Submission
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Inquiry into Financial Products and Services in Australia
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What precisely is wrong with commissions?

The public debate over the last few months has focused on "conflict of interest" caused by commissions. However, I have not seen any explanation for why commissions are so wrong that they should be banned. This submission seeks to explain why commissions are so inappropriate for someone calling themselves an advisor.
In summary, commissions reward the wrong behaviour for consumers seeking advice & punish good behaviour.

Note: This submission relates to investment advice including superannuation. There is a separate debate about how the issues identified in this submission relate to pure risks products (insurance). I note that the recent UK FSA's proposals also focus on investment advice.

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Attachment:

- "Financial planning commissions must be banned" 1 July 2008 Press Release by John Hewison, ex-chairman of the Financial Planning Association. http://www.hewison.com.au/publications/other-publications/20080701_Media%20Release_%20Ban%20financial%20planning%20commissions%20Hewisons.pdf

<u>Why should commissions for investment advice be banned for advisors?</u>

The public debate over the last few months has focused on focused on "conflict of interest" created by commissions. However, I have not seen any explanation for why commissions are so wrong that they should be banned.

Some conflicts of interest may be managed adequately. This submission seeks to explain why the conflict of interest caused by commissions is so great that it is inappropriate for someone calling themselves an advisor.

Key points:

- If a consumer is dealing with someone calling themselves "advisor", it is reasonable for the consumer to expect that the "advisor" is putting client's interest ahead of their own and ahead of the interests of the financial planning AFSL which the advisor represents.
  - I believe this is one of the points Sir Anthony Mason was seeking to make at the SPAA conference in March 2009 when he said "***"Indeed, our system enables the product seller to adopt the disguise of a financial adviser and endows that disguise with the aura of legitimacy by calling him a 'licensed' financial adviser."***

- For a consumer seeking advice, commissions **reward the wrong behaviour** and **punishes the right behaviour.** This relates to the behaviour of both the adviser and the financial planning AFSL.
  - Advisers on commissions sometimes get paid excessive amounts for very little work where there was a "simple sale" which requires little effort. Therefore, the **reward** of commissions shapes behaviour towards putting in the minimum amount of effort preparing advice, so as to achieve a product sale, so as to maximise commissions.
  - On the other hand, where a consumer needs a lot of advice and where the advisor needs to put in a lot of time, the adviser ends up poorly paid for a good job (i.e. **Punishment** for doing a good job.). Therefore, commission-based compensation does not support the provision of the best advice for the consumer.

- Commissions also encourage and support the advisor to provide "advice" on spec. This is also known as prospecting.
  - Providing financial planning advice on spec is like asking an accountant to prepare your tax return on the off-chance that you might pay him. What sort of behaviour do you think that would encourage? How motivated will the accountant feel to do a good and complete (as appropriate) job, if he does not know whether he will get paid for his efforts.
  - Providing financial planning advice on spec is like asking a lawyer to give you advice on the off-chance you might pay him. What sort of behaviour do you think that would encourage?
  - **In summary, doing work on spec is consistent with a product sales process, not an advice process**.
  - Yes, it has been very common practice that financial planners charge a token few hundred dollars to "prepare a financial plan" (the product sales proposal), seeking to "lock the consumer in" on the product sale of the products to be recommended in the product sales proposal (statement of advice), where many thousands of dollars of commissions will be earned by the financial planning AFSL if the sale goes ahead. This tactic of charging only a "lock-in" token amount to prepare a financial plan is purely a product sales strategy – but most consumers fail to realise how the game works. Rather, consumers more often feel that they have paid "all this money" for the financial plan (a few hundred dollars) and that they would be wasting that money if

they do not proceed, not properly appreciating that "advice" was really going to cost them many thousands of dollars when they proceed with the product sales proposal. I have seen very intelligent people fall for this sales tactic.

- **Commissions create and support the illusion that "the advice" is free**, while studies show that consumers typically end up paying more if they pay via commissions.

