products.

The diversity of legacy products and associated regulatory regimes has meant that while this topic has been debated by ASIC, APRA, Productivity Commission reviews, industry working groups and government deregulation taskforces over the last decade, the problem remains.

While there is general agreement on the need to undertake product cost benefit analysis, maintain consumer protection and tax neutrality, to date there are no appropriate powers and legislation to enable the back-book to be effectively cleared and a future build-up avoided.

Innovation, competition and market efficiency demands require this position to be resolved.

► **Review and rationalise regulator, licensing and capital requirements to facilitate innovation, flexibility and efficiency.**

Streamlined regulation is key to market efficiency, innovation and effective competition.

The positioning of Australia's regulatory framework relative to other jurisdictions is discussed in further detail in section 3.

Multiple regulators, layers of approvals, capital and governance requirements operate as a disincentive to innovation.

In an international context, the stalled introduction of new PRPP products in Canada reflects difficulties that can be imposed by regulatory design. While PRPP products have been introduced and endorsed at a federal level, state and territory based implementation is required before these products can be delivered to consumers.

Similarly, in the US, multiple regulators, fragmented state based and prescriptive legislation is viewed as a barrier to the development of hybrid products combining elements of annuity, health, general and life insurance benefits, notwithstanding consumer demand.

For Australia, such examples are instructive given the division between life and general insurance versus health insurance legislation (i.e. Life Insurance Act, SIS Act, Private Health Insurance Act and Corporations Law). These laws have been constructed around specific insurance products and services.

With increasing consumer demand for bundled products to meet integrated financial, health and broader well-being needs, revisions or consolidation of the laws to make them more contemporary and flexible for the future should be considered. In this context, differences in capital requirements between life insurance companies and superannuation funds also should be considered.

Capital requirement impacts for funding growth require consideration. Domestic rules introduced in connection with Basel III implementation need to be evaluated, particularly with reference to downstream impacts for business and SME lending, and early stage venture capital growth – see below. While overall financial stability remains a key concern, achieving an appropriate balance between higher capital requirements, potential funding gaps and diversification of funding channels needs to be assessed.

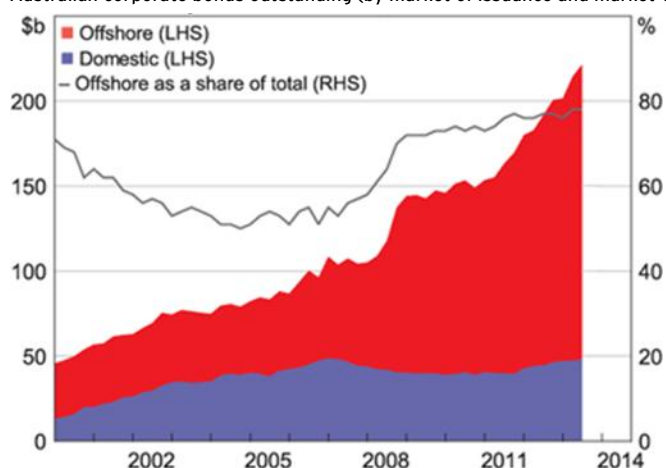
► **Review capital markets including depth and liquidity of bond markets and alternative funding channels for growth.**

Funding channel diversity and competition requires an active corporate bond and RMBS market. The Johnson review (Australia as a Financial Centre – Building on our Strengths) highlighted that Australia's domestic corporate bond market lacks depth and liquidity compared to equity capital markets, with the 'average maturity of Australian corporate debt on issue just 2.5 years'.

Regulatory changes have been implemented to help grow the corporate bond market. In 2010, ASIC provided class order relief to simplify the disclosure requirements for issuance of listed vanilla bonds, with the aim of helping grow retail market take-up.

Currently, Australian corporates continue to predominantly fund their activities through traditional banking channels, or via corporate bond issuance. Limited domestic bond issuance is reflected in pension fund asset allocation and Australia's relative exposure to international fixed interest compared to the US, UK and Canada. This is demonstrated in the chart below.

Australian corporate bonds outstanding (by market of issuance and market value)

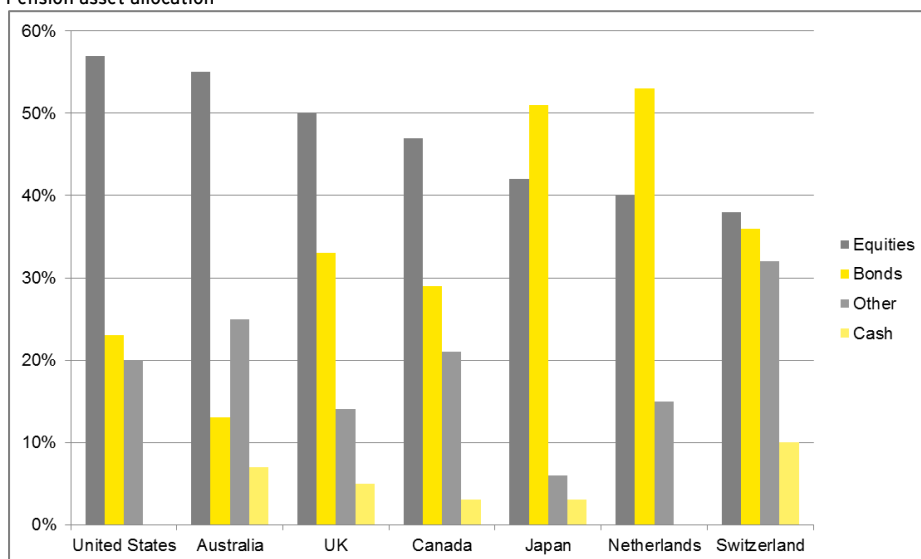


Sources: ABS, RBA

While this position reflects diversification, liquidity and governance preferences, Australia's tax system (in particular dividend imputation and discounted capital gains) introduce potential biases towards shares and equity over fixed interest and debt funding. Jeremy Duffield, Chair of the Australian Centre for Financial Studies noted in March 2012 'There is about a 1.25% to 1.65% difference in the return in Australian equities and Australian bonds, just on the basis of the tax difference'.

The following chart demonstrates that Australia along with the US and UK have significant portfolio weightings to equities.

