In 1992 compulsory superannuation was added to Australia’s pre-existing voluntary arrangements, resulting in the world’s first compulsory and pre-funded scheme in which ordinary workers bear sizeable investment risk. At the same time, the regulatory approach for financial markets has increasingly emphasised market efficiency, with regulation limited to market conduct and information disclosure requirements. The underlying assumption was that ordinary people would be both engaged in financial matters and be able to make optimal decisions using the information provided under financial product disclosure requirements. This framework has been found wanting. Many people have insufficient financial skills and have failed to engage in retirement saving decisions (Bateman et al. 2012). For many, participation in superannuation has been limited to legislated and scheme-specific defaults. At the same time, while greater system and product complexity has increased the need for financial advice, questions have been raised about conflicts of interest and the quality of advice.

A review of the financial planning industry by a Joint Parliamentary Committee (the Ripoll inquiry) was triggered by several episodes of poor outcomes for clients of some planners (JPCCFS 2009). The 2009 report of the committee led to changes to the Corporations Act under the heading of the Future of Financial Advice (FoFA). FoFA aims to improve financial advice by banning conflicted advice, restricting trail commissions, and introducing standards for the conduct of advisers and other measures. Equally valuable in bringing financial planners up to the mark will be the continued strength of the self-managed superannuation fund (SMSF) sector, which holds about a third of superannuation assets and acts as a socially beneficial ‘competitive fringe’ to an increasingly concentrated financial planning industry.2

Up to four out of five adults never see a financial planner and many of these rely on default options within the superannuation system. Indeed, over 95 per cent of workers fail to exercise choice of fund and opt for the default superannuation fund offered by their employer and around 60 per cent of workers in defined contribution schemes fail to elect an investment option (Super System Review 2010). This behaviour was interpreted as a lack engagement by the Super System (Cooper) Review. MySuper is designed to provide simple, comparable and low-cost default accounts (Parliament of Australia 2011c, Ellis 2012). As a default, MySuper could be seen as de facto advice and should be designed with mass-market application in mind. We suggest that MySuper could be improved with an explicit cap of one per cent on management expense ratios and an explicit glidepath on percentage exposure to growth assets that would see growth assets drop from 60 per cent to 40 per cent of default accounts once a MySuper account holder reaches 55 years of age.

The Future of Financial Advice

FoFA contains three key reforms: first, a prospective ban on conflicted remuneration, including commissions, volume payments, soft-dollar amounts over $300 and asset fees on geared products; second, the introduction...
of an adviser charging regime, which will require annual fee disclosure and client ‘opt-in’ every two years; and third, the introduction of a statutory fiduciary duty for financial advisers, requiring them to act in the best interests of their clients. The reforms are voluntary from 1 July 2012 and mandatory from 1 July 2013.

The ban on conflicted remuneration structures
FoFA seeks to restrict all ‘ongoing’ or ‘trail fees’ from clients to advisers and from product providers to financial planners or their licensees. This tightening applies even if advice is not ‘conflicted’ although the new law is especially concerned with banning conflicted advice. An objective is to ensure greater transparency and specificity in fees charged by financial planners, over and above the question of conflicted advice, though not stipulating that advice fees have to be paid fully upfront.

The reforms also impose a ‘ban on payments relating to volume or sales targets, including platform shelf space fees based on volume’. Here again the idea is to motivate planners to act in the best interests of their clients rather than the interests of licensees or providers. Sales of basic banking products and pure risk insurance enjoy a ‘limited carve-out’.

Asset-based fees can only be charged on ungeared products or investment amounts. Initial or upfront asset fees that are a mixture of advice fees and fees to the product provider are to be banned as well. These are welcome steps towards dampening pre-existing incentives for advisers to recommend risky investment strategies.

As part of FoFA’s endeavours to bring in ‘product-neutral’ advice, soft-dollar benefits of $300 or more will be banned, although ‘consideration will be given to appropriate transitional arrangements’. A soft-dollar benefit is ‘any benefit received by a financial planning firm, its representatives or associates, other than basic monetary commissions or direct client advice fees’ (Parliament of the Commonwealth of Australia 2011a, Shorten 2012a). This reform makes sense.

Introduction of an adviser charging regime with opt-in
The old law requires initial disclosure of an ongoing fee, but not ongoing disclosure. Now an adviser must fulfil a disclosure obligation: every 12 months she must send the client a statement of fees and of services rendered. There is also a renewal notice obligation: every 24 months a planner must accompany her fee disclosure statement with a renewal notice. Absent active renewal by the client, the contract automatically lapses. This requirement is described as opt-in and only applies to new clients. A March 2012 amendment enables the Australian Securities and Investments Commission (ASIC) ‘to provide relief from the opt-in obligations provided fee recipients are bound by an ASIC-approved code of conduct’ (Parliament of the Commonwealth of Australia 2011b, Shorten 2012b).

