

Part 3

Problems with Disclosure of Fees and Charges

INTRODUCTION

In this part of the report a number of problems with disclosure of fees and charges in Australian disclosure documents for financial products are examined. There is a widely held view that there is a need for improved disclosure of fees and charges. This was a common theme running through the meetings with key stakeholders although not all stakeholders agreed in relation to the degree of improvement needed and what should be done to improve disclosure. There is further discussion of the views of stakeholders in Part 6 of this report.

There is international interest in improving disclosure of fees and charges relating to financial products, as is evident with the recent publication of reports in the UK and USA, to name just two countries: Ron Sandler, *Medium and Long-Term Retail Savings in the UK: A Review*, Report Prepared for the UK Government, July 2002; United States Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses*, December 2000.

Part 3 of the report is divided into two sections. First, I present the results of two surveys of the adequacy of disclosure of fees and charges. Second, I summarise the results of a number of surveys which have tested consumers' understanding of fees and charges.

The analysis in Part 3 of the report is limited to initial disclosure documents such as prospectuses or product disclosure statements. However, as noted in Part 2, this project includes not only disclosure of fees and charges in selling documents but also disclosure in investor or member statements. Disclosure of fees and charges in these types of statements varies to an extraordinary degree. This type of variation is unfortunate because it is this document which provides an opportunity for an investor to ascertain precisely what fees and charges have been paid in relation to their investment. This cannot be done in a selling document where there is a limit to the

information that can be tailored to individual circumstances. In addition, it seems sensible to assume that investor statements may be more closely read than many selling documents. This can be for several reasons. First, the typical member statement is considerably shorter than the typical selling document. Second, it is the investor statement which gives details of the value of the investment and the investor therefore has a financial incentive to review the statement.

A review of investor statements reveals that on some of these statements, a precise dollar figure is given in relation to fees and charges for the period of time which the statement covers. In addition, there is a description of the fees and charges. These statements will provide a dollar value for the returns for the relevant period, then a dollar value for the fees and charges, and then a dollar value for the net returns.

This can be contrasted with those investor statements which provide no details concerning fees and charges. These statements may only provide a dollar value for the opening balance at the beginning of the period and a dollar value for the closing balance at the end of the relevant period, with no indication of the amount of fees and charges which have been paid. Although investor statements may be given quarterly, six monthly or yearly, once a year the investor will receive, along with the investor statement, an annual report. In this annual report, there can be expected to be reference to the Management Expense Ratio (“MER”). However, it is often the case that there is no reference on the investor statement to the fact that the MER is disclosed in the annual report and, in any event, the MER, as noted in Part 6 of this report, will typically be an imprecise measure of the actual fees and charges relevant to a particular investor.

SURVEYS OF ADEQUACY OF DISCLOSURE OF FEES AND CHARGES

This part of the report is divided into two sections. First, I summarise the results of a study undertaken in 2000 for ASIC of disclosure of fees and charges in prospectuses. Second, I present the results of a survey of prospectuses undertaken for the purposes of this project.

The most recent analysis of fees for superannuation products has been undertaken by Phillips Fox for IFSA and published in April 2002.⁴ Although the main focus of the Phillips Fox report is on competition and fees, there is some brief discussion concerning disclosure of fees. The following is an extract from this section of the Phillips Fox report:⁵

Our review of the annual reports of superannuation funds confirms that it is extremely difficult for any member to understand the fees charged to them. The range and quality of services varies significantly amongst the funds and it would not be easy for a member to evaluate these differences.

The authors of the report note that disclosure should improve under the Financial Services Reform Act in relation to superannuation products and that a competitive market can assist in forcing superannuation funds to minimise fees and charges and disclose fees and charges.

