The Delivery of Quality Financial Advice in Both Good and Turbulent Markets

By Julia Feher

Financial advisers and Financial Advisory Networks (FANs) have generally been proactive in supporting clients during the market turmoil created by the global financial crisis. How has this market turmoil affected the delivery of quality financial advice? What can FANs and their advisers do (over and above the requirements of the law and industry codes and guidance) to ensure the provision of quality financial advice in both good and turbulent financial markets?

INTRODUCTION

The quality of financial advice being delivered to clients is a key issue within the financial advice industry at present and one which has certainly been exacerbated by the recent market turmoil. High profile corporate collapses have focused attention on the quality of financial advice, what constitutes quality advice and how it can be measured. This report will explore how the market turmoil has affected quality; current initiatives that have been employed to improve the quality for the future; and some proposals for how FANs and advisers can deliver quality advice, unaffected by the performance of the financial markets. The shortcomings of the industry are too broad to be addressed by FANs and advisers alone. Significant issues such as remuneration and training impact the entire industry and need to be addressed by the Government, the regulator and industry bodies. However, there are also steps that can be taken by FANs to ensure quality advice for clients.

The market turmoil that affected so many investors seems to be over for the worst part. The markets are beginning to show signs of ‘green shoots’ and we will hopefully see the market continue to slowly but surely improve. The spotlight that is currently focused on the financial advice industry has identified the problems that have hindered its development, and we are now at a point where we are able to introduce new initiatives that will create opportunities for meaningful change throughout the industry.

To begin this process of change, we should look back to the core function of financial advisers. This is to act as a strategist and to ‘offer a process of independent professional advice to their clients to assist in the setting and meeting of financial and..."
lifestyle goals.” In our aim to lift the standard of the industry, we need to remember this core function and ensure that the industry operates to reflect it. The industry needs to work to improve standards so investors can have confidence in the advice they receive. Through beginning the process of eliminating the conflicts within the industry, we will be on our way to taking the industry to a more professional level and ensuring quality advice is delivered to clients in the future.

THE EFFECT MARKET TURMOIL HAS HAD ON THE QUALITY OF FINANCIAL ADVICE

Over the past 18 months, the world has watched as the effects of the sub-prime crisis in the United States spread through financial markets across the globe. The global financial crisis (GFC) has seen not only sophisticated investors lose wealth, but it has also had a significant impact on retail investors through their superannuation accounts and investments recommended by financial advisers. It has not necessarily been the market turmoil that has affected the quality of advice, but the bull market that preceded it. In most cases, good financial advice has been valuable in enabling clients to “respond appropriately to the crisis, and avoid crystallising unnecessary losses as a result of making rash an uninformed decisions.” However, we have also witnessed examples that suggest the market boom prompted overconfidence that saw investors become less vigilant and encouraged them to take on more risk beyond the range of their normal risk profile. In these cases, the GFC and the market turmoil that it caused have only been the circumstances through which the quality of advisers’ recommendations was exposed.

As the market falls, investors may realise that they are not as risk tolerant as they thought they were when the market was increasing. Financial advisers should assess their clients’ risk tolerance, not only by their expectation of returns, but also by their ability to bear loss. Kahneman and Tversky’s Prospect Theory explores the concept of decision making under risk. The theory suggests that people are two and a half times more sensitive to losses than they are to gains of the same magnitude. As investors faced significant losses as a result of the GFC, they may have come to realise that perhaps they could not bear the risk that saw them earn large returns prior to the turmoil. The GFC emphasised the importance of advisers accurately assessing a client’s risk profile and that it is a critical factor in determining the quality of the advice they give.

