20 May 2016

Ms Brooke Stewart
Senior Analyst
Financial Advisers
Australian Securities and Investments Commission
Level 7, 120 Collins Street
Melbourne VIC 3000

Email: brooke.stewart@asic.gov.au

Dear Ms Stewart

CONSULTATION PAPER: 254: Regulating digital financial product advice

The Actuaries Institute welcomes the opportunity to submit comments on the proposals in the above paper.

General comments

- The Actuaries Institute supports the development of digital innovation in Australia and agrees that digital support for consumers could offer convenient and low cost help to clients in understanding their financial planning needs.
- Whilst it makes sense that the law is technology neutral, as per paragraph 7 of your consultation paper, there are challenges around how algorithms can meet the best interests duty in s961B of the Corporations Act (where personal advice is limited in scope).
- We believe that this area is too complicated and fluid at this point to benefit from detailed regulations, but rather suggest that the area will develop best if providers of robo-advice are required to obtain appropriate professional advice. We suggest that members of the Actuaries Institute, the CFA Institute, and professionally qualified accountants can fulfil these roles. The advantage of professional oversight is that members of these professions have:
    - Appropriate in-depth training as to the subtleties of the various issues involved
    - Have access to the combined wisdom of the profession (reflected in standards and guidance notes)
    - Must limit themselves to areas of advice where they have appropriate knowledge
    - Are subject to professional discipline in order to limit commercial excesses

We do not believe that a RG146 qualification alone is sufficient to make these judgements.

- Many current ‘robo-advice’ propositions limit their scope to recommending an investment mix. The assumed client objective is to maximise long term capital growth subject to their tolerance for market volatility. This may be a suitable objective for younger workers in the accumulation phase, but for clients who are approaching, or in, retirement it is not appropriate to recommend an investment mix in isolation from the client’s other circumstances as set out in RG 175.287 below.

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Investment outcomes are uncertain and largely unmanageable. Much academic effort has gone into developing investment strategies to reduce risk and to match risk preferences. There remains considerable uncertainty as to the appropriate determination of the objective, let alone the implications, for investment.[1] Digital advice of this sort should therefore include sufficient warnings about the assumptions and uncertainty involved.

RG 175.287 Where advice relates to financial product(s) with an investment component, we consider that—depending on the subject matter of advice sought by the client—the client's relevant circumstances may include the client's:

(a) need for regular income (e.g. retirement income);

(b) need for capital growth;

(c) desire to minimise fees and costs;

(d) tolerance for the risk of capital loss, especially where this is a significant possibility if the advice is followed;

(e) tolerance for the risk that the advice (if followed) will not produce the expected benefits. For example, in the context of retirement advice, this may include considering longevity risk, market risk and inflation risk;

(f) existing investment portfolio;

(g) existing debts;

(h) investment horizon;

(i) need to be able to readily 'cash in' the investment;

(j) capacity to service any loan used to acquire a financial product, including the client's ability to respond to any margin call or make good any losses sustained while investing in leveraged products; and

(k) tax position, social security entitlements, family commitments, employment security and expected retirement age.

Note: This is not an exhaustive list.

- Detailed rules shift the focus of responsibility from industry to the regulator. They therefore stifle innovation and deflect energy into unnecessary compliance costs – for the industry and the regulator. The rules in any event, might focus on process not outcomes. The paper in the appendix suggests that many existing robo advice calculators are not fit for purpose. While the opinions are debatable, the proposed regulations will do nothing to address the problems. Professional bodies do however provide the necessary institutional framework to address these debates and create generally acceptable principles.

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[1] See for instance: Butt, Adam, & Khemka, Gaurav (2015). The effect of objective formulation on retirement decision making. *Insurance: Mathematics and Economics* 64: 385-395.
Haberman, S., & Vigna, E. (2002). Optimal investment strategies and risk measures in defined contribution pension schemes. *Insurance: Mathematics and Economics*, *31*(1), 35-69.
Kingston, G., & Fisher, L. (2014). Down the retirement risk zone with gun and camera. *Economic Papers: A journal of applied economics and policy*, *33*(2), 153-162.