PHILLIPS FOX SURVEY

In November 2000 Phillips Fox presented a report to ASIC which dealt with disclosure of fees, charges and commissions.⁶

Phillips Fox reviewed a number of prospectuses relating to financial products including prospectuses for unit trusts, Wrap accounts and various types of superannuation products. An important point made in the report is the lack of uniform terminology in prospectuses:

There is no standard for investment terms. This hinders any educational process as consumers have no familiarity with the terms used. Terminology can vary even within a disclosure document (as described in some of the examples later in this report). In addition, terms can be confusing. For example, an investment management fee could represent the fee charged by the fund manager for undertaking the management of the investments. It can also be the asset-based fee charged on the product, which can include the investment manager's fee, part

⁴ Phillips Fox, *Superannuation Fees and Competition*, Report Prepared for the Investment and Financial Services Association, April 2002.

⁵ Ibid, section 3.1.

⁶ Phillips Fox, *Financial Services Reform Act: Product Disclosure of Fees, Charges and Commissions*, Report Prepared for the Australian Securities and Investments Commission, November 2000.

of the administration fee as well as ongoing commission to an adviser. The disclosure of this fee can vary. It might be deducted from the earnings rate or expressed as an explicit fee.⁷

Other points made in the report in relation specific prospectuses reviewed are as follows:

- The MER is not always explained sufficiently.
- It is not always clear when specific fees are payable.
- In one prospectus maximum fees for the fund are stated yet in the same prospectus it is disclosed that this maximum was exceeded but without any explanation.
- In one prospectus it is stated that a monthly investment of \$100 will grow to a specified amount over five years. However, the calculation is accurate only if no fees or taxes are paid.
- It is not always made clear that entry fees or contribution fees are payable not just on the initial investment but may also be payable on subsequent investments.
- Some fees are shown as monthly and others as annually.
- The circumstances in which fees can be varied is not always disclosed.
- It is not always disclosed what fees are paid to advisers.

SURVEY OF PROSPECTUSES FOR THIS PROJECT⁸

For the purposes of this project, 30 prospectuses relating to various types of superannuation and managed funds were reviewed in order to obtain insight into the adequacy of disclosure of fees and charges. The prospectuses were selected at random. All prospectuses are recent (and current as of March 2002) and all have been issued by well-known product issuers.

Some general observations can initially be made concerning the overall quality of disclosure of fees and charges. This is followed by some specific observations. The following general comments can be made:

⁷ Ibid, section 2.4.3.

- There is significant variation with respect to the degree to which fees and charges are disclosed. This is evident not just in relation to a comparison of prospectuses for superannuation and prospectuses for managed funds, but also in relation to a comparison of prospectuses for the same products. For example, in some prospectuses, there is identification of fees and charges at a broad level. In other prospectuses, more detail is provided concerning specific types of fees.
- There is significant variation with respect to how the same fee is described in different prospectuses. The use of different terminology to describe identical fees detracts from the ability to compare prospectuses.
- In some prospectuses, fees and charges are referred to, but not defined.
- There is significant variation in relation to what the MER represents and how it is calculated.
- In some prospectuses, not all relevant fees are disclosed in the one section of the prospectus which means that a potential investor must review all of the prospectus to see what fees apply.
- Many prospectuses do not disclose how much notice is required to investors in relation to an increase in fees and charges.
- There is significant variation in relation to whether prospectuses disclose the maximum fees or charges that can be levied under the trust deed.
- There is significant variation in relation to disclosure of the purpose for which fees are imposed.

Apart from these general observations concerning disclosure of fees and charges, some specific examples of problems in particular prospectuses are worth identifying:

- In the fees and charges section of one prospectus it is stated that the ongoing management fee is a percentage of “total tangible assets”. In the same section it is then stated that the custody and compliance fee is a percentage of the “total gross investments of the Fund”. These terms, particularly the reference

⁸ The term “prospectus” is used rather than “Product Disclosure Statement” in this section of the report as the term Product Disclosure Statement applies only from March 2002, with the commencement of the Financial Services Reform Act 2001.

to total tangible assets, would be difficult for the typical investor to understand. Just as importantly, any difference between the two terms is not explained.