In the collapse of Storm Financial we saw evidence that clients were given advice that was not suitable to their risk profile. Storm’s business model was flawed and risky because it relied on asset prices continually rising and debt markets remaining open and liquid. Storm’s advisers commonly recommended margin loans against clients’ assets with additional leverage against unrealised market gains. These clients were generally modest income earners, many of whom were aiming to afford a comfortable retirement and were certainly not sophisticated investors. Many of these people have lost not only their investment, but their life savings and assets such as family homes and as such, have suffered an extraordinary amount of loss. During the bull market, these investors may not have been strongly concerned with the quality of the advice they were receiving – so long as their returns were sound and the value of their assets rose, it could easily be assumed that their adviser was giving advice that was reasonable and suited their specific circumstances. As the GFC took effect questions were raised as to the suitability of the advice given to clients. Did Storm advisers ensure the ‘know your client’ requirement was met? Did Storm advisers ensure clients fully understood the investments they were recommended? It is clear in this case that these issues were not a priority for advisers, and this was reflected in the poor quality of advice that was delivered to clients.

STEPS TO ENSURE QUALITY ADVICE IS DELIVERED IN BOTH GOOD AND TURBULENT TIMES

The outcomes of the GFC have highlighted the need for change within the financial advice industry. The changes that are required are considerable and beyond the scope of individual FANs and advisers. Changes need to be industry-wide and require intervention from the Government, the Australian Securities and Investments Commission (ASIC) and industry organisations such as the Financial Planning Association (FPA) and the Investment and Financial Services Association (IIFSA). Changes are necessary to ensure the highest quality of advice is always delivered, irrespective of the market’s performance. Recognising shortcomings is the first step in the challenging process of identifying what changes can be made to ensure the delivery of quality advice in the future. Industry leaders readily acknowledge that there are weaknesses which damage the operation of the industry – this is evident through the proposals that are discussed below.

ASIC

In 2008, ASIC’s restructure saw the formation of a stakeholder team focusing directly on financial advisers. One of the priorities of the team is to improve confidence by ensuring that consumers access quality advice. This is being done through a comprehensive project to improve quality of advice in Australia by developing benchmarks, obtaining industry data and considering the key drivers behind the quality of advice.

ASIC has also had significant involvement with the Parliamentary Joint Committee Inquiry into Financial Services. During a hearing into the Inquiry on 24 June 2009, ASIC Chairman, Tony D’Aloisio put forward suggestions as to the various factors that affect the quality of advice and suggestions as to how they can be addressed. Mr D’Aloisio stated “The barriers to entry are quite low, so the ability to take people out of the market and revoke licenses is quite limited … if you lift the entry levels on the basis of quality training education, it may lead to better results.”

Industry Organisations

The FPA has taken steps to improve the quality of advice by announcing that by 2012 fee-based remuneration should become the standard model for financial planners. The move is a key to protecting both consumers and the reputation of financial advisers. The removal of commissions will be a step in removing the accusations of conflicts of interest of the planner. Earlier this year the FPA released a consultation paper entitled Financial Planner Remuneration, which is intended as a starting point to determine the core principles and appropriate definitions of current remuneration practice. The paper suggests principles that should underpin all remuneration practices; the main charging structures in financial planning; and how these structures align with the FPA’s Practice Standards.
The proposed changes aim to ensure that when clients pay for advice, the value is the main factor in determining the cost. Remuneration by commissions does not ensure that the value of the advice is properly understood by the clients and consequently, the FPA has recommended that planners transition away from this method of remuneration.\textsuperscript{13} The new principles are proposed to evolve remuneration away from the influence of product providers and require the adviser to set the charges for advice and negotiate with the client.\textsuperscript{14}

In June, IFSA published its draft Super Charter which, as well as introducing framework that allows members to have a clear understanding of how their super investments are performing, they will also only be charged fees for the advice services they receive. One of the key policies of the charter is, “increased transparency and control in payments to advisers”.\textsuperscript{15} Under this policy, clients seeking personal superannuation advice will be asked by the adviser to agree to the fee they will pay and how the payment will be made. This will mean that no fees will be paid by the client regarding personal super advice unless the service is received and the payment and the mechanism of payment are agreed.\textsuperscript{16}

The mechanism of payment can be through one of the following methods:

- an agreed ongoing dollar or percentage-based fee paid by the member from either their super account or outside the super account; or
- an agreed up-front dollar or percentage-based fee paid by the member either through their super account or outside their super account.

