DDO’s won’t protect financial consumers from overpriced products

ASIC is currently consulting on the proposed regulations for the Design and Distribution Obligations (DDOs) of producers and distributers of financial products for retail customers. Originally proposed by the Australian Financial System Inquiry in November 2014, progress has been at a snail’s pace with legislation not passed until April 2019 and the requirements not due to come into effect until April 2021.

DDO’s require financial institutions to ensure that the products they produce and distribute are suitable for the needs and in the interests of the target market, and that they are not marketed to those for whom they are unsuitable. The implication is that profit-seeking should not be at the expense of retail financial consumers, but via undertaking transactions which also benefit those consumers.

Realistically, there should be little that is controversial about such obligations. They reflect the fundamental premise (gains from mutually beneficial trades) upon which the merits of a free market economy is founded. Reputable financial institutions, seeking to meet community expectations, should, in principle, already meet such obligations, but will incur some (hopefully minor) administrative costs of being able to demonstrate to the regulator’s satisfaction that the DDO’s are being met.

However, as history and the recent Royal Commission has shown, even a reputable financial institution’s procedures and processes can go awry and lead to badly designed products which exploit the unwary consumer. And there are always some in the financial sector who will, if they can, apply the old adage that “fools and their money are soon parted” to the wider group of financial consumers who are poorly informed or advised. Competition in a market with such ill-informed consumers can lead to a race to the bottom in terms of product quality.

Unfortunately, even if a financial product meets the DDO requirements of being “suitable” for the target market, it can be a bad purchase for consumers not aware of its true worth. Nowhere in the ASIC proposed regulations does reference to the “price” of a financial product occur (nor, arguably, should it). But a retail customer paying too much for a “suitable” product could incur a greater loss than one purchasing an “unsuitable” product. Buying a product at too high a price is not really much different from being sold an unsuitable product!

The DDO requirements thus only go part-way towards ensuring good outcomes for retail financial consumers. They should inhibit selling of the most egregious, poorly designed products (removing the “lemons”). But financial consumer protection also requires ways of ensuring that consumers can assess the quality and reasonably value financial products on offer – and avoid overpaying.

Many (most) financial products have characteristics which make them hard to value accurately. When product outcomes depend on future events, or depend upon options held by the issuer, accurate valuation of the worth of the product can be very challenging – particularly to those with limited financial literacy.

Some simple examples can illustrate. What is the appropriate yield on (or price to pay for) bank preference shares which contain a “bail – in” option? What is the likelihood of having one’s house burgled and the likely loss, and thus a fair price for insurance? What is a fair interest rate to be charged on a loan where significant penalties for late repayment, which could occur due to unexpected changes in personal circumstances, apply?

In these and other cases, the product might meet the DDO requirements, with the customer understanding the range of possible outcomes, and be suited to the customer's needs – but the customer may not have the information or expertise to avoid overpaying. For example a consumer may assume that there is a 10 per cent chance of an event covered by an insurance or risk management product occurring, when the true probability is less than 1 per cent. Not only would they then overpay (and perhaps do so repeatedly), but may never discover that they have overpaid.

The limits of the DDO regime in this regard can be seen using a simple example. Suppose a producer can supply a financial product profitably for any sale price over $6. Suppose that, given the product's characteristics, buying if for any price under $8 would be beneficial for the consumer, but that the consumer is unable to assess the true worth of the product. Since the supplier's profits increase as the selling price increases, what mechanism is there to inhibit the supplier increasing the price to above $8, making the transaction detrimental to the customer?

Standard answers to this question would invoke roles for competition, disclosure, financial advice, and financial education. Effective competition can limit pricing to "normal" profit levels, but in a market with imperfectly informed customers, competition can also take the form of lowering quality (and thus costs) in ways not transparent to the consumer. Reliance on disclosure, advice and education has been shown to be inadequate for financial consumer protection in the past.

None of these factors should be dismissed as unimportant and policy measures to improve their effectiveness are ongoing and welcome. But ultimately pricing decisions for financial products will be made by executives and managers of financial institutions responding to KPIs in line with governance and control structures of the organisation.

In this regard APRA's proposal that ADIs designate an accountable person for "end-to-end" product responsibility (design, delivery, maintenance, customer remediation, outsourcing, incentive structures, etc) under the BEAR (Bank Executive Accountability Regime) is an important step for "hard-wiring" institutional arrangements to meet DDO requirements. (In January 2020, the government announced the extension of these requirements to all APRA regulated entities under the proposed FAR (Financial Accountability Regime) legislation, with future extension to all ASIC regulated financial institutions mooted). But there is nothing in the BEAR or FAR that implies any responsibility for "fair" pricing.

DDO's, together with ASIC's new product intervention (temporary banning) powers for financial products it deems unsuitable, should help to rid the financial sector of the most egregious types of consumer abuse. But they do nothing to prevent profit seeking institutions setting prices for "suitable" products which can be expected to lead to poorly informed financial consumers suffering losses. Only if "fairness" can be instilled into corporate cultures (and how to do that is unclear) will better financial consumer protection eventuate.

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