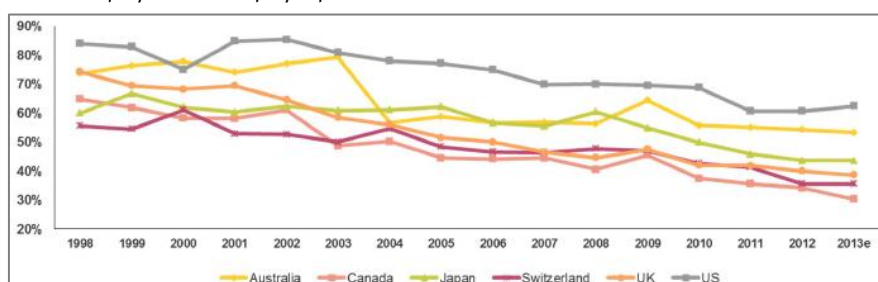
Pension asset allocation



Source: Towers Watson- Global Pension Asset Study 2014

Australia is only superseded by the US in terms of its exposure to domestic equities. The following chart shows a falling, but still significant, home bias relative to total equity investment. Should asset allocation weightings rebalance and international exposures increase, this may change superannuation funding of Australia's domestic capital markets.

Pension fund investment in domestic equities  
Domestic equity over total equity exposure



Source: Towers Watson- Global Pension Asset Study 2014

As demographic changes continue and more superannuation members move into decumulation phase, changing liquidity profile and risks should be considered.

In this context, further measures to enhance growth in bond markets including the issuance of long-dated Commonwealth bonds, inflation linked bonds, increased covered bonds and securitisation support should be considered.

This need to diversify funding channels is magnified by infrastructure requirements. This investment is critical to support GDP growth and export market development. The current pipeline of infrastructure projects is estimated to be \$750 billion (Austrade).

At present, institutional investment in infrastructure is estimated to be between 2% and 10% of Australian super fund portfolios. While estimates vary, around \$145 billion is currently invested in infrastructure. This could rise by a projected \$100 billion in the near term and \$200 billion by 2025, dependent on public sector privatisation, capital recycling programs and asset allocation strategies (EY/FSC Report on Superannuation Investment in Infrastructure - steps to further efficiency - January 2014).

A number of barriers to further superannuation investment in infrastructure have been highlighted. The EY/FSC Report on 'Superannuation Investment in Infrastructure - steps to further efficiency in January 2014' raised a number

of impediments which are present in today's market. Potential solutions include:

- ▶ **Project funding:** Government support for project funding and risk mitigation that would encourage investment from superannuation funds. If Governments assume more upfront development risks on green field projects then superannuation funds would be able to invest in operating assets with lower risk profile
- ▶ **Pipeline of infrastructure projects:** State and Federal Government to establish clear, long-term pipeline of infrastructure projects rather than fall into short-termism driven by political cycles
- ▶ **Broadening funding base:** Spread user pricing over a broader base. For example, uplift in charges on land that becomes more valuable as a result of the new infrastructure asset (for example, toll roads or public transport).

At the other end of the credit spectrum, Australia Private Equity and Venture Capital Association (AVCAL) have highlighted the challenges in funding early stage venture capital and private equity investment over recent years. For example, fundraising for the financial year 2012-13 was \$867 million, which has fallen from \$3.2 billion in the previous financial year.

Start-up funding and development capital is essential to drive and grow Australia's economy. Given banks' hesitation to lend to VC, PE and SME businesses, policy levers to help facilitate other forms of investment should be considered. This may include initiatives such as investor liquidity guarantees and loan repayments based on profits.

International emphasis on funding start-ups is illustrated by recent billion dollar early stage innovation and impact investment funds in the US, and on a lesser scale, SPRING Singapore.

- ▶ **Align financial product and service design, distribution and disclosure requirements with digital technologies.**

The continued growth of direct distribution channels, driven by the digitally connected and informed customer, is set to be a defining issue in financial services markets globally. Ensuring regulatory settings facilitate digital product design and delivery is essential for market competition and greater consumer engagement.

A step change in disclosure practices needs to accompany such dynamics, including the ability for consumers to actively select information relevant to their decision making. Dynamic sensitivity tables and calculators should be considered to empower investors to model how 'what if' scenarios impact their investment decision.

The provision of digital financial services should be extended to the provision of cost effective, quality financial advice. The ability for retail investors to effectively model their financial position and engage with their adviser, whether real or virtual, creates the need for financial services laws to be digital agnostic. A simple example is the transition from paper copies and wet ink witnessed signatures, to geo tagged and web-cammed authorisations and applications.

Internationally, digital and direct channels are changing the face of product and service distribution. For example, according to the J.D. Power & Associates report on direct investing in Canada (Sept 2013), the percentage of Canadian investors with only direct investing accounts increased 57% from 21% in 2012 to 33% in 2013.

Digital comparator and aggregation sites are becoming more prevalent. The drivers for this are both competition as well as government public policy. For example, a key recommendation of Singapore's FAIR review was for life insurers to develop direct channel distribution models and for the Life Insurance Association (LIA) in conjunction with the Monetary Authority of Singapore (MAS) to co-host a web-based aggregator to facilitate better consumer comparison of life insurance products.

Use of apps, web aggregators, crowd funding, peer-to-peer lending, alternative currency use and new methods of advice delivery are growing. Examples include Simple Bank, Kickstarter, SocietyOne and Bitcoin.

Digital enablement, data analytics, globalisation and convergence towards hybrid products and services are expected to continue to drive these trends. Key to momentum continuing is appropriate management of privacy, security and cyber-crime risk, as well as consumer education campaigns on point. These issues are considered in further detail in Sections 3 and 4.

## Recommendations

- 1.1 Maximise superannuation and ordinary money savings. Continue SGC phased increases to 12%. Consider further uplift to 15% or beyond. Review low income superannuation thresholds, contribution caps, increases in preservation age, withdrawal rates and diversification of retirement income streams to address Australia's retirement savings gap
- 1.2 Review retirement income streams and core elements of age pension eligibility
- 1.3 Consider measures to address underinsurance
- 1.4 Consider private disability insurance options to help reduce NDIS costs and welfare entitlements
- 1.5 Remove barriers to financial product rationalisation, merger and consumer portability
- 1.6 Review and rationalise regulator, licensing and capital requirements to facilitate product innovation and meet the financial, health and broader wellbeing needs of consumers
- 1.7 Review capital markets, including depth and liquidity of bond markets and alternative funding options
- 1.8 Align financial product and service design, distribution and disclosure requirements with digital technologies. Address evolving privacy, security and cyber-crime risks.

## Section 2: Competitiveness

### Background

Facilitating competitive neutrality and a level playing field between domestic and international market participants is critical to:

- ▶ Optimising the flow of investment capital and allocative efficiency
- ▶ Development of industry scale and innovation
- ▶ Effective consumer choice
- ▶ International expansion and export growth.