By 1 July 2010, IFSA intends to update its Standards and Guidance Notes to reflect the policies referred to in the Super Charter that IFSA members will have to adhere to.\textsuperscript{17}

It is encouraging to see leading industry organisations take positive steps in removing conflicts of interest from the industry. The initiatives are perhaps not broad enough to entirely remove conflicts of interest; however they are a start to creating meaningful change and improving the overall quality of advice.

**Parliamentary Joint Committee Inquiry into financial services**

As previously mentioned, there is currently a Parliamentary Joint Committee Inquiry into Financial Services (PJC Inquiry). As part of this process, participants of the industry were given the opportunity to make submissions on the terms of reference set by the Committee. The PJC Inquiry received over 200 submissions from a mix of former Storm clients, advisers and industry organisations. Many of the submissions comment on the flaws of the industry including the licensing process, remuneration, Professional Indemnity insurance and disclosure. A selection of the submissions also contain recommendations on how we can further develop the industry for the future. Some notable suggestions include:

- examine the current licensing process and look for improvements that will ensure licensees and authorised representatives are appropriately resourced and sufficiently competent;\textsuperscript{18}
- clearly distinguishing advisers from sales people;\textsuperscript{19}
- ASIC establishing a three-star grading system that directs consumers to highly rated advisers;\textsuperscript{20}
- legislate a fiduciary obligation between advisers and their clients;\textsuperscript{21} and
- creation of a professional body that is administered jointly by financial planners, ASIC and consumer representatives. The body would regulate those advisers who by virtue of experience, training etc are considered capable and worthy not being required to work under an AFS License. Only members of this body would be considered ‘Financial Planners’.\textsuperscript{22}

The Committee will report its findings by 23 November 2009 on the issues associated with recent financial product and services provider collapses such as Storm and Opes Prime.\textsuperscript{23} This inquiry has the potential to bring about major reform that will have the ability to transform the industry in a constructive and beneficial way.

**RECOMMENDATIONS TO IMPROVE THE QUALITY OF ADVICE IN THE FUTURE**

The initiatives discussed in the preceding section will bring important changes to the industry. However, there are also steps that can be taken by FANs and their advisers that will go over and above the laws and regulations to bring high quality advice to clients. Six proposed initiatives will work in unison to assist FANs and advisers achieve this.

**Remuneration**

Commission-based remuneration is widely seen as a model that creates a conflict of interest because the incentive of a commission may cause the adviser to recommend the product that offers the highest amount of remuneration for them, which inevitably leads to the adviser putting his or her own interests above those of the client.\textsuperscript{24} In an effort to eliminate or minimise this conflict it is imperative that changes are made. FANs need to encourage fee-based remuneration that is easily understood by clients. Firstly, FANs can put restrictions on the following types of payments:

- trail commissions – should be ‘switched off’ on a yearly basis. In order for the trail to be ‘switched on’ the adviser must demonstrate the services they have provided to the client;
- up-front commissions – set a limit on the allowable rate of commission that can be paid by introducing a ‘commission cap’ where a percentage can be charged, up to a set amount. For example, commission at 5 per cent to a maximum of $5,000, and
- soft dollar benefits – to be banned to eliminate any product-provider influence.

