Submission to the Australian Law Reform Commission

In response to Financial Services Legislation Interim Report A

February 2022

Thank you for the opportunity to provide this submission in response to Interim Report A of the Financial Services Legislation reference.

Disclosures and Disclaimer

From 1998 to 2006 I was a senior executive of the Insurance Council of Australia (ICA), concluding in the role of Deputy Chief Executive. I was at the ICA during the implementation of the Financial Services Reform package by the general insurance industry in Australia.

From June 2011 to October 2021 I was Chief Executive Officer of the National Insurance Brokers Association of Australia (NIBA). In that capacity I represented NIBA and its Members in a number of significant inquiries and reviews (Future of Financial Advice, Financial System Review, Royal Commission into Misconduct in Financial Services, Federal Government legislation arising out of Royal Commission recommendations).

Since my retirement from NIBA, I have been appointed by the ICA to chair its Business Advisory Council, a role that is ongoing at the present time. I am also a member of Industry Panels convened by the Australian Financial Complaints Authority.

In my various roles over the past 20 years, I saw first hand the impact of legislative “reforms” “on the ground”, and “at the coal face”. I saw this from the point of insurance companies having to implement the 2001 reforms in the general insurance sector, and I saw in great detail the ways in which insurance brokers struggled to implement legislative reforms in the past 10 years, and the compliance and other costs that were added to their businesses, ultimately to be paid for by their clients.

During this time I have also had considerable opportunity to research and consider the effectiveness of regulatory approaches in the financial services industry, including approaches in overseas jurisdictions. Financial services play a crucial role for individuals, small medium and large businesses, major corporations, governments, the economy and the nation as a whole. It is therefore critically important that products and services are provided in a fair and efficient manner in order to meet the needs of individuals and the community, and in doing so consumers are given adequate and appropriate protection from unscrupulous vendors and service providers. It is important that the system as a whole supports the making of sound financial decisions by consumers.

The comments in this submission are my personal observations based on the work I have undertaken over 20 years, primarily in the general insurance sector. The comments do not and are not intended to reflect the views and policy of the Insurance Council of Australia nor the National Insurance Brokers Association.

The problem

The Interim Report focuses quite rightly on the extreme complexity of Chapter 7 of the Corporations Act, and related legislative and guidance instruments. The Interim Report very clearly presents the empirical data which gives rise to and justifies the plea from Royal Commissioner Hayne to simplify the law.

That is not the only problem.

During the Global Financial Crisis no major Australian financial institution failed – a credit to the prudential regulatory approach of the Australian Prudential Regulation Authority, developed and refined after the failure of HIH insurance company in 2001.

However, during the Global Financial Crisis, thousands of Australians lost billions of dollars in investments, superannuation and other financial products despite Australia having one of the more sophisticated financial services regulatory structures in the world.

Further, the Royal Commission into Misconduct in Financial Services revealed misconduct among major financial institutions and other sectors of the financial services industry on an almost industrial scale. The extent of the misconduct was confirmed very recently by ASIC, when it announced that as at 31 December 2021 six of Australia's largest banking and financial services institutions had paid or offered a total of $3.1 billion in compensation to customers who had suffered loss or detriment because of misconduct or non-compliant advice (ASIC media release 22-020MR, 14 February 2022).

These losses, and this level of misconduct, has to raise the question of the true effectiveness of the regulatory framework in the financial services sector. This is the real problem that the ALRC needs to consider, and I believe should address under the current reference. Legislative complexity is certainly a part of the problem, but the core issues are more fundamental in my opinion.

Core objectives

The core objectives of a sound regulatory framework for the financial services industry have been set out in the Interim Report, and in the corporate plans and strategy statements from ASIC.

I believe these goals and objectives are entirely appropriate and proper for Australia and Australians.

My challenge to the ALRC is to seriously consider **<u>how best</u>** these goals and objectives can and should be achieved. In that regard, the reference to the ALRC could not have come at a more important time.

The current approach to the regulation of financial services involves complexity, confusion, very significant compliance and legal overheads, and processes and procedures that have been shown to not work in practice. My concern is that taking some steps to simplify some of the definitions and concepts in the Corporations Act will ease some of the burden of complexity but will not significantly improve the regulatory framework for consumers, other financial services clients, product manufacturers and product distributors and advisers.

As such, I have no real problems with the suggested changes to the Corporations Act set out in Interim Report A. I am not sure they will make much difference to the experience of clients and consumers, or to the administrative and compliance burden carried by financial services firms.

The wrong starting point

Looking back over the past 20 years, it has become apparent (especially in the last 5 years) that the Wallis vision of integrated financial firms providing a wide range of products and services to clients under the one roof has not come to pass. Initially major banks acquired significant wealth and advice firms, but they have now all been sold. Further, banks established or purchased or continued to operate general and life insurance companies, however these have now also been sold – the banks continue to offer these products, but only as distribution agents of other financial firms.

