Chant West

Consultation Paper 308

Chant West Submission

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Comparing Apples with Apples.

About Chant West

Chant West is an independent superannuation research and consultancy firm established in 1997. We specialise in researching superannuation and pension funds, and are well known within the industry for our research capabilities and market commentary.

We publish our research in various forms including, for institutional users, our Product Research, and, at the consumer level, our Super AppleCheck and Pension AppleCheck comparison tools. We publish regular performance and asset allocation surveys covering all the major public offer superannuation and pension products. We also publish a quarterly fee survey and a quarterly insurance premium survey.

Our research is used by many of Australia's leading superannuation providers and adviser groups. Over 7,000 financial advisers and eight million fund members have direct access to our research. The information we provide allows them to compare funds on an 'apples with apples' basis. We rate superannuation and pension funds and have developed a ratings methodology that considers investments, member services, fees, insurance and organization in determining the rating for each product.

Our research also feeds into our consulting work, which in turn provides us with a special insight into the workings of the industry. Over the past 20 years, we have advised many large and medium-sized employers on their superannuation arrangements, including options for outsourcing investment, administration and member services. We have also advised many super funds on their outsourcing arrangements – administration, asset consulting and implemented consulting. Through our research and consulting, we have an intimate knowledge of the Australian superannuation market, including all the key players, their operations and efficiency.

Disclaimer

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1. Introduction

This report has been prepared by Chant West to provide feedback on ASIC's Consultation Paper 308, 'Review of RG 97 Disclosing fees and costs in PDSs and periodic statements'.

Overall, we believe that the proposed changes to RG 97 and its accompanying regulations will greatly improve the disclosure of fees and costs for superannuation funds and managed investment products. In our opinion, the current iteration of RG 97, introduced in September 2017, has led to less consistent disclosure than what previously applied, and we do not believe that this consistency will improve without significant changes such as those proposed in the Consultation Paper. We commend ASIC for its commitment to provide a disclosure regime that provides greater consistency and comparability.

We should also emphasise that fees and costs are not the most important determinant of member outcomes. What really makes a difference to the retirement outcomes of superannuation fund members are the investment returns they receive, after the deduction of fees and costs. We strongly encourage ASIC to prioritise an investigation of how to improve the current disclosure requirements for investment performance. Indeed, the current disclosure requirements emphasise statements such as 'Past performance is not an indicator of future performance' which almost seems to instruct users of the disclosure to ignore past performance. This message is not helpful, as we believe that over suitably long periods, such as seven or ten years, past performance can convey some useful information about the investment skill of a fund and can indicate the likelihood of future investment performance, at least in a relative sense compared with other funds.

The strong focus on fees and costs is evident in the practice of many adviser practices where they are the primary comparison point between different portfolios, partly because comprehensive and comparable performance data on a wide range of investment options is often not available. Much more guidance needs to be provided in this area, to assist advisers and consumers give the appropriate weight to fees and costs and to effectively use investment performance data to compare products.

But even though we believe investment performance should be given a higher priority in comparisons between products, we also believe it is important to disclose the fees and costs that members pay in a product, either directly or indirectly. In almost every area of commerce, the price paid for a good or service is disclosed and is a factor that any purchaser is told and that can be taken into account in the purchasing decision. We believe that the fees and costs of a superannuation products should also be disclosed, although the differences in the quality and outcomes that are derived from a superannuation product, including investment performance, should be made much clearer to consumers.

2. Comments on Section A, 'Background to the proposals'

We agree with the stated purpose of the disclosure regime (A2 a-c), i.e. to ensure that 'consumers who actively seek information about fees and costs receive transparent and usable fees and costs information to help them to:

a) make confident and informed value for money decisions;
b) compare products; and
c) understand the fees and costs charged to them.'

We also agree that the complexity associated with compiling fees and costs need not translate into complexity for consumers (A7). It is critical that the published fees and costs are consistently disclosed and are therefore comparable. Consumers don't need to understand the process for compiling the fees and costs and all the component parts of the fees and costs, but they must be able to trust that the published fees and costs are consistently disclosed and comparable, so they can use these fees and costs to compare products and make informed decisions.