### Australia's relative positioning

From a competitive perspective, Australia's financial services system remains characterised by:

- ▶ A variety of market structures and competitive influences, including large industry, retail and public sector superannuation funds, over 500,000 self-managed superannuation fund vehicles and elements of concentrated ownership across product manufacturing, distribution and advice components of the value chain
- ▶ Ineffective product rationalisation rules that impede scale and entrench inefficient, legacy products
- ▶ Inconsistent treatment of financial products and advice providers
- ▶ Inconsistent licencing, capital and governance arrangements
- ▶ Complex administrative, taxation and regulatory rules
- ▶ Uncompetitive and distortive taxes impacting product selection and international market presence
- ▶ Low levels of export market penetration.

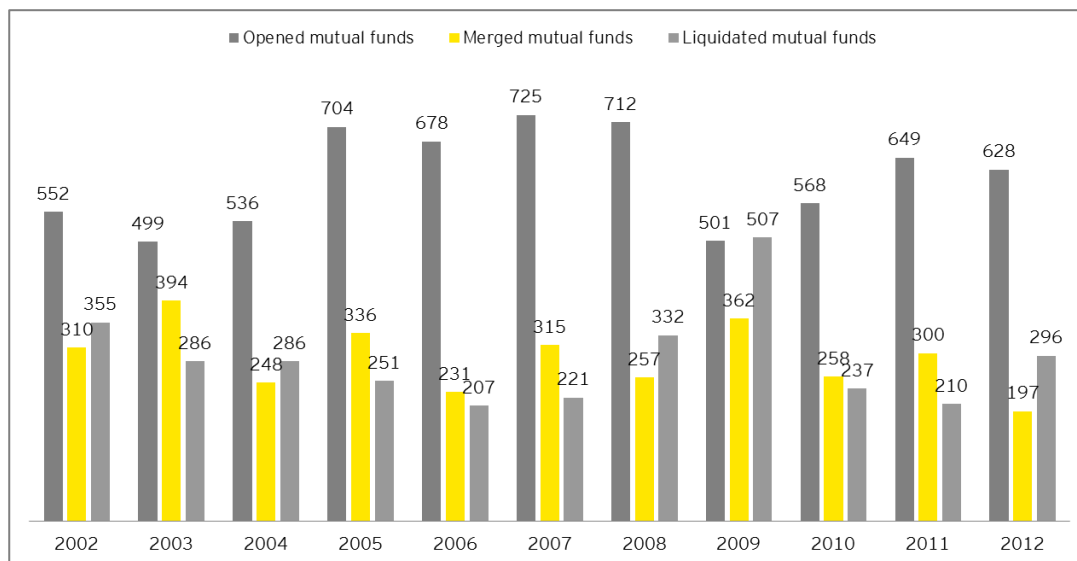
To varying degrees, these issues impact competition and ultimately consumer choice in both domestic and international markets.

While key export initiatives like fund passport and mutual fund recognition programs are currently underway, a number of the issues noted above have been subject to longstanding policy and regulatory gridlock.

By way of example, Australia's withholding tax regime has been actively debated and amended over a number of years. The urgency underpinning competitive resolution of this issue is now magnified by efforts to increase Australia's export presence in the region and the fact that other jurisdictions are actively building on their positions as regional financial services centres.

Similarly, product rationalisation and merger rules have been actively considered over the last decade, with a lack of resolution on key tax and financial services laws stifling action to transition clients to more efficient and cost effective products. By contrast, in the US, mutual funds are opened, merged and closed with greater frequency and ease. The chart below demonstrates that, over a ten year period from 2002 to 2012, the number of mutual funds merged or liquidated was almost the same as the number of new mutual funds opened.

Number of mutual funds leaving and entering the industry 2002 - 2012



Source: ICI 2013 Investment Company Fact Book

In Canada, while provincial and territory based regulations are problematic in a number of areas, product rationalisation relief has been provided in circumstances where areas of public policy benefit can be established. This was evident in relation to the closure of 'clone funds' on relaxation of foreign investment rules.

Competition in the jurisdictions observed is not limited solely to existing players with established brands and domestic points of presence. An example of competitive market forces in the UK was the recent market entry of Now: Pensions, backed by the European pension fund ATP. Given Australia's superannuation system maturity, sophistication and scale, coupled with implementation of Superstream enhancements, consideration should be given to ways in which Australia's front and back office expertise could be exported to markets where pension systems are being opened up to private sector players.

In broad terms, the recommendations made below seek to ensure regulatory settings promote competitive neutrality in the domestic and international market, thereby providing opportunities to further develop industry scale and export growth.

Key areas to consider include:

► **Address arbitrage created by tax and financial services laws.**

Australia's tax regime creates distortion between products and adds cost to the financial system.

Different after-tax outcomes may be generated by similar underlying investments in a unit trust, listed investment company, or managed discretionary account. Further, the taxation treatment of interest income versus that applied to property or shares creates disincentives to holding cash and term deposit accounts, which in turn create downstream impacts for retail deposit growth, wholesale funding and the provision of credit.

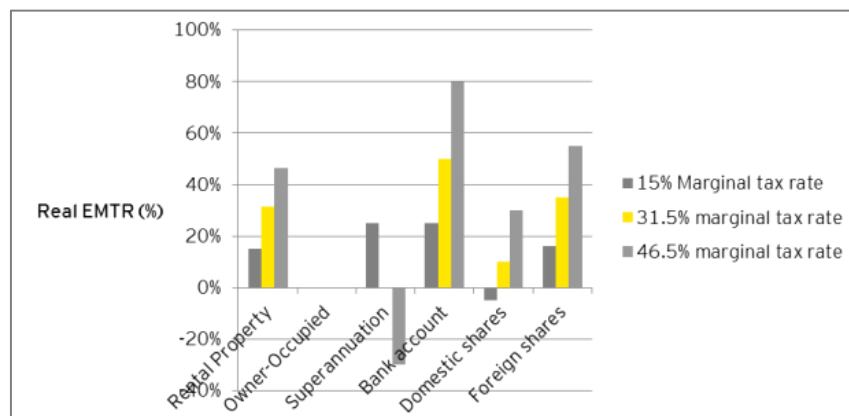
As noted in Section 1, the CGT discount and dividend imputation system create a material bias towards equity rather than fixed interest investment, which impacts the composition of Australian capital market growth. As outlined in the Henry review of Australia's Future Tax System, May 2010:

*"The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings. This can have adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals. The tax advantages from borrowing to invest in a rental property, for example, relevant for shares, leads to investors taking on too much debt and distorts the rental property market"*



The following chart demonstrates different effective marginal tax rates applying to alternative forms of investment. These differences and impacts for net wealth support the use of after-tax reporting as a means to assist investment decision making.

