What the Ripoll Report Didn't Recommend

The Report of the Inquiry into financial products and services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services (the Ripoll Report) makes eleven recommendations. They can be summarized as advocating greater disclosure and investor education, increased ASIC powers and supervision of advisors, giving advisors a fiduciary responsibility, improving self-regulation, and reducing commissions, and – if all else fails – considering an investor compensation fund.

As admirable as most of these recommendations are, and they are much like motherhood, they do not signal radical change nor really address the fundamental problem of the yawning, growing, gap between financial product sophistication and retail customer understanding, knowledge (and greed).

Unfortunately, there is a strong incentive to construct financial products which can be sold to retail customers for more than they are worth, recognizing that inadequate expertise means that customers may never realize they have paid over the odds, or taken excessive risks. In some cases, such as those of Storm and Opes Prime, the chickens come home to roost and prompt Inquiries such as this one, but more generally the value expropriated goes largely unnoticed.

Ensuring good financial advice may seem to be the antidote, but faces several fundamental problems. First, how is a poorly informed individual going to determine which among a growing gaggle of advisers is a good one? The answer: probably on the basis of mass marketing of a brand name, which unfortunately and increasingly happens to be that of a major supplier of financial products and software platforms to whom the adviser is linked.

A second problem is that individuals are naturally reluctant to part with cash up-front for advice – the quality of which they cannot judge. Hence, and also reflecting a fundamental aspect of human nature, there is a preference for payment via largely hidden, deferred payments to advisers built into future investment returns or borrowing costs.

So what might have been recommended instead (or in addition)? First, there are grounds for reexamining the biases in our tax system which encourage individuals into taking levered positions in risky assets. Negative gearing of property, equities, and also now available in superannuation, are cases in point. More generally, tax and subsidy arrangements applied to various financial products on the basis of perceived social costs and benefits could be considered (as we currently do for superannuation).

Second, banning retail investor access to certain complex financial products (perhaps unless they have passed an appropriate "driving" test) might be considered – although that seems somewhat draconian even in the current anti-free market climate of public opinion.

Less draconian would be a combination of "default options" with an adaptation of the ASIC "if not –why not" approach. This would involve specifying a range of financial portfolio positions thought appropriate for households with various characteristics, and requiring that financial advisers provide clients with explicit reasons for why they recommend departing from that range. We know that specification of default options biases individuals towards staying with the default, and potential liability for recommending departures might concentrate the minds of financial advisers wonderfully.

What about the problem of adviser commissions? Perhaps there is a case for requiring complete separation and independence of firms of advisers from financial product suppliers and platform providers. Is it really appropriate that the major banks and life insurance companies, through various subsidiaries, produce and market financial products on financial software platforms that the advisers they employ induce retail customers to buy?

More generally, why not give retail customers some say over the allocation of commission income. Would trailing commissions be seen as such a problem if it were required that the customer were advised each year by a product supplier of what commission is to be paid to the originating adviser unless the customer informs the supplier that the payment should go instead to a different registered adviser. Yes, that could be subject to exploitation if not appropriately structured (if, for example, the customer's brother is also a registered adviser) but it would give some power over commission payments to disgruntled customers and concentrate wonderfully the focus of advisers on after-sales service.

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