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Hayne gets it wrong on mortgage brokers

Noel Whittaker

The Royal Commission has certainly put a blowtorch on the practices of some of our banks but that was hardly a revelation. Many people, including myself, have been writing about them for years. Default interest on loans in arrears and shonky insurance policies for credit cards are just two examples.

Mortgage brokers and payment preferences

But what does concern me is the proposal to ban trailing fees for mortgage brokers. While this has been welcomed in certain sectors, there is a general ignorance of the purpose of trailing fees and how they work. It's a quirk of human nature that most people have no problem with expenses that are deducted but hate to receive a separate invoice. The classic case is the group certificate and personal income tax. Nobody seems to worry when \$20,000 is deducted in tax, but they will scream if they are asked to write a cheque for \$500 to the tax man.

When the financial services industry was in its infancy, the main remuneration was by an upfront commission. The problem with this was that the business had no recurring income and was solely dependent on chasing new business just to stay afloat. This also created the problem of how to charge a person who wanted ongoing advice from time to time.

It was unsustainable and eventually upfront commissions were cut and a trail fee introduced in lieu. This gave the business a basic income to rely on, while enabling it to provide ongoing service to their clients without issuing a new invoice. This is a different model to say a law office who will charge up to \$49 just to open an email.

Personal experience

I received a great insight into the mortgage broking business last month when I was researching borrowing for the family home. The options were overwhelming, the criteria for loan eligibility was inconsistent and confusing, the loan rate varied from lender to lender and the most suitable lender often turned on whether the borrower could meet certain eligibility criteria. My conclusion was to go to a mortgage broker – it's too hard to do on your own.

The mortgage broker told me that on a \$400,000 loan, he would receive an upfront commission of 0.6% or \$2,400 paid for by the bank. It could be clawed back if the loan was paid out within three years from

establishment. The lender would pay the broker a trail fee of 0.15% or \$600 a year as compensation for providing advice to the borrower as needed.

This could include advice about moving to a fixed rate, managing a change of employment or move interstate by the borrower, negotiating a better rate with the existing lender instead of changing banks, and what would be the best way to finance a change in residence or the acquisition of an investment property.

What might happen now?

The Royal Commission has recommended that this system be scrapped, including both upfront and trail commissions. Applicants who wish to use a mortgage broker will have to pay an upfront fee, and if they can't pay, it could be added to the loan!

Well, you know what's going to happen. No young couple looking for a loan will be prepared to fork out over \$2,000 to a mortgage broker to research the market and find out the best deal. Instead, they will go online to look for what appears to be the best deal and jump in.

The banks will have a field day. Without a mortgage broker as an intermediary to keep them honest, the hapless borrower will be at their mercy. Expect a return to establishment fees and even more complex products.

When the Royal Commission was taking place the values of bank shares were slashed. It speaks volumes that as soon as the market opened after the release of the Final Report, bank shares were up around 5%. I rest my case.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance, which can be found on his website noelwhittaker.com.au.

Watch for LICs that never return to par

William Gormly

Listed Investment Companies (LICs) are firmly established in the Australian investment landscape, with a market capitalisation in excess of \$40 billion.

A particular feature is that LICs will trade at a share price premium or discount relative to their net tangible assets (NTA), creating both opportunity and concern for investors. Whilst the underlying portfolio performance will explain the majority of the variation in the share price, other factors that affect listed equity prices include management fees and other costs, market sentiment, liquidity, forecast earnings and ability to sustain an ongoing dividend.

A common misconception of the premium/discount is that an LIC at a discount will return to trading at par to their NTA over time. As equities trade in perpetuity with no redemption date, this belief is often not realised, nor should it be expected in many cases. LICs will instead tend to trade around an historical premium/discount and a key consideration is comparing the current premium/discount to the historical average. Calculating a Z-score can assist in determining whether or not this difference is significant.

What is a Z-score?

Put simply, investors need a measure of how much the current premium or discount of the share price versus the NTA varies from historical norms. If a LIC trades at 10% discount but is normally at a 20% discount, it might return to the norm rather than towards par.

A Z-score calculates how many standard deviations the current premium/discount is away from the historical average. A Z-score of +1 is 1 standard deviation above the mean, etc. A z-score of -1 is below the mean. It is calculated by dividing the difference of the current premium/discount with the historical average with the historical standard deviation to produce a figure which can be used to assess whether a LIC is currently attractively priced or expensive based on price history.

A positive Z-score indicates a current premium/discount that is greater than the historical average. It may be expected to decrease back to the average over the long run, and vice versa for a negative Z-score. Due to this,

a negative Z-score may be considered more attractive. For example, it might mean the current discount is worse than normal.

Key considerations and an example

For the Z-score to be meaningful, we make the assumption that the historical premium/discount figures are normally distributed around the mean value. Using this assumption, 68% of premium/discounts fall within 1 standard deviation of the historical mean and 95% within 2 standard deviations. However, the data may not be normally distributed and a larger error is expected when using a shorter timeframe. The statistical analysis is therefore used to illustrate a theory that may not be statistically accurate. It is important to take into account all factors that will affect the premium/discount to NTA including options outstanding, dividends and takeover announcements.

