Institute of Actuaries of Australia

The Value of Advice

The Financial Adviser, Value Creation and Remuneration

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1 Introduction

A tourist, lost in the country stops his car to ask a local farmer how to get to his destination. The farmer answers 'Well I wouldn't be starting from here'

The financial advice industry has developed and transformed over the past thirty years from a primarily product driven sales force to a more professional industry focussed on giving quality financial advice to its customers.

However, the industry has not fully made the leap to being fully aligned with its customers and many structural issues, including cross subsidisation and free riders as well as a complex regulatory environment inhibits the next steps down this path.

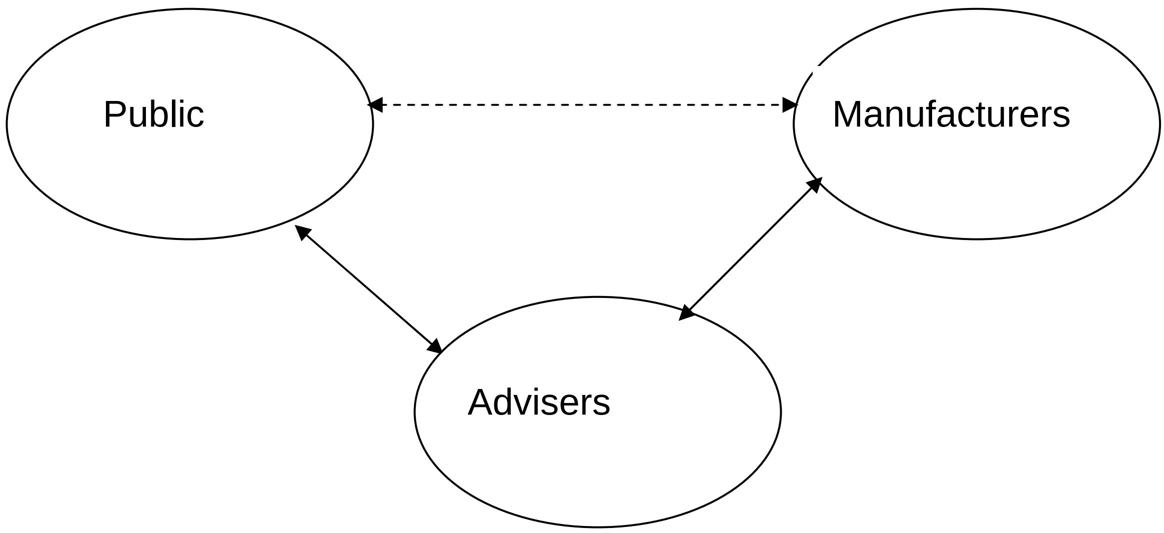
There is also, I believe, an issue around the provision of financial advice to more people for a cost that makes sense to them. Is it appropriate to have a form of 'decent advice' rather than 'best advice'?

Only around 17% of Australians have sought financial advice. This is a low proportion that, if increased, should result in benefits to society as people are able to make better provision for their financial needs.

This paper attempts to explore these issues.

2 The Value of Financial Advice

In order for financial advice to justify its existence it needs to provide value to its various stakeholders. This includes the consumers of financial advice, the product providers, regulators and the community. In addition to this, the advisers need to be adequately remunerated for their skills and efforts.



The public includes those who do not have significant financial product holdings. Manufacturers do not always deal with financial advisers. Many people purchase bank accounts, mortgages and other loans or investments without seeing a financial adviser. In many cases, however their relationship with the manufacturer is intermediated by a financial adviser.

This paper is focussing on the Financial Adviser segment. In the past the bank manager was a major source of financial advice to many people, but changes in the structure of the delivery of banking services has reduced the role of the bank manager in consumer financial services.

Other sources of financial advice are accountants, friends and family.

The value created out of the advice process is shared between advisers, clients and the manufacturers.

The apportionment of benefits between the three parties has changed over time as the market power of the three participants has changed. While it is hard to be conclusive about this it appears that over time the customers and advisers shares of this value have been increasing at the expense of the manufacturers.

2.1 To clients

So how do financial advisers provide value to their clients? Financial advice is an intangible product. It is ephemeral, you can't touch it. It can be quite expensive. People can find it difficult to understand what value they are getting from an adviser. Even after getting advice and implementing a plan, the value of that plan can only be compared to some hypothetical alternative course of action. One of the problems that the financial advice industry faces is convincing prospective clients of the value of their product.

Much of their value comes from providing a disciplined approach to customers' financial planning needs. Additionally, there are times where advisers can assist customers in maximising their after tax income, including accessing government benefits. Estate planning is also an important area where advisers can add value for their clients.

