Chapter Twelve

The Quality of Paid Financial Advice

Introduction

12.1 This chapter examines the quality of financial advice available to retirees and mature age employees approaching retirement. During the inquiry, a great deal of concern was expressed that financial planners are not, in all instances, acting in the best interests of their clients, with the result that retirees are being placed in inappropriate retirement products which do not serve them well in retirement.

The ASIC/ACA and ANZ financial advice surveys

12.2 In its written submission, the FPA indicated that financial plans prepared by financial planners generally:

- Outline the person's financial position and needs;
- Set out the person's goals;
- Explain the overall strategy to achieve them;
- Recommend investments and other steps for the person to manage their money;
- Show how each investment and any other steps will get the person to their goals;
- Discuss the risks and how to deal with them;
- Show all costs to the person; and
- Inform the person about any remuneration and other benefits that the adviser may receive for their professional skills.

12.3 However, on 11 February 2003, ASIC and the ACA released a joint survey very critical of the quality of advice provided by financial planners. The results of the survey are shown in Table 12.1 below:

Table 12.1: Results of ASIC and ACA survey of the quality of advice provided by financial planners

Grade	No. of Plans	Percentage
Very good	2	2
Good	23	19
OK	36	29
Borderline	30	24
Poor	21	17
Very Poor	12	10
Total	**124**	**100**

12.4 ASIC/ACA indicated that common deficiencies in plans included:

- failing to provide an Advisory Services Guide (15% of planners);
- failing to show how the recommended strategy and action was appropriate for the client;
- being hard to read and 'padded' with reams of generic information;
- ignoring key client requirements and not explaining why;
- recommending higher-fee investments (such as some wrap accounts and master trusts) without showing why these were better than cheaper alternatives; and
- recommending a switch without showing how new investments would be better than existing investments.

12.5 Commenting on the results of the survey, ASIC Executive Director of Consumer Protection, Mr Kell, said:

> The overall results of the survey show that many people aren't getting the quality of advice they deserve. This is a wake-up call to the financial advisory industry that significant improvements are needed.[1]

12.6 The Committee also notes that on 2 May 2003, the ANZ released the results of its first financial literacy survey, which looked at the ability of Australians to make informed judgments and decisions about the use and management of their money. Some of the key findings were:

- While investment fundamentals are well understood, with 85 per cent of people knowing that high returns equal high risk, nevertheless investors are potentially susceptible to misleading claims, with 47 per cent indicating that they would invest for 'well above market rates and no risk'.
- Planning for retirement is poor with only 37 per cent of people having worked out how much money they needed to save for retirement. Many also have

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1 ASIC Media Release 03-037, *Financial Planner Survey Results Released*, 11 February 2003.

unrealistic expectations, with 50 per cent expecting to be living 'at least as comfortable in retirement as they are today'.

- Knowledge of fees and charges varies with 88 per cent of credit card users and 78 per cent of those with bank accounts knowing their fees well. However, only 60 per cent of people with managed investments and 44 per cent of those with superannuation knew their fees well.
- Most people understand their bank account and credit card statements, however 21 per cent of people cannot understand their superannuation statements and further testing revealed that only 40 per cent can identify key items on a superannuation statement correctly.[2]

12.7 The Committee notes that the quality of financial advice clearly has implications for planning for retirement by mature age workers. The provision of poor quality advice to mature age workers has the potential to deprive them of a comfortable retirement, forcing them to rely more heavily on government provided assistance.

