Whitepaper

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And the walls came tumbling down: Why the industry must build a new foundation

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FORTNUM™ FINANCIAL GROUP

INNOVA

Chapter 1

Quality financial advice: Is it a myth?

By Jim Stackpool

Trusted financial advice is a myth for too many Australians. It's practically impossible to recognise a trusted financial adviser which is particularly frustrating given that compulsory superannuation was introduced over two decades ago and the industry has failed to build credible trustworthy firms filled with talented and ethical professional advisers over that time.

What have we been doing?

It's hard to believe that during the Global Financial Crisis, when fear and financial uncertainty abounded, financial planning firms were scrambling for work.

It's no wonder Australia's former assistant treasurer Josh Fredenberg described existing advice models as "nowhere near good enough". In the Australian Financial Review on February 19, 2015, Fredenberg confidently predicted that the Coalition would introduce the necessary reforms to lift the professional, ethical and educational standards of financial advisers. However, the latest round of proposed changes by the Financial System Inquiry (FSI), Trowbridge Report and the Parliamentary Joint Committee (Fawcett Inquiry) won't put the industry on the right path.

They may ensure that future advisers are tertiary qualified and abide by a code of professional standards overseen by a new professional membership body but they won't propel the industry forward or lead to better client outcomes.

The current approach bears a striking resemblance to the many failed past attempts. Despite numerous inquiries and reforms in the last two decades, there has been no fundamental change or improvement. The majority of advisers are still distributors of financial 'advice'.

Even the Financial Services Council, of which the major banks and life insurers are key members, displayed a

complete lack of confidence in the quality of advice when it conceded that the industry was incapable of self-regulation and called on the government to intervene. But no parliamentary inquiry has addressed the fundamental reasons why Australians don't trust the financial advice from Australia's financial institutions and advisers. The two underlying reasons are detailed below.

1. Incentives

Incentives are the single biggest problem and main cause of mistrust yet they're inherent in the advice industry because the majority of advice is delivered by financial institutions which profit from the sale of financial product.

Many, many financial services participants have gotten rich and fat off incentives, which trace back to the beginning of the life insurance industry, while consumers aren't much better off. Sales-based incentives, including commissions, volume rebates and buyer of last resort (BOLR) arrangements, are rife in financial services yet they're incongruous in any profession. If financial advice is to become a recognised profession which acts in the client's best interests it must do away with sales incentives.

Financial products are a core part of the financial planning value proposition. Institutions don't make money from the provision of quality advice. They make their money on the provision of financial products.

BOLR is the finest example of an ingrained, habitual sales culture. A BOLR contract between an institution and a financial adviser stipulates that when the adviser decides to retire or sell their business, they'll have a guaranteed buyer. The 'aligned' institution will buy their business at a price based on how much related-party product the adviser has sold.

The more 'aligned' product sold, the higher the business valuation. Ironically BOLR is the foundation of many advisers' retirement plan. BOLR is just one example. In life insurance advice, incentive-based commissions account for 82 per cent of transactions.

It's concerning that life insurers continue to lobby against changes to adviser remuneration by claiming such reforms would exacerbate Australia's underinsurance problem.

Notwithstanding that almost 100 years of a commission-laden approach to insurance sales hasn't improved the underinsurance problem, a recent review of life insurance files by the Australian Securities and Investments Commission found many consumers of life insurance from a financial adviser would've been better off without it. ASIC's study concluded that more than one third of advice was inappropriate and failed to comply with the law.

In addition to commissions, BOLR and volume rebates, other widespread incentives include discounted bank fees and interest rates, lower insurance premiums, discounted licensing and dealer services, and free tickets to major sporting events. Yes, many of these are illegal.

John Brogden
Past CEO
Financial Services Council
AFR 29.09.14

"There is an urgent need to build back public trust in advisers. The level of trust is at an all-time low. We need a circuit breaker. Self-regulation is not enough"

Terry Powell
Managing Director
PF Private Advice – Victoria

"Wealth creation is a journey not a race. Having the right attitude and behaviours will have the greatest positive impact on building wealth. Sadly the majority of people don't budget or save. They are then susceptible to the promises of wealth creation via an expensive investment product provided by a large part of our industry. Is it any wonder people don't trust financial advisers."

