CHAPTER 6

Disclosure

Introduction

6.1 During the inquiry, a number of issues were raised in connection with superannuation and insurance. The most contentious related to the ongoing management charge (OMC) which superannuation funds were required to disclose in their Product Disclosure Statements (PDSs).

6.2 In the insurance area, two issues emerged—the disclosure exemption at PDS level for commission paid on risk products in certain circumstances and the limitation of the disclosure requirement regarding unauthorised foreign insurers to the retail market only.

6.3 This chapter will explore the inquiry's findings.

Superannuation—ongoing management charge

Background

6.4 In the Senate on 16 September 2002, the regulations prescribing disclosure of the OMC were disallowed on a motion given by Senator Stephen Conroy.

6.5 Under the new provisions, most superannuation funds will have to provide fund members with a PDS. The regulations prescribe the content of the PDS for superannuation funds. Among other things, they set out in detail how the ongoing management charge (OMC) was to be reported in these documents.[1] The regulations provided a definition of OMC.[2]

6.6 Calculation of the OMC attracted substantial criticism from consumer and industry groups although one industry group expressed satisfaction with requirements. Most witnesses maintained that the OMC would not assist comparability between funds and was misleading.

Review of submissions and evidence heard

6.7 Among the critics of the OMC was the Australian Consumers' Association (ACA). The ACA queried whether the inclusion of the OMC in the PDS for superannuation products achieved the objectives stated in the Explanatory Memorandum, namely, that the PDS was 'to provide consumers with sufficient information to make informed decisions in relation to the acquisition of financial

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1 Regulation 7.9.11 and Schedule 10B of the Corporations Regulations.

2 Subregulation 7.9.01(1) and Schedule 10 of the Corporations Regulations.

products including the ability to compare a range of products'. In particular, concerns were expressed that:

> …the OMC does not capture entry and exit charges, which can have a severe impact on the potential returns to the consumer, and may thereby underestimate the costs of the product.
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> Schedule 10 of FSRA stipulates the requirements for the PDS and OMC. These include that the OMC be displayed as an investment OMC, non-investment OMC and total OMC over a period of 5 years and that these be further broken down into dollar amounts against an account balance of $10,000. In practice, this can translate to a bewilderingly complex array of calculations, not easily comparable with other products.[3]

6.8 In a similar vein, Freehills commented that:

> The question is, though, whether [the OMC] will actually produce any meaningful information for the member of the fund, because potentially the management charge has two components—it has an investment component and an administration component—and then, if there are investment strategies within a fund, the charge has to be given for each strategy. So with some funds that offer, let us say, 20 investment choices, the multiplicity of figures that will be produced could be absolutely dazzling and quite mind boggling.[4]

6.9 In its submission, the Association of Superannuation Funds of Australia Limited (ASFA) endorsed the principle of standardised disclosure, but argued that there were critical deficiencies in the calculation of the OMC. ASFA argued that the OMC would not facilitate comparability of funds but merely produce 'an impenetrable maze of numbers'. In this regard, ASFA said that, for a fund with five investment options, upwards of 75 separate OMCs (as ratios) and 25 flat dollar amount conversions would have to be disclosed.

6.10 ASFA cited the following specific concerns about the calculation of and PDS requirements for the OMC:

- the formula for the OMC does not include entry and exit fees that might dramatically affect a member's benefit;
- the example to be included in the PDS is based on single account balance (namely, $10,000) and could be misleading as it potentially advantages funds charging on a rising scale as opposed to funds charging a flat amount; and
- superannuation fund earning rates have to be presented net of investment expenses which could result in double counting of these expenses in the total OMC.[5]

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3 Submission 23, p. 3.

4 Pamela McAlister, *Committee Hansard*, 23 May 2002, p. 27.

5 Submission 5, p. 6.

6.11 In support of its claims about the difficulties posed by the OMC, ASFA provided the results of initial consumer testing which it commissioned Ageing Agendas to conduct. The survey tested consumers' comprehension of OMCs in two fictitious Product Disclosure Statements and indicated that only 10 per cent of those tested were able to answer 90 per cent of questions correctly.[6] ASFA has advised that this survey is the first in a series which will test various disclosure measures.