For example, Watermark Global Leaders (WGF) has a 1-year average discount of -16% to the pre-tax NTA. On 20 December 2018, the Board declared the intention to restructure WGF as an unlisted unit trust with a value that reflects the after-restructure cost NTA. The discount decreased given the probability of the proposed scheme being implemented. This example shows one of the limits of Z-scores, as other events can overwhelm comparisons with historic norms.

This news will have little effect on the NTA, but the share price rose leading to a decrease in the discount from ~16% to ~5%. The discount won't go to zero because investors are still factoring in the cost of the restructure that will come out of the NTA and also the possibility that the proposal may not happen.

As time goes on and the restructuring seems more probable of occurring, in theory the risk of it not happening decreases and investors are then happy to pay a little more for the shares, up until the price of the NTA minus restructuring costs.

A comparison would a company receiving a takeover offer at \$50. The share price will rarely begin trading the next day at \$50 because of the possibility the takeover is shut down. But overtime if it is probable of occurring the share price will shift to \$50, e.g. decreasing the arbitrage opportunity or discount.

The explanation of Z-scores can be rather confusing, as we are considering both an increase in a discount (say from -10% to -20%) or a decrease in a discount (say from -20% to -10%). For anyone interested in more detail, consider:

Example 1 (trading at a discount):

LIC historically trades at a discount of 10%

NTA is \$1.00 and the Share Price is \$0.90

If the next month the NTA decreases to \$0.95 and the Share Price decreases to \$0.82. Now the discount is 13.7%

Under the theory that the discount converges to the historical average (and holding the NTA constant – important) we should expect the Share Price to rise to \$0.855

Whether or not the Share Price is increasing or decreasing, you would be able to purchase the underlying portfolio at a relatively cheaper price (%) than has historically been available.

Example 2 (trading at a premium):

LIC historically trades at a premium of 15%

NTA is \$1.00 and the Share Price is \$1.15

If the next month the NTA increases to \$1.10 and the Share Price increases to \$1.20. Now the premium is now 9.1%

Under the theory that the premium converges to the historical average (and holding the NTA constant – important) we should expect the Share Price to rise to \$1.265

Whether or not the Share Price is increasing or decreasing, you would be able to purchase the underlying portfolio at a relatively cheaper price (%) than has historically been available.

The chart below compares Z-scores and the relative attractiveness of prices as at 30 December 2018, however, all factors need to be considered.

In reading this table, remember that a negative Z-score may be considered more attractive because it might mean the current discount is greater than normal. A positive Z-score may be considered less attractive because the current premium is more than usual.

Figure 1: 1 Year LIC Z-score (as at Dec 2018 NTA figures)



Source: IRESS, Bell Potter. This graph doesn't represent recommendation.

Each LIC should be reviewed and considered on its merits, and this is simply another input. Again, I wish to highlight that the assumptions used may not be statistically accurate.

Will Gormly is an ETF/LIC Specialist at [Bell Potter Securities](#). This article is general information and does not consider the circumstances of any investor.

5 common mistakes in running an SMSF

Graeme Colley

There are a lot of rules and regulations when it comes to superannuation and running your SMSF. Fund investments are for the sole purpose of providing benefits for the member or their dependants for superannuation purposes and not for personal reasons. Here are some common mistakes and how you can avoid them.

1. Don't use your SMSF money for personal reasons

Some people take money from their SMSF accounts and pay personal or business expenses to help themselves or a close friend or relative. Sometimes they do so inadvertently, and in other cases, they do not realise it is not allowed.

It is essential that everyone separates their personal and business bank accounts from their SMSF accounts. Taking money from superannuation before the correct time can result in severe penalties to the fund as well as the member. If an amount is withdrawn in breach of the rules, it should be repaid as soon as possible. Frequent breaches may result in being disqualified from running an SMSF and include financial penalties.

2. Investments not in the fund's name

Make sure SMSF investments are not mixed with personal investments. A requirement of superannuation law is that the assets of a fund must be in the name of the individual trustees or the corporate trustee. If this is not possible, supporting documentation that demonstrates the asset belongs to the fund, such as declarations of trust or trustee minutes, should be maintained. If a member becomes bankrupt, investments in the name of the fund are protected from the member's creditors in most cases. Being well organised will ensure the investments are in the right name.

3. Stick to the investment rules

It is possible for an SMSF to invest in a wide range of investments including term deposits, shares, property and cash.

However, it is essential to make sure the fund obeys the many rules applying to investments. Most of these rules apply where a person, company or trust has a significant link with the fund. This includes members, trustees, any of their relatives and companies or trusts they control. If the fund makes a loan, invests in or leases assets to a related party, penalties may apply, and the fund could lose its tax concessions.