Gary Lucas
Managing Director
DMG – Sale, Victoria

"Financial planning industry has too many similarities with our existing political parties. The inward focus, resistance to change, promotion of self-interests, the public criticism of other players, the defensiveness of past and sometimes conflicted relationships are overly prevalent. Governments should be more focused on governing, and the financial planning industry needs to be more focused on leadership for the future of professional advice helping Australians best achieve their aspirations"

Incentives are a structural problem with roots that run deep into the foundations of the industry. The majority of practices are built on this foundation. Existing policy and legislation is also built on this foundation which only reinforces the perception that financial advice is another product to be sold. New advice professionals must actively avoid real or perceived conflicts. Remuneration can't be linked to the quantity of product sold.

2. Industrialisation of advice

Australians were disgusted that it took two and half years for Australia's largest bank to uncover, understand and acknowledge the extent of the fraud and deception which occurred within its own branches. The Commonwealth Financial Planning scandal exposed the bank's aggressive sales culture and the reality of a product flogging approach to 'advice'.

Financial institutions worldwide profit from the industrialisation of advice but their sales culture and tactics are facing increasing scrutiny. This scrutiny threatens to negatively affect their profits.

British think tank, New City Agenda, recently estimated it will take generations for the big banks to fix their dysfunctional cultures where success is the result of selling products too complicated for consumers to understand.

Against this backdrop, the majority of advisers aligned to an institution don't actually sell advice. They sell product although they've done a superb job of passing product off as advice and persuading consumers that their 'advice' is trustworthy and will deliver confidence, peace of mind and security.

Of course the catch is that they can only have all of that if they purchase a suitable product. How else will the institutions be able to make money off them?

Professional strategic advice that stands on its own unaccompanied by financial product represents the worst possible scenario for the financial giants. Similarly this would be the worst outcome for many advisory firms.

Consequently, Australian consumers can't differentiate between financial advice and financial product.

Real professional advice is more akin to an invisible hand guiding the client to meet their unrealised financial objectives and directing them through challenging financial obstacles or complexities they can't overcome alone. This is the foundational value proposition of professional advisory firms.

The delivery of financial certainty isn't based on the delivery of product but rather the delivery of professional advice. In pockets of the industry, there are signs that advice and product is separating.

A growing number of financial advisers already charge only for professional advice and reimburse the client any payment they receive from product manufacturers. They charge clients a fee in terms they clearly understand: dollars, not product-calculated percentages.

Next steps

Let's start with truth in labelling. Those who take their payment from product or tie the value of their business valuation to a product manufacturer's BOLR contract should be called product providers. They are not financial advisers.

Advisers are those who price based on the value they deliver. They have no product bias so there's no question about the integrity of their valuable advice.

Another objective should be to improve the accessibility and affordability of advice for more Australians. It's clear that Australians are vastly under-insured and under-advised.

Even more concerning is that there'll be far fewer working-age Australians in the near future. According to the 2015 Intergenerational Report, there will be just 2.7 working age Australians for every one aged 65 or over in 2055.

The government's penchant for tinkering with super and retirement policy, coupled with swelling welfare costs, will only create further uncertainty for Australians.

Thankfully there are a small but growing number of advisory firms who act in their clients' best interests and provide non-conflicted advice. Their commitment to professionalism and independence at a time when clients require it the most will drive their ongoing success.

These firms represent the new era of advice.

The current product-based advice epidemic has deep roots in the foundations of the industry therefore any reforms and renovations which attempt to build a new advice profession on that foundation will inevitably crumble and crack.

The new advice profession must destroy that foundation and establish new paradigms. There will be another market downturn, another institutional scandal, more unexpected world events and consumers will demand a better financial solution to their age old problems.

Australians deserve much better.

Chapter 2

Breaking down the advice process

By Dan Miles

The creation of a new client-centric financial advice proposition is firmly underway. A handful of professional advisory firms, non-institutionally owned licensees and consultants like Certainty Advice Group, are laying the cornerstone for a new advice profession.

What is advice?

There's no universal definition of financial advice or general public understanding of what a financial adviser does.

The answer depends greatly on the individual adviser.

That's part of the reason why more Australians don't seek professional advice. There are too many unknowns.

They don't know what to expect and they don't understand the benefits. The industry hasn't done a good job of removing the mystery around financial planning.

A metaphor often used by Innova Asset Management to illustrate how the advice process should work is like a client who asks his adviser: "Should I only eat apples or chocolate for the rest of my life?"

The client isn't asking for redder apples or sweeter chocolate. They want to know what's in their best interest. Similarly, consumers don't want more financial product. They want help understanding their situation and options, and help making the right choice.