3. Responses to Section B, 'Recommendations we propose to adopt that require amendments to Schedule 10'

In this section we set out our responses to many of the questions asked in this section. Since we are not a product provider, we have not generally responded to the questions relating to systems and process changes, additional costs and a reasonable timeframe for implementation. Rather, we have focussed on whether or not we agree with the proposed approach and our reasons for our position.

3.1 Changing the superannuation product 'Fees and costs template'

B1Q1 – We agree with the proposed approach for changing the elements included in the fee template, as follows:

- all administration fees and costs are presented as one line item: when assessing the relative fees and costs, it is not important whether a certain fee is charged directly (generally a fee) or indirectly (generally a cost), as the member is impacted by the fee or cost regardless;
- all investment fees and costs are presented as one line item: as the current breakdown between investment fees and indirect costs is at the discretion of the trustee, the breakdown between these two components provides no additional information that will assist consumers compare fees and costs;
- remove advice fees as a line item and include in administration fees: this is already the current practice for almost every superannuation fund; and
- group together 'Ongoing annual fees and costs' and separate from 'Member activity related fees and costs': it is very important to clearly show which fees and costs are ongoing and which fees and costs are based on member activity. The current disclosure is unhelpful, as it shows indirect costs after all the member-activity related fees. We expect that this positioning is simply a result of indirect costs being the last item added to the fee template and therefore being added at the end of the fee template.

B1Q2 – We do not believe that issuers should be able to include an additional breakdown of investment fees and costs into investment fees and indirect costs. As stated above, the current discretion for the trustee to treat some costs as indirect costs, rather than investment fees, means that any breakdown between these two components provides no additional information that will assist consumers compare fees and costs. Indeed, we have seen some providers try to explain to customers that they should really only be concerned about the investment fees, as indirect costs are not directly charged to the member. We believe that providing any ability for issuers to provide a breakdown between these two components will simply led to confusion for consumers.

B1Q3-B1Q5 – We do not believe that rolling up administration fees and administration-related indirect costs into one number and rolling up investment fees and investment-related indirect costs into another number will provide a greater burden on superannuation funds. Changing the disclosure in PDSs to this regime should be relatively simple change, but it will be more work for periodic statements as system changes will be required. Product issuers will generally need almost twelve months to design, implement and test such changes. An implementation date for PDSs and periodic statements of 1 July 2020 may be feasible if the final regulations and guidance are issued soon after 1 July 2019.

3.2 Changing the managed investment product 'Fees and costs template'

B2Q1 - The inclusion of buy/sell spreads and transaction costs in the managed investment product template will help to better align the fees and costs disclosure for superannuation and managed investment products.

3.3 Including 'Cost of product information'

B3Q1 - We agree that the current 'Fee Example' for a $50,000 balance should be extended to all MySuper and choice investment options offered by a superannuation fund or manager investment scheme. We also agree that this information cannot be contained in a shorter PDS, for obvious practical reasons, but should be in a full PDS, other than for platforms where it should be incorporated be reference (see later discussion of platforms).

B3Q3 - We do not believe that it is necessary to include a $5,000 contribution for superannuation funds as we do not know of any open superannuation products that still charge such a fee. The inclusion of this information for superannuation products will add another data point that will distract from the message of the template and will provide no additional information. We do not believe that this difference from the managed investment product disclosure will make these two types of products any less comparable.

3.4 Simplifying periodic statements

B4Q1 – We support the change to disclose both the 'fees deducted directly from a member's account' and the 'fees and costs deducted from a member's investment', in clearer language than what is currently used.

B4Q5-6 – We believe there should be some guidance for how to calculate the above categories of fees and costs for the periodic statement, although since the fees and costs will be based on the particular member's account balance and transactions over the period, the periodic statement is less suited for use as a comparison document between products, so the consistency of calculation between funds will be less important. This guidance could be provided either by ASIC or by an appropriate industry group recognised across the superannuation/managed funds industry.