- Specific fees are referred to in prospectuses but are not defined or explained. For example, in one prospectus, a fee described as “a group asset transfer fee of up to 1% of the amount transferred to your account” is identified but not defined or explained. In another prospectus, there is reference to a “sector fee” which is not defined.
- In one prospectus there is reference to both ongoing management charges and management expense ratios which an investor may find confusing.
- In some prospectuses significant fees are not disclosed in the fees section but are disclosed in other parts of the prospectus. For example, in several prospectuses, switching fees are not mentioned in the fees section of the prospectus but are mentioned in other sections of the prospectus – such as the “Other information” section. In another prospectus, the maximum fees which can be charged under the trust deed are not disclosed in the fees section but in the section of the prospectus titled “What else do you need to know?”
- In some prospectuses, the actual management fee which has been paid in prior years is not disclosed in the section which deals with fees and charges. For example, in one prospectus, the actual management fee for the past two years is in the section titled “What else you need to know?” which is on page 19 of the prospectus, with the section on fees being on page 12 of the prospectus, with no cross-reference.

In summary, it can be seen that there is considerable scope for the improvement of disclosure of fees and charges in prospectuses. This conclusion is reinforced by an examination of surveys which have tested consumers’ understanding of fees and charges.

SURVEYS TESTING CONSUMERS’ UNDERSTANDING OF FEES AND CHARGES

A number of surveys have been undertaken in the last few years with the objective of testing consumers’ understanding of fees and charges in prospectuses and other

selling documents for financial products. In this section of the report a summary of the results of these surveys is presented.

COMMUNICATIONS RESEARCH INSTITUTE STUDY

In March 1997 the Communications Research Institute of Australia presented its report on the accessibility of prospectuses which it had prepared for the Investment Funds Association and the Australian Securities Commission (as it then was).⁹ The methodology employed was to engage in in-depth interviews with both experienced and inexperienced investors. There were 16 experienced investors and 16 inexperienced investors. Two different prospectuses for managed investment funds were selected for testing. They were selected to reflect differences in information and design in order to capture the range of differences across many managed funds prospectuses. One was a short prospectus of 40 pages offering only a few funds. The second prospectus was 72 pages offering many funds.

Those interviewed were asked to identify information in the prospectuses about particular items of information. One of these items was expenses (fees and charges). In relation to the first prospectus, 75% had some problem finding and understanding this section. Twenty-five per cent did not find or understand this section. In relation to the second prospectus, 38.5% had some problem finding or understanding this section. Fifty-four per cent did not find or understand this section.

EUREKA STUDY

In June 1998 Eureka Strategic Research presented the results of a research project that it conducted on behalf of the Investment and Financial Services Association and the Australian Securities Commission.¹⁰ The research project had, as its objective, obtaining information about the level of readership and comprehension of prospectuses. The methodology involved testing respondents' understanding of four matched pairs of short form and long form prospectuses for managed funds. A

⁹ Communications Research Institute of Australia, *Developing a Performance-Based Approach to Prospectuses*, Report to the Investment Funds Association and the Australian Securities Commission, March 1997.

¹⁰ Eureka Strategic Research, *Simpler Managed Investment Prospectuses*, Report to the Investment and Financial Services Association and the Australian Securities Commission, June 1998.

sample of 1005 investors was broken into matched groups and each group responded to questions about one of the eight prospectuses.

One question asked of the respondents was the relative importance of particular items of information contained in the prospectus. Fees and charges were ranked by the respondents as the third most important part of the prospectus. The most important part of the prospectus was the likely level of return on the investment followed by the risk of the investment losing value.

In relation to fees and charges, respondents were asked a specific question – whether entry fees applied. The result was that all but one of the short form prospectuses were superior to the long form prospectuses in explaining whether entry fees applied.