Any assets or money belonging to the fund must not be used for personal or business purposes unless it is specifically allowed by the superannuation law. For example, it is possible for the fund to lease commercial property to related parties providing it is on a commercial basis and permitted by the fund's investment strategy. The money in the fund is never to be used as a source of cheap finance and cannot be used for emergencies.

Complying with the investment rules requires some planning and monitoring of the SMSF on an ongoing basis, especially when the values of investments change or related parties are involved.

4. Pay at least the minimum pension

The minimum amount of pension must be paid or there can be problems for anyone in retirement phase or receiving a transition-to-retirement pension. It can mean unnecessary tax in the fund and compliance issues. One of the benefits of superannuation is access to tax concessions so why not maximise that opportunity.

Strict rules apply to pensions, when income earned on assets that support retirement phase pensions is tax-free. Not maintaining pensions properly may result in the loss of benefits and then paying tax on those earnings within the fund.

Sometimes unexpected errors can occur, resulting in small underpayments of the pension. It is possible to make a catch-up payment to get things back on track and not impact on tax concessions. Prevention is better than cure and arrangements should be made to ensure the minimum amount will be paid automatically before 30 June.

5. Store documents properly

Keeping the documents of the fund such as the trust deed, minutes of meetings and decisions, investment information, membership and trustee acceptances is essential for compliance, audit and when the trustees of the fund may be brought to account. Loss of any documents may result in an unsatisfactory outcome as disputes may arise between the trustees, members and others making a claim on a fund benefit.

Records that are required to be kept for five years are:

- accounting records that provide accurate information about the transactions and financial position of the fund
- the annual operating statements and the annual statements of the fund's financial position
- copies of all SMSF annual returns lodged with the ATO
- copies of any other statements lodged with the ATO or provided to other super funds.

Records that are required to be kept for 10 years are:

- trustee minutes of meetings and decisions on matters affecting the fund
- records of changes to trustees, and a member's written consent to be appointed as a trustee
- trustee declarations recognising the obligations and responsibilities for any trustee, or director of a corporate trustee, appointed after 30 June 2007
- copies of all reports given to members
- documented decisions about storage of collectibles and personal use assets.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at [SuperConcepts](#), a sponsor of Cuffelinks. This article is for general information only and does not consider any individual's investment objectives.

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The 'founder' mindset of an astute investor

Lawrence Lam

Investing is about understanding businesses and as with all things business-related, nothing is ever clear-cut. Businesses are comprised of a set of strategies which have been selected and implemented by management. However, no one can guarantee the success of a business strategy – not even management themselves. So what hope does an investor have?

In this article I'll explore the characteristics of a certain type of investor who holds an advantage. I've termed them the 'entrepreneurial investor'.

Business owners think differently

In 1947, Benjamin Graham coined the term the 'enterprising investor'. He outlined how an edge could be gained by delving deep into the numbers to determine the true underlying value of a business. But that edge is harder to find these days. There are simply less cigar butts and more people looking for a free puff. It's a tough game if you're only relying on that strategy.

So, if studying the numbers won't give you an edge, what will? One of the answers I believe, lies in the saying 'walking a mile in one's shoes'. If you've ever run a business or grown a business, big or small, you have an edge over those that haven't. You are an entrepreneurial investor. You possess an understanding of business that can't be appreciated through research alone. As important as the numbers are, they are only the first step of analysis. What's more important is being able to judge which numbers are important and knowing when to use intuition.

So, put yourself in the shoes of a founder – someone focused solely on growing the business over the long term. What truly matters to you and how you operate your business will be drastically different to a fly-in CEO chasing a bonus.

If you haven't owned a business or run a business, all is not lost. You just need to understand a few principles of how good business owners think, then apply them to your judgement as an investor.

Seeing opportunities when conservative investors don't

Running and growing a business involves the optimisation of multiple levers, such as decisions about the best allocation of fixed resources for maximum long-term return. If you have been in that position, you will know what constitutes good capital allocation.

I'll illustrate this by way of a real-life example of a company we are currently tracking.

Consider a dominant furniture retailer going through a transition period. After many years of leading the market, lower consumer sentiment has led to a recent decrease in sales. In addition, customers are increasingly heading online for homewares. Investment analysts have punished the stock for its recent earnings decreases. In response to the evolving market, the founding family and majority shareholder recently appointed a new CEO with a mandate to spend significant resources on a new digital online store. This expenditure has led to an even greater short-term cost blow out.

Conservative investors would steer clear of this investment. On the surface it seems like a dinosaur industry set for extinction. Investors would look instead for the 'safe' cash cow blue chip that pays a high yield.

However, for entrepreneurial investors, this represents a clever investment opportunity. Sentiment is low and the stock has not been this cheap for many years. The significant investment in the online store is a shrewd move by the founders. The direction towards digital distribution has been managed prudently and early results are promising. The once-off investment cost has masked the imminent turnaround and transition opportunity.

