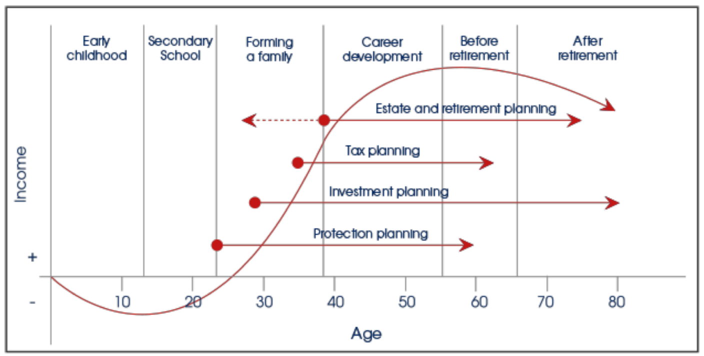
Relevance to financial planning

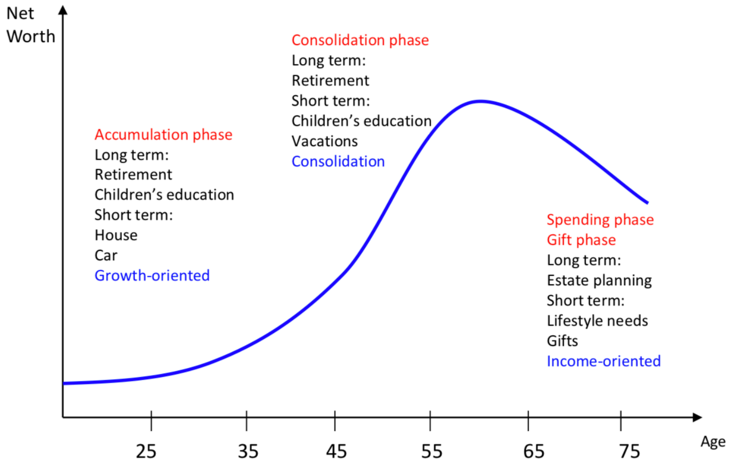
- Whilst the model is clearly unrepresentative of practice, this doesn't mean it has no relevance to personal financial decision making
- It is useful to examine the theory in terms of what is the basic objective of financial planning
  - i.e. financing planning is done to ensure that there is adequate lifetime income to meet lifetime consumption
- Informally, the objective of financial planning is to enable achievement of the life cycle model
- So, the theory and model is therefore relevant, at least as a starting point for examining financial phenomena
- The obvious difficulty in applying a theoretical model to practice is the existence of **uncertainty** in the real world; practical issues that have an impact on financial decision making include:
  - Risky income flows and assets
  - Age and life expectancy
  - Portfolio allocation choices
  - Inheritances and bequests
  - Changes in family circumstances or in preferences over time
  - Taxation and other government transfers

Life cycle 'phases'

- An approach that acknowledges this is to apply principals of the life cycle model, modified for practical realities
  - In effect, have an explicit recognition of different 'phases' of the life cycle
- Involves saving and investment strategies designed to meet varying preferences, needs, resources in different 'phases' of life, e.g.
  1. Young, single, no commitments
  2. Younger couple, two incomes, no children
  3. One-income family, young children, tight budget
  4. One- or two-income family, older children
  5. Retired, living off private income and/or government pension

Funding life cycle phases





Introduction to pension schemes

- In the context of this subject, a pension is an arrangement to provide people with an income when they are no longer earning a regular income from employment
  - i.e. a different focus to the common view of pensions, e.g. age or disability
- A major part of this course is about pension provision in *retirement*, and we will distinguish between different pension schemes
- We typically recognise two phases relating to pensions:
  - (i) the accumulation phase
  - (ii) The retirement phase

The **accumulation phase** focuses on a person's working life over which assets are accrued to provide for retirement

Retirement involves use of personal assets, possibly together with Social Security support, to provide a pension for residual life

- so, we use the term 'pension' broadly, to describe an income stream

Where do governments fit into the scheme of things?