Another part of the research undertaken by Eureka was one on one in-depth interviews with investors regarding the use of prospectuses to make investment decisions. There were 16 of these interviews, with participants reflecting a variety of investor backgrounds and experience levels. One of the specific findings of this part of the research was that investors stated that they wanted clearer information on fees. Eureka also undertook two group discussions with investment advisers. There was a consensus view from one group of advisers that information concerning fees and charges should be presented in a clearer and more prominent manner.

AGEING AGENDAS STUDY

In December 2000 Ageing Agendas presented its report to the Association of Superannuation Funds of Australia (ASFA) on Key Features Statements (KFSs).¹¹ The purpose of this research was to test several KFS documents in order to determine consumers' understanding of these documents. The research involved a three stage process:

- (1) A review and revision of a KFS developed by ASFA. This was followed by diagnostic testing with a sample of consumers.

- (2) Revision of the KFS in the light of the test outcomes, the development of two other KFS documents to test consumers' capacity to make informed decisions and diagnostic testing of the three documents.
- (3) Revision of a unitised KFS with entry and exit fees in light of the stage 2 testing. This was followed by diagnostic testing of the original and unitised fund to determine whether the KFS model could support a more complex fund structure and whether consumers could make fee and other comparisons using the two documents.

Twenty-four participants were interviewed for each of the three stages of the research project. Each interview lasted 30 minutes. The emphasis was upon those who did not hold tertiary qualifications. In each of the three stages, copies of the KFSs were sent to the consumers a week before the interview to allow them to read them as they would if they were choosing a fund.

One of the questions asked of the participants was to identify the information they would consider most important in choosing a superannuation fund. Fees and charges was ranked by the participants as the second most important information, with investment options being nominated as the most important and performance as the third most important. Some of the other findings of the research were:

- Issues of unitisation, fees and charges, and tax were the most troublesome for consumers.
- The use of percentages in fee information is a barrier to understanding, whether consumers are considering one fund only, or making comparisons. Where percentages are used, illustrating their effect in dollar terms improves understanding.
- The fee summary and comparison tables need to be moved to the beginning of the fees and charges section so that consumers recognise their significance and tables should be simplified.

¹¹ Ageing Agendas, *Summary of the Outcomes of Consumer Testing of the ASFA Super Choice Key Features Statements*, Report Prepared for the Association of Superannuation Funds of Australia Ltd, December 2000.

- The warning about future investment performance needs to be more explicit and placed next to the performance data so that consumers see its significance.

In relation to a table showing the effect of fees, Ageing Agendas recommended in its report that the following table be used to show the effect of fees for superannuation funds.

Effect of fees on account balance – no entry fee option

Impact on account balance from	Compulsory employer contributions of 9% on annual pay of \$20,000 (\$1,800)	Compulsory employer contributions of 9% on annual pay of \$40,000 (\$3,600)
If withdrawn	Impact of Fees	Impact of Fees
after 2 years	\$ 250	\$ 410
after 5 years	\$ 490	\$ 730
after 10 years	\$1,440	\$2,260
after 20 years	\$5,720	\$9,630

SWEENEY RESEARCH STUDY

In July 2001 Sweeney Research presented its report on consumer perceptions of fees and charges which it had prepared for the Investment and Financial Services Association.¹² The objective of this research was to assess the understanding and perceptions of fees and charges by consumers who had invested in managed investments. Five hundred telephone interviews were conducted with those who had invested in managed investments. In addition, four focus group discussions were held with managed investment consumers and two focus group discussions were held with financial planners.

The profile of those who participated was different to a number of the previous research studies as the Sweeney Research study tended to have more sophisticated participants and all were already investors. For example, 31% of those who participated had invested \$100,000 or more in managed investments. Another 14% had invested between \$50,000 and \$99,999. With respect to the household income of those who participated in the research, 30% had a household income of \$90,000 or more with another 22% having a household income of between \$60,000 and \$89,999.