Entrepreneurial investors understand that allocation to growth projects is not optional, it is a necessity. Risk is part and parcel of improvement. Improvement is not a choice; if you're not improving, you're a sitting duck. What's most important is that the allocation of capital to this project is thoughtfully considered and prudently managed. Look for favourable risk/reward trade-offs even though conservative investors may see differently.

Betting on moats, not news

Anyone who's started their own business venture knows that new initiatives take time. Usually longer than anticipated. Jeff Bezos of Amazon, one of the world's most successful founders, outlines his thinking on results,

"Today I'm working on a quarter that is going to happen [three years from now]. Not next quarter. Next quarter for all practical purposes is done already and it has probably been done for a couple of years."

For most fundies, Bezos's three-year time frame is too long. A fundie could change careers multiple times in that period. Fundies need to pick up quick results and so they favour a quarter-to-quarter game of news arbitrage. It relies on betting on news announcements, rather than betting on business moats. For investors to truly bet on a business moat, they need to allow ample time for the growth initiative to crystallize.

One such business I visited recently in Japan transformed itself from a printing company into a data provider. They now dominate the Japanese food industry – a slow moat-building process which has taken them 10 years to establish. Initially starting by digitising print data for their customers, they developed software that now owns the pricing data of the Japanese food advertising market. It is difficult for competitors to cross the moat.

Some strong Australian examples

Business owners understand the power of human nature. People, when aligned and motivated, can achieve great things. Drive, heart and nous are the most important things in a business but are instead often overlooked in favour of well-credentialed management teams with little vested interest.

When Warren Buffett took over Berkshire Hathaway, it was a struggling textiles business. Although you wouldn't have backed the original textile business itself, you would have backed Buffett's ability to change the core business.

Australian visionaries Roger and Andrew Brown (ARB Corporation), David Teoh (TPG Telecom), Andrew Hansen (Hansen Technologies), Frank Lowy (Westfield), Barry Lambert (Count Financial), and Graeme Wood

(Wotif.com) have been the heart and soul behind their companies. These founders have demonstrated an incredible ability to compound shareholder wealth i.e. their own wealth. Those who have invested alongside them have been repaid handsomely. They've all demonstrated a shrewd ability to take calculated risks and look for hidden opportunities.

Entrepreneurial investors understand that backing the right people is just as important as backing the right business. To do this sensibly, investors need to ensure there is genuine motivation and desire to further the growth of the business for the long term.

For this reason, we favour investing in founder-led companies

Investors with experience owning and running their own business have an edge over the typical conservative investors. They are 'entrepreneurial investors'. They've been in the shoes of management. They know what's important and they're comfortable backing the right people with carefully considered strategies. They recognise that business success requires continual improvement and calculated risk-taking. By drawing on this experience and combining it with financial analysis, they have more strings to their bow than the typical conservative investor.

Happy compounding.

Lawrence Lam is the Founder of [Lumenary](#), a fund that uncovers the best founder-led companies in the world. We invest in unique, overlooked companies in markets and industries beyond most managers' reach. The material in this article is general information only and does not consider any individual's investment objectives.

Active ETFs a Chris Meyer a great Aussie invention

Chris Meyer

Active Exchange Traded Funds (ETFs) are a great Aussie invention for investors as well as a global-leading product. They combine the benefits of active fund management (the 'active' part) with the convenience of being traded like a share on the stock market (the 'ETF' part).

Australia is one of only two countries (Canada is the other) in the world that allow Active ETFs in the way we define it. In the US, they are limited to 'smart beta' funds as so-called Active ETFs in the US must provide daily disclosure of their portfolio and active managers are unwilling to disclose their stock selections daily. Authorities in Australia gave approval to Magellan initially for quarterly portfolio disclosure and that was the start of the Australian Active ETF market.

Some misunderstandings of Active ETFs

Much has been written about ETF risks and definitions. For example, Roger Montgomery wrote in a note to clients, "Is this another diversification trap", in November 2018 that

"investors who think ETFs offer safety through diversification are no more protected than those who invested in mortgage-backed collateralised debt obligations (CDOs) before the global financial crisis."

I realise this is meant to refer to the pitfalls of market cap index investing and its concentration in certain sectors but it fuels the confusion that ETFs themselves are bad by associating ETFs overwhelmingly with passive investing.

Arian Neiron from Van Eck (an ETF provider) wrote in July 2018 that, "Active ETFs are not ETFs" because they don't track an index, don't publish their holdings and have higher fees than passive index ETFs. This implies that passive index ETFs somehow have the 'right' to be called ETFs but Active ETFs don't. The same logic would suggest that a passive managed fund is not a managed fund as the vast majority of managed funds are active funds. Neither is true.

ETFs have benefits for investors

Neither Montgomery nor Van Eck's arguments go to the heart of what an Active ETF is, including:

Simple: I'm not sure when last you applied to invest directly in a managed fund but I'm sure after the first 20 pages of form filling you were left wondering why it's so hard. Try doing that across multiple managed funds and it's enough to head to the pub to spend your hard-earned savings. Any ETF, active or passive, are bought and sold like a share on the ASX. Open a brokerage account once. Trade as many ETFs as you like at the click of a mouse without any more forms.

