Dear Treasurer,

Introduction

We are writing to provide the Property Funds Association's (**PFA's**) views on the recommendations set out in the Final Report of the Financial System Inquiry (**Final Report**) which was released on 7 December 2014.

The PFA is an industry body representing the Australian unlisted wholesale and retail property funds sector, currently some $79 billion in size. A sector which forms a central plank to the property market in Australia, given the high incidence of institutional property ownership in Australia.

The PFA endorses the aim of the Final Report and the Financial System Inquiry (**Inquiry**) to promote trust and confidence in the financial system. Maintaining the trust and confidence of consumers in the property funds sector is critical to the continued viability and success of the sector. However, this aim must be balanced with the need for efficiency, ease of use for both consumers and financial firms and the promotion of innovation in the sector to allow property funds to be competitive with other investment products in Australia and with the sector internationally.

Executive summary

The Final Report sets out 44 recommendations. In relation to the property funds sectors, the relevant recommendations which may impact on the sector can be categorised into the following four main areas:

1. Regulatory framework and legislative framework
2. Consumer protection
3. Funding
4. Innovation and technology

This letter sets out the PFA's views on the Final Report and the relevant recommendations grouped under these themes.

Prior to addressing the recommendations specifically, the PFA would like to set out two general principles which should guide the Government's approach to acting on any recommendations in the Final Report:

1. As has been previously noted by the Inquiry's Chair, Mr David Murray, many of the recommendations are interdependent and linked. In particular, the recommendations relating to changes to ASIC funding and enforcement powers. The Government should consider the recommendations as a package, rather than assessing each recommendation on a standalone basis.

2. Largely due to the extensive scope of the Inquiry, the Final Report and the recommendations are by necessity general in nature. Therefore, we stress the need for the Government to undertake further examination of the empirical basis underpinning the recommendations, consult widely with industry participants as to the details and specifics of any reforms and the most appropriate methods of implementing reforms.

Conclusion

The Final Report and its recommendations provide a high level blueprint for some of the key issues facing the Australian financial system. Much of the detail and specifics will need extensive consideration, consultation and co-ordination.

The PFA welcomes this opportunity to provide its views on the Final Report and any opportunity to provide further information. Please do not hesitate to contact us if you have any queries.

Property Funds Association

Response to the recommendations

1. **Regulatory architecture and legislative framework**

The Final Report states that the Inquiry considers that Australia's current regulatory architecture does not need major change. However, the Final Report does suggest fundamental changes to the regulatory architecture which will affect managed investment schemes and property funds.

The Final Report recommends:

- creating a new Financial Regulator Assessment Board and imposing greater accountability and performance indicators for regulator performance (Recommendation 27);
- providing regulators with more stable funding and introducing an industry funding model, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews, as well as boosting ASIC's regulatory tools (Recommendation 28 and 29);
- the introduction of a proactive product intervention power for ASIC where there is risk of significant consumer detriment (Recommendation 22);
- increasing the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently (Recommendation 31); and
- supporting Government's review of the Corporations and Markets Advisory Committee's recommendations on managed investment schemes (Recommendation 42).

PFA's views

The PFA strongly agrees with recommendations that ASIC receives more stable funding. A review of the funding and resources which ASIC requires in light of any additional responsibilities or powers to be given to ASIC should be undertaken to ensure that ASIC has adequate resources to effectively carry out its duties. The PFA also endorses the increased use of performance indicators to hold ASIC and other financial regulators accountable.

The concept of an independent oversight body for financial regulators warrants consideration. An assessment of the costs and benefit of creating a new body to review the regulators (including costs of the regulators in reporting to FRAB) compared to the alternative of providing additional resources to the financial regulators and imposing performance indicators to increase accountability and transparency should be undertaken.