Real effective marginal tax rates for selected asset classes



Source: Henry review of Australia's Future Tax System, May 2010

State based taxes are inefficient and distort consumer decision making. For example, fire services levies and stamp duty increase the cost of insurance premiums. Consumer perception of poor value and rising costs are contributing factors to underinsurance in Australia. The state based patchwork of taxes makes compliance and the issuance of products in each state or nationally more costly and acts as a barrier to competition.

Recommendation 79 of the Henry review of Australia's Future Tax System, May 2010 proposed that all specific taxes on insurance products, including the fire services levy, should be abolished.

In an international context, a number of jurisdictions have sought to remove tax distortions and create competitive neutrality across investment and retirement products. For example, Hong Kong has recently waived stamp duty on ETFs (extending a waiver from 2010 that scrapped stamp duty on ETFs that track indexes comprising not more than 40% of Hong Kong stocks) to enable investors to access these funds with no tax disadvantage or reduction in after tax return.

Similarly, Canada is heavily focused on removing VAT on MERs in managed funds to ensure a level playing field with other products.

Continued tax reform is essential to addressing distortions in the system and should be reflected in the Government's White Paper on tax reform, which is designed to canvass options for lower, simpler, fairer taxes.

Inconsistencies introduced by financial services laws are as prevalent as those created by tax laws. By way of example, while policy rationale exists, the competitive impacts of different fee arrangements applying to insurance in and out of superannuation, or between advice delivered in a personal or intra fund context should be examined.

Similarly, different regulatory settings apply to the assessment of conduct risk at each element of the value chain - from product manufacturing through to platforms, research houses and financial adviser forces. Arguably, this is counter-intuitive given the inter-relationships that characterise financial services market activity.

As a final example, regulatory settings that distort MySuper choice under different employment arrangements, allow anti-competitive behaviour or operate to practically favour one form of superannuation vehicle (i.e. retail industry or self-managed super fund) over another should be assessed.

- **Address arbitrage between financial products and services created by licensing, capital, governance and disclosure requirements.**

Licensing, capital, governance and disclosure arrangements can act as a significant incentive or barrier to domestic competitive neutrality and international competition. These issues have been addressed in section 1 and 3.

- **Address MIT withholding tax and collective investment vehicles arrangements.**

In 2009 the Board of Taxation handed down their report on the Review of Taxation Arrangements Applying to Managed Investment Trusts. This root and branch review provided government with 48 recommendations to improve certainty, reduce compliance costs, and assist international competitiveness.

Post this review, a reduction in the rate of withholding tax from 30% to 7.5% was signalled. This was intended to promote increased non-resident investment through managed investment vehicles and reduce the arbitrage between debt and equity investment structures. Subsequently, the MIT withholding tax rate has moved back to 15%, negatively impacting market positioning and prospects for inbound investment flows.

Review of withholding tax arrangements is essential to export market growth.

- **Continue broad based government action to promote financial services.**

Since 2008, the World Economic Forum Annual Financial Development Report has provided global rankings by economy. Australia has moved from a ranking of 11 in 2008, to a ranking of 4 in 2012. The rise of the Asia Pacific region is demonstrated by Hong Kong being ranked number 1 in 2012, having moved from number 8 in 2008. The maturity of economies in Europe and North America is demonstrated with the US, UK and Canada retaining top 6 rankings in 2008 and 2012.

Global Financial Development Index rankings

Country / Economy	2012 Ranking	2008 Ranking
Hong Kong	1	8
US	2	1
UK	3	2
Singapore	4	10
Australia	5	11
Canada	6	5

Source: World Economic Forum Annual Financial Development Report

All jurisdictions have embarked on strategies to tackle domestic regulation and actively promote inbound and export oriented financial services.

Australia has introduced the Investment Management Regime which is designed to exempt investors from Australian income tax gains or losses made by an entity that meets the definition of an 'IMR foreign fund'. This is in relation to portfolio interests in equities and interests in other financial interests such as certain debts instruments.

The Investment Company Institute's (ICI) October 2013 white paper on Market Access for Regulated Fund Managers in the United States and the European Union ('Market Access Paper') considers market access for managers of 'regulated funds', commonly referred to as mutual funds or registered investment companies in the United States and UCITS for funds authorized under the UCITS Directive in the EU. At June 2013, \$1,616.17 billion (11.6%) of open-end registered investment company (RIC) assets and \$49.3 billion (18%) of closed-end RIC assets were managed by European-owned investment advisers or their affiliates. At over 11%, European fund managers represent the largest segment of foreign owned managers. The ICI statistics demonstrate that foreign owned management companies continue to access the US market.

The UK remains Europe's leading centre for funds management, with GBP 4.9 trillion funds under management, generating GBP 12 billion annually. Notwithstanding this position, its share of fund domicile has fallen in the last decade with the rise of Luxembourg and Ireland.

To combat this, the UK government has implemented a concerted effort to improve its competitive position. The strategy's inclusion in the Chancellor of the Exchequer's 2013 budget underlies its significance and government commitment. The strategy's three main focus areas are:

- ▶ **Taxation:** ensure the tax regime is simple, fair and streamlined. For example, abolition of the Schedule 19 stamp duty reserve tax charges on funds (to take effect in tax year 2014/15)
- ▶ **Regulation:** ensure a regulatory environment that applies high, internationally consistent regulatory standards and remains responsive. For example, the FCA will engage actively with industry representatives in relation to the process for authorising funds. This will include hosting roundtables with Treasury to explore improvements that can be made and to enhance understanding on all sides
- ▶ **Marketing:** work closely with key industry bodies to employ a co-ordinated marketing approach to all corners of the globe.

Hong Kong's financial services strategy comprises four key components - vision, market opportunities, enablers, and foundation.

The Hong Kong government's broader aim is to 'avoid complacency' which has led them to establish the Financial Development Services Council (FDSC) in January 2013. The FDSC is a government advisory body that engages with industry to generate strategies and measures to expand the scope of Hong Kong's financial markets and enhance the competitiveness of Hong Kong as an international financial centre. For example, a recent focus area is the development of Hong Kong as an Offshore Renminbi Centre, which is designed to address competitive challenges posed by London, Singapore and Taiwan.