They often have more options than they think but they need an adviser to lay them all out and explain the advantages and disadvantages of each.

A diet of only apples or only chocolate carries many risks. A better alternative, and what the client actually needs if he or she wants to maximise the chance of living a long and healthy life, is a nutritious balanced diet.

Bearing in mind that there's often a disconnect between a client's stated needs and actual needs, it's an adviser's role to firstly understand the client's situation and what they want to achieve. They must decipher what's really important and what isn't.

A big part of the advice process is asset and liability matching – or what Innova terms "future liability immunisation". It's essentially about understanding what a client's future liabilities will be and identifying the risks they're exposed to. The process should determine if a client can tolerate those risks and if not, how to minimise and manage them. Only then can the adviser start to put together a financial strategy for the client.

The advice process is not about getting the client to invest in a financial product.

Historically, that was the case.

Over time, regulation and compliance became the key focus. Ironically, as the industry 'advanced' it became less concerned about ensuring the client achieved the right outcome.

But the new advice process must purely be about getting the client to understand what they actually need, not what they think they need. It must uncover a client's true goals and objectives, show them what's realistically achievable given their situation, what they need to do to achieve their goals, how to manage risk, and keep them on track over the long-term to maximise the chances of success.

The apples versus chocolate scenario seems ridiculous but it perfectly illustrates how the advice process has traditionally been built around product to the detriment of the client.

Financial product is merely a means to an end. Advice and product should be separate. The new generation of professionals are reinventing the advice process so it isn't linked to product.

They know that the performance of equity markets and financial products is beyond their control and they won't link their value proposition to factors they can't control or influence.

New tools to optimise advice: A game changer

There are hundreds of different ways to slice and dice a person's financial pie.

By tweaking a person's financial behaviour, priorities and strategy, over different lengths of time, different outcomes can be achieved.

But the financial advice process hasn't traditionally used sophisticated modelling tools to visually show clients the impact of different actions under multiple scenarios in a completely product-agnostic way.

Advisers have had to rely on words, numbers and probabilities to explain concepts and consequences to clients.

For example, taking out a $1 million mortgage versus a $500,000 mortgage, lowers the probability of you being able to travel widely and send your kids to private school by 20 per cent.

For the average person, that kind of statement has little meaning and therefore impact.

But it's only a matter of time before advanced visual tools are readily available. Some advisory groups, including Innova, are currently developing such tools.

They will allow advisers to have more meaningful, engaging and emotive client conversations.

They will illustrate the power and effectiveness of prioritising.

Most people want to travel, eat out regularly, pay down the mortgage quickly and give their kids a top education but they may not be able to do it all now. They need to prioritise.

With the right tools, an adviser can show clients the impact of prioritising one goal over another.

For example, if sending the kids to a private school is a client's top priority then they may have to accept paying off the mortgage over 20 years instead of 15 and only travel overseas once every five years. It's then up to the client to make an informed decision.

It's not an adviser's job to tell the client what to do, even if it is in their best interests. It's an adviser's job to provide insight and direction; continuously monitor a client's situation to ensure their financial strategy remains appropriate; and keep them on track to maximise the chances of them achieving their objectives.

At review time, the conversation shouldn't be about whether or not the client's portfolio beat the market. That's largely irrelevant information because the advice process is about helping clients to achieve their goals with the lowest amount of risk possible.

Advisers aren't fortune tellers. They can't predict the direction of investment markets. They can illuminate what can go wrong under different scenarios. Technology will play a much greater role in the advice process of the future and help advisers do their job more effectively.

Chapter 3

Not for sale: How to earn trust

By Ray Miles

Consumer confidence in the financial planning industry is at a record low. At a time when the baby boomers are retiring and in desperate need of professional advice, only 15 per cent of Australians use a financial planner, according to the BlackRock Global Investor Pulse Survey.

Instead, 54 per cent rely on their own thoughts and ideas when making financial decisions and planning for the future.

Unfortunately, financial planning has become inextricably linked to product selling and conflicted remuneration. Australian investors don't trust financial advisers to act in their best interests, even if it is the law.

The advice industry must be more transparent and proactively stamp out conflicts if it hopes to improve its image and earn consumers' trust. It should embrace, indeed spearhead, sensible reforms rather than insist on self-regulation which it has repeatedly failed to do.

How do we earn their trust?

There are two key ways the industry can earn the trust of investors.