<u>Goal Setting</u>

Many people do not have clear financial goals. Sitting down with them and establishing some realistic targets can be an important first step for many people.

<u>Budgeting</u>

Reviewing customers' budgets and establishing a capacity to save is a very useful process that results in clients' having savings where nothing was being saved before. Many people find that they lack the discipline to put money away each month without the discipline of a forced payment into a savings vehicle, whether this be paying off a mortgage, putting money into a savings account at the bank, an old style whole of life policy or a regular contribution to a unit trust.

<u>Superannuation</u>

All Australians are today, obliged to have contributions of at least 9% of salary made to a superannuation fund. Modelling work indicates that this will not, on its own, give sufficient assets for people to retire on. Depending on earnings and spending patterns there can be scope to make additional contributions to superannuation, as long their ability to meet short-term needs is covered. The adviser can ensure that customers are maximising their contributions to superannuation. One of the issues with superannuation saving is its lack of flexibility. Money invested is locked up until retirement.

Given the level of compulsory contributions it is possible that advisers have a limited capacity to add value in this area other than through fund selection, fund consolidation and optimisation.

Tax

Financial Advisers are generally not tax experts. However, tax is a very important part of investment strategy and advisers can ensure that their clients are investing in a tax effective manner. This can be done through standardised tax effective strategies such as gearing, investing in growth assets and shares which generate imputation credits.

Government Benefits

For retirees, the interaction between their assets, income and benefit entitlements can be very complex. Advisers can help customers optimise the outcome through their understanding of this interaction. Examples of this may include the use of allocated pensions and annuities.

Government benefits and entitlements are effectively an ‘off balance sheet asset’ for most retirees. Maximising this, while not foolishly investing other assets is a difficult, but worthwhile action.

Risk Profile

People typically are very risk averse. Investments often show a very high bias toward cash and property. Many investors have poorly balanced portfolios with cash and fixed interest, maybe a few shareholdings and an investment property. This exposes the investor to undiversified investment risk due to the concentrated nature of the portfolio, but probably insufficient market risk, giving lower long-term returns than could be achieved.

The adviser can also advise customers against participating in foolish or ill thought out risks that might lead to losses that the client cannot bear such as investing in some schemes offering unrealistic returns or risk. This capital protection role can be very important.

Achieving the correct risk profile for clients can result in significantly higher long-term earning than the customer may have obtained on their own.

Gearing

The use of gearing can be an effective way of increasing risk and improving tax outcomes. Gearing can be used for a wide range of investments, such as property, shares and managed funds. The tax deductibility of interest and the lower tax rate on capital gains can be a useful enhancer of long-term value.

Diversification

Retail investors are usually insufficiently diversified and as a result are exposed to unsystematic risk, which is not rewarded through increased returns. Using managed funds or a broad range of investments, advisers can ensure that their clients are appropriately diversified, both by asset class and security. This is a significant benefit for their clients.

Fund selection

There is a bewildering array of investment funds available to the public. The performance of these funds can vary a lot, even within the same investment sector. There is considerable debate as to whether fund managers can consistently outperform the market, but it is possible that an adviser can assist clients in selecting better performing investment funds. This could give customers better returns and hence increase their long-term assets.

On an a priori basis, from a customer's point of view there is unlikely to be a big difference between the outcomes of going with different manufacturers.

A simple model

How do we quantify the benefits of utilising a financial adviser? One way is to evaluate the long term consequences of adopting a financial plan and then comparing it to the outcome if the current strategies had been continued.

It is difficult to quantify some of these value-adding activities. The most easily quantified are the revised risk profiles and additional savings from improved budgeting. Of course, the cost of the advice needs to also be included in the evaluation of the advice. The vale added has to exceed any fees charged or commissions earned.

The time horizon to evaluate the benefits of advice to a client is an interesting question. In theory the results could be projected out for the remaining life of the customer. However, individuals' family and work situation, the legislative environment and the economic environment change regularly. It is hard to envisage a plan not requiring a significant review after five years or so.

A simple model has been constructed to evaluate the value added by advice.

If we take a person with a salary of $40,000p.a., He has currently accumulated $40,000 of superannuation and has $10,000 of existing saving. He is contributing to compulsory super and saving 5% of pre-tax income. Superannuation is currently invested using a very conservative investment strategy.

A review of the family budgeting increases savings to 7% of income. A long term, equity based investment strategy is adopted, enhancing returns. Further the adviser's fund selection improves returns by 1%p.a.

It has also been assumed that the initial advice costs $1,000 and that annual fees for ongoing service are $500 increasing by inflation.