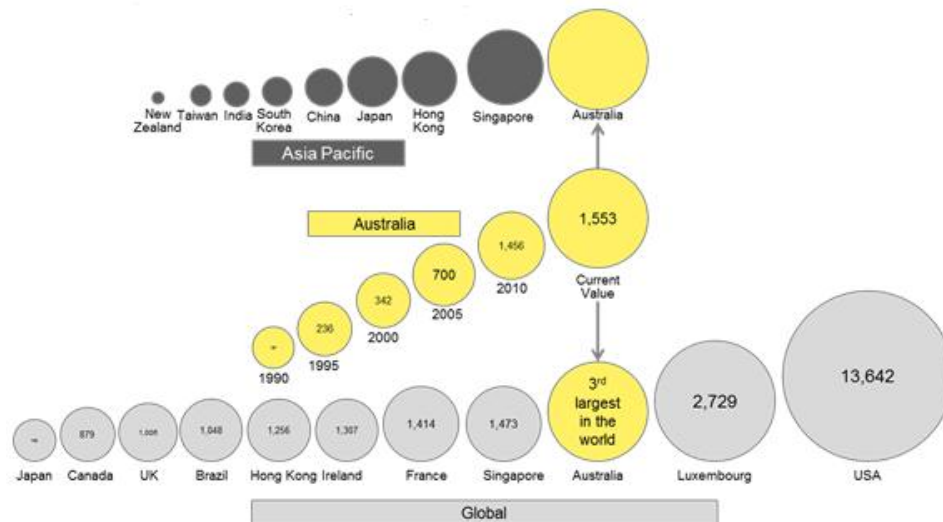
Singapore is a driver of ASEAN's financial integration framework in the areas of financial services, payments and settlement systems, and capital markets. In October 2013, Singapore and China agreed on new initiatives to strengthen cooperation on financial sector development and regulation. The new initiatives are designed to promote the international use of Renminbi (RMB) through Singapore.

In September 2013, Singapore and Australia were participating countries to sign a Statement of Intent to jointly develop the Asia Region Funds Passport (ARFP) that facilitates cross-border offering of funds in Asia. This was an initiative originally canvassed by the Johnson Review.

In summary, the following chart demonstrates that Australia remains well placed in the region and globally. However, it is clear from international government and market activity that for Australia to grow and advance its presence and reputation in offshore markets will require significant and sustained action. A 'do nothing' approach will see Australia falling behind in its aspirations to grow as a leading financial centre.

Broader issues and regulatory settings impacting competitiveness have been outlined in Sections 1, 3 and 4 of this report.

Global significance of Australia's investment fund assets pool  
Investment Fund Assets, US\$ billion, June quarter, 2013



Source: Investment Company Institute, *Worldwide Mutual Fund Assets and Flows, Second Quarter 2013*; Hong Kong's data (Non-REIT fund management business - the sum of asset management business and fund advisory business of licensed corporations), sourced from Securities and Futures Commission, *Fund Management Activities Survey 2012*; Singapore's data sourced from Monetary Authority of Singapore, *2012 Singapore Asset Management Industry Survey*; Austrade.

## Recommendations

- 2.1 Address arbitrage between products and services created by tax and financial services laws, and implications for consumer choice
- 2.2 Address arbitrage between financial products and services created by licensing, capital, governance and disclosure requirements
- 2.3 Address MIT withholding tax and broader tax review recommendations for collective investment vehicles
- 2.4 Continue broad based government action to promote financial services exports, funds passport, mutual recognition and investment manager regimes.

# Section 3: Regulatory design and consumer protection

## Background

Robust policy and regulatory design must strike an appropriate balance between reduction in red tape, industry growth, competition and consumer protection objectives.

Fundamental to these objectives are:

- ▶ Open, transparent and consistently applied frameworks for policy development and regulatory oversight
- ▶ Decision making based on relevant, high quality data
- ▶ Effective industry consultation and collaboration
- ▶ Robust cost-benefit analysis in regulatory impact statements, mandatory post implementation reviews and assessment of implications for policy achievement, competition and industry growth
- ▶ Appropriate licensing, capital and governance standards
- ▶ Consistent tax laws that maintain a level playing field and foster domestic industry, capital market, funding and export growth
- ▶ Measures to promote consumer protection, including via enhanced financial literacy
- ▶ Ongoing assessment of opportunities to streamline regulation
- ▶ Ongoing assessment of regulator performance with reference to aligned KPIs.

## Australia's relative positioning

Australia's twin peaks regulatory framework has been effective. APRA and ASIC's performance has been praised by a number of international bodies and jurisdictions. According to the International Monetary Fund, Australia: financial system stability assessment 2012:

*'The Financial regulatory and supervisory framework exhibits a high degree of compliance with international standards'*

Reflecting the success of this model, the UK has recently adopted a twin peaks prudential and conduct based framework via establishment of the Prudential Regulation Authority and the Financial Conduct Authority.

As noted in Section 1, the main components of Australia's regulatory framework is federal and principles based. This contrasts with jurisdictions such as the US, where prescriptive rules and state based legislation applies and is perceived to be an impediment to business growth, market efficiency and competition. Similarly, while the success of Canadian authorities in navigating the global financial crisis has been widely acknowledged, its multi-layered federal, provincial and territorial system involving 13 regulators is regarded as challenging.

While Australia does not face the same structural issues, clear opportunities to improve the current regulatory framework exist.

Some key areas for consideration include:

- ▶ **Robust cost-benefit analysis of complex regulation and post implementation reviews, irrespective of whether a regulatory impact statement has been performed.**

Such reviews should take account of impacts for all major constituencies and provide sufficient opportunity for industry consultation and feedback. Review of regulatory settings should be considered, particularly in light of the likelihood of policy success and any unintended consequences.

By way of example, Basel III impacts for funding growth, particularly in respect of business and SME lending should be undertaken. Calls for robust evaluation of FOFA and Stronger Super impacts have been made.

The importance of such requirements is highlighted by international examples, including recent Treasury Select Committee reports in the UK estimating retail distribution review costs of approximating £3 billion, relative to original FSA projections of £430 million one-off and £40 million ongoing costs (subsequently revised to £1.4 billion and £1.7 billion in 2010) over the first five years.

- ▶ **Root and branch review of Australia's disclosure regime.**

In many jurisdictions, disclosure is no longer viewed as a panacea for all ills, due to limitations relating to complexity, low levels of financial literacy and consumer behavioural bias.

While disclosure should remain a fundamental tenet of Australia's regulatory framework, further work is required to improve the effectiveness of what remains a sub-optimal instrument for informing and educating consumers. Simplification beyond 'short form' measures, digital engagement, visualisation and the provision of transparent information that aids comparative analysis and consumer choice is imperative.

Other jurisdictions continue to pursue these goals. By way of example, Canada is moving towards more transparent fee disclosure under the new Client Relationship Model - Stage 2 (CRM2) requirements, the SEC has previously implemented summary prospectus measures with internet supplements and the UK has established simplified prospectus arrangements.

- ▶ **Increased industry collaboration and consultation.**

Effective industry engagement should extend to regulatory impact statements, post implementation reviews and standard setting with regards to prudential requirements, good practice levels of conduct and competency, as well as education requirements.

Standard setting processes employed by the Canadian Life and Health Insurance Association Inc (CLHIA) and the prudential regulator, Office of the Superintendent of Financial Institutions (OSFI), have been highlighted as a particularly effective example of efficiency and design benefits that can be achieved where close industry and regulator collaboration takes place.