12.8 Various parties cited the findings of the ASIC/ACA survey of financial advice in their written submissions to the inquiry.[3] For example:

a) The COTA National Seniors Partnership expressed its concern that thousands of people have received advice that is borderline, poor or very poor, leaving their capital and retirement income potentially at risk or underperforming.[4]

b) Similarly, the ACTU argued that there is a need for greater disclosure of fees and commissions in the superannuation industry, and greater regulation of the financial planning industry.[5]

12.9 Similar concerns arising from the ASIC/ACA and ANZ surveys were also raised in hearings. Ms Wolthuizen from the ACA noted that there are some very alarming deficiencies when it comes to the quality of advice offered by financial advisers and consumer comprehension of financial products, particularly when it comes to superannuation and planning for retirement. Ms Wolthuizen noted:

- The ANZ research shows that even basic understanding is very low when it comes to retirement planning and super. The ANZ survey found that 55 per cent of respondents knew nothing about super fees, and only 37 per cent had worked out how much they would need for retirement. The survey also cited a hypothetical scenario put to respondents of a 53-year-old with just over $25,500 in superannuation savings. The respondents were asked whether that would be

2 ANZ, Media Release, 'ANZ Releases Australia's First Financial Literacy Survey', 2 May 2003.

3 See IFF, the ACTU, Mr Mair, the COTA National Seniors Partnership.

4 *Submission* 31, COTA National Seniors Partnership, pp. 28-29.

5 *Submission* 24, ACTU, p. 4.

enough for the 53-year-old to retire on at 65. While a majority said no, there were still a proportion who indicated that, yes, $25,500 would be more than enough for the 53-year-old to live on comfortably from the age of 65.[6]

- The ASIC/ACA survey found that 51 per cent of the plans assessed received borderline or fail ratings, and only two out of 124 were rated as being very good. The common problems were out and out non-compliance; failure to know clients – such things as risk profile forms being sent out after the plan had been provided; or no consideration of the client's existing financial position or existing investments and assets or no consideration of specific goals, such as wanting to pay for children's education.[7]

12.10 In response to the findings of the ASIC/ACA and ANZ surveys, Mr Hristodoulidis from the FPA, which represents some 14,500 financial planners across Australia, acknowledged in the hearing on 8 May 2003 that the FPA was concerned about the findings. At the same time, Mr Hristodoulidis indicated that the FPA was disappointed at the emphasis placed on some of the results in the two surveys and the impact this may have on consumer confidence.[8]

12.11 Mr Hristodoulidis noted that the FPA, since its inception some 10 to 15 years ago, has been to the forefront in raising the standards of advice and practice in the financial planning industry. In the last two years, he indicated that the FPA has received 262 complaints against members, conducted 26 disciplinary hearings and posted 46 charges of misconduct. The FPA also recently launched its Professional Partner Program, aimed at driving incompetent and unethical planners out of the industry.[9]

<u>Case Study</u>

12.12 The Committee wishes to cite a case study showing the difficulties faced by many retirees when investing their superannuation entitlements. The case study is based on evidence tabled by Mr Potticary in the hearing on 9 May 2003.

12.13 Mr Potticary retired in mid-1997, at which time he took a separation package of approximately $68,000. He invested this in an allocated pension on the advice of a financial planner. Table 12.2 below shows the performance of that pension since 1997.

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6 *Committee Hansard*, 5 May 2003, p. 2.

7 *Committee Hansard*, 5 May 2003, p. 3.

8 *Committee Hansard*, 8 May 2003, p. 144.

9 *Committee Hansard*, 8 May 2003, pp. 144-145.

Table 12.2: Mr Potticary's Allocated Pension – 30/6/1997 – 31/12/2002

Date	Initial investment	Initial fee + 6 monthly fee	Tax + payg	Fund earnings	Pension payment
30/6/97	$68,000	$2,400		$104	
31/12/97		$608	$306	$2,043	
30/6/98		$608	$411	$2,821	$4,207
31/12/98		$605	$103	$2,260	$2,151
30/6/99		$604	$103	$1,321	$2,151
31/12/99		$587	$107	$4,255	$2,163
30/6/00		$594	$107	$1,511	$2,164
31/12/00		$612	$59	$896	$2,189
30/6/01		$597	$59	$2,030	$2,248
31/12/01		$581	$61	$428	$2,234
30/6/02		$583	$299	-$405	$2,234
31/12/02		$583	$294	-$99	$2,140
Total 31/12/02	**Now worth $54,980***	**$8,931#**	**$1,909^**	**$18,947~**	**$23,822**

* $ value of investment has decreased by $13,020
# Total fees charged represent 47 per cent of earnings
^ Widely varying amounts of tax show instability in government taxation policies
~ Negative fund earnings are a source of worry for retirees and make them wonder whether allocated pensions are worthwhile at all. The fund earnings have been negative for the last 18 months.
Source: Mr Potticary, tabled document, 9 May 2003.