- **Commissions steer advisors (and financial planning AFSLs) towards recommending expensive products.** For example:-
  - products with high up-front commissions or
  - products with high management expense ratios that can support
    - high trailing commissions or
    - high volume over-rides (and other payments by product manufacturers to financial planning AFSLs).

  Ultimately, this is not good for the consumer because it means that the consumer pays more than they should have to.

- **Commission-based compensation discourages advisors from recommending investments with low fees and investments which pay no commission.**

- **Commissions are a payment mechanism that consumers generally cannot stop.** If the consumer believes they are getting poor service or no service in exchange for the commissions taken out of the client's account, the consumer should be able to require that those payments cease – and these amounts be rebated to the consumer. For example a relative of one of my staff bought a whole-of-life policy 20 years ago, and is still paying trailing commission – even though he has never met the salesman whose name is currently on his policy – and where he has not received any service for any representative for about 19 years. These commissions are coming out of the consumer's account.

- **Commissions and Centrelink advice.**
  - There are many strategies that financial planners employ to optimize Centrelink payments for clients.
  - **Assertion:** Most Centrelink-related advice may only produce a gross benefit to the consumer (before fees) of the order of hundreds of dollars.
  - But the financial planner needs to be paid – and under our current regulatory system, it is very difficult to give advice that does not cost at least hundreds of dollar.
  - My guess is that where a financial planner advises a Centrelink client AND that planner is paid on commission, that the payment to the planner (which comes indirectly out of the client's pocket) often exceeds the value that the client receives from the advice. That is, I fear that there is significant over-servicing of Centrelink beneficiaries, where the effective cost of the advice exceeds the benefit the consumer might get from the advice.
  - **Proposed solution:** If Centrelink clients could see how much it was going to cost in advance (eg fee for service) – and could weigh that up against the likely benefit, I suspect that many of these Centrelink clients would not see the value for money, and would desist with getting the advice prepared – and the consumer would be better off. Self-checking mechanisms are one of the most important dimensions on protecting consumers. Ensuring that Centrelink clients can see the value in any financial planning advice, before the advice is provided is a very powerful self-checking mechanism.

- **Related issues – spin-off effects of the commission-based payment system that produces advice that may not put the client's best interests first.**
  - The commissions system above, encourages some financial planning AFSL to focus their businesses on selling expensive (high MER) product which can support the payment either a large trailing commission or large volume over-ride (see supplementary submission 3V2).
    - Alternately, a reliable flow of trailing commissions and volume over-rides can be sold by a financial planning AFSL when the principal seeks to retire or exit the industry. In Appendix B you will find Money Management article "Question mark over future pricing of planning practices" which discusses some aspects of this issue.
    - Alternately the financial planning AFSL can then sell their business to an AFSL such as Count Financial at a Price/Earnings ratio of maybe 3-5. It should be possible to extract a high price selling the financial planning AFSL business to a business like Count Financial than selling to another small financial planning business – because businesses like Count Financial can potentially extract far greater value from the purchase. The additional value can be extracted in the following ways:-
      - Firstly, since Count Financial is listed on the Australian Stock Exchange and currently has a price/earnings ratio of 20, this is an inexpensive way for Count Financial to drive up earnings and hence drive up the share price of Count Financial.
      - Secondly, because of larger scale, Count Financial may be able to extract higher volume over-rides from the fund manager. Alternately, if the AFSL business purchased solely used the BTWrap platform for all of their recommendations, then by readily swapping the clients into Count's white-labelled BTWrap platform, Count should be able to increase the share of the platform MER that goes to the financial planning business rather than to BTWrap. So there are 2 clear ways that Count can extract more value from the purchase. Despite this, many small AFSLs would much prefer accepting a lower price for the sale of their business, because of the comfort that the sale is to a financial planning AFSL is a better cultural fit to look after the clients.
  - The commissions system above, encourage some financial planning AFSLs to focus their businesses on selling expensive managed funds rather than inexpensive direct listed securities (or inexpensive unlisted index funds). By doing this, these financial planning AFSLs may be able to sell their businesses at a high price to companies like ING and IPAC, both of which have been acquiring financial planning businesses over the last decade. The view is that over time, the client bases of the purchased businesses would be able to be switched to the in-house brands, so as to increase profit for the purchaser. It should be noted that, from my understanding, financial planning businesses which recommend a major percentage of (inexpensive) direct listed securities, are not attractive to these sort of buyers of financial planning AFSLs, because these client-bases are typically not readily convertible to the in-house managed funds.

