



ASIC

Australian Securities & Investments Commission

Financial Ombudsman Service

2009 National Conference

Financial services – the changing landscape

An ASIC Update

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11-12 June 2009

Crown Promenade Hotel, Melbourne

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1. Introduction

- 1 The global financial crisis was not, and still is not, a laughing matter. This is why there are no good jokes to tell about it. There was the comic strip explaining sub-prime mortgages and their ultimate impact on a Norwegian pension fund, but it was not very polite and so not suitable for sharing with you today. The remaining jokes are, I'm afraid to say, a sorry reflection on an industry known for its creativity. Maybe the regulator should be responsible for some decent jokes in any future financial crisis! (Look out). Anyway, here is a sample of what I am complaining about:
 - What's the difference between an investment banker and a pigeon? A pigeon is still capable of making a deposit on a new BMW.
 - A director decided to award a prize of \$100 for the best idea of saving the company money during the credit crunch. It was won by a young executive who suggested reducing the prize money to \$20.
- 2 Now many of you would be thinking that I probably shouldn't be hanging on to my job for too much longer after telling jokes as bad as that. Well you are partly right. I have recently been appointed to chair a year-long Review into the *Governance, Structure, Efficiency and Operation of Australia's Superannuation System*. This will be the first comprehensive review into Australia's compulsory \$1.1 trillion superannuation system, focused on removing unnecessary costs, fees, commissions and complexity and boosting returns and retirement incomes. This is a full-time role and I will be finishing up at ASIC later this month.
- 3 The theme of this conference is 'Financial services – the changing landscape'. There would be few organisations more aware of how much has changed in financial services in recent times than ASIC. So I am pleased to be able to talk to this theme from the regulatory perspective.
- 4 As we all know, around two years ago, the world was at the height of its economic boom. London - lauded for its principles-based regulatory approach - was the new global financial centre and home to a new generation of investment bankers and hedge fund managers who were living it up.
- 5 Bonuses of millions of pounds were commonplace. *Movida*, one of London's most extravagant clubs, added a £35,000 cocktail to its menu. The *Flawless* comprised a mix of Louis XII cognac, Cristal

Rose champagne, brown sugar, bitters, a few chips of 24-carat edible gold leaf and an 11-carat diamond ring at the bottom of the glass. Our very own Kylie Minogue was apparently 'shouted' one.

- 6 In the financial services sector, most Australians believed their super funds would continue to deliver double-digit returns and there were many other clear signs of a bull-market mentality.
- 7 Even when the tide started to turn in the UK and the US, Australia showed every sign that it would ride out the GFC unscathed. This time a year ago - June 2008 - the resources boom continued unabated, interest rates were high and the Aussie dollar was trading at around 94 US cents.
- 8 Well, we all know what happened next.
- 9 However, the S&P/ASX 200 is up nearly 30% since its low in March this year. ASIC also felt the market had demonstrated enough signs of stability for us to lift the ban on covered short-selling of financial stocks before the market opened on 25 May.
- 10 Yet, even if these figures evidence the green shoots of a longer term recovery, on the ground, consumers and retail investors are still feeling the pain. One need not look further than FOS' most recent dispute statistics to show that a market recovery will take time to work its way through to consumers and retail investors.
- 11 FOS data shows that from January to the end of April this year, the FOS Banking & Finance division recorded a 52% increase in disputes compared to the same period in the previous year. Likewise, the Investments, Life Insurance and Super division recorded a 68% increase in disputes.
- 12 This is in line with comparable agencies overseas. In its annual review of 2008-2009, the UK's Financial Ombudsman Service recorded significant increases in complaints received. For example, investments disputes were up 30% and disputes related to mortgages and unsecured loans were up 11% and 44 % respectively, reflecting the impact of the credit crunch.
- 13 These figures will not come as a surprise to any of you. However, they serve to illustrate how timely ASIC's new external dispute resolution regime is, and how necessary it is that we facilitate consumer access to effective and efficient dispute resolution at this challenging economic time.

2. EDR Scheme

- 14 So let's talk a bit about ASIC's new external dispute resolution scheme framework.