- Relates to the roles of governments, which usually include providing social support for its constituents

The pension problem

- A practical consideration is that governments are faced with the problem of caring for their retirees (as are current and future retirees themselves)
- There are traditionally four pillars of retiree pension provision:
  - i. Social Security
  - ii. State sponsored complementary private schemes
  - iii. Individual savings
  - iv. Continued earnings in retirement

- In Western countries, these pillars are recognised as an attempt to avoid a fifth pillar, 'family support', where children take responsibility for care of their elderly parents
- The problem arising is that providing adequate Social Security benefits is increasingly becoming beyond the resources of most governments
- This is why Australia introduced a state sponsored complementary private pension scheme (in 1992, the "Superannuation Guarantee Scheme")
- Until relatively recently, the proportion of persons in OECD countries in working age (say 18-65) and persons over working age (i.e. over 65) was relatively stationary
- This meant that governments had the option of levying tax at a relatively constant rate to provide a pension on which retirees could live

The Demographic Imperative

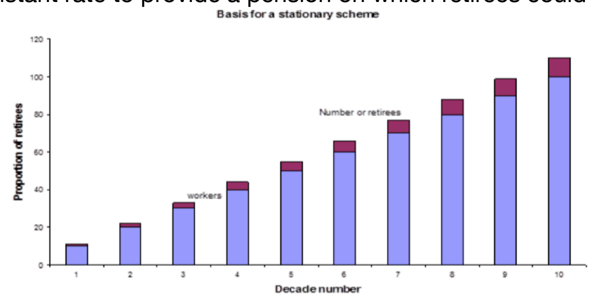


Figure 1. In the diagram, the proportion of retirees/workers remains at about 10% as the population increases

- However, in most countries today, the *proportion of persons over working age is increasing*
- therefore, governments no longer have the tax option, as it would lead to 'inter-generational inequity' - workers in successive generations having to pay more and more tax to support the increasing proportion of retirees
- The solution that most countries have adopted, or are in the process of adopting, is to require its working population to pay for its own retirement by contributing to government regulated funds
- In most countries these are called 'pension funds' - in Australia, they are 'superannuation funds'

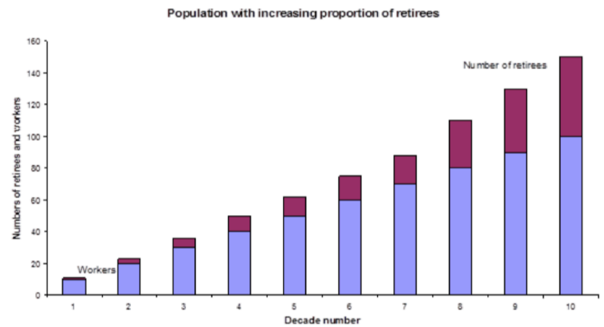


Figure 2. The proportion of retirees/workers is increasing over time as the population increases

Fiduciary Duty (i.e. Best Interest Duty)

- Applies to advice to retail clients only
- **Retail client** is essentially defined as someone who is not classified as a wholesale client under the Corporations ACT (s. 761G) - I.e. they have not met the income of wealth tests in the Corporations Act to be deemed a wholesale client and have not been assessed as being an 'experienced investor'
- The rule of fiduciary duty is also referred to the 'best interest' duty, in that it requires the adviser to act objectively and **solely** in their client's best interest

The fiduciary/best interest duty embodies two key principles:
(1) Know your client;
(2) Know your product

To ensure that advisers have a reasonable basis for their advice, it is necessary to:

1. Perform a detailed investigation of the client and research his* needs
2. Carefully record all relevant aspects of the client
3. Formulate clear advice for the client
4. Obtain the client's decision and implement it

The 'Best Interest' Duty

The following four standards apply in assessing the behaviour of the financial adviser

1. The planner must have acted with a reasonable level of expertise in the subject matter advised on
2. The planner must have exercised reasonable care
3. The planner must have objectively assessed the client's relevant circumstances
4. The planner must have regarded any action implemented as being in the client's best interest in the circumstances

Wealth creation

The principal wealth creation (investment) strategies are (not in order):

1. Superannuation
2. Gearing
3. Equities and bonds
4. Investment in the family home
5. Investment in your own business
6. Salary packaging