  Bottom line: The commission-based system encourages sale of more expensive (higher MER) product, not just because there are higher ongoing trailing commission and volume over-rides, but also because it later makes it easy to profit by selling the practice at a higher price.

In summary, **commissions** are of a style and character that support a product sales business. Commissions punish "good" behaviour and reward bad behaviour for advisors who seek to provide excellence in advice and to put the consumer first. Commissions can also reward financial planners to pursue WIN-LOSE relationships with consumers, where the financial planner WINS and the consumer LOSES – where the financial planning AFSL pursues his short-term gain ahead of the consumer's best interests.

By contrast, a **fee-for-service** approach is needed to best support the behaviour (and standards) that the community should expect of someone holding themselves out as an advisor. However, we need to ensure that fee-for-service is not simply commissions packaged up under another name.

What are the characteristics of fee-for-service that are required to meet consumer expectations?

To meet community expectations, a fee-for-service business model needs to meet the follow tests. The fee-for-service financial planning advisory business model:-

- Must support profitable recommendations of investments that pay no commissions equally with those that pay a commission or a fee.
- Must empower the consumer by allowing the consumer to direct any product manufacturer to cease paying any fees to the financial planning AFSL – and to have those fees rebated into the consumers own account. This must also include platforms such as Wraps and Mastertrusts. This ensures that the consumer can for example turn off payments in the case of no service and in the case of unsatisfactory service. This provides a very important discipline for fee-for-service providers, to ensure that advisor continues to provide a quality ethical and professional service.
- Is best to support a WIN-WIN long-term accountable relationship between consumer and the financial planning AFSL.

Likewise, fee-for-service financial planning advisory business must, where the fee is paid from the product provider to the financial planning AFSL, not accept ANY payments that are not debited to the consumer's account. This is consistent with the policy being pursued by the UK FSA.

Another general principle – the fee should not be disproportionate to the likely benefit.

Appendix A. Product sales quotas reward bad behaviour and punish good behaviour.

For a consumer who is seeking advice, product sales quotas reward bad behaviour and punish good behaviour – just like commissions.

Advisers with products sales quotas are able to rapidly proceed towards meeting their sales targets with where there was a ”simple sale” which requires little effort. Therefore, the reward of meeting sales targets shapes behaviour towards putting in the minimum amount of effort preparing advice, so as to achieve a product sale, so as to achieve the product sales target.

On the other hand, where a consumer wants a lot of advice and where the advisor needs to put in a lot of time, this makes it a lot more difficult for the advisor to meet their sales target. Not meeting the product sales target often leads to retrenchment as the article below indicates i.e. While the consumer might benefit if the advisor is able to spent sufficient time with the consumer, the advisor risks being punished for doing so. Therefore, product sales targets are not consistent with the provision of the best advice for the consumer. In fact, as my supplementary submission 4 argued, the whole product distribution-model can make it very difficult for advisors in those distribution channels to provide the best advice.

http://www.moneymanagement.com.au/article/Suncorp-planners-torn-between-advice-and-sales/489758.aspx

Suncorp planners torn between advice and sales

9 July 2009 | by Corrina Jack

The pressure to hit sales targets is compromising the level of advice some bank planners say they are able to provide their clients.