Accessible: A typical managed fund has a minimum investment size of anywhere between \$5,000 and \$20,000. ETFs have no minimums and can thus be bought in smaller amounts.

Low transaction cost: Investing in ETFs requires the payment of a brokerage fee as with buying or selling an ASX share. These costs usually depend on the size of the transaction but trading online starts at \$10 to \$20. This includes the ASX as your 'platform' to settle and report a trade. Those costs are good compared to managed fund platform costs that are between 0.2% – 0.4%. Fund manager fees for Active ETFs are broadly similar to equivalent strategies in an unlisted managed fund. Passive ETFs typically have lower fees than Active ETFs, much the same way that passive unlisted managed funds have lower fees than active unlisted managed funds.

Liquid: One of the most common misunderstandings about ETFs is that they are only as liquid as the number of ETF units that trade on the ASX. ETFs do trade like shares and the liquidity of a share is indicated by its average daily value traded. Unlike shares, ETF's hold a basket of securities (such as shares) and the liquidity of the ETF is determined by the liquidity of the underlying basket of securities. The ASX rules only allow liquid securities to be invested in Active ETFs and thus the liquidity of an Active ETF is many multiples larger than the 'on-screen' ASX value traded in the ETF. If all the investors in an ETF wanted to sell out of the ETF, the ETF issuer could sell the (liquid) basket of underlying securities to return the cash to the investors. Two identical strategies in the form of an ETF and a managed fund would have the same liquidity. The ETF would have the added 'liquidity' benefit to an investor of the ability to buy and sell the ETF (and switch into other ETFs) intraday. This liquidity is not available in unlisted funds.

Transparent: ETFs are bought and sold at net asset value or NAV (less a bid/offer spread much like managed funds). There are no discounts or premiums to consider, which can exist with closed-end funds such as Listed Investment Companies (LICs). ETF prices are quoted 'live' on the ASX during trading hours and issuers of Active ETFs publish an indicative NAV or iNAV that closely approximates the actual portfolio NAV during the day. Unlisted funds by comparison typically offer end of day NAV for subscriptions and redemptions. An investment made in the morning must wait for a price to buy the fund at the end of the day. Active ETFs are required to disclose their full portfolio holdings. Yes, for some Active ETFs, this is only provided quarterly, but it's still a higher level of disclosure than most unlisted managed funds.

The rise of Active ETFs

The ETF industry in Australia is still relatively small. ASX-listed ETF assets under management (AUM) at end December 2018 was about \$40 billion, roughly the same size as the LIC market. This is not a bad effort given the ETF market is much younger.

Of that, Active ETFs are only about \$3.5 billion and are the new kid on the block. By contrast, the Australian retail managed fund industry AUM is about \$600 billion, most of which is in active funds.

ETFs therefore make up less than 7% of the managed fund industry in Australia. By contrast, in the US, the ETF industry has US\$3.5 trillion of AUM and is about 20% of the size of the mutual fund (managed fund) industry. The penetration of ETFs in Australia is destined to catch up with that of the US. Active ETFs, coming off a low base, will show even stronger growth.

Active ETFs are a great Australia invention and the regulator and stock exchange should be applauded for showing global leadership.

Chris Meyer is Director of Listed Products at [Pinnacle Investment Management](#) which includes global equities manager [Antipodes Partners](#) that recently launched an active global equities ETF. This article is for general information and does not constitute personal financial advice nor consider the needs of any individual.

8 problems the Royal Commission missed

Graham Hand

Commissioner Kenneth Hayne and his staff have done a good job, and rightly, he now has an exalted place in Australian financial markets history. It's almost sacrilege to criticise, but either due to the limited time allowed, the mandate or his focus, the work was not perfect.

The lack of time was somewhat self-inflicted. Many months ago, as someone who watched maybe 100 hours of hearings, I became frustrated with the amount of time the Commission was spending on a few issues. I wrote this editorial on 10 August 2018:

"Okay, we get it, please move on. The Royal Commission is doing great work uncovering poor practices in financial services, but after nearly three days on superannuation, it had interviewed only one company. The witness list has 16 entities on it. We already know from Round 2 in April that there is a systematic problem with advice fees. I have listened to a dozen hours of the Commission this week and we have run around in circles with two MLC/NAB witnesses, and one has returned for more questions today on Day 4 ...

There's so much else it should address: performance reporting, fee calculations, rates paid on cash, valuations of unlisted assets, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc. And what about the dubious banking practices which have changed little in the 20 years since I wrote [Naked Among Cannibals?](#)

These issues will have more long-term impact on the vast majority of customer returns than charging fees for no advice or to dead people. I hope the Commission does not run out of time."