- 15 The key changes to the old regime are twofold.
- 16 First, from 1 January 2010, all schemes will be required to deal with claims worth up to \$500,000. This is even though schemes will be allowed to limit the maximum amount of compensation payable per claim to less than that amount, in accordance with their rules.
- 17 As you know, EDR scheme rules currently bar completely a complaint involving more than the applicable compensation limit. This is a vast improvement in getting consumer complaints through the door. Although the compensation that the complainant may actually be awarded will be much less than \$500,000, this change removes a significant barrier for consumers in getting their complaint heard without having to go to court.
- 18 Second, from 1 January 2012, EDR schemes will only be allowed to limit - or cap - the maximum amount of compensation payable per claim to a minimum of \$280,000 with the ability to opt for a higher figure in the rules of the scheme. The minimum is lower (\$150,000) if the claim relates to an insurance broker.
- 19 This represents a significant increase for some disputes and again is about improving access for consumers to dispute resolution.
- 20 There are other significant changes. For example, EDR schemes will also be able to award interest in addition to compensation awards where it is appropriate. EDR schemes will also have a discretion whether or not to cancel a member's membership or to continue to handle a complaint where a member ceases to carry on business (eg an insolvency situation).
- 21 This change, in particular, will improve complainants' access to EDR in light of difficulties some investors have had in the wake of recent corporate collapses.
- 22 I won't go into more of the specifics as I am sure the changes will be discussed in detail over the next couple of days. But, as an amalgamation of five dispute resolution bodies, we are certainly looking to FOS to set the standard for external dispute resolution across the board.
- 23 Now I appreciate that one of the key issues in relation to these changes is the issue of professional indemnity insurance.
- 24 ASIC is well aware that there has been a real hardening of the PI market, which is making it more difficult and more expensive to get insurance cover.
- 25 So, in recognition that PI insurance is a real concern for stakeholders, we have delayed increasing the minimum compensation limits until 2012. We think this should give plenty

of time for financial services businesses, EDR schemes and the PI insurance market to adjust to these changes.

3. Swimming Between the Flags

- 26 Of course, ASIC is also focussed on the bigger picture: what can we do to reduce the number of complaints and disputes in the first place? This is because we recognise that many complaints arise when retail investors get themselves into real trouble.
- 27 The market downturn has highlighted how exposed many Australian retail investors are to flawed business models and failed investments. In too many cases, this has caused them devastating financial losses.
- 28 There are many dimensions to poor financial outcomes for retail investors; including lack of access to quality advice, poor product design, poor investor behaviour and low literacy levels (both financial and general literacy), conflicts of interest and poor disclosure.
- 29 One possible solution ASIC is looking at is how retail investors might be prompted, in a very simple way, to ask themselves how much risk they think they are taking before they invest. A sort of 'Slip! Slop! Slap!' campaign for retail investors.
- 30 ASIC believes that all retail investors should know about basic things like asset allocation, diversification and the concept of risk-adjusted return. The problem is that, to many people, those terms sound like mumbo jumbo and they switch off. How can we get the message across all the same?
- 31 We think that the answer is to sidestep the jargon problem altogether and use a visual image instead. To this end, ASIC has decided to use the image of 'swimming between the flags': a metaphor suggesting a type of investment behaviour that should keep most people out of trouble, most of the time.
- 32 All investing involves some risk, so investing between the flags, just like at the beach, is never risk-free.
- 33 This recognisable Australian image aims to help retail investors understand when they are 'swimming between the flags' and so in 'patrolled waters' and when they are 'outside the flags' and so taking more risk.
- 34 Many of the retail investors who have suffered losses in failed investments in recent times have been swimming well and truly outside the flags, but without realising it.

- 35 This leads one to ask whether their advisers should have told them they were swimming outside the flags. This is complicated, but at least some of the time, advisers were caught up in the same problem: that the concepts and language around risk disclosure are simply inadequate to convey the message to the average investor – ie the mumbo jumbo problem.
- 36 At its simplest, swimming between the flags is investing in a diversified way between bank deposits, your super, blue-chip shares, vanilla managed funds (and other investments with relatively low risks) or with independent, professional advice.
- 37 Swimming outside the flags is investing in more complex, illiquid, undiversified investments or leveraged products; all the way along the spectrum to outright scams. Each person's flags might be a slightly different width apart and some people are better swimmers than others, but the point is not to split hairs about what is inside and what is outside the flags; it detracts from the simplicity of the message and the force of the metaphor.
- 38 If investors ask themselves whether they might be about to swim outside the flags, they can decide their next move. Should they swim back between the flags, get a stronger swimmer to go with them (ie get independent advice) or simply take the risk? You are, of course, allowed to swim outside the flags; you just need to be aware that's what you are doing and be ready for the consequences.
- 39 For the 'flags' message to be truly successful, advisers also need to use it as well. Margin lending by retail investors is nearly always outside the flags, but how many financial advisers would have explained this to their clients in such simple and clear terms? We also want clients to remember to ask advisers whether their advice is 'between the flags'.
- 40 Over time, with a bit of hard work and luck, this image might mean something to the bulk of Australian investors.
- 41 I can also foresee a time when it will even be relevant in resolving something at EDR level to find out whether the retail investor understood they were swimming outside the flags.
- 42 What else do we think is outside the flags?
 - Complexity – if you don't understand it, then it's outside the flags
 - Gearing – direct gearing is outside the flags as are investments with high internal leverage or other 'financial engineering'
 - 'Maturity transformation' products that are not prudentially regulated – eg debentures and mortgage trusts. These products have caused a lot of damage to retail investors who did not

realise they were swimming outside the flags by investing in them

- Lack of diversification – unless all your money is in the bank, putting all your eggs in the one basket is outside the flags
- Tax-driven schemes
- Hot tips, fads, stock picking and nearly all forms of forecasting eg "this investment is really going to out-perform..." are all outside the flags

- 43 There are many other examples and investment experts will no doubt share their views with us on this and debate some of our views; a process that we welcome.
- 44 As you will have probably realised by now, the flags campaign is a financial literacy initiative. But, it must be emphasised that financial literacy is not a panacea and is a very long-term, incremental and aspirational proposition.
- 45 One of the most challenging aspects of any financial literacy programme is to keep up with the emergence of ever more innovative and complex products. It is like a seesaw: the more complex the choices that have to be made by the retail investor, the greater the pressure on financial literacy to redress the informational asymmetry created by the complexity.