- As per ASIC research, clients struggle to identify a suitable scope for the advice they need. Sections 128 & 129 of ASIC Report 279 state that:

  > (128) Advisers are generally in a better position than clients to determine which topics are critical to their advice. They should discuss and agree with the client an appropriate scope for the advice service. They should then clearly communicate the scope of their advice, taking particular care when excluding important issues from the scope. We consider it poor practice to exclude a central or core issue that the client may need or expect the advice to cover.
  >
  > (129) Some clients have difficulty in determining the scope of the advice that they need. Clients place considerable trust in their adviser, and advisers should help their clients to understand what advice options are available and to decide on an appropriate scope of advice in the circumstances. We expect advisers to consider what scope of advice would be in the best interest of the client in the circumstances, including the fees and costs associated with the advice.

  We note that professions require the scope of advice to be clarified and need to disclose any limitations to the advice, conflicts of interest etc.

- We point out that as the superannuation system moves to focus more on providing income throughout retirement, digital advice providers are likely to move toward advising on CIPRs (Comprehensive Income Products for Retirement as introduced in the Financial System Inquiry Recommendation 11[2]).
- We further suggest that the skills requirements set out in ASIC RG 146.145 be extended to more specifically cover the methods advisers need to satisfy RG 175.269 and RG 175.287. The Actuaries Institute would be happy to discuss these skills requirements further.

We enclose specific answers to your questions in the attached paper.

The Institute would welcome the opportunity to discuss this issue in further detail and, if required, to assist in drafting further guidance on this matter. Please do not hesitate to contact the Chief Executive Officer of the Actuaries Institute, David Bell (phone 02 9239 6106 or email david.bell@actuaries.asn.au) to discuss any aspect of this letter.

Yours sincerely,

Andrew Boal
Convenor, Superannuation Practice Committee

[2] As per Financial System Inquiry Recommendation 11, the features of a person's Comprehensive Income Product for Retirement should include a regular and stable income stream, longevity risk management and flexibility.

Specific answers:

A1Q1. Overall is the proposed guidance helpful? If not, why not?

Yes, but there is too much detail. The detail is not principle based, and while we accept that there are those in the industry that want additional guidance, we suggest that responding to these requests moves the focus of responsibility for development to the regulator rather than providers. The option to contact ASIC when another manner is appropriate clearly transfers the focus of responsibility to ASIC.

We do not believe it adds any information that a professionally trained reviewer of a robo-advice algorithm would not already know. It is too general to act in any way to enforce better outcomes, but rather focuses on processes that may well add no value to the final outcomes. Overall it adds another layer of compliance to no purpose.

A1Q2. Is our proposed guidance (in Section D of the draft regulatory guide) helpful in assisting digital advice providers to provide scaled advice that is in the best interests of clients? If no, why not?

Partly. Section D is helpful in introducing key regulatory concepts and in signposting where to find more information and detail.

There are a number of areas where the regulation may create risks for providers and so reduce the scope of innovation. We suggest the second bullet point of RG 000.94 is a particular risk area. For clients over age 50 in particular, the client should be informed that the best investment mix for their needs is impacted by each of the items in RG175.287. Clients should be made aware of this before agreeing to a scope that considers only RG 175.287(d) in isolation. Enforcing any regulation over these areas is a hopeless task. Clients will be getting advice from a host of sources (including overseas and unregulated robo-advice sites). The most ASIC can do is to ensure that Australian providers that do not have the necessary skills in-house themselves take professional advice.

B1Q1. Do you agree with this proposal *[to require that a digital advice licensee has at least one responsible manager who meets the minimum training and competence standards for advisers]*? Please provide supporting arguments.

We agree that digital advice processes should be signed off by a suitably qualified professional (either in-house or external). RG146 does not provide adequate training. Where the algorithm involves long term projections involving complex cash flows and life expectancy then this element of the algorithm should have actuarial certification.

B1Q2. Do you agree that, if the changes proposed in the Corporations Amendment (Professional Standards of Financial Advisers) Bill 2015 become law, at least one responsible manager should:

(a) Meet the new higher training and competence standards (i.e. have a degree or equivalent, pass an exam, complete a professional year and undertake continuing professional development); and

(b) Comply with the proposed ethical standards (i.e. comply with a strict code of ethics and be covered by an approved compliance scheme)?