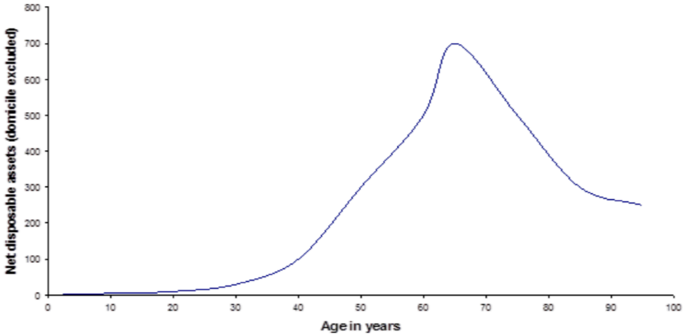
Asset protection

Protection of assets will include checking that the client has:

1. Adequate general/life insurance cover
2. Secure custody of assets
3. Mechanisms in place for asset protection in the event of family breakdown
4. Business breakdown/succession contingencies in place (if applicable)
5. Risk-mitigation measures in place against their investment exposures (especially In retirement phase

Investor Life Cycle

Typical growth of investor wealth over investor's life. The broad objective of an effective retirement strategy is to flatten out the downswing near the peak, so that there is little (and slow) diminution of assets during retirement.



Retirement planning

- Initial focus is on financial aspects
  - e.g. estimated size of lump sum, debts, dependents, home ownership, other assets, etc.
- Financial products will be recommended
  - Annuities, allocated pensions, age pension?
- Other information is to be gathered to "know your client"
  - Insurance, health, retirement activities and objective, etc

Estate planning

- Estate planning involves orderly (tax-effective) disposal of your assets - this may be during your life or after you die
- The main issue being addressed is: how do you go about the allocation of your estate?
  - This can accommodate a bequest motive
- Assets may be disposed of via wills, of course
- However, we will see that a SMSF provides the best vehicles for estate planning (but subject to some restrictions)

Under this topic, we will also consider:

- Requirements for a valid will
- Intestacy and its consequences
- The issue of dependents
  - Superannuation dependents
  - Tax dependents
- Disposal of assets that are not will assets
  - Joint and common tenancies, superannuation and trust assets
- Business succession planning

W2 Financial Planning Industry in Australia

Today's lecture

1. Introduction to the Financial Planning Industry
2. Compliance - an overview
3. Best practice principles
4. Financial services regulatory regime
5. Documentation:FSF, SoA, PDS RoA
6. Penalties and complaints procedures

Why Financial Planning?

- As a starting point, note that if finance theory did hold in reality, there would be note role for financial planner
  - E.g. MPT would apply and everyone identifies the market portfolio (M*) and holds a mix of M* and r_f
- The industry exists due to the need of individuals investors to access expert advice to build 'portfolios' tailored to their personal situation
- This is a legitimate advisory role, due to:
  - Inadequate financial knowledge in some (many) cases
  - Differing expectations of earned or investment income, tax situations, family circumstances, investment horizons, etc.
  - Insufficient or illiquid assets

The Financial Planning industry

- In other words, the fact that many individuals do not possess the level of understanding required to do their own financial planning has spawned the financial planning (FP) industry
- Recall that the main areas covered in the FP industry are:
  - Wealth creation
  - Asset protection
  - Retirement planning
  - Estate planning
- Specialist knowledge is required to advise in these areas

Who is an adviser?

- Under the legislation, advisers comprise principals, authorised representatives and 'paraplanners'
- When a principal is referred to, it is any one of
  - The holder of a dealer's or adviser's licence
  - Any person who obtains a licence under FSRA
  - A registered life insurance broker
  - A life insurance company
- Principals employ or appoint both authorised representatives (quality) and paraplanners (unqualified or partly qualified)

‘Best Interest’ fiduciary duty

- General law fiduciary duty: advisers must act objectively and solely in their client’s best interests
- The following standards apply in assessing if the financial adviser has met its fiduciary duty, the adviser must have:
    1. Acted with a reasonable level of expertise in the subject matter of the advice
    2. Exercised reasonable care
    3. Objectively assessed the client’s relevant circumstances
    4. Regarded any action implemented as being in the client’s best interest in the circumstances

- As noted, the FoFA Act introduced a statutory ‘best interest’ duty from 1/Jul/2013 (Corps Act s.961B)
- There are eight requirements of this duty: s.961B(2)
- The Best Interest Duty will be deemed satisfied if certain steps are taken, depending upon whether the advice relates to:
    - Basic banking products: s.961B(3)
    - General Insurance products: s.961B(4)
- More guidance: s.961C - s.961J; penalties: s.961K, M, N

When is a financial service provided?