1. Separate product and advice
2. Solve the client's problems

Separate product and advice

The Future of Financial Advice (FoFA) legislation banned conflicted remuneration, introduced tougher fee disclosure requirements and forced advisers to act in their clients' best interests but it did not separate financial product and advice.

If the industry is to earn the trust of investors, it must separate financial product and advice.

Advice should not be moulded around a product sale, be that a super fund, model portfolio, wrap platform or insurance policy.

The only motivation for advice should be to help investors uncover their true needs and objectives; understand the different financial strategies they can implement to achieve their objectives; understand the different risks involved; and empower them to make the right decision for them.

Although implementing advice will most likely require product, it should never be predicated on product sales.

Five ways to expedite the divorce process

A. Greater transparency from licensees

Dealer groups and Australian Financial Services Licensees (AFSLs) should be forced to publicly disclose their revenue and profit, and the average cost of providing licensing services. In addition to client fees, they should be clear and upfront about non-client revenue sources like rebates, subsidises and allowances.

B. Advisers must publicly declare all revenue sources, payments and institutional ties

Financial planners should be made to disclose any non-advice related payments from a product provider.

While they must provide clients with details of any commissions and payments they receive by a product issuer in relation to advice in a statement of advice (SoA) or record of advice (RoA), they don't have to (and don't) disclose if they received a payment to join an institutionally-owned licensee, or if their practice is part or fully-owned by a product provider.

If an institution has acquired an interest in a practice, as is increasingly common, advisers are not required to disclose the sale price or details of the arrangement, for example, if a higher price can be achieved by hitting specific sales targets within a set time period.

Arguably clients have a right to know given these payments and deals have the potential to influence advice. In cases where advisers also own equity in their licensee, they should also disclose any dividends.

C. Outlaw subsidies to licensees

In theory, FoFA's ban on commissions makes it illegal for product manufacturers to cover or subsidise the cost of superannuation and investment advice.

Yet product manufacturers are able to prop up and subsidise their own third party licensees without disclosure.

Often the client has no idea they are being sold advice and product from an adviser linked to an unprofitable licensee, which is being supported by an institution.

It should be illegal for product manufacturers to bank roll licensees unless they are salaried sales agents operating under an institutional brand.

D. Make it illegal for product manufacturers to coerce advisers to sell related product

It should be illegal for product providers to pressure advisers to sell their products.

In other industries, coercion is regarded as criminal behaviour, however, it's largely ignored in financial services especially within the salaried networks.

Given Australia's compulsory super system which forces people to save and invest for the long-term, coercion is especially dangerous.

There must be clear and enforceable boundaries between advisers and product manufacturers to protect consumers and advisers.

E. Lift the entry requirements to be a financial adviser and an AFSL

It should be much harder than it is to gain an AFSL. The AFSL is the primary protection mechanism for consumers. The AFSL is liable for poor advice and rogue planners.

Yet many of the product failures that have occurred in the past decade, have been distributed through small independently-owned AFSLs run by people with limited compliance experience and little understanding of how investment products work and should be selected.

Applying for, and gaining, an AFSL can cost as little as $6,000. There must be tighter restrictions on who can be granted an AFSL and the must be closer monitoring of AFSLs.

The minimum education requirements for AFSL holders should also be lifted significantly.

Solve the client's problem and we'll solve the adviser's problem

Trust will happen (or begin to return if you believe we ever had it), when clients believe that financial planners are working in their best interests and the industry is structured to protect them.

Consumers must also have confidence in the regulator's ability to prevent product failure, identify rogue planners and design sensible, effective policy and legislation.

If financial advisers are able to add value by delivering bespoke strategic advice and a high level of ongoing service, which removes financial complexity in their lives and maximises the chance of them achieving their goals and objectives, trust will return to the industry.

The solution will also require the industry educating and providing the media and other stakeholders with evidence of the good work advisers do and the value of advice.

About the Authors

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Previously Ray established dealer group Associated Planners in 1989, which was sold to Challenger Financial Services in 2004 and later renamed Genesys Wealth Advisers.

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Innova is a boutique asset consultant that advises on and implements asset selection and allocation, trade and execution, and manager selection for the Innova Managed Accounts.

Jim Stackpool

Jim Stackpool is an author, professional speaker and business coach.
He founded Strategic Consulting and Training in 1993 to help improve the profitability, productivity and value of Australian financial advisory firms.
He is also the founder and managing director of Certainty Advice Group.