The Financial Advisory Industry Review (FAIR) in Singapore has resulted in industry bodies developing web aggregators for consumers that compare different financial products issued by market participants.

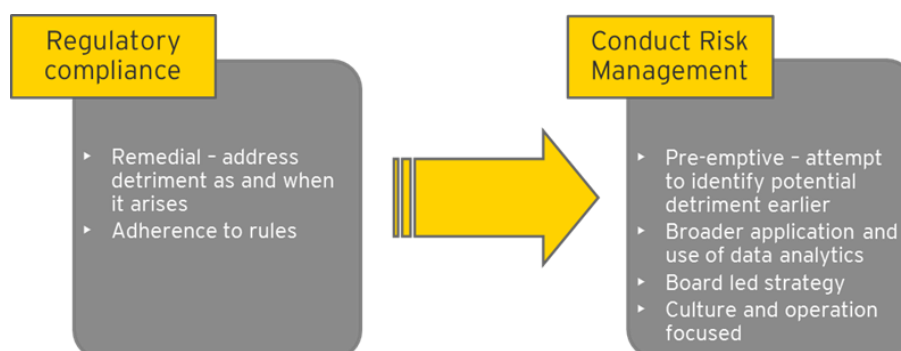
- ▶ **Advice related reforms.**

Failings in advice processes and controls, mis-selling, conflicted remuneration and market structures have contributed to a wave of policy reform and regulator focus globally.

- ▶ Australia's FoFA provisions have led to once in a generation reform of the financial advice industry, with debate currently centring on the implications of streamlining the best interests duty, removal of opt-in arrangements and maintenance of volume based charging for product sales backed by general advice.

While uncertainty exists in relation to the final shape of provisions, the following should be considered:

- Use of enhanced data analytics and risk models to proactively capture, triangulate and act early on culture, conflicts, conduct and mis-selling risks. The following graphic compares a reactive versus preventative compliance risk management model.



Source: EY

- Continued focus on risk culture and ongoing assessment of actual rather than expected behaviours.
- Positive obligations regarding financial product suitability assessment. Such measures are featured in Hong Kong and Singapore, with the UK actively considering the suitability of specified product features and the promotion of particular product types to different classes of retail investors.
- Revised disclosure measures to differentiate between general product information versus 'personal advice' and between financial advisers (for example, qualified financial planners, accountants, etc) versus others acting principally in a product sales capacity. This remains a material consideration in international markets where product distribution flexibility, concentrated ownership and bancassurance structures are common place.

By way of example, recent submissions by the Coalition for Professional Standards for Financial Planners in Canada have concentrated on the need for reform in relation to:

*"the use of terms as a sales pitch to sell products... who imply through title and/or advertising that they are financial planners.. but do not in fact have qualifications demonstrating their competence in financial planning... consumers believe they do"*

In the UK, the RDR has introduced a two-tiered structure for classifying advisers as either 'independent' or 'restricted' based on the scope of advice and services delivered to consumers.

- Further measures to increase the advice pool.  
Individuals with a financial adviser are expected to save an additional \$1,590 annually (after costs) based on KPMG Econtech research in 2011. The research found that if an additional 5% of Australians received financial advice, national savings would increase by \$4.2 billion (or 0.3% of GDP) by 2016-17.

In addition to the abovementioned measures, tax deductibility for upfront advice should be revisited as a mechanism to reduce the costs of personal advice and encourage take-up. Forecast increases in wealth generation, GDP growth and reduced welfare costs (e.g. via self-funding of retirement and uplift in insurance coverage) should act to offset revenue impacts.

► **Clarification of application of 'wholesale' investor tests.**

In the context of consumer protection, wholesale investor exemptions should be considered with respect to self-managed superannuation fund trustees, in particular, income and asset level thresholds applying on a look through basis.

While the logic of wealth levels alone as a proxy for wholesale investor classification has been examined, such measures could arguably be strengthened in light of financial literacy concerns and greater understanding of consumer behavioural issues.

► **Assessment of regulator performance against re-defined KPIs.**

Consistent with recommendations 3.1 and 3.3, regulator KPIs should be revised to include consideration of industry collaboration, growth and competition objectives.

In the US, the SEC is mandated to consider efficiency, competition and capital formation, in addition to public interest and consumer protection concerns. In Hong Kong, one of the HKMA's main functions is to maintain Hong Kong's status as an international financial centre. Australia's growth and export imperatives arguably support a rebalancing of KPIs along these lines.

► **Harmonisation and simplification of tax laws.**

The level playing field, product rationalisation and export impediments created by Australia's tax system have been discussed in Sections 1 and 2 above. For completeness, the Henry review of Australia's Future Tax System, May 2010 outcomes regarding simplification are noted:

*"Australia has too many taxes and too many complicated ways of delivering multiple policy objectives through the tax system...around 90 per cent of Australian tax revenue is raised through only 10 out of some 125 different taxes that are currently levied on businesses and individuals"*

► **Harmonisation and simplification of licensing, capital and governance requirements.**

Consistent with recommendation 1.6, revision and consolidation of insurance laws should be considered to assist product innovation.

In a different context, product convergence and distribution trends foreshadow an increase in non-traditional players (including technology providers) entering financial services markets. Measures to ensure appropriate licencing, capital and governance arrangements extend to such players should be considered.

Appropriate licencing and oversight of shadow banking and broking participants also needs to occur.

The dual operation and roles of ASIC and the Tax Practitioners Board (TPB) under the limited licensing regime should be reconciled, including with respect to the provision of taxation services.

From a capital perspective, harmonisation of prudential regulation should extend to review of the competitive impacts of capital rules applying to banks, insurers and superannuation funds, particularly with respect to the delivery of like products and services through different channels.

As noted, capital and liquidity requirements applying to domestic banking institutions via existing prudential standards and the domestic application of Basel III need to be evaluated with reference to impacts for funding, competition and industry growth. Modelling of risk weights, accreditation processes, guarantees and capital ratio reporting should be considered, including with reference to G20 alignment.

Given the importance and compulsory nature of superannuation, the definition, role and number of 'independent directors' required on superannuation boards should be reviewed, as well as requirements for disclosure of conflicts of interests.



► **Harmonisation and simplification of consumer complaints resolution schemes.**

Multiple complaints resolutions scheme currently operate in Australia, including the Credit Ombudsman Service, Financial Ombudsman Service and the Superannuation Complaints Tribunal. Notwithstanding functional differences, cost efficiencies and establishment of uniform standards should be considered via streamlined complaints handling processes.