Increase in value					
		Value arising from			

Year	Total	Budgeting	Risk	Fund selection	Cost of advice
5	**10,772**	4,959	6,319	3,026	(3,531)
10	**33,569**	12,545	19,792	9,010	(7,779)
15	**74,830**	23,814	45,066	19,550	(13,601)

It can be seen that in this example the greatest potential expected value add comes from the correct risk profile. The contribution from improved budgeting is also significant. Even if we remove the value added from improved fund selection, the value of the advice is significantly greater than the cost over a five-year time horizon. This customer is not a high net worth customer, but the advice has been very valuable for him. It is often people in this market segment who are reluctant to seek financial advice because they perceive that they will find it hard to get value for their money.

Of course, the closer that a client is already toward having an optimal strategy the less scope there is for an adviser to add value. For example of the superannuation investments already had an appropriate risk profile then the value added from adopting an appropriate risk profile is much less. In this case the five-year value added reduces to $2,437.

Another issue is how long a financial plan can remain effective without a major review. Changes in personal circumstances and the frequent variations in retirement income and tax legislation mean that plans frequently need to be revised and additional costs incurred.

This raises the question of how expensive financial advice can be and still remain value adding for a client.

Where a client has larger funds and higher income then there is greater potential to add value. Implementing the strategy gives a higher value added, because of the greater amount of funds employed.

Interestingly, this implies that if advisers are to be rewarded for value added to clients then remuneration could be related to funds employed, this would mean that customers with little funds are paying appropriately for the services of an adviser.. However, product related remuneration is only tangentially related to the specific value added activities of the adviser. This can also introduce conflicts of interest for the adviser.

This issue will get discussed further, later in this paper.

One interesting issue is the ability of customers to evaluate whether they are receiving good advice. Given that they have employed an adviser because they don’t know much about finance, the quality of advice has to be taken largely on trust. Again, the customer has to assume that conflicts of interest have been managed satisfactorily.

2.2 To manufacturers

The value created by advisers for manufacturers is more directly measurable. This value comprises the future fees and profit margins that will be earned from any financial products that are sold.

Generally the NPV of profits from a financial product is in the range of 3% to 5% of the funds subscribed. This value is after the payment of commission and other distribution related costs, although profitability is sensitive to these expenses.

In addition to the profits to be derived from the business manufacturers also receive fees to cover the expenses of their business.

Manufacturers have a very strong interest to ensure that their product is sold rather than competitors' products. If we accept that from the consumer's point of view that there is not a large difference between products it can be seen why most distribution has been funded and supported by manufacturers, rather than by fees from customers.

2.3 To Dealerships

Dealerships take a proportion of commissions earned by advisers in order to pay for the various dealership services provided to advisers. These include management, compliance and depending on how the dealership operates it may include office and other support.

Dealerships build up value for their shareholders by increasing the dealership's funds under advice and pool of trail commissions.

2.4 To advisers

Advisers obviously receive initial commissions and the right to receive trail commissions if they are being renumerated by commissions. They have also developed a customer relationship that may produce further business over time. The customer may also provide leads to family and acquaintances which may generate additional customers.

3 The costs of financial advice

The economics of the financial advice industry are rather unusual, as it is rife with cross subsidies. Many parts in the chain do not support themselves

3.1 Dealerships

The main sources of income for dealerships are the commissions and fees generated by the financial advisers working for the dealership. The bulk of this income is passed directly on to the adviser. The dealership retains a portion of the income to meet its overheads such as management, administration and compliance.

Often a dealership will use a manufacturer's master trust platform in order to simplify its administration and client reporting.

Dealerships also benefit from extensive support from manufacturers in the form of education, platforms, administration assistance, technical advice and incentive arrangements.

Typically, dealerships break even or make a modest profit, as expenses eat up their share of income despite all this support. The advisers who work for it capture most of the income created by the dealership.

Despite the disappointing profitability when a dealership is sold, it usually sells for well in excess of NTA. This indicates that there are other benefits to owning a dealership. Most dealership acquisitions have been by manufacturers who see value in being able to influence the flow of new business. Sometimes, where an independent dealership has a concentration of business with a manufacturer, that company has a defensive motive for purchasing the dealership in order to protect its existing book of business.

The above point may explain the motivations of independently owned dealerships. The object may be to build a business that can be sold when it is sufficiently large and well established. This potential payout encourages the dealership owners to accept the sub economic returns of running a dealership. This may be subsidised through the earnings of the dealership principals. Who may be high earning advisers themselves.

3.2 Clients

For clients the cost of financial advice is the fees or commissions that they pay to an adviser.