There are serious concerns with granting ASIC the power to intervene in the launch of an investment product in the manner prescribed in the Final Report. The test of 'risk of significant consumer detriment' is subjective, untested and is likely to lead to significant uncertainty for ASIC and product issuers. Appropriate safeguards need to be considered if this recommendation was adopted.

Product issuers are going to be reluctant to launch products (especially innovative products) with the risk that the product may be stopped or amended by ASIC during a 12 month period. Product issuers may wish to seek ASIC confirmation that a product will not be stopped prior to issuing the product. This raises two issues. Depending on the resources available to ASIC, the launch of a product is likely to take longer than it currently does. This may mean that product issuers miss the optimal time to launch products. Secondly, ASIC also faces a moral hazard issue. ASIC may be more inclined to stop products or require changes to innovative products to conform to standard products so that it is not seen as approving a novel product which may lead to consumers suffering detriment.

The effect on innovation, whether there are alternative regulatory options and the practicalities of ASIC exercising the additional powers should be carefully considered before granting such additional powers to ASIC.

There have been a raft of regulatory changes in the managed investment scheme sector. Participants require time to review their existing practices to ascertain what changes are required to comply with new regulatory changes, and to implement and assess the implications of new processes. The PFA agrees that participants should be given at least 6 months to implement regulatory changes or additional time for more complex changes. The transition period should commence when full details of the regulatory change have been announced by the regulator. The PFA is also supportive of regulators consulting with industry participants in formulating the implementation of regulatory changes or initiating pilot programs to ensure that any transition issues can be addressed as early as possible.

The Final Report's support for the CAMAC proposals may also lead to significant regulatory reform for the managed investment scheme sector. The PFA agrees with the priority areas for review noted in the Final Report, especially the focus on facilitating cross border transactions and mutual recognition which the Asia Region Funds Passport seeks to address.

However, the main proposal in the CAMAC discussion paper on managed investment schemes that the regulatory regime for managed investment scheme should be aligned with that of companies should be considered before it is adopted wholesale.

As discussed in our previous submissions to the Inquiry, the PFA is concerned that unlisted property funds are being left out of innovative initiatives such as mFunds, Asian Funds Passport and simple PDS initiatives on the basis that they are illiquid investments. However, this denies the sector the ability to be part of new, innovative and cross-border initiatives which will ultimately disadvantage investors in denying them access to desirable property investment. Illiquidity should not be used as a proxy for complexity. This is not necessarily the case.

2. Consumer protection

The Final Report states that the current focus of disclosure, financial advice and financial literacy is not sufficient to allow consumers to make informed financial decisions. This is due to the behavioural biases and information imbalances which affect the decisions which consumers make.

The Final Report proposes various measures to improve consumer outcomes:

- introducing a targeted and principles-based product design and distribution obligation (Recommendation 21); and
- aligning interests of financial firms and consumers by raising industry standards, raising the competency of advisers, renaming 'general advice' and requiring disclosure of ownership structures for advisers (Recommendations 24, 25 and 50).

PFA's views

The PFA supports the premise that product issuers and distributors need to be accountable and promote customer-focused business practices. However, the PFA is not convinced by the Inquiry's view that there will be minimal additional costs for customer-focused businesses to comply with the proposed changes.

Currently, customer-focused business practices for product issuers means focussing on providing adequate disclosure which is relevant to the consumer. The shift from disclosure to product design, distribution and after sale review will most likely involve additional costs, in terms of assessing the financial literacy of potential consumers and managing the flow of information to financial advisers and co-ordinating after sale reviews with financial advisers. The costs for financial firms in adapting to changes to the product design, distribution and review requirements should be taken into account in devising a targeted and principles-based design and distribution obligation.

The Final Report states that shortcomings in disclosure stems from inherent biases which result in consumers misunderstanding the disclosure and being sold financial products which are not suited to their needs or circumstances. The question of whether the disclosure regime itself may affect the effectiveness of disclosure to consumers is not examined or addressed in the Final Report.