In an international context, the Financial Industry Disputes Resolution Centre Ltd (FIDReC) was established on August 2005 in Singapore, which provides an avenue for consumers to resolve disputes across the financial sector. FIDReC took over from the banking industry's Consumer Mediation Unit (CMU) and the insurance industry's Insurance Disputes Resolution Organisation (IDRO), bringing all capital market transactions under its dispute resolution scheme.

► **Review, harmonise and simplify minimum standards of conduct, competency and education**

In addition to differing compensation outcomes arising for losses incurred by entities under prudential supervision versus not (for example, retail funds versus SMSFs), inconsistencies exist with respect to conduct and competency oversight. Reconciliation between supervision and enforcement activities conducted by ASIC, APRA and the ATO across product and service providers, particularly in the SMSF sector, requires consideration.

As noted above, we believe there is a strong role for industry groups to play in this regard.

► **Data collection and analytics requirements to aid better decision making and the preventative management of risks.**

The use of robust data analytics to manage risk on a proactive and preventative basis is extremely important.

This requires market participants and regulators to have access to and assess aggregated data on investments, products, services and consumers to better manage risk. This is currently problematic.

The more effective use of industry data to aid consumer decision making (for example, the FCA's requirement in the UK to publish claims payout ratios in relation to various insurance products), reflects the need for regulatory design to also recognise and overcome consumer behavioural biases. Data collection and publication requirements need to reflect these objectives.

► **Evaluation and management of broader systemic risks including shadow markets, concentration risk and environmental, social and governance (ESG) challenges.**

Licensing, capital and governance arrangements need to be extended to market participants operating in shadow banking and broking markets.

The relative concentration of Australia's financial services market - home bias, concentrated Australian equity exposure, vertical integration and dominance of a small number of large players, requires assessment. Concentration risk impacts for capital market growth have been outlined in Section 1, along with liquidity challenges posed by demographic shifts and moves to decumulation.

In addition to these issues, the World Economic Forum 'Top 10 global risks of highest concern' and 'Global Trends 2030: Alternative Worlds' point to a range of broader ESG and systemic risks. These risks are set out in the table below:

#### Ten Global Risks of Highest Concern - DAVOS 2014

No.	Global Risk
1	Fiscal crises in key economies
2	Structurally high unemployment / underemployment
3	Water crises
4	Severe income disparity
5	Failure of climate change mitigation and adaptation
6	Greater incidence of extreme weather events (eg floods, storms, fires)
7	Global governance failure
8	Food crises
9	Failure of a major financial mechanism / institution
10	Profound political and social instability

Source: *Global Risks Perception Survey 2013-2014*

In this context, consideration should be given to how Australia's regulatory framework addresses these risks at a wholesale and retail market level and ultimately ensures the innovative flow of capital to sustainable enterprise and broader social needs. We recognise that the FSC has implemented an industry standard which mandates that members must develop and implement an ESG risk management policy for MySuper products. Consideration of these risks and their impacts for investment decision making are also being considered in a variety of ways by the overseas jurisdictions observed, most notably at the institutional investor level.

As noted in Section 1, the above measures are perceived to be potential sources of future innovation, domestic and export market growth.

## Recommendations

- 3.1 Mandate quantitative cost-benefit analysis as part of Regulatory Impact Statements and robust post implementation regulatory reviews. Include assessment of impacts for industry growth, competitiveness, costs and consumer protection as part of the initial assessment and assessment of policy objective achievement, unintended consequences, with review of regulatory settings where appropriate, as part of the post-implementation review
- 3.2 Undertake root and branch review of PDS and broader disclosure regime. Simplify and enhance comparability of information and digital engagement
- 3.3 Determine the optimal role for industry in regulator mandates. Assess effectiveness of consultation and potential for industry body involvement in standard setting
- 3.4 Review advice related reforms, including from a product distribution flexibility and consumer protection perspective. Consider:
  - ▶ Enhanced risk based frameworks that proactively assess culture, conflicts, conduct and mis-selling risks
  - ▶ Positive obligations regarding financial product suitability assessment
  - ▶ Disclosure mechanisms to ensure clearer distinctions between the provision of 'advice' versus the delivery of general product information, including differing obligations and competencies required to deliver advice
  - ▶ Further measures to increase the advice pool, including upfront tax deductibility.

- 3.5 Clarify application of 'wholesale' investor tests, particularly with respect to superannuation trustees
- 3.6 Assess regulator performance against re-defined KPIs, taking into account oversight responsibilities, preventative capabilities, industry collaboration, growth and competition objectives
- 3.7 Review, harmonise and simplify tax laws
- 3.8 Review, harmonise and simplify licensing, capital and governance requirements
- 3.9 Review, harmonise and simplify consumer complaints resolution schemes
- 3.10 Review, harmonise and simplify minimum standards of conduct, competency and education requirements. Undertake in close consultation and collaboration with industry having regard to existing codes of conduct, professional obligations, education, training and CPD requirements
- 3.11 Review, harmonise and simplify data collection and publication requirements
- 3.12 Incorporate data analytics requirements to aid better decision making and the preventative management of risks
- 3.13 Evaluate and manage systemic risks.

## Section 4: Financial literacy

### Background

The efficiency and robustness of a principles, disclosure based financial services system is enhanced greatly by educated consumers. Such consumers are able to make informed choices between financial products and services, which is essential given the range of market offerings and evolving channels for distribution.

Enabling consumers to genuinely 'vote with their feet' is an important contributor to not only consumer protection objectives, but also ensuring market participants genuinely compete on the quality and pricing of their financial products and services.

Accordingly, financial literacy measures, including recognition of consumer behavioural influences is vital to market competition and allocative efficiency.

### Australia's relative positioning

There is general consensus that many Australians lack basic financial management skills. Where knowledge does exist, it typically relates to simpler topics such as budgeting, as opposed to more complex concepts such as investing and saving for retirement.

Currently, only 1 in 5 Australians receive financial advice. Prior shadow shopping exercises conducted by ASIC have highlighted the difficulties consumers face in determining whether the financial products, services and advice they receive is good, bad or otherwise. The ability of consumers to appropriately 'value' financial advice is equally problematic.

Recent surveys in Australia have identified the following groups as having lower levels of financial literacy:

- ▶ People who are relatively young (under 25 years)
- ▶ People with no formal post-secondary education
- ▶ People with lower income and assets (household incomes under \$25,000, those with less than \$2,000 in savings and investments)
- ▶ Those working in lower blue collar occupations.

A number of initiatives have been pursued by Government and regulators in an effort to enhance financial literacy, including:

- ▶ National Financial Literacy Strategy
- ▶ Delivering financial literacy programs through school curriculums and the higher education system, employer, union sponsored and community based programs
- ▶ Implementing a professional learning package for teachers of financial literacy education
- ▶ Maintaining a dedicated website for consumers and investors for example, MoneySmart, which provides financial literacy resources for the community
- ▶ Developing new financial literacy resources such as seminars and a booklet on the theme of 'Investing Between the Flags'.

