A Holiday Rort, Courtesy of the Coalition

13 January 2014

While you were enjoying your holidays, the Abbott Government gave a gift to the financial services industry - the right to plunder your superannuation, writes Ian McAuley.

Some unlucky Australians return from holidays to a home that's been burgled. Even if the would-be robbers do nothing more than enter and leave the door open, it's a distressing experience.

Just before Christmas, on 20 December, Assistant Treasurer Arthur Sinodinos announced a rollback of the Future of Financial Advice (FOFA) reforms, leaving the door open for financial advisers to plunder our savings.

Financial advisers mostly operate on a commission basis, giving them a personal financial incentive to promote products with high fees. It is almost a no-brainer to point out that this incentive rarely aligns with the interests of investors.

Investors choosing a superannuation fund, a place to park an inheritance, or an investment account for their children, however, have been attracted to the "free" advice offered by financial advisers. That free advice, of course, has been funded from percentage-based commissions paid to advisers, which go on year to year, and in fact grow as clients' balances accumulate.

A 1 per cent commission may not sound like much, but it takes a big slice of an investor's earnings. If an investor has $200,000 in her account and it is earning a 5 per cent return – a realistic long-term after-inflation "real" return – 1 per cent of capital is $2000, coming out of $10,000 earnings.

As a percentage of earnings, that's 20 per cent. The hour or so of "free" advice will have cost the investor $2000 – not just in the first year, but an increasing amount every year after that.

The Rudd Government's FOFA reforms were modest initiatives ("lukewarm" in the language of one expert) designed to require financial advisers to behave more in line with the interests of their clients - generally, to require advisers to act in investors' "best interests".

One reform was to stop advisers automatically collecting commissions year after year for advice never sought and never given. Advisers would have to offer their services every two years, and if clients declined, would be prohibited from collecting further commissions. Another was to require advisers to disclose commissions to existing clients.

Actuaries Rice Warner, in research commissioned by the Industry Super Network, estimated that the FOFA reforms, once fully implemented, would reduce the average cost of advice from an average of $2046 to $1163. (Actuaries like precise figures.) They estimated that because of savings in fees and the incentives on advisers to give more appropriate advice, the reforms would add $144 billion to private savings by 2027.

Sinodinos's proposals would scrap those reforms. A return to the pre-FOFA days would not only reward the financial services industry, but would also allow the re-emergence of firms unconstrained by any investor "best interest" rule – firms like Storm and Westpoint which wiped out many depositors' life savings.

Banks and other financial institutions, the beneficiaries of commissions and high-fee products, are thrilled with Sinodinos's proposals. Others, speaking for the public interest, are rightly critical. Michael O'Neill, Chief Executive of Australian Seniors, said, "Financial advisers are being given a free lunch pass on the back of consumer savings".

Writing in Crikey, Bernard Keane described the proposed changes as "a low, shabby act of politicking from the Coalition, and one that will cost a huge number of Australians dearly when they come to retire".

Politically, it reveals hypocrisy and inconsistency. In order to lessen the nation's bureaucratic overhead the public service is to be cut back, but commission agents in the private sector, pulling in six figure incomes for doing nothing, are to be protected.

Similarly the car and fruit canning industries are not worthy of assistance, but private health insurers and the salary packaging industry – parts of the financial sector simply shuffling money around and contributing no real value – are to be subsidised through tax breaks, cash payments and legalised rorts.

In all probability the Senate, which from July will be more representative of the top end of town, will pass the Sinodinos FOFA amendments. We can, however, protect ourselves against plunder.

For a start we should be wary of "free" financial advice, just as we should be wary of get-rich-quick schemes, and if we have been tricked into commission-based products we should consider transferring our funds out of them.

The Independent Financial Advisers Association offers links to advisers who give independent advice, do not charge asset-based fees and are not conflicted with commissions or incentive payments from product manufacturers. They generally operate on a fee-for-service basis.

Such independence in itself does not guarantee competence, but it removes a strong incentive for unethical behaviour, and when we are aware of the fees we are paying we are more likely to be engaged with the advice we receive.

Paying, say, $500 or $1000 for financial advice may sound expensive, but many people with $50,000 or $100,000 in their superannuation accounts are paying that much every year, and getting no benefit.

Some will choose to move their superannuation funds from retail to industry funds. Industry-based funds exist purely to provide benefits to members (rather than to contribute to a parent financial firm's profit), pay no commissions to financial advisers, and generally charge lower management fees.

A fee difference of 0.2 per cent, say, between a retail fund charging 0.8 per cent of assets and an industry fund charging 0.6 per cent may not sound large, but that could mean an extra $30,000 (inflation-adjusted) in accumulation at retirement for someone earning an average wage. (See my "supermodel" calculator.)

While a few funds are restricted to employees of particular industries, many are open to all investors. Over the 10 years to 2013, a period including the GFC, industry funds achieved an average annual return of 7.1 per cent, while retail funds achieved only 3.8 per cent – barely ahead of inflation.

We would all do well to examine our statements and to learn as much about fees as possible. Some fees are not well-disclosed: for example, master trusts may involve many layers of fees, with only the top layer adequately exposed. For those seeking diversification there are much cheaper vehicles than master trusts.

Those with substantial superannuation balances, of $300,000 or more, may choose to start their own self-managed funds. Provided their affairs are kept simple they can reap the benefits of fixed accounting and audit costs which stay constant as their balances accumulate.

The most general advice is to take responsibility for our own investments, be that inside or outside superannuation. Don't expect encouragement from this Government, however. Liberal Party rhetoric may be about "self reliance", but its policy is to privilege the financial sector, diverting our savings to support those who live off the efforts of others.