It requires considerable judgement and experience to distil financial advice into algorithms. We support proposals to raise the professional, ethical and educational standards of advisers providing personal advice.

In light of evolving regulatory and demographic developments in Australia, we recommend ASIC also review RG146 A2.1 to ensure that adviser training covers sufficient methodologies about how households can set up portfolios of retirement products (including the Age Pension and the investment mix within each product) to deliver a sustainable retirement income that covers their lifetime spending needs.

This is a growing area that digital advice algorithms are likely to move into. The Actuaries Institute would welcome the opportunity to discuss possible ways of ensuring that the advice provided to Australians meets the highest possible standards while still helping Australians make decisions that are in their financial (and thus the country's) interests.

C1Q1. Do you think we should be more detailed in our guidance on the ways in which we think digital advice licensees should monitor and test algorithms? If so, what additional guidance should we provide?

No

C1Q2. Please provide feedback on any costs or savings to your business as a result of this proposed guidance.

Consumers will benefit if they can obtain appropriate, accurate advice through the internet. For higher value decisions, we'd expect them to do their research, then consult with an adviser. This will reduce adviser workloads.

C1Q3. Do you think we should introduce a self-certification requirement which would require digital advice licensees to certify that their algorithms have been adequately monitored and tested?

Where the subject matter of the advice is straight forward then self-certification is sufficient – as long as it is performed by a professional with appropriate skills.

Where the subject matter of the advice is more involved or relates to overarching client objectives that impact their long term financial situation then providers of digital advice who do not have the necessary skills in-house should obtain professional advice as discussed under the "General Comments" above and below under C1Q4.

C1Q4. Should we require independent third-party monitoring and testing of algorithms? If so, in what circumstances would this be warranted?

Where the client's goal is to improve their future financial situation, projections are likely to be needed to formulate advice. Such projections involve assumptions and applying complex rules (such as modelling the Age Pension means tests which apply at household level) and often require considerable knowledge and judgement, particularly when allowing for uncertainty.

Actuaries are specialists in complex cash flow modelling and have considerable experience with communicating difficult financial concepts to individuals such as superannuation members.

Although we do not believe that third party review is generally necessary, it should be required if the digital advice provider does not have relevant skills in-house.

Appendix – taken from Anthony Asher , Adam Butt, Ujwal Kayande & Gaurav Khemka (2015) Formulating Appropriate Utility Functions and Personal Financial Plans http://www.actuaries.asn.au/Library/Events/SUM/2015/ButtEtAlUtilityFunctionsPaper.pdf

There is *prima facie* evidence that the financial advice available to members of DC retirement funds is inadequate in many countries. Ciccotello and Wood (2001), Dorfman and Adelman (2002), Kotlikoff (2006) and Turner (2010) have found huge variations in the advice given by US website calculators and personal financial advisors. A preliminary survey of different Australian websites suggests similar differences exist here.