The ‘set and forget’ feature permitted by the old law may have rendered customers of financial plans vulnerable to ‘inertia selling’ whereby a potential customer has to take active steps to avoid buying a product. Couples may have been particularly vulnerable. If, for example, one member of a couple becomes unable for health reasons to keep looking after the family’s paperwork, years could elapse before the other member of the couple is in a position to take stock of whether the family is continuing to get value for money from an adviser. In the future, the value of the adviser’s services is more likely to receive regular scrutiny by the client’s family and this is commendable. However, the release from opt-in if fee recipients are bound by an ASIC-approved code of conduct has overtones of an unenforceable honour code and privileging industry association members over non-members. Advisers will be required to disclose the charging structure to clients in a clear manner, including total adviser charges payable, expressed in dollar terms and there must be separate fees for product and advice. These reforms are overdue.

Introduction of ‘best interests’ duty
A statutory fiduciary duty on Australian Financial Services Licensees and their authorised representatives will require them to act in the best interests of their clients. This reformulation is described as clarifying that in no circumstances can advisers place their own interests ahead of their clients’ interests. The duty will include a ‘reasonable steps’ qualification. However, in relation to questions such as how many funds an adviser investigates on behalf of clients, like a number of other FoFA initiatives, the ‘best-interests’ rule is far from finalised. Clearly, it is realistic that ‘advisers and authorised representatives are not expected to base their recommendations on an assessment of every single product available in the market’ (Bowen 2010.)

Other reforms
Other FoFA reforms address scaled advice, ASIC’s power to licence and ban advisers and the accountant’s exemption. ASIC intends to release regulatory guidance on these and other issues once the legislative process is completed.

The existing package which provides for simple advice within a superannuation fund (known as intra-fund advice) will be extended to new topics to facilitate simple, single issue, personal advice in a compliant matter. However, specifically excluded will be advice relating to: consolidation of superannuation accounts; a switch away from the member’s current superannuation fund into another superannuation fund; recommendations in relation to financial products that the member holds outside.
To Retirement (TTR) pension. There may be scope to unbundle the initial fee from ongoing fees in the event that the couple decides to remain with their pre-existing superannuation fund while adopting the planner’s recommendations concerning salary sacrifice and a TTR pension (so ‘scaled’ advice predates FoFA). This particular fee appears to satisfy FoFA’s rules about conflicted advice and itemisation of services rendered.

If the couple does switch its superannuation balances into the fund recommended by the FPA’s model plan, the investor pays 1.89 per cent p.a. of assets under management to the product provider. This type of fee would appear to remain legitimate under FoFA. On the other hand, the provider pays 0.6 per cent p.a. of assets under management to the licensee, ‘from their management fees’, and ‘to pay the cost of ongoing advice’. This fee appears to be conflicted. Similarly conflicted is the fee whereby the provider may pay 0.2 per cent to the licensee for recommending its products. Finally, whereas the provider may pay soft-dollar benefits of between $10,000 and $20,000 per planner per year, FoFA caps soft-dollar benefits at $300.

**Evaluation of FoFA**

How will FoFA affect a traditional holistic financial plan? In 2008 the Financial Planning Association included on its website an example statement of advice (SoA) (FPA 2008). As discussed in Kingston (2009), the example SoA sets out five different fees. Based on our interpretation of FoFA, three of these fees would be conflicted (see Figure 1).

In more detail, ‘initial’ advice is charged out at $8,277, after tax and on a fee-for-service basis. This initial fee appears to be primarily in exchange for receiving the tax benefits of salary sacrifice and a Transition to Retirement (TTR) pension. There may be scope to unbundle the initial fee from ongoing fees in the event that the couple decides to remain with their pre-existing superannuation fund while adopting the planner’s recommendations concerning salary sacrifice and a TTR pension (so ‘scaled’ advice predates FoFA). This particular fee appears to satisfy FoFA’s rules about conflicted advice and itemisation of services rendered.

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**MySuper**

The 2010 Super System Review was concerned with the fact that only about 40 per cent of super fund members actively choose an investment option (Shorten 2011). These provisions should increase access to financial advice.

On 23 June 2012 the government announced a new, limited form of Australian Financial Services Licence (AFSL) that will enable accountants and other financial advisers to give strategic advice short of specific product recommendations. The government also announced a requirement that SMSF auditors be registered. The conditions for registration include a tertiary accounting qualification, qualification in audit, a ‘fit and proper’ test, professional indemnity insurance, 300 hours of SMSF audit experience in the three years prior to registration, undertaking continuing professional development (CPD) training every three years, and passing a competency examination set by ASIC, which issues AFSLs. At the time of writing, however, comparable requirements for financial planners were still under review.