The different and overlapping layers of legislative provisions (in the Corporations Act and the ASIC Act), regulations, ASIC class orders and regulatory guides which constitute financial services regulation makes it difficult for investors to understand complex and lengthy disclosure documents. The regulatory requirements also impose additional costs on financial firms and stifles innovation in the sector. The complex legislative framework makes it difficult and costly for regulators to take enforcement action and hampers the ability of regulators to enforce provisions on a consistent basis.

In addition to increasing accountability for product design and distribution on financial firms so that consumers are not sold products which are not suitable, the PFA also encourages the Government to review the existing disclosure regime to gather evidence to determine whether the disclosure regime can be improved before substantial changes are made to the regulatory framework.

The PFA strongly endorses measures to raise the standards of financial advisers and to clearly disclose information about financial advisers to consumers, including any conflicts of interest.

3. Funding

Funding for different parts of the financial system needs to be stable, accessible and adequately regulated in light of changes in technology and economic factors.

The following recommendations in the Final Report may impact on the funding available for the property fund sector:

- recommendations relating to the policy objectives and operations of the superannuation sector (Recommendations 9 to 13);
- development of the impact investment market and encourage innovation in funding social service delivery (Recommendation 32);
- reducing disclosure requirements in the retail corporate bond market (Recommendation 33); and
- development of fundraising regulation to facilitate crowdfunding (Recommendation 18).

PFA's views

The PFA understands the need for changes to be made to the superannuation system. Given the funds under management in the superannuation sector and the amounts invested in various asset classes, the superannuation system must be predictable and reliable over the long term. This is to ensure that there are no extreme shocks throughout the financial system.

The PFA welcomes the Government to examine ways in which it can facilitate funding for social infrastructure and development of the impact investment market. The managed investment structure makes it an ideal vehicle for investment in funding social services and infrastructure.

Reduced disclosure requirements in the retail corporate bond market should also be considered for managed investment schemes. Schemes should have access to funds in the same manner as companies.

The PFA is supportive of the measures to promote crowdfunding. The PFA asserts that property funds should be able to access crowdfunding. The regulatory regime adopted should ensure that disclosure requirements are appropriately set so that start-up entities are able to access crowdfunding easily and at a reasonable cost.

4. Innovation and technology

The PFA believes that the following recommendations in the Final Report will allow financial services to be more accessible and more targeted for consumers:

- establishing a permanent public–private sector collaborative committee (Recommendation 14);
- developing a national strategy for a federated-style model of trusted digital identities (Recommendation 15);
- facilitating innovative disclosure (Recommendation 23);
- Technology neutrality (Rec 39)

The PFA supports the Final Report's recommendations to ensure that the financial system adapts to the technological advances, as well as remains innovative.

The PFA is encouraged by the adoption of technology in the delivery of financial services, such as the mFunds platform and the proposed move towards electronic disclosure by ASIC. However, the PFA believes that these programs should be more widespread and apply to a broader range of financial products, including property funds.

The PFA acknowledges that different risk profiles of certain financial products may have meant that different treatment was warranted. However, the recommendation in the Final Report regarding product design and distribution obligations, combined with the use of technology to better target financial products to suitable consumers, means that the grounds for treating financial products differently are slowly dissolving. The PFA would support property funds being included in the mFunds platform.

The use of technology may allow product issuers and financial advisers to fulfil any product design and distribution obligations imposed (as per Recommendation 21). For example, product issuers may require consumers to complete an online questionnaire (including substantial questions on financial literacy for verification) to determine which financial products are suitable for the consumer. Consumers would only be able to access the disclosure document after completing the questionnaire and being assessed as suitable. After sale reviews can also be completed online.

As noted in the Final Report, the regulatory setting will impact on the extent innovative products can be made available to consumers. For example, in relation to the effect of the product design and distribution obligation on the creation of innovative financial products. Any regulatory changes should also be assessed in terms of its impact on innovation.