Chapter Seven

Commission-based selling

Introduction

7.1 During the inquiry, various parties argued that implementation of the Bill in its current form would encourage commission-based selling of retail funds, and would, in turn, lead to higher costs and lower returns for not-for-profit funds.

7.2 This chapter examines:

- the relative merits of different forms of commission-based selling; and
- the impact of commission-based selling on fund costs and fund returns.

Commission-based selling

7.3 During the inquiry, various parties raised concern that the lack of financial literacy of many employees will leave them vulnerable to commission-based selling of retail funds by financial advisers. In its written submission, the MTAA Superannuation Fund submitted:

> In such an environment, we fear that many employers and employees, especially those in the small business sector, will be fair game for any unscrupulous agent or pseudo financial planner who might choose to treat this opportunity as a commission-induced or trailing fee-paying ‘feeding frenzy’.[1]

7.4 Similarly, the Industry Funds Forum also expressed concern that implementation of choice could lead to a rise in the selling of higher-cost funds by commissioned agents:

> The underlying basis of such a system would not be improved value or performance for a member, but the financial rewards available to an agent who is able to sell a new or different fund to an employee, thereby earning a commission.[2]

7.5 Cbus argued that, with commission selling, choice would benefit financial planners at the expense of employees:

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1 *Submission* 11, MTAA Super Fund, p. 9.

2 *Submission* 30, Industry Funds Forum, p. 3.

> Instead of contributing funds towards the retirement savings of individuals, choice of fund will lead to Australia's superannuation system being used to contribute to the retirement of financial advisers.[3]

7.6 In its written submission, the ACTU cited a recent article by Tom Collins entitled *Industry Repair should be First Priority*, in which he was particularly critical of the commission-based remuneration system for financial planners. He argued that commission-based selling encourages so-called 'churning', whereby employees are constantly moved from one fund to another, to the benefit of the financial planners.[4]

7.7 In response to these concerns regarding commission-based selling and 'churning', the FPA cited in its written submission section 947D of the *Financial Services Reform Act 2001*, which it argued ensures a high level of disclosure when planners advise their client to change their investments. In addition, the FPA noted that the FPA's Code of Ethics and Rules of Professional Conduct, to which members of the FPA must adhere, states at Rule 118:

> A member (of the FPA) shall not move a client or cause a client to move from an investment to another investment without explaining to the client, in terms the client is likely to understand, the reasons for the move. The Member must demonstrate that the move is appropriate for the client.[5]

7.8 In the hearing on 11 September 2002, Senator Sherry raised with Mr Breakspear from the FPA the applicability of section 947D of the *Financial Services Reform Act 2001*. He noted that financial advisers are remunerated partly on the basis of commissions they receive from funds which they recommend, which may prevent them from being objective in their assessment of suitable funds for employees.[6]

7.9 In response, Mr Breakspear argued that section 947D of the *Financial Services Reform Act 2001* requires financial advisers to set out in writing advice to clients, indicating the basis on which they recommendation an employee change or not change funds. They must also indicate any benefit or commission they would receive from a change of fund. By law, if they make a recommendation based on their own financial gain rather than the client's financial gain, they are liable to prosecution by ASIC.[7]

7.10 Mr Rosser from the Treasury also made this point in the hearing on 11 September 2002. He indicated that even where a financial adviser provides advice to a client who is financially illiterate, and therefore vulnerable to commission-based

3 *Submission* 16, Cbus, p. 8.

4 Cited in *Submission* 5, ACTU, p. 5.

5 *Submission* 37, FPA, pp. 4-5.

6 *Committee Hansard*, 11 September 2002, p. 218.

7 *Committee Hansard*, 11 September 2002, pp. 218-219.

selling, the financial adviser would nonetheless be required to comply with their legal requirement to provide financial advice in the best interests of their client.[8]

7.11 The Committee also notes that in evidence, Mr Breakspear acknowledged that approximately 95 per cent of financial advisers do not recommend industry funds in their advice to clients. Partly this is because many are not public offer funds. However, Mr Breakspear also acknowledged that most industry funds do not offer a commission to financial advisers for bringing new members to the fund. Mr Breakspear defended this situation, however, on the basis that financial advisers that operate on a commission basis rather than an up-front fee basis, would be unable to continue to offer advice if they included industry funds in their portfolio of funds from which they make recommendations.[9]