An adviser is providing a financial service when:

- Providing financial advice
    - But note there is a distinction between general and personal advice
- Dealing with a financial product (http://www8.austlii.edu.au/cgi-bin/viewdoc/au/legis/cth/consol_act/ca2001172/s763a.html)
- Making a market in a financial product
- Operating a registered scheme
- Provided a custodial or depository service

We focus on the first, which includes making recommendations and providing a statement of opinion or written advice report

General Advice

When **general** advice is given to a retail client, the adviser must:

- Warn that the advice is not based on knowledge of client circumstances and objectives
- Indicate that the client must consider the advice in this light if inclined to act
- Suggest that a Product Disclosure Statement should be considered (if applicable) before acting

ASIC has stated that the following warning is sufficient:
“This advice is general; it may not be right for you”

Personal Advice

Personal advice does take into account knowledge of client circumstances and objectives. In RG175, ASIC notes that advice may be regarded as ‘personal’ even when:

- It is not given face-to-face (even no direct contact with client)
- It relate to only one product
- The client is a body corporate
- The adviser (subjectively) did not intend to provide personal advice

ASIC guidance on personal advice (cont.)

- The adviser explicitly offered to provide advice (and, for example, provided appropriate documentation)
- The adviser had an existing financial relationship with the client
- The client requested personal advice
- The adviser requested details about the client’s personal circumstances
- Personal circumstances are referenced in a recommendation
- The adviser had received or already possessed information about the client’s personal circumstances

Quality of Advice

- Personal advice does not have to be ideal, perfect or even best, but it must satisfy three elements outlined in RG175:
    i. Reasonable enquiries have been made into client’s relevant personal circumstances
    ii. The provider gives considered advice, the subject matter of which has been investigated and is reasonable in all the circumstances
    iii. The advice must be appropriate for the client

There are two key elements of quality advice:

1. The ‘suitability’ rule

- Effectively, this is practical outcome of ‘know your client, know your product’ rules
- Includes consideration of products alternative to those suggested; clients should not have a product presented as the only available solution
- Reasons for the recommended product should be augmented by comparisons with competing products
- ‘suitability’ also implies an assessment of each client’s risk tolerance (this can be controversial, as attitude to risk cannot be considered ‘constant’

So, how is risk assessment done?

- By examination of previous investments made by the client(s) – this is ok if the client has a long history of investment (though in this case, the client probably doesn’t need advice from a FP);
- by use of a questionnaire – many FP firms provide one of these for clients

Levels of risk tolerance

- **Defensive investor** – 100% of assets invested in defensive assets (cash/fixed interest)
- **Conservative investor** – 80% in defensive assets, 20% in growth assets (e.g. shares, property)
- **Moderately conservative investor** – 60% defensive assets, 40% growth assets
- **Balanced investor** – 40% defensive assets, 60% growth assets
- **Assertive investor** – 20% defensive assets, 80% growth assets
- **Aggressive investor** – 100% growth assets

2. Informed consent

- Advice to the client must be communicated in a clear and concise manner
- In particular, this requires that the advice is not misleading, deceptive, incomplete or provided in a pressured environmentI
- f the adviser is responsible for implementation of the plan, a written signed statement to the effect that the client understands the projected course of action and agrees to the adviser’s implementation of it, should be obtained and kept

Acting efficiently, honestly and fairly

- Best practice also requires advisers to act efficiently, honestly and fairly
- These terms are not legally defined, but in the context of financial advice, they are:
    - ‘**efficiency**’ in conducting business, e.g. providing a plan and documentation in a timely manner
    - ‘**honesty**’ relates to ethics, conduct and fiduciary principles
    - ‘**fairly**’ requires advisers to treat clients equally, i.e. not discriminate between clients