If FANs restrict the type and amount of commission paid, fee-for-service remuneration models will be encouraged. In order to ensure access to advice does not decrease with higher upfront fees, fee-for-service remuneration should become a tax deductible expense for higher income earners in the investment year. The Government should also provide a subsidy or scheme similar to Australia’s Medicare system for lower income earners, where investors can claim a rebate on the investment fee. Secondly, FANs should abolish the use of sales targets as a measure of performance of advisers and instead use the quality of advice as the key measure. For example, adviser bonuses should be paid as a result of client satisfaction that is gathered from client feedback surveys (discussed later).
Learning and knowledge requirements
The level of knowledge and learning required to become an adviser is another area where there is industry-wide room for improvement. Currently, the only requirement that must be met is set by Regulatory Guide 146 Licensing: Training of financial product advisers (RG146). RG146 sets the minimum standards for the training of advisers which must be met by persons who provide financial product advice to retail clients. The standards are met by completing training courses listed on the ASIC training register or through the demonstration of competence of the training standards to an authorised assessor.25
The recent high profile collapses have raised questions about both the professional qualifications and ethical requirements of advisers.26 According to the director of Pinnacle Financial Services Academy, the problem lies with the variability of training courses within the industry. Some courses offer very brief material in courses which are fast to complete, whereas others offer detailed and thorough courses which require a lot more effort and study.27
The learning requirements should be improved to ensure FANs employ advisers of the highest calibre. To begin, FANs should collaborate to form a professional organisation, or alter an existing organisation, such as the FPA, to which advisers must meet specific requirements to enter. In its infancy, this organisation will have representation and participation from ASIC, which will be phased out as the organisation establishes itself as the main regulator of the industry.28 In order to become a member, applicants will sit a standard examination, set by the professional organisation in conjunction with ASIC. The standard entrance exam will create consistency at a level that is accepted industry-wide. The introduction of a standardised exam will also allow for a continued need for education trainers in preparing applicants for the entrance exam, which will ensure their role does not become obsolete. Subsequent to successful completion of the exam, FANs should introduce the first year of practice as a development year, where the adviser completes ongoing training, development and mentoring by a senior adviser.
In further development of this proposal, advisers who wish to advise on more complex products such as gearing, derivatives or self-managed superannuation funds can demonstrate proficiency in these subjects and gain an accreditation/specialisation that self-managed superannuation funds can demonstrate proficiency in these areas and gain an accreditation/specialisation that will allow them to provide advice in these areas. This specialisation will make it easier for clients to find an adviser in relation to specific advice they are seeking. Specialisations held by advisers will be promoted on the Financial Advisers Register (discussed next). Once the professional qualification is earned, members will be required to complete continuing professional development and adhere to a code of ethics set by the body. This model is akin to how professional bodies in other industries operate such as the Institute of Chartered Accountants Australia, CPA Australia and law societies in each state. Once established, use of the term ‘financial planner’ or ‘financial adviser’ will be restricted to members of the professional organisation so that qualified advisers are easily identifiable to consumers.

The Australian Financial Adviser Register
FANs can promote quality advice through a joint venture project that introduces the Australian Financial Adviser Register (Register), on which individual advisers will be listed. The Register will contain general information such as the adviser’s name, location and licensee, as well as information regarding qualifications, years of experience and specialisations. This project would be mutually beneficial for clients and advisers. Clients could easily find a financial adviser that suits their needs, and FANs and advisers would be able to promote their services to clients.
The Register could be developed to include a feedback and rating system similar to that which is used by online auction company, eBay. On this site, buyers (clients) can check sellers’ (advisers) reputation by clicking on the ‘Feedback Rating’ beside the seller’s user ID. The buyer is then able to read what other buyers have said about the seller’s reliability, product quality and level of service.29 Over time, members of the eBay community develop a ‘Feedback Profile’ based on the comments and ratings left by other members. For each transaction, buyers and sellers can rate each other by leaving a positive, negative or neutral rating. These ratings are then used to determine ‘Feedback Scores’. This feature is valuable to eBay because it gives members a good idea of what to expect when dealing with other members. It is also a way to increase goodwill in the eBay community by expressing positive feedback for other members.30
A model comparable to this would be extremely useful for the Financial Adviser Register as it would give clients the opportunity to provide feedback on the advice they have received. Clients browsing the Register would be inclined to contact an adviser with a positive rating and good feedback, while poor advice would also be reflected in a rating, which would allow advisers who have previously given poor quality advice to be weeded out, thus creating healthy competition in the industry and motivating advisers to develop and demonstrate their skills.