7.12 Responding to Mr Breakspear's evidence, Industry Fund Services advised the Committee that:

> The simple fact of the matter is that financial planning organisations almost invariably never recommend non-commission paying superannuation funds, and a retirement income system which combines compulsory superannuation contributions with unfettered commission-based selling is a recipe for disaster.[10]

7.13 Cbus expressed similar concern, stating in its submission that:

> The Superannuation Guarantee currently requires employers to contribute 9% of the gross ordinary time earnings of an employee into a complying superannuation fund. There is a question as to whether it is legitimate for commission to be debited from the funds that employees must compulsorily preserve until retirement.[11]

7.14 Various parties also advocated a ban on commission-based selling during the inquiry. For example, in its written submission, the MTAA Superannuation Fund argued that until Australians demonstrate an ability to make informed and educated choices, a ban should be imposed on commission-based selling of superannuation products in respect of mandated SG payments.[12]

7.15 Similar arguments were expressed in hearings. For example, Mr Silk from the Industry Funds Forum argued in the hearing on 11 September 2002 that SG

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8 *Committee Hansard*, 11 September 2002, p. 295.

9 *Committee Hansard*, 11 September 2002, p. 221.

10 *Submission* 44, Industry Fund Services, p.2.

11 *Submission* 16, Cbus, p. 8.

12 *Submission* 11, MTAA Super Fund, p. 8.

contributions are mandated by legislation, and that there is no basis for individuals to enrich themselves at the expense of members' retirement savings.[13]

7.16 The Committee also considered in hearings the issue of third-line forcing, whereby superannuation providers offer 'deals' in which superannuation is packaged with a range of other products, effectively locking an employee into a superannuation fund which is not in their best interest.

7.17 In his response to this issue on behalf of the ABA, Mr Loveridge argued in evidence on 11 September 2002 that Australian banks would not consider using third-line forcing as a strategic initiative. At the same time, however, Mr Bell noted that 'bundling' products and services is legal under the *Trade Practices Act 1974* where an individual is fully aware of it.[14]

Trailing commissions

7.18 During the inquiry, various parties advocated a ban on trailing commissions. For example, in evidence on 3 September 2002, Ms Dyson from AIST indicated that AIST opposed trailing commissions by financial advisers, in favour of an up-front fee, disclosed at the time the client goes in for service. She also suggested that the up-front fee should be a cash amount rather than a percentage charge. Similarly, Dr Pragnell from ASFA acknowledged the possibility of abuses by commission agents using ongoing commission fees, and supported a limit being placed on commission fees in favour of an up-front fee.[15]

7.19 In response to these arguments for a ban on trailing commissions, Mr Murphy from the Association of Financial Advisers argued that trailing commissions constitute an essential part of his business:

> It (the trailing commission) provides me with the infrastructure and support to be able to give benefits to the members of the funds.[16]

7.20 At the same time however, Mr Murphy argued that 'the consumer does not care' about the level of fees – on the basis that the client gets what they pay for: 'If they want cheap, we give them the Yellow Pages and the phone book'.[17]

7.21 The Committee also raised a ban on trailing commissions with Mr Hristodoulidis from the FPA in the hearing on 11 September 2002. He also opposed a ban on trailing commissions on the basis that they are disclosed up front, and that payment should go with a service:

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13 *Committee Hansard*, 11 September 2002, p. 267.

14 *Committee Hansard*, 11 September 2002, p. 262.

15 *Committee Hansard*, 3 September 2002, pp. 145-146.

16 *Committee Hansard*, 2 September 2002, p. 33.

17 *Committee Hansard*, 2 September 2002, p. 35.

> Where service is being delivered by the financial adviser, that is an ongoing relationship, and they should be available to assist the client with their affairs. Then payment should follow service.[18]

7.22 In this regard, Mr Breakspear from the FPA indicated that normally, financial advisers would review a client's funds on either a six-monthly or yearly basis, depending on the size of the fund, and provide the client with a written report of their situation. In addition, there may be events throughout the year that require contact between the adviser and the client.[19]

7.23 Finally, in evidence on 11 September 2002, Mr Gilbert from IFSA also supported the charging of trailing commissions where such fees are disclosed in accordance with the provisions of the *Financial Services Reform Act 2001*.[20]

The international experience

7.24 During the inquiry, various parties cited the example of super funds in the UK in the mid-1980s, when defined benefit schemes were opened up to competition from retail funds. The result was that life agents 'encouraged' people to leave their defined benefit schemes and transfer into personal pension products with higher fees and commissions, thereby adversely influencing their retirement savings.