12.14 The Committee notes a number of points out of the above case study:

a) Mr Potticary paid an initial fee of $2,400, and currently pays ongoing fees every 6 months.

b) The total fees and charges on the allocated pension from 30 June 1997 to 31 December 2002 amount to $8,931, which represents 47 per cent of the earnings ($18,947).

c) The value of the investment has decreased by $13,020, including negative returns at 30 June 2002 and 30 December 2002.

12.15 In the hearing on 9 May 2003, Mr Potticary indicated to the Committee that he did not understand the fee structure or cost structure of the allocated pension at the time he took it, and did not appreciate the impact of ongoing fees commissions on his retirement income.[10]

10 *Committee Hansard*, 9 May 2003, p. 242.

12.16 Mr Potticary also acknowledged that at the time of taking the allocated pension, he should have sought advice from a different financial planner.[11]

12.17 The Committee appreciates the evidence of Mr Potticary as an example of the difficulty faced by many retirees when it comes to investing their superannuation lump sum.

Improving the quality of paid financial advice

12.18 During the inquiry, various parties made reference to measures designed to improve the quality of paid financial advice available to pre-retirees and retirees.

The Financial Services Reform Act

12.19 The *Financial Services Reform Act 2001* (FSR Act) is a new licensing regime for those carrying on a financial services business. The FSR Act, which is enforced by ASIC, includes a number of measures designed to improve the quality of financial advice:

a) It outlines the requirements that must be met by a financial service provider to obtain a license.

b) It requires that clients of financial service providers be provided with a financial services guide which presents information, for example, on fees, commissions and charges, so that the client can make an informed decision.

c) It requires that financial service providers outline the basis of their advice to a client, including any charges in taking up the product and any benefits the client might lose, amongst other things.[12]

12.20 The FSR Act commenced on 11 March 2002. However, it has a two-year transition period until 11 March 2004. In the hearings on 15 May 2003, Mr Rosser from Treasury noted that currently the FSR Act is just over half way through the transition period. Approximately 800 licenses have been issued, but ASIC ultimately expects to issue about 6,000 licenses.[13]

Financial industry commissions

12.21 In its written submission, the Industry Funds Forum (IFF) focused on the issue of commissions to financial planners for the sale of financial products and the impact commissions may have on the level of retirement incomes. The IFF noted that there are several different types of commissions:

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11 *Committee Hansard*, 9 May 2003, p. 242.

12 *Submission* 46, Treasury, p. 6.

13 *Committee Hansard*, 15 May 2003, p. 295.

a) Up-front commissions which may be deducted immediately from a new account and paid to the selling financial planner.

b) Trailing commissions, which are currently more common. These commissions may be deducted from the consumer's account on an annual basis for an indefinite period.

c) Volume servicing commissions whereby, as an agent's sales volumes for a particular financial institution increase, the rate of the commission increases.

12.22 The IFF argued that the system of percentage commissions clearly has the capacity to act against the best interests of retirees and those planning their retirement. A percentage fee is an inappropriate charging mechanism because there is not a direct relationship between the amount of client money and the amount of work involved for the financial planner. The IFF continued:

> The system needs reform, where the desirable outcome would provide for a more direct relationship between the level of work and the fees charged, and incentives to provide conflict-free, objective advice.[14]

12.23 In her evidence to the Committee on 5 May 2003, Ms Wolthuizen from the ACA also argued that the Government should examine restrictions on, or the removal of, commissions as a whole. However, she argued that the FSR Act essentially entrenches commission based remuneration arrangements. She noted:

> FSR is disappointing in the sense that it relies on disclosure as the means of trying to overcome the conflict of interest that is presented by commission remuneration. We have found that commission remuneration is not in consumers' interest.[15]

12.24 Accordingly, Ms Wolthuizen expressed the ACA's preferred position that commissions be banned and the industry operate on a fee-for-service basis.[16]

12.25 In response to these arguments, Mr Hristodoulidis from the FPA argued in the hearing on 8 May 2003 for the maintenance of commissions as a means of paying for financial advice, provided that the disclosure regime under the FSR Act is appropriate. Mr Hristodoulidis commented that 20 per cent of respondents to the ANZ financial advice survey, and 30 per cent of respondents to a Roy Morgan survey conducted on choice, indicated that they would prefer to pay for advice through a commission rather than an up-front fee.[17]

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14 *Submission* 7, IFF, pp. 2-3.

15 *Committee Hansard*, 5 May 2003, p. 8.

16 *Committee Hansard*, 5 May 2003, p. 8.

17 *Committee Hansard*, 8 May 2003, p. 147.

12.26 Senator Sherry subsequently also raised with Mr Hristodoulidis whether there is a conflict of interest where financial planners are paid to provide independent advice, but at the same time may be remunerated in part or in whole based on the commission they collect from the products they recommend. In response, Mr Hristodoulidis argued that the new FSR Act obliges financial advisers to disclose any conflict of interest, and to make it clear to the client what they are entering into.[18]

12.27 In reply to Mr Hristodoulidis, Senator Wong noted that the safeguard provided by the FSR Act may not be sufficient, given the findings from the ASIC/ACA survey that commission-only agents performed particularly badly, even when compared to the general underperformance of the industry, receiving only a 44 per cent average score under the survey. In answer, Mr Hristodoulidis made two substantive points:

a) The results from the ASIC/ACA survey show that financial planners who offered their clients the option of paying fee-for-service or commission actually outperformed the fee-for-service only providers.

b) The ASIC/ACA survey was conducted under the old Corporations Law, whereas the new FSR Act actually raises the hurdle of what needs to be disclosed, and the penalties for non-disclosure.[19]

12.28 Finally, the Committee notes that in the hearing on 8 May 2003, Ms McAlister from the industry regulator, ASIC, expressed her belief that the new FSR Act will address the issue of commissions:

> What we are saying is that we see the new law as significantly raising the standards around disclosure of commissions … We have not really seen whether the new law standards, combined with strong regulatory messages about the way we think those new law standards ought to be implemented and administered by industry, have had an impact yet.[20]

12.29 In addition, the new FSR Act includes provisions that whatever advice is given to consumers, it must be appropriate to their needs, circumstances and objectives.[21]

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18 *Committee Hansard*, 8 May 2003, p. 148.

19 *Committee Hansard*, 8 May 2003, p. 160.

20 *Committee Hansard*, 8 May 2003, p. 111.

21 *Committee Hansard*, 8 May 2003, p. 111.

The deductibility of financial planner fees

12.30 In its written submission, the FPA noted that generally, financial plans take from 7 hours to 30 hours of work to complete, which at a cost of $200 an hour, means an overall cost from $1,400 to $6,000. However, the FPA continued that the up-front cost of a plan is not tax deductible. This seriously inhibits the provision of fee-for-service financial advice.[22] This point was also made by IFSA[23] and the ABA[24] in their written submissions.

12.31 In the hearing on 8 May 2003, Mr Hristodoulidis from the FPA argued that the up-front cost of preparing a financial plan should be tax deductible:

> The critical aspect at the moment is that you have two systems operating. You have a system where the cost of obtaining some advice is tax deductible, and the fees and charges for other forms of advice that you may receive are not deductible. We are saying that there needs to be consistency in the approach.[25]

12.32 The Committee also raised this issue with Mr Negline from the ICA in the public hearing on 5 May 2003. He also indicated that initial advice provided by a registered financial planner is not deductible if it is paid for by an up-front fee. This is because the up-front fee is perceived, from a legal taxation perspective, as relating to a capital investment. By contrast, trailing commissions relating to ongoing advice are perceived, from a legal taxation perspective, as relating to income, and hence are tax deductible.[26]