6.12 Rainmaker Information Pty Ltd (Rainmaker) commented that difficulties in prescribing meaningful disclosure requirements were attributable partly to the differing terminology used by superannuation funds to describe their fees and the distinction made between fees charged to members and fund costs. With regard to the latter, Rainmaker said that, while disclosure tended to refer to fees, it did not refer explicitly to fund costs, which themselves were important because they affected members' returns. The comment was made that:

> Rainmaker has found that the subtle distinction between these notions [of costs and fees] can lead to ambiguities because a superannuation fund can claim it has no fees simply because all its costs are paid by the overall fund. In some cases this can cause tremendous difficulty in assessing the true picture of how much a member is really paying for their superannuation. Indeed, Rainmaker believes that from an investor's perspective there is really no material difference between fees and costs.[7]

6.13 At the hearing on 23 May 2002, Mr Alex Dunnin, Director of Research for Rainmaker, noted that the OMC did not include contribution charges and said that, from a consumer's perspective, this was an important omission. Mr Dunnin commented that it was possible to create a conceptual framework from which dollar amounts for fees could be calculated without too much difficulty.[8]

6.14 Rainmaker suggested that the OMC should be amended:

- to include contribution charges and fund costs as well as fees;
- to provide definitional guidelines of what constituted a fund cost or expense and what constituted gross earnings from which fees and costs were deducted; and
- to state clearly whether any hypothetical examples given were likely to produce distortions.[9]

6.15 Mr Dunnin commented that he did not favour the use of the Management Expense Ratio (MER) because, for multi-optioned retail products, the MER usually

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6 The Committee understands that the results of this survey (dated September 2002) had not been made public at the time of writing this report.

7 Submission 21, p. 5.

8 *Committee Hansard*, 23 May 2002, pp. 49–53.

9 Submission 21, p. 9.

only reflected investment management costs which might only be a quarter of the total costs paid by a consumer.[10]

6.16 The Investment and Financial Services Association (IFSA) was supportive of the OMC. With regard to the utility of the MER, Mr Richard Gilbert, Chief Executive Officer, said that:

> …this industry has used a thing called a management expense ratio for the best part of the last 15 years, and I do not think anybody has been able to say that it has not been a good comparator between funds. Except for one difference, the management expense ratio essentially is the same as the OMC, and that one difference now is investment management charges…The MER is a worldwide best practice measure to compare funds. In looking at some web sites I noticed that the Canadians and the US have that particular model. We support the OMC because it has worked for us in the old superannuation regime…It does what it says it is going to do: it is the ongoing management charge. It is not the charge going into a fund or the charge going out of a fund; it is the charge of staying in a fund.[11]

6.17 IFSA argued that the OMC was appropriate because it applied to all people in a fund whereas entry and exit fees could be applied selectively depending upon a person's circumstances. IFSA commented that the $10,000 was 'a good illustration of an average superannuation investor'.

6.18 At the Senate Economic Committee's Consideration of Budget Estimates Hearing on 6 June 2002, the OMC was a subject of discussion. An officer from the Department of the Treasury said the OMC was intended to give a broad indicator to enable comparison of funds on a general but not individual level and acknowledged that the OMC was not a total expenses ratio.[12]

6.19 At the Committee's hearing on 7 August 2002, officers from the Department of the Treasury commented that the OMC was an enhanced version of the MER which had been prescribed under the *Superannuation Industry (Supervision) Act 1993* (SIS Act). The Department advised that the enhancements comprised:

- an indicative dollar amount;
- a breakdown of investment-related and non-investment-related management charges; and
- underlying investment costs associated with outsourcing.[13]

6.20 With regard to the issue of whether the OMC had been sufficiently consumer tested, the Department advised that it had consulted with about 40 different

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10 *Committee Hansard,* 23 May 2002, p. 52.

11 *Committee Hansard,* 7 August 2002, p. 252.

12 Susan Vroombout, *Committee Hansard*, 6 June 2002, p. 564.

13 Brett Wilesmith, *Committee Hansard,* 7 August 2002, p. 257.

stakeholders, including a number of consumer organisations. The Department further advised that, although one consumer group had opposed additional prescription for disclosure, no other consumer groups had opposed the OMC model per se. The Department commented that the focus of debate during consultation had been on the quantum of the dollar amount example provided in the OMC rather than its other features.[14]

6.21 In a recent report on disclosure commissioned by ASIC, Professor Ian Ramsay commented on the similarities between IFSA's MER and the OMC prescribed in the FSR regulations and noted that the key difference was that the latter also included expenses a direct investor would incur. With regard to the utility of the 'OMC/MER', Professor Ramsay's view was that:

> …it is typically recognised that the OMC/MER provides useful information relating to relative costs across similar funds and can identify trends in relation to ongoing management charges and expenses over time. It is to be noted that similar operating expense ratios are used in other countries such as Canada, New Zealand and the United States…[15]

6.22 Professor Ramsay concluded that an OMC should be used as an expense measure across all products including superannuation and other investment products. He expressed doubts about the use of a single global figure in lieu of the OMC and said that, while it might have initial attractions, a number of important fees would still have to be disclosed separately. These would generally include entry and exit fees whose application or quantum might be discretionary.[16]

6.23 In its media and information release on Professor Ramsay's report, ASIC commented that:

> The report will facilitate further consultation by ASIC with industry and consumer representatives about the future direction of disclosure for investment products under the FSRA regime.[17]

6.24 Given that his is the only independent report on the issue of fee disclosure, the Committee gives considerable weight to Professor Ramsay's conclusions.