Hence the initial intention of Chapter 7 of the Corporations Act – to provide a single regulatory regime across financial services in order to reflect an integrated financial services industry – is now no longer fit for purpose. Financial products and services continue to operate in their various product groups:

- Banking – savings and loans
- Financial Planning and Investments with a short to medium term outlook
- Superannuation and retirement savings with long term outlooks
- Life insurance – now mostly entrenched within superannuation or group life insurance arrangements
- General insurance
- Other specific areas such as the stock market and other financial markets.

The Wallis approach of trying to establish a "one size fits all" regulatory structure has not worked. Indeed, the experience of the past 20 years has shown that every time a major rule has been developed, it has been necessary to apply exemptions, qualifications and carve outs in order to recognise that the rule cannot and does not operate effectively across all product areas. This has led to the extensive complexity of exemptions, qualifications and so on now comprehensively identified by the ALRC.

Prior to the 2001 reforms the life insurance and general insurance sectors were regulated under Federal legislation that was targeted and designed to reflect the needs and circumstances of those sectors. They reflected 200 years of insurance law, as well as core legal principles designed to balance the rights and obligations of policyholders and insurers, including the doctrine of Utmost Good Faith.

One ongoing concern I encountered over the past five plus years has been the failure to investigate the impact of proposed reforms to the Corporations Act on the existing insurance law of Australia. Indeed, my understanding is that the Design and Distribution Obligations reforms were developed with little or no comparative analysis on the impact they would have on existing Insurance Contracts Act rights and obligations, or on other areas of insurance law. The net result of this process is that insurance companies, insurance brokers and others now have to meet both insurance law and corporations law obligations, and the protections offered to policyholders and third party claimants are not necessarily consistent across the two regimes. This should not have occurred.

A timing challenge

As the ALRC has noted, the Federal Government is about to conduct the Quality of Advice Review, which is due to report to the Government by December 2022. That review will examine a number of important features of the existing regulatory regime, including the nature of personal advice, how best to protect individuals and small businesses, and what advice could or should look like. Many of these matters are discussed at length in Interim Report A.

The timing of the Quality of Advice Review overlaps with the ALRC reference. In one sense that is unfortunate.

However, I would like to suggest that (with changes to the ALRC Terms of Reference if needed) it could well be appropriate for the ALRC to take the policy recommendations of the Quality of Advice Review, and determine how best to design and develop a legal regulatory framework which would give effect to those recommendations, and which would operate in an objectively consistent, fair, and efficient manner, giving the appropriate protections to consumers and clients, and being able to

be implemented in a consistent and efficient manner by financial services firms. This would hopefully achieve the “simplify the law” pleaded for by the Royal Commissioner, and would substantially improve the regulatory framework for the benefit of all concerned.

Bite sized chunks

As noted above, financial services has not developed along the lines of an “allfinanz” or integrated financial services model in Australia, with the possible exception of the products and services offered by the Suncorp Group. Even there, my impression is that the banking and insurance arms operate relatively independently, and the Group has sold its life insurance business.

My strong recommendation to the ALRC is to examine the potential to move away from the “one size fits all” model of regulatory framework, and to develop regulatory structures and processes more appropriate for the respective areas of activity.

This can be explained as follows. Take the following products:

- A transaction banking account, with a credit/debit card
- A home loan product
- A general insurance policy for a person’s home and contents, or their motor car
- A small investment portfolio with a low level of risk appetite
- An investment portfolio with a degree of risk appetite
- A retirement savings plan including superannuation
- Family protection via life insurance.

In each of these cases, the nature of the product is very different. The nature of any conversation between the provider/distributor and the client will be very different. The goals and objectives of each product are very different. The time frame during which the product will operate will most likely be very different (for a general insurance policy, the time frame is normally 12 months, for retirement savings the time frame is up to 30 – 40 years). The operation of the product is very different: investments have a degree of risk, but the expectation is that funds invested will be returned with the expected level of interest. In the case of general insurance, the premium is paid and in most cases that is the end of the matter, unless an insured event occurs, and a claim has to be assessed and paid in accordance with the terms of the policy.

It has been my observation, based on taking part in many industry discussion groups with government agencies and financial services regulators, that many regulatory proposals are developed in the context of financial planning and investment advice being provided to individuals, but are then applied more broadly without any real assessment of the relevance, impact or cost of implementation in other sectors. In many cases, the language used by those involved clearly indicates that the intent is to regulate financial planning and investment advice, but the proposals are nevertheless applied more broadly.

This has occurred regularly with general insurance broking. Under the existing corporations law, general insurance brokers are regulated as “financial advisers”, as they give financial advice to their clients on risk and risk financing options. This very different to financial planning and investment advisers, who give advice on savings and investment products. Nevertheless, the two are regulated in essentially the same manner. Initiatives designed to address issues and concerns in relation to financial planning and investment advice are applied more broadly, even though those issues and concerns may not have arisen in other sectors.