B4Q7-8 – Since periodic statements should disclose the fees and costs that members have actually incurred, either directly or indirectly, they should include GST less reduced input tax credits. There should be some flexibility whether the transactions that appear on the periodic statement include these components or are shown separately, as various administration systems will treat these amounts in different ways, and there may be different dates used for when GST and stamp duty are applied to the transaction. However, for the sake of clarity for consumers, our preference is for all transactions shown on the periodic statement to include GST less RITC and stamp duty, where relevant.

B4Q11-12 – Clauses 301(5) and 301(6) should be removed or clarified as they can be interpreted in different ways by various product issuers, partly due to different treatments of the tax benefit derived from operating expenses that reduce the fund's income tax. The issue of the tax benefit issue will be discussed under 'Costs paid from reserves'.

3.5 Changing the treatment of transactional and operational costs

B5Q1 – We support the disclosure of explicit transaction costs as a separate line item as these costs are of a different nature to other investment fees and costs, which generally reflect payments to investment managers for managing money. We agree that transaction costs should be disclosed net of any amounts recovered by buy/sell spreads to avoid double counting, as buy/sell spreads are shown separately in the fee template.

The separation of explicit transaction costs from indirect costs, and the inclusion of transaction costs in the managed investment product 'Fees and costs template' will greatly improve the alignment of superannuation fund and managed investment product disclosure. While superannuation funds and managed investment products are different investment structures, most managed investment products are provided to consumers through superannuation platform products. This means that, currently, these providers don't need to disclose transaction costs in the 'Fees and costs template' and therefore they disclose lower fees and costs than a non-platform superannuation product with exactly the same investment. If we are seeking for consistency in disclosure, this must be addressed. The proposed change of including transaction costs in the 'Fees and costs template' for managed investment products largely resolves this misalignment.

We believe that transaction costs should also be included in the 'Example of annual fees and costs' and 'Cost of product information' for managed investment products, as these documents should consistently use the same fees and costs.

3.6 Removing property operating costs, borrowing costs and implicit transaction costs

B6Q1 – We support the removal of these costs from PDS disclosure. Operating costs and borrowing costs (ie interest costs) are very different in nature to the other costs disclosed in the fees and costs template, ie investment management costs or transaction costs. Implicit transaction costs are more obscure and harder for a consumer to understand. And there is no common methodology of calculation which means there is little consistency in disclosure. While some technical users of this data may find this useful, we believe the scope for the misunderstanding and misuse of this data is significant. We know of some users of the current disclosure who believe they should be using all the disclosed fees and costs, including these costs disclosed in the 'Additional Explanation of Fees and Costs' section, wherever they compare products. Such a practice will likely yield some misleading results and some poor product selections.

We believe that, for the sake of clarity, there should be an explicit reference to the exclusion of market impact costs in clauses 103(2)(c)-(d), perhaps by adding a further sub-point (e).

3.7 Inclusion of counter-party spreads

B7Q1 – It is important to note counter-party spreads are a type of implicit transaction cost, generally when there is a market maker for a certain type of transaction rather than a broker. While we understand that some investment managers may charge a counter-party spread so they can charge a lower investment management fee, we are concerned that it will be very difficult to formulate a consistent methodology for calculating these counterparty spreads. We would not want the complexity of this issue to delay the introduction of the other important changes to the fee and cost disclosure regime that have been proposed.

For this reason, we recommend the exclusion of counter-party spreads from the requirements of RG 97 in this round, but we also recommend that ASIC and the superannuation/managed fund industry pursue a program of determining how this could be achieved in a later iteration of RG 97. We recognise that there may be little incentive for the industry to provide a solution if it would mean the disclosure of higher fees and costs so ASIC may need to take the lead, at least initially. During this period, it would be very important for ASIC to monitor the use of such investment structures and identify any providers that appear to be selecting these more complex types of investments simply to reduce their disclosed fees and costs.