Overseas jurisdictions have also placed considerable weight on improving financial literacy. By way of example:

- ▶ In the UK, the government has funded a free 'Money Advice Service' in order to assist people improve their understanding and knowledge of financial matters and their ability to manage their financial affairs.

The Personal Finance Education Group (PFE) has been effective in ensuring financial literacy remains on the government's agenda, with the newly

published National Curriculum for England confirming financial education's place in secondary mathematics and Citizenship courses from September 2014.

- ▶ The Canadian Centre for Financial Literacy was launched in 2008 to provide money management, financial training and resources to Canadians, in particular low-income groups. This followed a number of financial literacy initiatives implemented since 2004, including the establishment of the Financial Consumer Agency of Canada and a National Task Force on Financial Literacy.

A recent Canadian Financial Capability Survey (CFCS) conducted in 2011 tracked literacy scores across 5 capabilities, revealing only 26% of those surveyed as high scoring, with lower scores most prevalent among younger and older Canadians (17% and 16% respectively).

Canada has recognised the need to accelerate activities, including adding financial literacy to the core school curriculum and developing introductory financial literacy courses as a standard part of financial advice services.

- ▶ In Hong Kong, the 'Investor Education Centre' (IEC), supported by the territory's four regulators, was established in November 2012. The IEC's mission is to improve financial literacy with education programs being conducted via mass media and online channels, including radio dramas, short videos, print media, outreach programs and online learning.

Further, the 'Smart Kid' financial education program offers secondary students the opportunity to participate in simulated financial decision-making and model responsible credit management.

- ▶ In Singapore, a national financial education program, MoneySENSE, was launched in October 2003, which brings together industry and public sector initiatives to enhance consumers' financial literacy.

A joint project by Citi Singapore and Singapore Management University (SMU) has led to the rollout of Singapore's first structured financial literacy program for young adults in 2012, focused on providing personal finance knowledge to those aged 17 to 30 with low incomes.

- ▶ In the US, the Consumer Financial Protection Bureau (CFPB) was established by the Dodd-Frank Act in 2012. A core function of the CFPB is to protect consumers by carrying out federal consumer financial laws, with promotion of financial education initiatives being a key objective.

Given international efforts and known market deficiencies, it is not surprising that widespread support exists for the initiatives implemented in Australia. However, further efforts are required to promote confident and informed consumers of financial products and services. This is particularly the case given the forecast rise in digital platforms and enhanced marketing and sales techniques expected to be employed through direct channels.

Further measures that should be considered include:

- ▶ Consistent with UK, Canada, Hong Kong and Singapore, embed financial literacy courses and skill development in school curriculums.
- ▶ Embed consumer behaviours analytics in financial literacy measures, in particular understanding of how such behaviours impact 'rational' decision making.

Understanding consumer biases is increasing and helping shape future regulatory settings and approaches to driving effective competition. The UK has led major initiatives on point, including establishment of the world's first government institution (Behavioural Insights Team) - 'Nudge Unit', devoted to the application of behavioural sciences. Working with a range of government departments, this team applies insights from academic research in behavioural economics and psychology to public policy and services.

Reflecting this position, the FCA is adopting a 3 step process to apply behavioural analysis, including:

- ▶ Identifying and prioritising consumer risks

- Understanding root cause analysis
- Designing effective interventions, including the use of cost-effective, well-designed ‘nudges’ that can lead to better consumer decision making.

#### FCA Application of Behavioural Analysis

Questions addressed	
<b>Step 1: Identify and prioritise risk to consumers</b>	<ul style="list-style-type: none"> <li>► How can we spot risks of consumer detriment caused by biases?</li> <li>► How can we prioritise these risks?</li> </ul>
<b>Step 2: Understand root causes of problems</b>	<ul style="list-style-type: none"> <li>► Could consumers be choosing reasonably?</li> <li>► If consumers are biased, what do they truly want and need?</li> <li>► How should we analyse firm-specific issues?</li> <li>► How should we analyse market-wide issues?</li> </ul>
<b>Step 3: Design effective interventions</b>	<ul style="list-style-type: none"> <li>► What interventions are available to protect consumers?</li> <li>► Should we intervene and, if so, how?</li> <li>► How can we assess the impact of interventions</li> </ul>

Source: *Applying Behavioural Economics at the Financial Conduct Authority*

- **Co-funded education campaigns to promote the value of advice, insurance and retirement income streams.**

If competition and consumer protection imperatives are to be met, financial literacy measures are needed to promote the value of advice. Advice systems around the world have suffered from the devaluation and practical positioning of advice as a loss leader into product sales – a situation which is now sought to be addressed by policy makers and regulators.

Transparency of fees, removal of remuneration conflicts, enhanced best interest and fiduciary duties, product suitability, distinctions between advice delivery and types of financial advisors are all measures designed to improve quality and trust. However, a viable and growing advice industry also relies upon consumer understanding of:

- The complexity, competency, skill and infrastructure required to deliver high quality financial advice
- Benefits and value provided
- Appropriate fees for services delivered.

Co-funded education campaigns promoting these objectives should be extended to insurance and retirement income stream take-up, focusing in particular on underinsurance, adequacy and longevity risks.

- **Promote consumer awareness and understanding of digital delivery.**

As noted above, digital platforms are rapidly increasing. Consumer engagement has been demonstrated to be contingent upon better understanding of privacy and security risks, which financial literacy measures should specifically address.

## Recommendations

- 4.1 Embed financial literacy courses and skill development in the national education curriculum
- 4.2 Embed consumer behavioural analytics in approaches to reform, financial literacy and assessment of competitive impacts
- 4.3 Co-fund education campaigns to raise awareness of the importance and value of financial advice, adequate insurance and retirement income stream products
- 4.4 Promote consumer awareness and understanding of digital delivery of financial products and services.

## EY | Assurance | Tax | Transactions | Advisory

### About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organisation and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organisation, please visit [ey.com](http://ey.com).

This communication provides general information which is current at the time of production. The information contained in this communication does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Ernst & Young disclaims all responsibility and liability (including, without limitation, for any direct or indirect or consequential costs, loss or damage or loss of profits) arising from anything done or omitted to be done by any party in reliance, whether wholly or partially, on any of the information. Any party that relies on the information does so at its own risk.

© 2014 Ernst & Young, Australia.  
All Rights Reserved.

Liability limited by a scheme approved under Professional Standards Legislation.

**[ey.com/au](http://ey.com/au)**