Those who are experienced in the Suncorp Life (Suncorp) work environment say **the emphasis placed on selling products that were substantially Suncorp manufactured saw it become increasingly difficult to provide a financial planning service.**

Adding to the pressure was the planners' awareness of the consequences of not reaching targets.

A former senior employee who did not wish to be named said, “If you continually underperformed, there was a risk of being managed out”.

Planners who chose to do the right thing by customers and spend time giving advice would likely see a drop in their sales “and you might have been retrenched”, the former senior employee said.

The issue has been underscored by recent retrenchments at Suncorp, which saw the loss of 22 planners in a move Suncorp believed was in planners' favour.

“That should really mean that planners who are in roles today have a better opportunity than they did before we made the reductions ... it's actually a better environment for them to be successful in,” said Suncorp executive general manager David Carter.

Carter said where performance requirements such as sales, compliance and behaviour weren't met, “We can and will take action”.

Carter did, however, add that a “reasonably extensive process of counselling and coaching” would be undertaken before any action.

“With sales targets, we probably would spend longer working with someone to help them improve,” Carter said.

A former Suncorp planner who also declined to be named said **“the key objective of the company is to bring in new business, not to service those existing clients”.**

Carter said sales targets reflected what Suncorp expects the market and business to be and planners should speak out if they feel pressured.

Suncorp standards include providing advice appropriate to client needs and circumstances and we test for that, Carter said.

Changes to the Suncorp remuneration model have seen an increased focus on retention, he added.

Appendix B. Question mark over future pricing of planning practices.

http://www.moneymanagement.com.au/article/Question-mark-over-future-pricing-of-planning-practices/489764.aspx

Question mark over future pricing of planning practices

9 July 2009 | by Lucinda Beaman

Structural reform regarding commission payments in the financial planning industry is creating uncertainty around the future sale prices of planning practices.

Financial planning businesses have traditionally been valued on a multiple of annual recurring revenue, including trail commissions on investments, which clients have historically been unable to 'turn off'.

But under recommendations being made by the Financial Planning Association (FPA) and the Investment and Financial Services Association (IFSA), clients will be able to 'turn off' trail commissions on investments made after 2012 if they feel they are not receiving value from their adviser.

Chris Wrightson of Centurion Market Makers said there are various views on the impact the removal of guaranteed trail commissions will have on the potential purchase price of financial planning businesses.

One view is that "given the valuation reliance on annual recurrent revenue, eliminating trail commissions could reduce the value of practices and of client books", Wrightson said.

An alternative view is that books of business with ongoing trail commissions attached (ie, those that are 'grandfathered' under the FPA and IFSA recommendations) will in fact become "a valuable legacy".

"Over time the diminishing supply of these books could potentially increase their value," he said.

Wrightson said financial planning practices have historically attracted "quite high valuations compared to small businesses in other industries". These valuations have been supported by projected superannuation growth rates, the certainty of income provided by trail commissions, as well as the valuations set in 'buyer of last resort' facilities by institutions.

Wrightson said many financial planning practices are already separating advice and investment management fees. He believes doing so is one way for planners to have "greater ownership of the advice fee" and deliver certainty to the annual income of their practice.

He believes redefining a practice's advice offer can also lead to increased revenue

Appendix C. "Financial planning commissions must be banned" by John Hewison 1/7/08

The time for rhetoric is over and commissions in the financial services industry must be banned, according to John Hewison, CEO of a leading independent wealth management firm and former Chair of the Financial Planners Association.

Hewison's comments follow the Australian Securities and Investments Commission's action on advertising for candidates to their financial adviser stakeholder team. This ASIC team will seek to increase competition among planners and overhaul their disclosure of fees, risk, and relationships that could create conflicts of interest.

Hewison, who has been a vocal campaigner against the commission system since the early '90s, is astounded that the debate continues into the 21st Century.

"Financial disasters like Fincorp and Westpoint that cost investors millions of dollars would be much less likely to happen if there were no commission incentives for advisers to recommend them," says Hewison.