3.8 Removing the distinction between performance fees and performance-related fees

B8Q1 – We support the removal of any distinction between performance fees and performance-related fees so the disclosure of such fees will be the same, regardless of whether the portfolio is being considered as a product offered by an investment manager or is part of an underlying investment vehicle.

3.9 Calculating performance fees and disclosing performance fee

B9Q1 – We support the proposed change to show performance fees as the average over the previous five financial years (or the operating life of the investment option if it has been in operation for less than five years). This change will reduce the variability in total fees for some investment options where there are large changes in performance fees from year to year. The five year average should provide investors with a better estimate of the level of performance fees and total fees over time.

One consequence of this approach is that, when a new investment option is introduced, the disclosed 'average' performance fees in the first few years of operation will be dominated by the actual performance fees for the first few years. For example, the first year's actual performance fee will contribute 100% to the 'average' performance fee disclosed in the first year of operation, 50% of the 'average' performance fee in the second year, 33% of the 'average' performance fee in the third year etc.. Despite this, we still believe that the average of the performance fees over the operating life of the option, during the first five years, is a better estimate than the fee for the last financial year, which is currently used.

One complicating factor is that in periodic statements, in order to best reflect the experience of members, it may be best to show the performance fee for the relevant year rather than the five year average. This would mean showing one performance fee in the PDS (ie the five year average) and another in the periodic statement (ie the performance fee for the last year). This would complicate disclosure for product issuers. ASIC may make the decision that the additional benefit of the accuracy of providing the actual performance fee for the year is less than the potential for confusion with the use of a one year and five year performance fee, so that the five year average could also be used on the periodic statement.

Guidance will need to be provided for this issue, either by ASIC or an industry-wide group, to describe how it will work in different situations.

B10Q1 – We believe it is important to allow issuers to include a further explanation where they believe that the five year average performance fee is not representative of the coming period.

B10Q2 – We do not see why administration fees needs to be included in clause 209(b)(i) as performance fees only relate to investment fees and costs.

B10Q3 – We believe that the disclosure of the performance fee for each of the five years would be helpful, as well as the five year average, as it would allow investors to understand the variability of the performance fees that will impact their investment from year to year. However, this needs to be balanced with the additional work required and the danger of confusing consumers with five more numbers.

3.10 Clarifying the treatment of costs paid from reserves

B11Q1 – The issue of costs paid from reserves is closely related to the practice of some funds that credit the benefit of tax deductions related to operating expenses to their administration reserve, which is then used to pay some of the fund's operating expenses that are not covered by the fees charged to members. This section will discuss this important issue in some detail.

The issue of the comparability of fees in relation to their tax treatment is problematic. Let's consider the differing practices of two funds, both of which are profit-for-member funds and therefore work on a cost recovery basis. Both funds have $100 in expenses per member that they need to charge to members. Fund A passes on all costs to members by charging each member a fee of $100. But then it recognises that the expenses that these fees are meant to cover reduce the tax payable by the fund and effectively provides the fund with a tax benefit. Since the member pays a fee to cover these expenses, it believes the member should also benefit from the tax benefit related to those expenses and so it applies the 15% tax to concessional contributions less the $100 fee. This means that the member pays $15 less in tax on their contributions, so long as they receive at least $100 in concessional contributions. After this tax benefit is taken into account, the member has paid a 'net of income tax' fee of $85. On the other hand, Fund B recognises that it doesn't need to pass on the full $100 charge to members as it receives a tax benefit for these expenses and so it simply charges the member $85 and discloses that same amount, $85.

Clearly, the same member in both funds would be in the same situation in relation to fees, after the tax benefit is taken into account – both would be charged a net fee of $85. But Fund A discloses $100 and Fund B discloses $85. If the new regime of fee disclosure is to 'improve consistency of fee disclosure', clearly something must be done about this.