How Hayne rewrote the rules and achieved strong results

Hayne set new standards of enquiry which will lead the way for regulators. We knew something was unique from the moment the Commissioner aggressively pointed his finger at National Bank's counsel, Neil Young QC, who was questioning why his client needed to return the next day. Young had said, "On our instruction, her answer will be that she had no involvement in these matters." Hayne hit the roof.

"You will not give her her answer, Mr Young. You will not. Do you understand me?"

And barely a peep was heard from any QC for the rest of the year.

The Royal Commission struck gold with a simple approach. Prior to the commencement of hearings, financial institutions were given the opportunity to come clean with their past mistakes. Hundreds of pages of misdemeanors flooded into the Commission, and thereafter, the skilled QCs assisting Hayne played back the admissions before embarrassed executives. Rowena Orr's 'Let me show you a document' became a chilling phrase. Witnesses were forced to admit the sins of themselves, their companies and colleagues, and along the way, many did not survive. Sam Henderson, Terry McMaster, Chris Kelaher, Craig Mellor, Catherine Brenner, Andrew Hagger, the four majors, AMP, IOOF and many more became victims.

Major issues missed by the Commission

Acknowledging the Royal Commission did a great job in shining light into dark corners, what did it miss, touch on or struggle with?

1. How banks price their products

Banks and other financial institutions offer a vast array of services. They are effectively the 'plumbing system' of the economy, especially in providing payment systems and intermediating between borrowers and lenders. Yet it is not difficult to find vital services which received little or no Commission attention.

Take the example of the way banks price their products. Why do the banks rollover the term deposits of existing customers at sub-market rates, forcing loyal customers to make a phone call to achieve a better rate? The vast majority can't be bothered or don't know the benefits, and what banks call 'retail inertia' makes a major contribution to interest margins. Why have credit card rates remained above 20%, when the poorest customers without the ability to pay off their cards each month suffer the most? Why do new customers receive lower mortgage rates than existing? Ross McEwan went to RBS in the UK after he missed the CBA CEO job to Ian Narev, and he said in 2014 that he found it,

"... absolutely abhorrent that you would give a new customer a better deal than someone who has been with you for 30 years."

I have written extensively on the subject of how banks price their products to protect profits, including in [this article](#). For me, failing to address this was Hayne's biggest shortcoming, because it affects millions of Australians in their everyday banking. Instead, the Commission spent day after day on financial advice and issues such as 'charging fees to dead people' which impact a relatively small number of people.

2. Difficulty pinning down culture

The complex subject of 'culture' seems at the heart of the problem in banks, but like many before him, Hayne struggled to define and grasp it. The most common phrase in response to the Commission will be 'rebuilding trust', which is convenient because there's no real way to measure it.

In the Final Report, Commissioner Hayne said:

"Too little attention has been given to the evident connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks."

But what to do about such a culture?

A significant problem is how to define community expectations. A leading law firm, Allens, told *The Australian Financial Review* that while Hayne was extremely well placed to opine on matters of the law, he had no special expertise in deciding a benchmark for community standards. Banks do not have one dominant type of culture, although Hayne said poor behaviour could be traced to the pursuit of profit over other purposes.

We have written more on culture [here](#).

3. Accessing the financial advice that people need

It's well established that most people are unwilling to pay enough for financial advice to cover the cost of providing the full service. Many financial advice groups are thriving by servicing wealthy clients, willing to pay 1% or \$20,000 a year for advice on a \$2 million portfolio (and of course, much more). But charge 1% on \$50,000 and \$500 pays for two hours with a decent adviser, which is barely enough time to crank up the spreadsheet let alone have a decent conversation and produce the obligatory 70-page Statement of Advice.

The large banks addressed this problem by cross subsidising, selling their own products such as managed funds to help pay for advice. This led to the claims of not putting the clients' best interests first and favouring in-house products.

The end result of the criticism is banks stepping away from providing financial advice and fewer Australians having access to the services they need. Long-term planning and retirement incomes are likely to suffer as a result. Financial advisers do not only focus on investing, but they address aged care, social security entitlements, superannuation structures, estate planning ... on it goes. Is it better that the bank teller will send the bank client to the adviser in the office above the real estate agent, and hope the conflicts are less there?

The unclear mix of a sales culture with provision of financial advice confused the best interest duty of advisers for their clients. The revelations at the Royal Commission have further undermined public confidence in financial advisers, and are no doubt partly responsible for the outflow from retail funds to industry funds. But most industry funds have modest advice businesses, often focussed on limited or 'scaled' advice given the difficult economics of servicing members with low balances.

4. Fund commissions remain in certain sectors

Hayne has come down hard on commissions paid by product manufacturers to financial advisers, recommending a banning. But what about commissions by another name, such as paid by new issuers in Initial Public Offerings (IPOs) on the ASX? Commonly, the issuer will pay the lead broker and other brokers a 1% or more selling fee. Some brokers then offer this to financial advisers to sell the IPO to their clients, and while some advisers may reimburse it to clients, many do not. Why is a financial adviser prohibited from accepting a commission from a fund manager for an unlisted fund under the Future of Financial Advice rules and now Hayne's recommendations, when a Listed Investment Company from the same manager indirectly pays the adviser a fee?