With respect to the occupation of the main income earner, 45% were classified as professional/executive; 27% as white collar; 11% as blue collar; and 13% as retired.

The 500 investors who participated in the telephone interviews were asked to consider the importance of a number of factors that they used to select managed investments. 86% of the consumers considered fees and charges to be either “important” or “very important” when evaluating managed investments. Factors which were considered to be more important were reputation of the fund manager (96%); long-term performance of the fund (96%); and risk associated with the investment (88%). When the consumers were asked to identify the single most important factor in choosing a managed investment, only 2% of consumers said that fees and charges were the most important factor in their decision-making process. The factors ranked as more important were long-term performance of the fund (54%); risk associated with the investment (17%); reputation of the fund manager (14%); advice/recommendation from financial adviser (5%); short-term return on investment (4%); and awards or ratings (3%).

Consumers were asked the extent to which they were “comfortable” with the information they had on the fees and charges at the time they selected the most recent managed investment. The replies were as follows:

- very comfortable (30%);
- somewhat comfortable (46%);
- somewhat uncomfortable (20%); and
- very uncomfortable (4%)

It is to be noted when interpreting this data that the information the consumers had about fees and charges relates to all sources of information. When asked to identify the sources of their information about fees and charges, 42% replied that it was advice from their financial adviser with 35% stating that it was the prospectus. Consequently, it is important to note that the responses concerning the extent to which consumers are comfortable with information about fees and charges must be

¹² Sweeney Research Pty Ltd, *The IFSA Fees and Charges Consumer Perceptions Study: A Summary*

interpreted in light of the fact that the major source of information about fees and charges for the consumers was not a prospectus but a financial adviser.

Sweeney Research then asked more detailed questions concerning consumers' understanding of fees and charges. A number of the results revealed difficulty in consumers' understanding. As noted by Sweeney Research, for many consumers, the results show that it is difficult to understand the fee structure and that it is not easy for consumers to work out exactly how much a managed investment will cost. For example:

- 61% agreed with the statement that “it is difficult to understand the fee structures”;
- 59% agreed with the statement that “as so many of the costs are hidden it is difficult to know how much you are paying”; and
- 53% disagreed with the statement “it’s easy to work out how much the fees and charges associated with the fund will cost me”.

Consumers were asked how confident they were they knew what the actual fees and charges were applying to their managed investment. The replies were:

- very confident (31%);
- somewhat confident (39%);
- somewhat unsure (18%); and
- very unsure (12%).

Consumers were asked to identify what type of fees and charges apply to their managed investments. Sweeney Research states that “perhaps the most striking finding is that close to one-third (32%) of consumers were unable to define the types of fees and charges they are paying”. In order to further test consumers' knowledge of specific fees, consumers were asked to estimate what percentage of their total investment was charged (a) as an entry fee and (b) as an ongoing management/administration fee. Thirty-two per cent replied that they did not know

what they were charged as an entry fee while 40% of consumers replied that they did not know what were the ongoing fee levels.

Consumers were asked their preferred means of fee disclosure in prospectuses. Fifty-two per cent stated that they preferred the fees to be expressed in dollar terms. Forty-two per cent stated that they preferred fees to be itemised as a percentage/management expense ratio.

Consumers were then asked their preference for the reporting of fees and charges in ongoing statements. They were presented with four different reporting options and asked to put forward a preference. The results were:

- expressing fees both as a percentage of the investment and in actual dollar terms (54%);
- expressing fees in actual dollar terms (24%);
- showing the investment balance after fees have been deducted (12%);
- expressing fees as a percentage of the investment (7%); and
- don't know (3%).

SUMMARY

This review of the results of a number of studies which had, as their objective, testing consumers' understanding of fees and charges, reveals that a significant number of consumers fail to understand basic information about fees and charges. It can therefore be concluded that there is significant scope for improvement in the disclosure of fees and charges. Options for improved disclosure are discussed in Part 6.