"The issue is deeper and more sinister than just sales and trail commissions. The public is paying substantial hidden costs from financial advisers who work on a commission base."

Hewison believes the quality and breadth of advice is being seriously compromised by a system of bribes, incentives, and conflicts of interest.

"The entire financial product industry is based on churning out obscure complicated 'flavour of the month' products just to give them a fresh sales pitch," he says.

"The key to professional financial planning advice is that it should be specifically designed for the individual client's particular needs. It's what they seek and what they expect. They don't want this advice tainted by product bias, conflicts of interest, or sales commissions."

While Hewison concedes there are many legitimate planners using the commission system, he claims the regime is indefensible because individual planners can't opt out of the systemic influence of incentives on behalf of their clients.

"Logic says that by definition, commission is a sales-oriented payment and must be seen as being biased, whether real or perceived."

Hewison says there are fundamental problems with the financial advice industry starting with a product-based regulatory regime flowing through a product-driven industry.

"There's no doubt that the product manufacturers see the financial advisory community as their sales force and provide financial incentives to gain favour and loyalty," Hewison claims.

"Apart from sales commissions, there's a raft of hidden incentives directly impacting the costs of client investments. These include 'shelf space' fees to have products included on an advisory firms recommended list, volume incentives to encourage bias towards a product or brand, promotional or sponsorship subsidies – the list goes on.

"All these costs are included in the manufacturers' pricing but are born by all investors who are directed into managed products."

Hewison's view is that all service providers should be responsible for carrying their own costs and price their services accordingly. He believes that consumers have the right to make value judgements based on a clear appraisal of the service offered and its relative cost.

Apart from the costs and lack of transparency, Hewison claims that advice given to consumers is also being compromised by the corruption of the research and investment selection process.

“Consumers have a right to expect that adviser-recommended investments have undergone a rigorous research process. If that process is corrupted by an overlay of listing criteria involving payment for shelf space or other matters, then the selection process is seriously flawed,” he says.

On the question of the cost and accessibility of financial advice, Hewison claims the argument to justify the commission system is spurious.

“The notion that the commission system gives access to financial advice to those who can’t afford to pay is just absurd,” he says.

“It implies that the cost of obtaining advice can be met by the product recommended so the consumer doesn’t need to write a cheque. It simply typifies the attitude that ‘what the consumer doesn’t see won’t hurt them’ but the consumer pays either way – sometimes more through long-ended trail commissions.”

Hewison argues that financial advice should be affordable and the regulator needs to ensure that advisers are not tied down with onerous compliance requirements that won’t allow them to provide such advice.

“If a mechanism is required to enable consumers to pay their adviser by instruction to an investment institution, so be it – but let’s make sure the consumer approves it and understands what they are approving,” he added.

Hewison is adamant on his firm’s stance for the sanctity of professional advisers and the separation between advice and product. “We strongly believe that financial advice and product advice must be separated in every sense of the word,” he says. “Advisers must not only act but be seen to be acting solely in the best interest of their clients and their particular needs.”

Hewison believes that the integrity of the financial advice profession needs to be addressed by both regulators and the profession.

“In a perfect world ASIC would ban commissions and the Financial Planning Association (FPA) would do likewise. But the reality is that the regulator won’t take on the ‘big end of town’ so the FPA needs to step up and take a firm stance as the rightful guardian of the profession and surrogate protector of the consumer,” he said.

“There’s no doubt that it would be a gutsy move for the FPA as there would be a huge backlash from the institutions that have a foot in both camps. But in my view the FPA would weather that storm, and come out of it with an even higher standing because the community would know it fought for their right to untainted financial advice.”

John Hewison CFP, FFPA, MFinPlan, JP is CEO of Hewison & Associates, a Melbourne-based private client wealth management firm operating since 1985. He is a former Chairman of the Financial Planners Association of Australia and a vocal advocate for reform in the financial planning advisory industry.