Disclosure to the client

- Clients clients have the right to know of any issue that may be seen as having the potential to impact on the objectivity of advice provided
- The main disclosure duty relates to ‘conflict of interest’
- The Financial Planning Association (FPA) insists on ‘managing conflicts of interest’; many believe that this is not enough
- When the FP industry was under review, one prominent commentator, Alan Kohler (The Age, 07/04/2006) stated: “It isn’t a matter of ‘managing’ conflicts of interest – financial advice is a fiduciary relationship that is <u>incompatible</u> with them”

Conflicts of Interest - FPA principles

Principle 1: Cost of financial planning advice should be separately identified in the SoA and total fees paid for ongoing advice should be disclosed on a regular basis
Principle 2: when it is appropriate to recommend a product to a client, FPA members will undertake the due diligence necessary to offer the products which suit the needs of the client and do not bring the industry into disrepute
Principle 3: no remuneration or benefits paid by a FPA principal to one of their FPs should be biased against or not in the interests of the client
Principle 4: separate corporate governance arrangements should govern FPA principal members and all or any related financial services provider and/or entity

- The tradeoff to this risk/uncertainty is their potential for better capital growth and returns, plus they offer greatest flexibility (to protect against longevity risk)
  - This is because the owner can determine when and how much is drawn, which will also determine how much remains invested as a lump sum
- This product can be used to deliver both basic income and discretionary income
  - The latter is extra drawings, if required
  - This typically is not an available option under non-account based products

Account-based payment standards

- In the first year, the minimum is pro-rated based on number of days remaining; thereafter, it is percentage of the super account balance as at 1 July each year
- Minimum income payment must be made, at least one per year (calculated to nearest $10)
- No maximum, unless TTR involved (then 10% max.) or Fund Deed imposes a maximum (rare)
- Commutations are allowed at any time
- May be reverted on the death of recipient only to a dependent

2. Non-account based products

- Non-account based products are those purchased from an annuity provider by a lump sum of the member
- The annuity provider does not maintain an account balance specifically attributable to the member, but pays from funds that are pooled
- They provide an income stream that is payable for:
  - The life of member of reversionary beneficiary
  - A specified fixed term
- These payments must still meet the 'minimum' standards, as essentially the (lump sum) purchase price is converted to annuity payments
- A Residual Capital Value (RCV) may be available to the estate (uncommon)

- Fixed term (nil RCV) income streams
  - Commutable income stream payable for a fixed term and priced based on the recipient's age at commencement
- Lifetime (nil RCV) income streams (two types)
  - Existing 'complying' lifetime income streams (non-commutable), which relate to old (pre-2007) arrangements and are effectively being phased out
  - A commutable lifetime income stream, which are the only lifetime ones that can be purchased now

Pricing of pensions and annuities

- These are priced as an ordinary annuity, which is characterised by the following features:
  i. The periodic payments occur at the end of regular intervals (e.g. at the end of each month or year)
  ii. The effective rate of interest, i, per payment interval remains fixed over the annuity term, i.e. locked at time of purchase
  iii. The term is a fixed number, n, of regular intervals

*Recall PV of an ordinary annuity: $A_n = R[1-(1+r)^{-n}]/r$
  - In these circumstances, the unknown variable is R

Annuity example

- A retiree looking to spend $300,000 on a 15-year annuity available at a yield of 5.5% p.a. would be required to pay (PV of $1 p.a.):

  $a_{15,0.055} = (1-1.055^{-15})/0.055 = 10.0375809$
- *Interpretation*: must pay $10.0375809 for each annual dollar of this annuity (would change if period changed)
- Therefore, $300,000 would provide an annual amount of $29,887.68 paid at the end of each year, i.e.