7.25 The CSA referred the Committee to the Report of the Sandler Review of Medium to Long-term Retail Savings in the UK, which found that widespread commission-based selling of medium to long-term retail savings products in the UK had operated to the detriment of consumers. As a result, the UK regulator was forced to intervene in the interests of fund members.[21]

7.26 The ACA advised the Committee that the estimated cost of compensation for the mis-selling of life insurance after the deregulation of that market in the UK in the late 1980s was £11.5 billion to 1.1 (m)illion consumers in what has been described as 'the largest consumer compensation exercise undertaken anywhere in the world'.[22]

7.27 The Committee raised these issues with Mr Boneham from the Treasury during the hearing on 11 September 2002. He argued that the disclosure regime in the UK during the mid-1980s was not as robust as the regime operating in Australia under the *Financial Services Reform Act 2001*, and that accordingly it was not valid to extrapolate the UK experience to Australia.[23]

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18 *Committee Hansard*, 11 September 2002, p. 226.

19 *Committee Hansard*, 11 September 2002, p. 227.

20 *Committee Hansard*, 11 September 2002, pp. 241-242.

21 Cited in *Submission* 13, CSA, p. 7.

22 *Submission* 53, p. 2.

23 *Committee Hansard*, 11 September 2002, p. 294.

Not-for-profit fund costs

7.28 In evidence to the Committee on 3 September 2002, Ms Rubinstein from the ACTU argued that retail funds are run for the benefit of shareholders, and have to recoup costs, whereas not-for-profit funds are run solely for the benefit of fund members, and thus can keep costs to a minimum.[24] However, several parties argued during the inquiry that under a choice environment, not-for-profit funds might nevertheless face higher administrative and marketing costs.

Administration costs

7.29 During the inquiry, various parties argued that not-for-profit funds currently have lower administrative costs than retail funds. For example, in its written submission, the MTAA Superannuation Fund noted that since the fund's establishment in the mid-to-late 1980s, it has reduced its weekly administration fees from an average of $4 per week per member to around $1 per week today. This has not changed in the last eight years, despite inflation of approximately 30 per cent.[25] Cbus also currently maintains a $1 a week administration fee.[26]

7.30 The MTAA Superannuation Fund further cited recent studies by Dr Hazel Bateman from the UNSW, Access Economics and Rainmaker Information Services that average administration charged in not-for-profit industry and corporate funds are up to half those of funds that operate in the marketplace for profit.[27]

7.31 The ACTU also cited in its written submission a study of November 2001 from the ASFA entitled 'Are Administrative and Investment Costs on the Australian Superannuation Industry too High?', which found that retail master trusts average at least twice the cost of industry, public and corporate funds.[28]

7.32 Given the low costs of not-for-profit funds, various parties argued in their written submissions that choice of fund will force not-for-profit funds to increase outlays on administration. For example, Corporate Super argued in its written submission that administration fees may rise as a result of strains placed on funding due to the lack of predicability of membership. This could particularly apply to defined benefit funds, as the mix of ages and service of members becomes less predictable.[29]

7.33 Similar concerns were raised in hearings. For example, in evidence to the Committee on 2 September 2002, Ms Butera from Cbus questioned whether the fund

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24 *Committee Hansard*, 3 September 2002, p. 126.

25 *Submission* 11, MTAA Super Fund, p. 6.

26 *Committee Hansard*, 2 September 2002, p. 50.

27 *Submission* 11, MTAA Super Fund, p. 7.

28 *Submission* 5, ACTU, pp. 4-5.

29 *Submission* 13, CSA, p. 5.

would be able to maintain a $1 weekly charge should choice of fund be introduced.[30] In addition, Mr Ward from Mercer argued in evidence to the Committee on 2 September 2002:

> For industry funds the expenses will increase because, as you say, they are competing against a wider marketplace with paid salesmen or commission salesmen out there. At the moment industry funds are not really competing against those other funds but they would be under a choice environment. On the other hand, though, there may be some reductions in cost in those bank and life office funds as they do start to try and compete.[31]

Marketing costs

7.34 Various parties also argued that the introduction of choice of fund under the current Bill would force not-for-profit funds to increase outlays on marketing. For example, Cbus noted in its written submission:

> In a choice of funds environment, market visibility is essential for Cbus to protect its position against larger, multinational fund managers.[32]

7.35 Dr Anderson from ASFA also made this point in evidence to the Committee on 3 September 2002. She indicated that not-for-profit funds have minimum expense bases, but that choice of fund would require not-for-profit funds to spend extra revenue promoting their product.[33]

7.36 The MTAA Superannuation Fund also cited in its written submission the proposed introduction of choice of fund in 1998. The MTAA Superannuation Fund argued that at the time, several household brand life offices and banks launched saturation, mass media, advertising campaigns, timed and predicated on what was expected to be the imminent introduction of choice of fund.[34]

7.37 The Committee also notes the evidence of Mr Rosario from Westscheme that following the introduction of choice in WA on 1 July 1998, there is no evidence that fees and charges went down. Nevertheless, Westscheme itself has effected reductions in fees through economies of scale from having more members and greater funds under management.[35]

7.38 In response to these concerns, however, Mr Hajaj, appearing on behalf of the Financial Services Consumer Policy Centre at the UNSW, claimed that, based on anecdotal evidence that comes from watching television, industry funds currently

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30 *Committee Hansard*, 2 September 2002, p. 50.

31 *Committee Hansard*, 2 September 2002, p. 102.

32 *Submission* 16, Cbus, p. 12.

33 *Committee Hansard*, 3 September 2002, p. 148.

34 *Submission* 11, MTAA Super Fund, p. 12.

35 *Committee Hansard*, 2 September 2002, p. 64.

engage in more marketing activity than retail funds.[36] However, the Committee notes that there is also a great deal of advertising on television in relation to superannuation products by retail funds.

Not-for-profit fund returns

7.39 In its written submission to the inquiry, the MTAA Superannuation Fund argued that not-for-profit funds had achieved superior investment returns for their members in 2001-2002 when compared to retail funds. In 2001-2002, two not-for-profit industry funds (MTAA Superannuation Fund and REST) achieved returns of two per cent and 3½ per cent for their members when other funds returned negative results. The MTAA advised that:

> These results have not occurred by some fluke of good fortune. Not-for-profit industry funds, through their own efforts as well as the work of such innovative companies as Industry Fund Services, amongst others, have consistently delivered time and time again quality products for their members as well as superior investment returns on the assets under management – all for a far lesser cost than those charged by many 'for profit' retail funds.[37]

7.40 However, various parties argued during the inquiry that not-for-profit funds may not be able to achieve such good results in the future if choice of fund is introduced under the current Bill. As stated by the CSA:

> The FSR legislation lays the ground rules in terms which are tailored to the situations of these For Profit providers. Employers and Not For Profit trustees, on the other hand, are at a disadvantage. They may in fact be very competitive, but do not actually want to compete – this is not their objective. They are trying to meet their obligations to their employees, or to fulfil their obligations in operating a fund for the benefit of members. They do not have a budget for marketing to members, and hence are at a financial disadvantage.

7.41 The MTAA Superannuation Fund suggested in its written submission two reasons why choice of fund may lead to reduced returns from not-for-profit funds. First, 'churning' between funds may require funds to retain more liquid assets so as to be able to meet their liquidity obligations. Such asset classes, essentially cash and fixed interest, generally under perform growth assets over the mid to long-term.[38]

7.42 Second, the MTAA Superannuation Fund argued that in a highly competitive market, funds would be less inclined to invest in asset classes that have long lead times before producing positive returns, and which also happen to offer the most support to Australia's broader economic development (eg infrastructure,

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36 *Committee Hansard*, 2 September 2002, p. 27.

37 *Submission* 11, MTAA Super Fund, p. 7.

38 *Submission* 11, MTAA Super Fund, p. 12.

developmental capital, and members' home loans). Instead, they are likely to invest in the types of asset classes that may produce early high returns, but may be speculative.[39]

7.43 The Committee notes, however, the statement by the NFF in its written submission that the NFF 'hopes that it [choice] will lead to a potential growth of investment within rural and regional Australia.'[40] In the hearing on 11 September 2002, Ms Harris expanded on this claim, suggesting that with choice, there may be a greater pool of superannuation funds, and potentially more funds directed towards rural and regional Australia.[41]

39 *Submission* 11, MTAA Super Fund, p. 12.

40 *Submission* 1, NFF, p. 3.

41 *Committee Hansard*, 11 September 2002, p. 211.