There are also implementation costs for many financial plans. These can be considerable, even if managed funds are not purchased. These might be:

- Brokerage on share purchases,
- Stamp Duty and other transaction costs for purchasing real estate,
- Accounting fees for record keeping relating to investments
- Compliance costs for a self managed superannuation fund,
- Property management fees for rental properties,

Alternatively, many clients will have a meeting with a financial adviser and then execute a plan independently (or perhaps end up doing nothing). If their adviser is remunerated by way of commissions then these people will not incur any costs for financial advice.

To date, there has been considerable customer and adviser resistance to adopting a fee for service model, although it is gradually becoming more common.

There are many reasons for this:

- Fees for financial plan preparation are not tax deductible while commissions are deductible for product manufacturers (although review fees are deductible),
- The fee for a financial plan can be quite large and is an up front expense before the plan is seen, although at least this cost is certain.
- The variable quality of financial advisers and the difficulty of assessing adviser quality (ie is the financial plan likely to be any good?),
- Commission payments are not transparent and when presented as a percentage often look small. Trail commissions in particular look very modest.

- People are not convinced of the value of advice,
- There is a great deal of apathy around having a financial plan, so people don't often spontaneously approach financial planners. If they have to pay $1,000 for the privilege, even if they don't act upon it, then this increases their reluctance.

Clearly there is work to do before a fee for service model becomes universal.

3.3 Manufacturers

For the manufacturers, distribution costs have a number of components:

Commissions

Commissions to financial advisers obviously make up a large part of distribution costs.

Distribution Support

The maintenance of commission payment systems, platforms, education, incentive schemes,

Lapse Risk

Where lump sum commissions have been paid the manufacturers need to put up capital to fund these acquisition costs. If a policy lapses after a short time then the manufacturer will lose its investment. In order to mitigate this there are usually some claw-back arrangements if a policy lapses within one year, but this only reduces this risk a little.

There is a temptation for advisers to rewrite business on a regular basis in order to receive more commission income. This doesn't appear to have happened on a large scale in Australia but has in other countries. This rewriting can be presented favourably to the client as the adviser doing his job and improving the customers' returns or getting them a better deal. Fees would avoid this conflict. This could reduce prices as this risk is ultimately passed back to customers through product pricing.

Distribution Company Subsidies

Where manufacturers own distribution companies they usually end up subsidising their operation. As discussed above the distribution companies are not usually economic in their own right.

3.4 Advisers

An adviser needs to be paid at an appropriate level to justify his or her level of training and expertise.

Advisers spend their time doing a range of activities:

- Prospecting for new clients,
- Meeting clients,

- Preparing financial plans,
- Executing financial plans,
- Compliance activities,
- General business administration,

Under a commission payment regime, they only get paid for actually executing financial plans, and then only if the products utilised pay commission.

If paid under fee for service, they only get paid for meeting clients and preparing and executing financial plans. So fees charged need to cover the time spent on other activities and also to cover the cost of overheads such as rent, technology and support staff.

In either case, advisers need sufficient pay to justify the time spent prospecting as well as time on keeping up to date on legislation and products. That is, a full week's pay needs to be generated by what may only be 15 to 30 hours of actual billable, client contact or work.

Compared to some other fee for service professional businesses there is no core of legally required work to provide a base level of business.

There have been various strategies adopted to try and reduce the costs of advice or improve adviser productivity (two sides of the same coin really)

Use para-planners for detailed plan preparation. These can be cheaper than advisers and be more suited to the technicalities of detailed plan preparation, freeing up the adviser for client contact.

Attempts have been made to automate parts of the advice process. Examples of this is the creation of tool kits to enable the modelling of financial plans for customers as well as automating the data capture for fact finds and passing this data on to plan preparation and modelling tools. Given the commonality of many people's financial position it is possible to use some classification of the answers to a fact find or similar set of questions in order to provide reasonably generic advice. Alternatively sufficient information is presented in order to allow a client to come to his or her own conclusions as to the correct strategy to follow.

An interesting possible influence on adviser productivity is commission levels. Some research on the US real estate industry, where commissions as a percentage of sales is pretty constant over the whole country regardless of price levels, shows that real estate agent productivity is the inverse of the price level in an area. That is, if prices are low, then fewer real estate agents operate and sell many more houses. Average income per agent was fairly stable regardless of the prevailing prices in each area. [1]

A similar phenomenon was observed in the Australian financial services industry with the demise of large up-front commissions. Many low productivity agents left the industry, leaving a smaller, more productive force of financial advisers.