This issue first came to light in 2003 when Chant West conducted research on this issue amongst retail funds. It turned out that fund managers were showing fees gross of income tax (like Fund A) and life offices were showing fees net of income tax (like Fund B). The result was that all retail funds moved to gross of income tax disclosure, ie they charged the $100 and passed back the $15 either as lower tax on contributions or by only charging the member $85 instead of $100. At the time, there was a range of practices with industry funds, with some following Fund A and others fund B. Since that time, few industry funds have changed their practice, as it would be require a non-trivial system change. Most funds believe that they should disclose what they physically charge members (they have a point!) but this means that the disclosed administration fees of many industry funds are not comparable with retail funds and other industry funds. It should be noted that the difference is not huge, but it is material. In our example of Fund A and Fund B, it is a difference of $15, which translates to 3 bps on a $50,000 balance, 6 bps on a $25,000 balance and 1.5 bps on a $100,000 balance.

Like other areas of fees and costs disclosure, the goal must be for consistency between funds - we do not have this at the moment. There seem to be three possible ways to achieve this consistency:

- Show all fees gross of income tax: This can be defined as assuming the member receives the tax benefit from the expenses related to the fees they pay, either as lower tax on contributions or the physical deduction of a lower fee than what is disclosed. And if the tax benefit is not passed on to members, but is retained by the fund to pay for some of the operating expenses, then the fee is 'grossed-up' by dividing by 0.85 to show the equivalent fee the fund would need to charge to provide the same member outcome as if the tax benefit was passed back directly to the member. In this case, the best way to think about the $100 is that it is like a comparison rate for mortgages – it is not what is charged to members but is a notional amount that allows comparison between products.

  This is the approach that Chant West has used to align the fees disclosed by different funds and is consistent with ASIC's approach of showing fees and costs on a gross of income tax basis. It is also consistent with the disclosure of investment fees, which are typically calculated as the weighted average of the fees charged by investment managers and are therefore gross of income tax.

  The disadvantage of this approach is that funds that operate like Fund B would have to disclose a fee of $100 even though they only physically charge members $85 and there is no transaction on the member's account that has anything to do with $100.

- Show all fees net of income tax. This would require that the funds that currently retain the tax benefit (ie like Fund B) would simply disclose the fee that they currently charge members, and that the funds that pass on the tax benefit to members (ie Fund A) would show the fee net of the tax benefit passed on to members.

  The disadvantage of this approach is that it would mean that investment fees and costs would be disclosed gross of income tax (ie before any tax benefit is recognised) and administration fees would be disclosed net of income tax (ie after taking into account the tax benefit). It also seems to go against ASIC's position that fees should be shown gross of income tax.

  The advantage of this approach is that it should be reasonably simple for those funds using the approach of Fund A to show the fees and costs net of the tax benefit passed on to members and those funds using the approach of Fund B just keep doing that they are doing. This approach would be the easiest to implement and is likely to attract the least resistance from industry.

- Include costs paid from reserves (ASIC's proposal): Rather than just showing the fees and costs deducted from a member's account, either directly or indirectly, ASIC's proposal is that funds must also show the additional amount of operating expenses that are not covered by these fees and costs. This would require an additional cost amount to be disclosed for those funds where the fees and costs recouped from members is not sufficient to pay operating costs, and so requires a drawdown from an administration reserve that in most cases is topped up by the benefit of tax deductions relating to operating expenses. This solution would also deal with the practice of some funds that transfer the benefit of the tax deductions relating to insurance premiums to the administration reserve to meet some more of the operating expenses.

  Part of ASIC's logic for this approach is that the reserves are notionally owned by each member and so any diminution of the reserve is a diminution of their entitlement and should be disclosed. While this is not the way we have generally regarded reserves, it is a fair question to ask who owns the reserve if it is not the members. ASIC's approach also raises the question of the use of other reserves in a fund such as in relation to the rounding of crediting rates that can generate a movement in reserves which we wouldn't want to impact the administration fee disclosure. This is less likely to be an issue for funds that have moved to unit pricing, but many industry funds still use a form of crediting rates.