  300,000 / 10.0375809 = **$29,887.68**
- Annual annuities are not common in practice

Term certain annuities and pensions

- More practical than an annual payment is an annuity payable at regular intervals, i.e. "*p*thly" (*p* times a year)
  - Predicated on a fixed rate of interest
  - Payable for a fixed term
  - Can be indexed in various ways,
  - There are restrictions on this if they are 'complying' annuities (as noted, no new complying annuities can be bought, but there are still some people with existing pre-2007 **complying** annuities)
- Can have a residual capital value (RCV) at the end of term
  - Again, limitations apply if they are 'complying'

Cost of term certain annuities

- Assume a 20-year annuity payable monthly (p = 12) at a yield of 6.19%, costing $100,000 as both (i) unindexed, or (ii) indexed at 3.0% p.a.

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- In the first year, $A(1/12) is payable at the end of each month (i) for 20 years or (ii) for the first year
- (ii) in the first month of the 2nd year, this amount is indexed to $A(1.03/12), which is then payable at the end of each month throughout the 2nd year

Term certain annuities

- In the first month of the 3rd year, this amount is indexed again to $(1.032/12), which is then payable at the end of each month throughout the 3rd year …
- … in the first month of the 20th year, the amount payable is $(1.0319/12) for the final 12 months
- Cash flows: for each annual dollar of annuity over 20 years, the up-front cost is **$14.70708**
  - (the unindexed annuity costs $11.61206 - next slide)
- These figures derive from the formulae explained on the next few slides
  - e.g. the formula on underlying this calculation is a growth annuity formula

Unindexed term certain annuity (non-growing annuity)

- Unindexed:

$$a_{n:i}^{(p)} = \frac{1-(1+i)^{-n}}{i} \times \frac{i}{i^{(p)}}$$

where $i^{(p)} = p\{(1+i)^{1/p}-1\}$

- Here: $i^{(p)} = 12\{(1.0619)^{1/12}-1\} = 0.0602103$ and $a_{n:i}^{(p)} = 11.61206$
- So, monthly unindexed income stream =

  (100,000 / 11.61206) / 12 = **$717.64**
- And annual unindexed income stream = $717.64 x 12 = **$8,612**

Indexed term certain annuity (allows the annuity to grow)

- Indexed (rate of indexation *g*% at the start of each year after the first):
- Here: $i^{(p)} = 0.0602103$ and $a^{(p)}_{n:i:g} = 14.71708$
- So, monthly indexed income stream in first year

  = 100,000/14.71708 = $6,794.83/12 = $566.24
- Monthly amount in 20th year = $566.24 x ($1.03^{19}$) = $992.89

Life annuities

- Life annuities are those that will be paid for as long as the purchaser / annuitant is alive (and stop as soon as the annuitant dies)
- Compared to term certain annuities, they are relatively expensive
- Their pricing is based on actuarially determined life expectancies (e.g. the *Australian Government Actuary's* 2010-2012 mortality table)
- For illustration purposes, indicative per dollar costs are given below for Australian males and females (the annuity is indexed at 3% p.a., payable monthly, 4% interest rate)
  - 60 year old: Female $26.366, Male $23.635
  - 65 year old: Female $22.938, Male $20.276

What a PoA cannot do

- Make a will for the donor
- Undertake illegal acts
- Delegate power to another (unless expressly specified by the PoA)
- Exercise the donor's power as trustee
- Make decisions about the donor's 'lifestyle', for instance in the matter of medical treatment (unless there is an express provision in the PoA as exists to a limited extent in Victoria or ACT)

Estate planning vehicles

- Key tools / documents for effective estate planning include wills, life insurance policies, trusts, SMSFs, joint tenancies, reversionary annuities and BFAs
- It is important that FPs are aware of the nature and applicability of these items
- As discussed, wills can be challenged
- On the other hand, disposals of superannuation assets cannot be challenged, so are highly flexible and tax-effective, especially when dependents are involved

- To re-cap, two of the more important objectives of effective estate planning lie in:
  (1) Establishing a tax-effective structure by which estate assets and income are able to be distributed to intended beneficiaries, and
  (2) Providing the will-maker with control over how their estate assets will be distributed and managed after their death
- To achieve these objectives, *trusts* are often established through a will (or before)