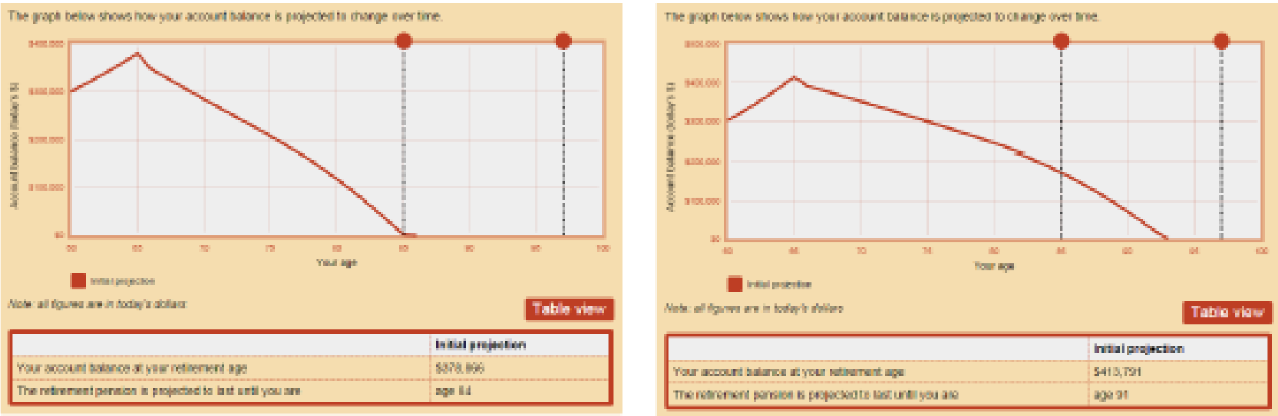

Figure 2: Typical Web Calculator (Source: Association of Superannuation Funds of Australia Retirement Projector – accessed from www.superguru.com.au in December 2014)

We suggest that many of the calculators available on the internet are not fit for the intended purpose. A common error is illustrated in the screenshots in Figure 2 above. The same information for an individual aged 60 has been provided for both charts, but the left chart has a "Conservative" asset allocation, whilst the right chart has a "High Growth" asset allocation. The calculator simply assumes a higher expected return for the "High Growth" asset allocation without acknowledging the additional risk, and providing some warning about the likelihood of underperformance.

Numerous examples exist in the literature of what appear prima facie to be suboptimal asset allocations as a direct consequence of poor financial advice. For example, Bodie (2003) reports that the advice on investment options and asset allocations provided to self-directed retirement plans in the US is logically flawed and dangerously misleading. The advice provided by financial services firms and investment advisory services leads to "a strong bias in favour of investing retirement savings in the stock market without insurance against a market decline". Mullainathan et al (2012) find that financial advisors fail to undo behavioural biases and misconceptions of the clients. Instead their portfolio recommendations "reflect either biases that are in line with the financial interests of the advisers (e.g., returns-chasing portfolio) or run counter to their interests (e.g., a portfolio with company stock or very low-fee index funds)". This is not to mention the role of conflicts of interest. The Australian Securities and Investments Commission (2014) report on the quality of life insurance advice found over a third of the advisors they questioned were giving advice that was illegally conflicted.

One of the consequences of inconsistent advice is underinsurance, or inappropriate insurance. Gokhale and Kotlikoff (2002) investigate underinsurance in the US and suggest that "66 percent ... of poverty among surviving women and 37 percent ... of poverty among surviving men resulted from a failure to adequately insure survivors." They also find almost no relationship between the actual amounts of life insurance families have, and the amount of insurance that the authors believe is appropriate. They therefore find many families are over-insured. In considering the reasons for this problem, they suggest that "questionable financial advice, inertia, procrastination, and the unpleasantness of thinking carefully about one's death are the likely culprits." One relatively easy solution to this is to automatically provide life and disability insurance through retirement funds. Not only does this remove the unpleasantness of thinking about death, it is more cost effective, and provides greater coverage as much cover can be given "free of underwriting". Hubener et al (2013) show how life insurance needs can be generated relatively easily from financial lifecycle modelling, given age, income and family status. While family status is not available to Australian superannuation funds, it is available to retirement funds in many countries. The calculator envisaged in this product will also give life insurance advice, and would perhaps have an application for retirement funds.

Bodie, Z. (2003): An Analysis of Investment Advice to Retirement Plan Participants. In *The Pension Challenge: Risk Transfers and Retirement Income Security* ed. Olivia S. Mitchell and Kent Smetters (19-32). New York: Oxford University Press.

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Dorfman, M. S., & Adelman, S. W. (2002): An analysis of the quality of internet life insurance advice. *Risk Management and Insurance Review* ***5*****(2)**, 135-154.

Gokhale, Jagadeesh, and Laurence J. Kotlikoff. (2002): The Adequacy of Life Insurance. *Research Dialogue*, no. 72 (July): www.tiaa-crefinstitute.org.

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Turner, John, (2010): Rating Retirement Advice: A Critical Assessment of Retirement Planning Software (April 9, 2010) Pension Research Council Working Paper No. 2010-03. http://ssrn.com/abstract=1706204.