4. Financial product design

- 46 At least some of the solutions to the global financial crisis have to come from better design of financial products.
- 47 More attention needs to be paid to how things work. It is a fair point that more time and effort seems to be expended on ensuring that a toaster is safe from catching fire than is the case with many financial products. Many systems, including Australia's, have tolerated relatively dangerous 'financial toasters', so long as the risks of incineration are clearly disclosed.
- 48 There is an argument for building safer and simpler financial products, creating defaults and soft-compulsion options where good design seeks to compensate for flawed investor behaviour and the 'animal spirits' that drive booms and busts. Do consumers need so many bewildering choices with basic financial products? Or are well made defaults a better option? Often, the choices retail investors are offered amount to a 'choice illusion' often at their expense in terms of extra costs for bells and whistles that are not used.

5. Credit

- 49 One of the most significant upcoming changes to the financial services regulatory landscape is ASIC's proposed new responsibility for the regulation of consumer credit.
- 50 From November 2009, ASIC is scheduled to become the national regulator for consumer credit and finance broking, taking over from the States and Territories.
- 51 This means that home loans, personal loans, credit cards, overdrafts and line of credit accounts, among other products and services, will be regulated under Commonwealth legislation and administered by ASIC.
- 52 On 27 April 2009, the then Minister for Superannuation and Corporate Law, Senator Nick Sherry released the public exposure draft of the National Consumer Credit Protection Bill. The exposure period provides members of the public with an opportunity to make a submission on the draft Bill.
- 53 The program to bring the regulation of consumer credit under the Commonwealth – the National Consumer Credit Action Plan – will be introduced in two phases. The Commonwealth Government will assume responsibility for the Uniform Consumer Credit Code by enacting it as Commonwealth law.
- 54 The second phase will consider a review of unsolicited credit card limit extension offers, the possible regulation of reverse mortgages and further measures, where necessary, to address unfavourable lending practices.
- 55 ASIC and The Treasury, industry representatives and other key stakeholders are working together to implement the changes.
- 56 Another significant upcoming change to financial services regulation concerns margin lending.
- 57 Early last month, Minister Sherry released draft legislation. The proposals require margin lending providers to be licensed by ASIC and those who provide advice on margin lending will need to be trained to provide that advice.

6. Further regulatory reform

- 58 The global financial crisis has demonstrated the interdependence of the world's financial markets: America sneezed and the rest of the world caught the sub-prime flu.
- 59 This has clearly started an international debate about the future of financial regulation. Most of this debate has centred around reform

in the regulation of financial institutions and the instruments they trade in.

- 60 In Australia, the focus is likely to be somewhat different. This is because our financial institutions have withstood the GFC very well. Rather, our problems have tended to be in the retail sector where retail investors have suffered in a stream of collapses and failed investment products.
- 61 So, the debate in Australia may well become more about whether the Australian regulatory system should continue to allow risky financial products to be sold to retail investors on the basis that disclosure is an adequate tool to ameliorate the risk of harm to them.
- 62 Australia is something of an outlier in this regard. Nearly all other legal jurisdictions intervene in the design and availability of products for retail distribution. Looking at such intervention should not be seen as a move to stifle innovation or to remove all forms of risk from retail investment, but a recognition that there are often certain key features of a product that make a material difference to its risk characteristics. Most of these boil down to very simple elements; leverage, liquidity and the viability of the business model on which the product is based. The proposition here is that most financial products have a few key levers that can be pulled to make them more suitable for retail investors.
- 63 These are issues that are currently before the Parliamentary Joint Committee on Corporations and Financial Service in its inquiry into corporate collapses, such as Storm Financial, and related issues.

7. Conclusion

- 64 So to conclude:
 - Australia's retail investors have experienced some real pain as the economic downturn worked its way from the wholesale market through to the consumer;
 - Complaints and disputes have increased and this is a trend that is likely to continue for at least a while yet;
 - ASIC's new EDR regime is timely and we are looking to FOS, as the largest EDR scheme, to set the tone for dispute resolution across the board;
 - ASIC and industry must partner to improve financial literacy standards – ASIC's swimming between the flags message is one approach that we hope will take root in the community;

- Credit and margin lending are significant financial services regulatory reform items on the horizon domestically and will have large implications for EDR schemes; and
 - The Storm PJC inquiry will be an interesting test of the current regulatory settings for retail investors.
- 65 I am sure this conference will provide an excellent forum for debate and discussion and I look forward to continuing to work for better outcomes for Australian retail investors.