12.33 This advice was confirmed by representatives of Treasury in the hearing on 15 May 2003. Mr Brake reiterated to the Committee that the general tax principle is that deductions can only be claimed for expenses incurred in earning assessable income, and that superannuation advice paid for by an individual in advance is not incurred in earning an assessable income.[27]

12.34 To address this perceived problem, the FPA recommended in its submission that the ATO and the Federal Government develop an investment advice related expense section in the *Income Tax Assessment* Act *1997* similar to the treatment of tax-related expenses in Section 25-5 of the *Income Tax Assessment Act 1997*. This section specifically provides a tax deduction for expenses incurred in connection with the person's tax related affairs, even expenses of a capital nature that would otherwise

22 *Submission* 32, FPA, pp. 15-16.

23 *Submission* 27, IFSA, pp. 2-3.

24 *Submission* 41, ABA, p. 13.

25 *Committee Hansard*, 8 May 2003, pp. 146-147.

26 *Committee Hansard*, 5 May 2003, p. 90.

27 *Committee Hansard*, 15 May 2003, p. 299.

be denied under Section 8-1. The FPA suggested that a similar section could be inserted to make the up-front cost of a financial plan deductible. [28]

An 'Australian standard' for financial planners

12.35 In his private written submission, Mr Mair argued for the development of an 'Australian standard' for financial plans and their disclosure of pricing by Standards Australia. Mr Mair criticised the Government for refusing to play a greater role in promoting standards for the 'services' and 'product' offered by the financial services industry and their terms of sale.[29]

12.36 Senator Lightfoot raised this issue with Mr Brunner from APRA in the hearing on 16 May 2003. In response, Mr Brunner indicated that Standards Australia sets standards that are at a fairly generic level, providing guidelines for all financial industry members, whether they are in banking, superannuation or insurance. However, Mr Brunner argued that specific standards for particular industries such as the superannuation industry should be implemented through disallowable instruments put before the Parliament. As stated by Mr Brunner:

> The Standards Australia standards are a very useful starting point, but I think developing the specific standards as disallowable instruments is a more effective way of providing standards for superannuation than developing a specific Standards Australia standard for superannuation.[30]

The viability of not-for-profit funds

12.37 Given the evidence cited above in relation to financial planning standards, commissions in the financial planning industry and the FSR Act, the Committee notes the concern expressed by Mr Brookes from the CSA in the hearing on 8 May 2003 in relation to the viability of not-for-profit corporate funds and the fund recommendations made by financial planners.

12.38 Mr Brookes argued that that the superannuation industry is being 'oligopolised' – not-for-profit corporate funds are being forced out of the superannuation market and progressively replaced by for-profit, commission-driven financial conglomerates. In support, Mr Brookes cited APRA figures that the number of corporate funds had been reduced from 3,200 to 2,600 as at the end of last year.[31]

12.39 Mr Brookes further argued that this is to the detriment of superannuants. Mr Brookes cited research by APRA that not-for-profit provision of super has the highest return on assets for superannuants – about 6½ per cent per annum at present (50 per

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28 *Submission* 32, FPA, pp. 15-16.

29 *Submission* 26, Mr Mair, p. 3.

30 *Committee Hansard*, 16 May 2003, p. 312.

31 *Committee Hansard*, 8 May 2003, p. 133.

cent better than the retail sector). In addition, he argued that the cost structure of not-for-profit funds is massively lower than that of retail funds.

12.40 Mr Brookes also argued that contributors to many corporate not-for-profit funds are willing to pay above the SG rate of 9 per cent. The average contribution to members of the CSA is 11½ per cent – 2½ per cent over and above the SG rate. In addition, two-thirds of corporations pay for the administration costs of corporate funds, and 62 per cent also pay the members' insurance costs.