I firmly believe that much complexity, and most exemptions, carve outs and qualifications, can and would be removed if the regulatory framework was broken into sector specific requirements that addressed the fundamental nature of the products and services provided in the sector, and provided tailored regulatory obligations and protections appropriate to the sector. In the context of general insurance, this would take strong account of the existing insurance law of Australia, and the rights and obligations of parties that have been developed at common law and in relevant statutes over the past 100 years.

Disclosure does not work

One important aspect of the existing regulatory framework is the emphasis it places on disclosure, often in complex and lengthy documents – now known as Product Disclosure Statements. Additional disclosure documents have been developed, such as the Key Facts Sheet, and more recently the Target Market Determination.

In 2015 the Insurance Council of Australia commissioned a report on how consumers made decisions in relation to their general insurance needs. The project was closely informed by behavioral economics experts. The report "Too Long, Didn't Read" was a critically important contribution to how consumers make decisions – at least in relation to their general insurance policies. There was no surprise: they simply didn't read the reams of materials provided to them, and mostly didn't read important content such as the policy schedule either.

It is now generally accepted that consumer protections based on product disclosure information amounts to very little protection for consumers at all. It is crucial, therefore, that the ALRC bears this in mind when considering simplification of requirements for the disclosure of information to consumers.

Focus on the coal face transaction

My final comment is that before making any firm recommendation for change to the regulatory framework, it is important that the proposed change be critically examined for its intended operation when a provider or their distributor speaks with a consumer, or when an adviser speaks with their client. This is the point where regulatory obligations take effect, and it must be clear that the obligation will actually achieve the policy objective for the "reform", AND that it will be cost effective for both the client/consumer and the financial services firm to implement and deliver the "reform".

I will give two anecdotes which support this comment.

In 2021 the unfair contracts terms (UCT) regime was applied to insurance contracts, despite the extensive consumer protection provisions of the Insurance Contracts Act and other provisions of insurance law in Australia, and despite the fact that insurance law is based on "utmost good faith" and not on the basis of "let the buyer beware". My understanding is that the result of this "reform" has been the withdrawal by insurers of a number of policies and product wordings which were previously regularly recommended to clients by their insurance brokers because of the positive protection they provided for their respective risks. Insurers indicated it was either too expensive to review the policies for UCT exposure, or because even after the review they were unsure of their ongoing exposure to change of policy terms and conditions under the UCT regime.

The second matter relates to the Design and Distribution Obligations reforms. My view is that these reforms work reasonably well in the context of financial planning and investment products and advice. The product manufacturer will develop products with reasonably clear levels of risk, and the

target market will be investors who wish to invest in products with that level of risk profile. In relation to a general insurance policy for a motor car, a very different process occurs: the insurer invites an application for insurance cover, and in the course of making the application the consumer discloses information and makes a number of decisions about the nature and extent of cover they wish to purchase. At the same time, the insurer will be assessing the information from an underwriting point of view, and will determine whether to offer a policy, the terms and conditions attaching to the policy and the premium payable. The consumer will then decide whether to proceed with the purchase of the product. The actual product is not determined until this process is concluded. My point is this: in all the discussions in relation to Design and Distribution Obligations, I never once saw a worked example of how the proposals were intended to operate in relation to general insurance products purchased by individuals and small businesses. Therefore, I have to assume there was never any detailed analysis of the relevance and cost effectiveness of DDO in the general insurance space.

My main reservation about Interim Report A is that it involves an extensive technical legal analysis of the operation of the words in the statute, but has little or no discussion of the impact of those words when a financial services provider or their agent interacts with a consumer. This is the point where the regulatory framework must be effective (for the consumer) and efficient (for the provider).

Responses to ALRC Proposals and Questions

I would like to offer the following brief responses to the List of Proposals and Questions:

Question A1: I urge the ALRC to examine the impact of the legislative framework and legislative complexity on the various sectors of the financial services system, with a view to achieving greater simplicity by implementing sector specific regulation rather than continuing with a "one size fits all" approach.

Proposals A3 – A6: I support the proposals set out in the Interim Report.

Proposal A8: I strongly urge any change to financial product disclosure to be very carefully tested in practice prior to implementation, in order to ensure it is likely to be effective and will achieve better outcomes for consumers and clients. The principles of behavioral economics are crucial in this regard.

Proposals A9 and A10: I strongly support these proposals.

Proposals A13 – A15: I support the proposals in principle, however it may be preferable to defer recommendations in this area until the conclusion of the Quality of Advice Review.

Question A16: as discussed above, my strong preference is to develop sector specific regulatory structures, including for general insurance products and services, so that the regulation of the sector is relevant, appropriate and cost effective in relation to the obligations it imposes and the benefits it provides to clients and consumers.

Questions A18 and A19: I support the adoption of the six "norms" listed by the Royal Commission as core objectives to be listed in an objects clause.

Conclusion

I would be very pleased to discuss any aspect of this submission with the ALRC.

Thank you for your consideration of this submission.

Dallas Booth