5. Underestimating the competitive role of mortgage brokers

According to a Momentum Intelligence survey of 5,782 borrowers, 79% were not concerned that brokers are paid commissions by banks. The report, called *Consumer Access to Mortgages*, found 96% of people who use or intend to use a mortgage broker would be unwilling to pay the average upfront commission of \$2,000 that banks pay to settle a mortgage. There was a perception among those surveyed (who may not represent the entire population) that brokers source the best loans and deliver the widest choice. Of course, the Royal Commission and some bank CEOs have offered different examples of brokers acting in their own best interests with poorly-structured incentive schemes.

If the service were not available, a competitive force would be removed with borrowers dealing directly with the banks with the biggest branch networks. A KPMG survey says mortgage brokers have helped reduce net interest margins of the banks by up to 20% in the last 10 years through increased competition.

In the interests of full disclosure, it should be noted that Momentum Intelligence is part of a media group that publishes titles aimed at mortgage brokers and real estate professionals. Nevertheless, with brokers now commanding a market share of mortgage origination of over 50%, it's easy to see how a ban on payments by banks to mortgage brokers will increase the power of the big banks.

In the Final Report, mortgage brokers will be subjected to a best interests duty and a ban on trail commissions from July 2020. Many brokers argue they provide a significant ongoing service, but Hayne rejected this, saying:

"The chief value of trail commissions to the recipient, to put it bluntly, is that they are money for nothing."

In the only exception to agreeing to implement all 76 recommendations, Josh Frydenberg said the Government would delay its decision on Hayne's call for upfront commissions to be banned and replaced by a customer-paid fee.

In response to the Final Report, Peter White, the Finance Brokers Association of Australia Managing Director, said,

"If a user-pays model was implemented, we know that most borrowers wouldn't pay, and banks would make more money and standards would drop further. It's very disappointing that the Royal Commission wants to destroy some 20,000 small businesses for the monetary gain of the big banks, and we trust the government will see clearly on this and continue to work extensively with our industry to improve consumer outcomes."

6. Industry funds escape detailed scrutiny

If the Productivity Commission recommendation on choosing the 10 'Best in Class' superannuation funds as defaults is adopted, industry funds are likely to dominate and their success will be further consolidated. Retail funds will struggle to compete. As the dominant institutional provider of retirement savings, Hayne should have explored some of the criticisms levelled at them more.

Instead, we are left wondering if the claims of competitors such as retail funds have merit. Examples include the methods used to value unlisted assets, which carry a higher weight in industry fund portfolios than in retail funds. The role of union members as directors of the boards of industry funds and the extent to which their board fees are paid to their unions and ultimately to assist the Labor Party, was overlooked. There was some scrutiny of entertaining at major events and industry funds spending millions a year on *The New Daily* publication, but the not-for-profit sector enjoyed the Royal Commission.

7. Financial advisers have a right to charge 'fees to dead people'

It's a great headline and the type of phrase people can easily recall, and on the surface, it sounds terrible to charge 'fees to dead people'. But the profession (the legal people at the Commission) arguing financial advisers should not victimise dead people is the same profession that often charges 'fees to dead people'. When a lawyer handles the will of a dead person and helps to administer the estate, do they do so with a feeling of sadness and benevolence and not charge fees? Of course they don't, it's a major part of many legal practices.

Financial advisers often have considerable work involved with an estate. Accounts remain open until probate, the process of proving and registering the will of a deceased person with the Supreme Court. When a person dies, many people are involved with their estate, and the executor of the will administers the estate and handles the disposal of assets and debts. Is the financial adviser the only one who is not supposed to be paid?

8. Lack of financial literacy taught in schools

At the heart of many issues uncovered by the Royal Commission is a community with poor overall financial literacy. Many people do not know which superannuation fund they are in, its cost and features, they pay for insurance they don't need or can't claim on and hold multiple accounts with duplicate fees. They carry credit card debt costing 20% and buy properties off-the-plan from spruikers.

Okay, this was a 'misconduct' Commission, but with both the Government and Opposition promising to implement recommendations, it was an opportunity to direct funds to education and help better-informed people make educated decisions and reduce the misconduct opportunities in future.

Finally, back to the earlier point, what about ...

... performance reporting, fee calculations, rates paid on cash, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc.

Feel free to add any comments on other issues the Royal Commission could have addressed.

Graham Hand is Managing Editor of Cuffelinks.

Royal Commission Final Report highlights

Graham Hand

The [Final Report](#) of the Royal Commission will not force radical changes to the financial services landscape, such as separating wealth and insurance from banks or merging regulators, but it does include many recommendations with wide-ranging implications.