FoFA enhances the powers of ASIC to license and ban individuals. Specifically, FoFA empowers ASIC to ban individuals from holding a licence on the grounds that they are not ‘fit and proper’. This looks reasonable.

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**FIGURE 1: How FoFA affects a traditional holistic financial plan**

<table>
<thead>
<tr>
<th>INVESTOR</th>
<th>LICENSEE</th>
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<td>$8,272</td>
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<table>
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<tr>
<th>PRODUCT PROVIDER</th>
<th>FINANCIAL PLANNER</th>
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<tbody>
<tr>
<td>1.89% of balance</td>
<td></td>
</tr>
<tr>
<td>0.6% of balance</td>
<td></td>
</tr>
<tr>
<td>0.2% of balance</td>
<td></td>
</tr>
<tr>
<td>Soft dollars $10K-20K</td>
<td>0.98 x $8,272</td>
</tr>
</tbody>
</table>

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*Note: Figure 1 illustrates how FoFA affects a traditional holistic financial plan. The diagram shows the various fees involved in the process.*
Viceira’s estimates for a risk aversion coefficient equal to 2 makes more sense for a worker who is engaged with her superannuation, if only because this case entails gearing in the early years of working life. On the other hand, his estimates for a risk aversion coefficient equal to 3 suggest a simple two-step mandated glidepath for MySuper: a 60 per cent weight to growth assets for workers under 55 years of age, and a 40 per cent weight to growth assets for workers over 55 years of age.

### Concluding comments

After FoFA, planners will probably continue to derive most of their income from asset-based fees (hopefully not conflicted ones). Asset-based fee income typically hits a maximum at the point of a client’s retirement. Average fees on the growth assets in the FPA’s model plan exceed average fees on cash and ‘income’ assets by 33 basis points. These two considerations tempt planners to overweight high-fee growth assets at the retirement point of a client’s life cycle. By contrast, theory suggests that the case for a high weight on growth assets applies at ages well before retirement, as having many years left in the workforce is comparable to having a big position in bond-like securities. Perhaps FoFA’s plans to promote scaled advice will improve matters.

The age pension, which is indexed to the maximum of wage and price inflation, is means tested and is payable for the remaining life of the pensioner, all of which promotes moral hazard in advice on exposure to growth assets. There is a need for offsetting regulation that protects the taxpayer in the wake of bear markets. To date, however, the official family has expressed little interest in ensuring that self-funded retirees retain their ability to self-fund. A step in the right direction would be to require that Statements of Advice to clients aged over 55 disclose the percentage allocation to Australian-dollar-denominated interest-bearing securities rated as least ‘high quality’ by a major credit-rating agency.

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**TABLE 1: Optimal percentage weight on growth assets**

<table>
<thead>
<tr>
<th>Risk aversion coefficient</th>
<th>Expected years to retirement</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>35</td>
</tr>
<tr>
<td>2</td>
<td>130</td>
</tr>
<tr>
<td>3</td>
<td>63</td>
</tr>
</tbody>
</table>

**Notes:** The assumed risk premium is four percentage points and the assumed volatility of stocks is 18% p.a. The assumed correlation between stock returns and growth in real wages is 25%. The estimates assume that the worker can neither be forced to retire early nor choose to postpone retirement. The two estimates in excess of 100% correspond to geared positions in stocks.

Source: Viceira (2001, Table 1).
Notes
1. We would like to thank the Australian Research Council who kindly assisted us via DP120102239.
2. FoFA estimates that 85 per cent of financial planners are sponsored. The theory of ‘contestable’ markets (due to William Baumol) holds that markets with few sellers may in fact act like competitive ones if there is a ‘contestable fringe’ of suppliers capable of entering and exiting the market at low cost.
3. A licensee is an entity which holds a Financial Services Licence issued by ASIC.
4. Examples of an activity fee include a family law fee, whereby a member is required to have their account split as a result of a family law settlement, or a death benefit nomination.
5. Basu and Drew (2010) offer a detailed and sophisticated treatment of the question of investment strategy for default investment options. They recommend ‘strategies heavily tilted towards stocks’. We have reservations about their approach. It does not consider how steep the glidepath needs to be. It assumes wages are uncorrelated with stock returns. In frameworks like Viceira’s, by contrast, with an explicit utility function, wages uncorrelated with stock returns can generate very aggressive allocations early in the life cycle of a worker-investor, including hefty gearing. In our view, the decision to opt for an aggressive allocation (including a geared one) is best reserved for engaged investors, although there is room for more research on the positive and normative economics of asset allocation for unengaged investors.
6. And, possibly late in retirement as well, depending on how the client’s investments have performed, the retiree’s minimum acceptable income stream, and the importance of bequests (discretionary spending in most cases) in a retiree’s overall budget.

References
Joint Parliamentary Committee on Corporations and Financial Services (JPCFCS) 2009, Inquiry into financial products and services in Australia, Commonwealth of Australia, November.