Benchmarking
The professional organisation discussed in the previous section will develop benchmarks that are publicly available to enable consumers to compare the advice they have received and determine whether specific criteria are met. Benchmarking is a useful mechanism that would allow clients to assess quality quickly and effectively and assist them in making informed decisions. If the criteria are not met the client can choose not to execute the advice and return to the FAN and seek alternative recommendations.
In ASIC’s Summer School 2008 Report, Nicholas Gruen, chief executive officer of Lateral Economics introduced the idea for advisers to keep a sample portfolio with only the performance of the portfolio made public, which will create information in the market and a standard by which advisers could be compared. Gruen extends this idea to suggest advisers could create three sample portfolios – conservative, balanced and high risk, the values of which could be tracked over time.31 Investors would be able to assess the performance of these portfolios and use the information to make informed investment decisions. Advisers’ sample portfolios could be incorporated as an element of the Financial Adviser Register discussed before to give potential clients an idea about the returns they may receive if they were to engage a particular adviser.
Client feedback surveys

FANs and advisers should survey clients on their satisfaction with the quality of advice they receive. Six months to a year after the advice is implemented, a satisfaction survey should be sent to the client to gain feedback on their thoughts of the advice they received. The information gathered through this process will be reportable to the licensee and could be used as a measurement of the adviser’s performance. This would provide valuable feedback for the adviser and give the client the opportunity to express either concerns or praise he or she has for the adviser.

Consumer education

Consumers’ complete understanding of the products they are investing in is essential. In the case of Storm, many clients did not understand that market drops could cause them to be sold out without notice. A way in which FANs and advisers can gauge consumers’ understanding is through requesting them to complete an online survey from which insight can be gained into what consumers understand about different types of investments. For complex investments such as margin loans, FANs should hold information seminars for their client base to assist in their basic understanding of certain investments. Advisers should obviously reinforce this information before advice is implemented. The client feedback survey should include questions assessing whether the adviser ensured the client’s understanding before proceeding.

CONCLUSION

The market turmoil has caused many investors to suffer significant losses. However, one positive outcome of the GFC is that it has highlighted the opportunities for meaningful change within the financial advice industry. The current shortcomings of the industry are broad and cannot be addressed by FANs and their advisers alone; we need to implement industry-wide changes that will benefit clients and advisers alike. We are at a point where industry leaders are providing initiatives that will develop the industry, and the outcomes of the PJC Inquiry will no doubt add significantly to this progress. Now is the ideal time for FANs and advisers to apply their own initiatives, on top of those recommended by industry leaders, as they will ensure quality of advice in the future and give clients complete confidence in the advice they receive.

NOTES

1. This paper represents my own personal views and does not represent the views of the Australian Securities and Investments Commission.
2. This is demonstrated by the All Ordinaries index on the Australian Securities Exchange. The All Ords are currently trading at approximately 4,200, compared to March 2009 when they were approximately 3,000.
7. Speech to the Australian Financial Counselling & Credit Reform Association by Tony D’Aloisio, July 2009.
8. ibid.
12. ibid., page 5.
13. ibid., page 5.
14. ibid., page 8.
16. ibid., page 5.
17. ibid., page 13.
18. Investment and Financial Services Association (July 2009) Submission to the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services, page 5.
20. ibid.
27. ibid., page 15.
28. The FPA’s submission to the PJC inquiry discusses the role and importance of a professional body for the industry. Certain requirements must be filled by this body to ensure it operates effectively including: voting rights for members, representatives of good standing, minimum academic requirements, code of ethics, disciplinary procedures and reporting procedures.
REFERENCES


Financial Planning Association (July 2009) Parliamentary Joint Committee on Corporations and Financial Services Inquiry into financial products and services in Australia, submission by the Financial Planning Association of Australia.