  One problem with ASIC's current wording in the proposed version of RG97 is that it seems to require the disclosure of all costs paid from reserves, in addition to any fees deducted from members that may have been paid into a reserve, which would constitute double counting. One possible solution would be to change the wording to require the disclosure of any expense paid from reserves 'in excess of the fees credited to the reserve during the period'.

  Under this approach, the disclosure rules would also need to deal with the practice of funds that may not transfer the tax benefit relating to operating expenses (or insurance premiums) to a reserve but may use the tax benefit more directly to cover some of its expenses.

In conclusion, we need to change the disclosure of administration fees and costs as there are currently quite different practices used in the industry that have led to inconsistent disclosure. Any of the three approaches described above could provide that consistency. Perhaps it doesn't matter much which approach is used as long as an approach is adopted that will ensure funds are disclosing these fees and costs in a consistent manner.

On balance, we believe ASIC's suggested approach is probably the most durable approach and it is an elegant solution to a disclosure problem that has existed for the past 20 years. It avoids the vexed issue of defining what 'gross of income tax' or 'net of income tax' means in relation to administration fees and costs in an environment where there are a number of different operational practices between funds.

However, the net of income tax approach is likely to be the least disruptive approach to current practice and less open to different interpretation as it simply requires all funds to show the fee deducted from the member, less any tax benefit that is passed onto the member. We would need to assume a level of concessional contributions to allow a member to receive the tax benefit, but this is consistent with the practice of assuming a $5,000 annual contribution for the 'Example of annual fees and costs'. While it would not be ideal to disclose an administration fee that is net of the tax benefit but an investment fee that is gross of the tax benefit, this approach may be the best way to ensure administration fees and costs are compared on a like-with-like basis, which is the main issue.

4. Responses to Section C, 'Recommendations we propose to adopt that do not require amendments to Schedule 10'

C1Q1 – We support consumer testing of the fee template proposals, although we would caution against prioritising consumers' desire for simplicity to combine administration fees and costs with investment fees and costs. We believe that since the 'Cost of product information' already combines these fees and costs together, it is not necessary to combine them in the fee template. These two amounts contain quite different information that will be very important to some consumers who will want to assess the respective amounts charged for two very different services – administration and investment services.

C2Q1 – In terms of additional resources for consumers on the importance and relevance of fees and costs, it is very important to explain the importance of net returns to consumers so that they don't place too much emphasis on fees and costs when comparing products.

C5Q1 – If platforms are not required to disclose the costs of underlying managers, it is very important to include a clear statement that the disclosed fees and costs do not include the fees and costs charged by the issuers of the financial products accessed through the platform.

C9Q1 – The proposed changes significantly reduce the differences in fees and costs disclosure between superannuation funds and managed investment products. However, it appears that the OTC derivative costs for hedging purposes will still be included for superannuation products but not included for managed investment products. This should be addressed.

C10Q1 – It will be very important to provide a consolidated version of Schedule 10, rather than having to consult several different instruments and determine how they work together.

5. Responses to Section D, 'Recommendations that we do not propose to adopt at this stage'

D2Q1-Q9 (Platforms) – The proposed guidance includes the requirement for platform operators to include a statement that the disclosed fees and costs do not include the fees and costs charged by the issuers of the financial products accessed through the platform. While this disclosure is helpful, indeed necessary, we believe that an investor should be able to readily view a document that shows all the costs of their product, including the fees and costs charged by the issuers of the investment options available on the platform.

We understand that it would be unworkable to provide this information as part of the platform product's PDS, as these platforms may have over 500 options. However, we believe there should be a requirement for a platform product's PDS to include a link to a webpage that includes the investment fees and costs for all accessible investment options, as well as the total cost of product if the whole balance was in each investment option. Several platform products already provide a similar table on a webpage that shows the management costs for each investment option, so this approach would simply extend the current practice for some platform providers and require other providers to follow suit.

We believe it is important for a client to be provided with access to a table that shows all the fees and costs for their product, rather than having to consult many different underlying PDSs on the websites of different fund managers.