The Committee's views

6.25 The Committee believes that because of the special features of superannuation—it is compulsory, attracts tax concessions and importantly has to be

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14 *Committee Hansard*, 7 August 2002, pp. 258–59.

15 Ramsay, *Disclosure of Fees and Charges in Managed Investments, Review of Current Australian Requirements and Options for Reform,* released 25 September 2002, p. 205.

16 *Disclosure of Fees and Charges in Managed Investments,* p. 198.

17 ASIC Media and information release 01/352 *ASIC releases Ramsay Report on disclosure of fees and charges,* 25 September 2002.

preserved—it is desirable that consumers have appropriate tools to compare funds to assist them in choosing the right one for them.

6.26 The Committee notes IFSA's comments that the MER, on which the OMC has been based, has been used by the superannuation industry for some years under the old legislation. It further notes Professor Ramsay's comments about the MER and OMC.

6.27 The Committee appreciates the difficulties involved in developing a 'one-size-fits-all' disclosure formula to assist comparability across funds. With this in mind, the Committee makes the following recommendation:

Recommendation

The Committee recommends that:

- **ASIC and the Department of the Treasury work together to continue the momentum generated by ASIC's initial investigations into the disclosure of fees and charges for investment products[18] to produce guidelines for a leading-edge, consumer-friendly superannuation fee disclosure model that will facilitate comparability of funds; and**
- **upon the development of an appropriate disclosure model, ASIC should publish details in a guide for use by the superannuation industry. ASIC should also alert consumers to the advantages of the model and provide working notes.**

Insurance

Commission on risk products

6.28 Financial services licensees and their authorised representatives are required under the *Corporations Act 2001* to provide certain information to retail clients in the Financial Services Guide (FSG) and Statement of Advice (SOA). Both documents require disclosure of commission.

6.29 With PDSs, disclosure of commission is only required if the commission may or will impact on the amount of the return generated by the financial product.[19]

6.30 The Explanatory Memorandum for the *Financial Services Reform Act 2001* (FSR Act) explains why commission on risk products does not have to be disclosed in the PDS:

> The purpose of commission disclosure at point of sale of the product is to enable the client to assess the likely return on the product. In order to do

18 These initial investigations refer to Professor Ramsay's report into fees and charges which ASIC commissioned: *Disclosure of fees and charges in managed investments, review of current Australian requirements and options for reform,* released on 25 September 2002.

19 Paragraph 1013D(1)(e) of the *Corporations Act 2001*.

> this, [the legislation] requires commissions, or other similar payments, to be disclosed to the extent that they will ultimately impact on the return that the holder of the product will receive.
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> …For the most part, when a consumer purchases a risk insurance product they pay a premium in order to insure against a future risk…Even though the premium the consumer pays includes a portion that will ultimately be paid to the financial service provider as commission, the payment of the commission will not affect the amount paid if the event occurs. [20]

6.31 The Financial Planning Association of Australia Limited (FPA) was critical that the disclosure of commission at PDS level was not uniform under the FSR Act. The FPA said that, as the PDS was effectively a marketing tool, there should be a requirement for disclosure of commission on all financial products.[21] More specifically, the FPA submitted that where risk products were offered as part of a package with an investment product, the return on the investment product could be artificially raised by loading up the commission on the risk product component.[22]

6.32 A contrary view expressed by the Association of Financial Advisers (AFA) at the hearing on 23 May 2002 was that, while members supported the disclosure of commission where this affected the end benefit, they did not support disclosure where commission had no such effect. The AFA argued that for trauma or income protection insurance, the client's premium and end benefit would be the same regardless of the commission paid. Furthermore, they contended that consumers were not interested in having commission payments disclosed to them.[23] The views of the AFA were also reflected in the submission and evidence given by Mr Michael Murphy from Murphy Financial Services (SA) Pty Ltd.[24]

The Committee's views

6.33 The Committee considered the issue of commission on risk products during its two previous inquiries into the financial services reform legislation and concluded that:

- cost and service—not commission—were the primary influences on consumers of risk products; and
- a disclosure requirement for risk products would be particularly detrimental to small business operators.

6.34 The Committee consequently recommended against disclosure of commission on risk products and does not depart from this position in this report. The legislation

20 Financial Services Reform Bill 2001, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p.148.

21 *Committee Hansard*, 11 July 2002, pp. 127–28; Submission 4, p. 2.