Types of trusts

- A fixed trust (or unit trust) gives beneficiaries a fixed entitlement to distributions and capital in proportion to number of units held
  - Akin to shares in a company
- A discretionary trust gives beneficiaries an entitlement to be considered for distributions from the trust but not the right to receive distributions
  - Provides the benefit of flexibility; trustee has a range of choices in distributing income and capital from the trust to the beneficiaries
  - A common use of a discretionary trust is as a family trust, wherein family assets are held by the trust and the income these assets generate is distributed (at trustee's discretion) to beneficiaries, e.g. children

Estate planning and trust

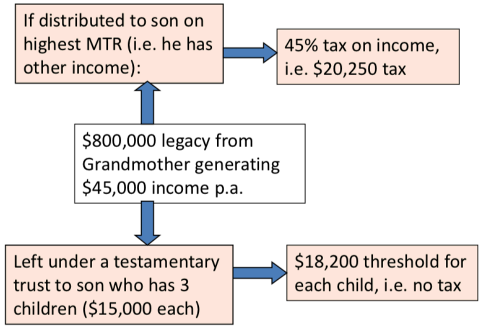
- There are two main types of trusts in the context of estate planning:
  1. A living, or *inter vivid*, trust (established during a person's lifetime
  2. A testamentary trust (established after the death of the testator, by the will) which only comes into effect upon the testator's death

  (Each can be either fixed or discretionary)
- **Testamentary trusts** can be set up as beneficiary trusts, superannuation proceeds trusts, restricted trusts and discretionary life interests

Testamentary trusts

- Testamentary trusts (TT) can be used to provide:
  - For minors and/or family member with disabilities
  - Asset protection for intended beneficiaries
  - Maintenance of social security benefits
  - Taxation benefits, particularly generation of 'excepted income' (minor beneficiaries)
    - These beneficiaries pay tax on income received from a trust at adult MTRs
    - Income splitting between the surviving spouse and children is possible

Example 1



Example 2

Jack Smith – two adult children, Claire (no TT) & Andrew (TT); leaves $200,000 to each of them

Claire:
- married with 2 children, earns $90,000 pa
- receives $200,000 cash
- invested at 6% pa
- earns the interest income ($12,000) in her own name
- pays tax at her MRT (37%)

After tax income from legacy:

Income	$12,000
Tax paid	4,440
Net income	$7,560

Andrew:
- married with 2 children, earns $80,000 pa
- receives $200,000 in a discretionary testamentary trust
- Andrew and his 2 children are beneficiaries of the trust
- invested at 6%
- income is distributed to his children Jess and Tom who pay tax at adult rates

After tax income from legacy

Jess	
Income	$6,000
Tax paid	0
Net income	$6,000
Tom	
Income	$6,000
Tax paid	0
Net income	$6,000
Total net income	$12,000

Avoiding the pitfalls of TTs

- It is important to understand that TTs are not always the best solution for every client
  - The manner in which they are drafted can significantly impact upon how they operate
  - Poorly drafted trusts in inappropriate circumstances can at best be a nuisance and at worst can lead to outcomes that greatly devalue an inheritance
- A discretionary trust can long outlive the client (maximum life span of 80 years)
- Control of the trust and its assets must therefore be carefully considered when drawing it up

Capital Gains Tax

- Dying does not constitute disposal of an asset, i.e. it is not a CGT 'event', but it does constitute an acquisition by the beneficiary or the executor https://www.ato.gov.au/General/Capital-gains-tax/Selling-an-asset-and-other-CGT-events/Types-of-CGT-events/
  - Cost base implications (typically MV)
- CGT will apply if the executor disposes of an asset in the course of administering the estate
  - It is probably better to distribute assets to beneficiaries if possible, rather than selling assets and distributing proceeds
  - The original acquisition date (i.e. by the deceased) will determine cost base in the hands of beneficiaries

- Pre 20 Sep 1985 assets:
  - Assessed at market value
- Post 19 Sep 1985 assets:
  - Assessed at indexed cost base at date of death of deceased or cost base of deceased post 1 October 1999 (50% discount applies)
- Post 19 Sep 1999 assets:
  - Cost base of deceased (50% discount applies)

- CGT does not apply to the principal residence of the deceased if it:
  - Is sold within 2 years of the date of death
  - Becomes or remains the principal residence of spouse (under control of executor)
  - Is left to another beneficiary and it is their principal residence