Commissioner Kenneth Hayne started his Report by saying financial institutions and their staff focus too much on the pursuit of profit and personal gain:

"Providing a service to customers was relegated to second place. Sales became all important. Those who dealt with customers became sellers. And the confusion of roles extended well beyond front line service staff. Advisers became sellers and sellers became advisers."

The Final Report makes 76 recommendations, and both the Government and Opposition have already promised to 'take action' to implement all of them, with one exception. The Treasurer said the Government would not immediately accept the ban on upfront commissions paid by banks to mortgage brokers, due to competitive implications.

Here are some highlights of Hayne's recommendation:

Mortgage brokers and best interests duty

The law should be amended to provide that mortgage brokers must act in the best interests of the intending borrower. The obligation should carry a civil penalty provision.

The borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.

Changes in brokers' remuneration should be made over a period of two or three years, by first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, then prohibiting lenders from paying other commissions to mortgage brokers.

After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.

Financial advice ongoing fees

The law should be amended to provide that ongoing fee arrangements:

- must be renewed annually by the client

- must record in writing each year the services that the client will be entitled to receive and the total of the fees that are to be charged
- may neither permit nor require payment of fees from any account held for or on behalf of the client except on the client's express written authority

Financial adviser disclosure of lack of independence

The law should be amended to require that a financial adviser who would contravene the Corporations Act by assuming or using any of the restricted words or expressions including 'independent', 'impartial' and 'unbiased' must, before providing personal advice to a retail client, give to the client a written statement explaining simply and concisely why the adviser is not independent, impartial and unbiased.

Grandfathered commissions

Grandfathered provisions for conflicted remuneration should be repealed as soon as practicable.

The Government subsequently announced this would be implemented from 1 January 2021. Many financial planners who borrowed money to buy trail commissions books have two years to adjust their businesses to a loss of this revenue.

Hayne added:

"the time when the initial advice was given and the initial conflict arose has passed. The influence of the commission has already done its work once. But the problem remains. The influence continues. Advisers have an incentive to keep their clients in products with grandfathered commissions rather than advise them to move to better products. There can be, and is, no justification for maintaining the grandfathering provisions."

Superannuation trustee obligations

The trustee of an RSE (Registrable Superannuation Entity) should be prohibited from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.

Fees on MySuper accounts

Deduction of any advice fee (other than for intra-fund advice) from a MySuper account should be prohibited.

Deduction of any advice fee (other than for intra-fund advice) from superannuation accounts other than MySuper accounts should be prohibited unless the requirements about annual renewal, prior written identification of service and provision of the client's express written authority (as above) are met.

No hawking of super products

Hawking of superannuation products should be prohibited. That is, the unsolicited offer or sale of superannuation should be prohibited except to those who are not retail clients and except for offers made under an eligible employee share scheme.

One super default fund

Consistent with the Productivity Commission's proposal, it's recommended that a person should have only one default account. To that end, machinery should be developed for 'stapling' a person to a single default account.

Retention of 'twin peaks' regulation and superannuation

The 'twin peaks' model of financial regulation should be retained (that is, separation of APRA and ASIC).

The roles of APRA and ASIC in relation to superannuation should be adjusted to accord with the general principles that:

- APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system; and

- as the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.

A new oversight authority for APRA and ASIC, independent of Government, should be established by legislation to assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects. Graeme Samuel has already been appointed to run this function.

Other details

The Report makes 24 referrals of institutions for misconduct which may involve civil or criminal proceedings, but contrary to expectation, it does not name any individual. The only major bank to escape mention is Westpac. Regulators need to decide the next steps, including the potential for criminal charges. Hayne says regulators have failed to prosecute when given an opportunity:

"Very often, the conduct has broken the law. And if it has not broken the law, the conduct has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them. Too often, financial services entities that broke the law were not properly held to account."

He draws attention to sales techniques in branches, saying:

"That is why the attempts by ANZ and CBA to sell superannuation in bank branches under a 'general advice' model may have contravened the law."

Concluding comments

Kenneth Hayne has passed the baton to legislators and regulators to act on his recommendations, including enforcing existing laws and giving far greater priority to customer needs over profits.

One of the fears behind the impact of the Royal Commission is the reduction in lending by banks to all sectors of the economy, especially small business. There is no news in the Final report to suggest it will become worse than it already is, and Treasurer Josh Frydenberg said,

"Let me be clear. Personal responsibility for financial decisions rests with those who make them. However those who suffer harm as a result of misconduct will have access to redress."

If looking for the most damning criticism of any company or people, it is probably NAB's Ken Henry and Andrew Thorburn who appear most exposed. Hayne said of them,

"I am not as confident as I would wish to be that the lessons of the past have been learned ... Overall, my fear – that there may be a wide gap between the public face NAB seeks to show and what it does in practice – remains."

Like the consequences for the entire report, the real improvements to the financial system after a year of unprecedented scrutiny, are ahead of us.

Graham Hand is Managing Editor of Cuffelinks.

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