12.41 Mr Brookes attributed the oligopolisation of the superannuation industry to the difficulty for the consumer in getting clear, independent, unbiased and disinterested advice. As Mr Brookes noted:

> It is very hard to do, because the so-called independent consultant, who is perhaps an asset consultant, has almost certainly got their fingers in other pies—for instance, a master trust or a financial planning subsidiary. They could go to the bank manager. The bank manager unfortunately is part of financial planning. Even an asset consultant in an investment management firm is as well. Witness the takeover by banks of those very mechanisms. Witness the reverse point, where investment consultants have gone into financial planning. How about financial planning itself? At the moment, you get advice. One is obliged, through the barriers to entry and the barriers to staying in the game, to go to a financial planner. Surprise, surprise: at last count 80 per cent of those firms are owned by the financial conglomerates. As was pointed out earlier, the advice given by those planners is limited, is biased and has commission attached to it.[32]

12.42 Elaborating this point, Mr Brookes argued that financial planners are simply not paid to give independent advice. Rather, it is in their interest to direct retirees into for-profit retail funds, in order to earn money from commissions.[33] Mr Brookes continued:

> If we look at the incidence of oligopolisation—it is a long word but it does summarise it all very well—we see that the question for the Australian independent person is: to whom do I turn for fair, independent advice? That is the central question: who do you go to? Before the financial services act, one could turn to the guardians of one's own money, and by that I mean the trustees of the corporate not-for-profit fund, who in fact represent themselves; that is, the members of the fund. The advice there was freely given, independent, disinterested; that is, there was no commercial advantage or link to the provision of that advice. With the advent of more regulation, more control and more cost—that is, the financial services act—the provision of that advice is now subject to a licence.[34]

32 *Committee Hansard*, 8 May 2003, p. 134.

33 *Committee Hansard*, 8 May 2003, p. 134.

34 *Committee Hansard*, 8 May 2003, p. 133.

12.43 Senator Wong subsequently raised with Mr Brookes her interpretation of his argument, namely that the FSR Act may of itself be leading to a decline in the availability of disinterested and impartial financial advice. In response, Mr Brookes argued that there are some aspects of the FSR Act which are really excellent, but that the downside is that it treats not-for-profit funds exactly the same as if they were for profit funds. Put simply, corporate funds are not permitted to give information to members of the fund regarding the operation of the fund.[35]

12.44 Senator Wong in turn suggested that there might have been some difficulty in the industry if industry and corporate funds were treated differently to retail funds in relation to the giving of information to members. In response, Mr Brookes commented:

> I wonder why. If the basis is that those who stand to gain from doing something should be regulated in a certain way, it is a different playing field entirely for those who do not stand to gain or who stand to gain nothing. … The fear—and it is fear of being sued, fear of liability—is that different members of regulatory bodies will have different opinions on what they consider is advice versus information. In other words, there is a clear exemption there, but the interpretation of it is various.[36]

12.45 Subsequently at the hearing on 8 May 2003, the Committee raised with Mr Hristodoulidis from the FPA the likelihood that financial planners would recommend industry, corporate and public sector funds which do not pay commissions, and which are not on their list of products to recommend. In response, Mr Hristodoulidis noted that there are some financial planning groups which do recommend industry and corporate funds. In addition, a consumer may go to a financial planner, who may recommend that the consumer stay in their current industry or corporate fund, rather than moving to a retail fund.[37]

12.46 The Committee also raised with Mr Hristodoulidis whether financial planners should be required to have on their recommended list of funds a representative cross-section of funds from industry, corporate and retail sectors, or whether a planner should be permitted only to have commission based products on their list. In response, Mr Hristodoulidis indicated that just because financial planners do not have a particular fund on their list does not mean that they will not recommend that fund.[38]

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35 *Committee Hansard*, 8 May 2003, pp. 135-136.

36 *Committee Hansard*, 8 May 2003, p. 136.

37 *Committee Hansard*, 8 May 2003, p. 152.

38 *Committee Hansard*, 8 May 2003, p. 152.