22 Submission 4, p. 2.

23 *Committee Hansard*, 23 May 2002, p. 38.

24 Submission 13; *Committee Hansard*, 23 May 2002, pp. 35–48.

and regulations partly reflect this position in not requiring disclosure of commissions in PDSs, although requiring it in the FSG and SOA.

6.35 The Committee accepts this and recommends that there be no changes to the present requirements. The Committee notes, however, the comments made by the FPA about the potential loophole created by the concession for the loading up of commissions in some circumstances. While the Committee is concerned that there may be potential for such a practice, the Committee considers that it would be premature to recommend any action at this stage.

6.36 Although not strictly within the terms of reference for this inquiry, the Committee believes consideration of this issue is appropriate because of the potential adverse effects a change in the legislation could have on small business operators. Furthermore, the Committee notes that this issue ties in with others affecting life insurance agents who are having to adapt to changes within their industry indirectly arising from the new regulatory regime. These are discussed in Chapter 9.

Unauthorised foreign insurers

6.37 The National Insurance Brokers' Association of Australia (NIBA) referred to certain disclosure provisions that had been carried over to the FSR Act from the *Insurance (Agents and Brokers) Act 1984* (IABA). NIBA said these provisions required certain disclosures to be made for insurance placed with unauthorised foreign insurers and raised concerns that the FSR Act required disclosure only to retail clients and not also to wholesale clients as had been the case under the IABA.[25] Specifically, the requirements entail:

- providing warnings in relation to dealing with an unauthorised foreign insurer;
- providing details of the insurer with whom the broker is dealing and client is contracted; and
- disclosing various associations with insurers and disclosing binder arrangements with insurers.

6.38 In addition, NIBA said the IABA provision which required insurance intermediaries to lodge information with ASIC about insurance placed with unauthorised foreign intermediaries had also been discontinued under the FSR legislation.

6.39 NIBA urged that the Committee recommend their reinstatement through regulations made under section 949B of the FSR Act.

6.40 In support of NIBA's argument that the unauthorised foreign insurer disclosure obligations were just as pertinent for wholesale as for retail clients, Mr John Hanks, Consultant for NIBA, commented that the rationale for the limitation to retail clients appeared to be that '[wholesale] people were big enough to look after

25 Submission 33.

themselves'. He queried this and suggested that the retail/wholesale distinction for risk insurance was not the same as the retail/wholesale distinction that might exist for other financial products.

6.41 In this regard, he commented that:

> You do not have to be a very large player to be classified as a wholesale person purchasing insurance…A small businessman insuring his own property or his liability would be classified as wholesale…At the present time there is a difficult insurance market. People are being forced to look overseas for their insurances because they just cannot buy in Australia: it is difficult or the price is not right. We are seeing more and more people looking at purchasing overseas… [Retail insurances] are not the insurances that people are going overseas to purchase.[26]

6.42 While NIBA acknowledged that some unauthorised foreign insurers were reputable, it was concerned with the growing trend for wholesale consumers to seek insurance from overseas insurers because of problems in the domestic market. Although not able to provide statistics relating to the quantum of wholesale insurance that was purchased through offshore providers, NIBA said that the figure was not inconsequential.

6.43 NIBA commented that it would not be an imposition on intermediaries to require them to make the relevant disclosures to both retail and wholesale clients as this would merely involve the continuation of requirements that had existed under the IABA for the previous 15 to 20 years.

6.44 With regard to the discontinuance of reporting to ASIC, NIBA argued that this requirement should be re-instated because such information was vital for the effective monitoring of insurance in Australia particularly given the increasing use of unauthorised foreign insurers.

The Committee's views

6.45 The Committee accepts that NIBA's concerns are well-founded and agrees that a continuation of the disclosure and reporting practice originally required under the IABA would not represent an unreasonable imposition on the insurance industry.

6.46 The Committee therefore makes the following recommendation:

Recommendation

The Committee recommends that regulations be made to continue the existing provisions in the *Insurance (Agents and Brokers) Act 1984* with application to wholesale clients in addition to retail clients regarding:

- **dealing with unauthorised foreign insurers;**

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26 *Committee Hansard*, 12 July 2002, pp. 232–33.

- **providing details of the insurer;**
- **disclosing an association with an insurer; and**
- **disclosing binder arrangements with insurers.**

Recommendation

The Committee also recommends that ASIC be empowered to collect information about licensees dealing with unauthorised foreign insurers as was the case under the *Insurance (Agents and Brokers) Act 1984.*

6.47 The Committee believes that these amendments by way of regulation will be consistent with the consumer protection objectives of the FSR Act.