Another issue with adviser remuneration is how new advisers build up sufficient income to at least equal what they may earn in some other job that they are qualified for. If payment is only by trail or level commissions, it can take a number of years before an adviser is generating sufficient income to live on. They need support from a dealership or a manufacturer, or some financing mechanism recognising the value of future commissions in order to be able to survive through this period.

Fee for service advisers have a similar issue of how to build up a sufficiently large client base to make a decent living. Note that in order to generate $100,000 of annual revenue an adviser needs 200 clients if each pays $500p.a. of fees.

3.5 Free rider issues

Where cross subsidies exist and not all participants pay for their benefits, or they are paid in a way that is tangential to the service being provided this results in some people being overcharged and others undercharged. Some participants will pay nothing at all and get a free ride off the system.

Examples of free riders are clients who get a lot of advice from an adviser and then execute the plan using discount manufacturers.

Another example is a manufacturer who refuses to pay commissions or other remuneration to advisers and therefore has low expenses. It could expect financial advisers to sell its products without remuneration because its low fees are favourable to the client.

Other cross subsidies include:

- Large clients subsidise small clients. Clients who generate significant commissions generate profits that support services to smaller clients.

- Some manufacturers don't subsidise dealer networks, yet nevertheless obtain business from those dealerships. Their cost base is obviously lower than their competitors although they have less control over their distribution. We can see this occurring through the rise of specialist, boutique fund management firms that are able to generate sufficient sales through alliances, good returns and product differentiation.

- The removal of cross subsidies through moving to a universal fee for service model may make it even harder for people without significant means to access advice under the current regulations.

- The fee for service model may well generate less revenue per client for advisers. This means that adviser productivity will have to rise in order to maintain incomes. This could happen in two ways. If the changed remuneration model results in a larger market, then there will be more customers to go round. The alternative will be that marginal advisers will exit the industry, resulting in a smaller, but more efficient adviser industry.

4 Independent Financial Advice

There has been a strong regulatory and consumer emphasis on the independence of financial advice. Yet we have seen most dealerships being acquired by manufacturers and becoming in some sense aligned with a manufacturer. Why has this happened? In my view there are several possible reasons

- Economics - As discussed above, most dealerships rely on extensive manufacturer support and still don't make a significant operating profit. In order to dispense with this manufacturer support then they would need to pay a lower percentage of income to the advisers, which would make it difficult to attract good advisers to the dealership. Only a small number of financial advisers seem to have made the fee for service model really work, although there is a trend toward fee for service.

- Client confusion – There is a case that clients do not appreciate the difference between aligned dealerships and truly independent dealerships and think that they are getting independent financial advice when they aren't.

- Client indifference – In the minds of many people there is a blurring among financial services brands. There is awareness of major brand names that they might be happy to invest with. As long as an adviser recommends one of these they don't care very much which company it is. This is actually a pretty rational approach. Financial market theory tells us that it is very difficult for an investment manager to consistently outperform the market. Therefore, so as long as a manufacturer passes a threshold of competence and reputation and as long as fees paid aren't way out of line with the market then from the client's point of view they get a reasonable result. In a largely commoditised market the choice of manufacturer is not the most crucial decision.

  The analysis on the value of advice supports this view. The main value of advice arises from strategic planning around appropriate risk levels, budgeting, taxation and welfare benefits. Little or none of the value comes from manager selection (depending on one's view of the ability to pick managers who outperform).

In the light of this analysis is the concept of completely independent financial advice overrated?

This is not to ignore the conflicts of interest that advisers face in a commission based remuneration system, but it is possible that the effects can be overstated. Perhaps other mechanisms may be used to address deficiencies in the commission system.

5 Regulation of Financial Advice

Australia has developed a complex system of regulation around the provision of financial services and advice. It is a curious mixture of stringency and laissez faire with some huge gaps, primarily around direct property investments and mortgages.

While the provision of financial products is very tightly regulated with extensive disclosure requirements such as Product Disclosure Statements, property is still very much a caveat emptor market. There is no ready disclosure of market prices or recent transactions. Sale methods, such as auctions, often seem better designed for the agent's needs rather than the actual buyers and sellers. The effectiveness of self regulation is doubtful. Neil Jenman, in particular, has been very critical of many practices in the real estate market.

People can borrow many times their income and go into a highly leveraged property investment with great ease. Property investments are also characterised by high transaction costs and are relatively rare in most people's lives.

The very stringency placed around the provision of advice can, in fact, prevent many people from receiving advice at all by making it too expensive for many people to access. This can leave them prey to all sorts of mistakes.

What is the appropriate level of financial advice?

The great bulk of peoples' financial positions fall into fairly generic situations. Saving to buy a home; paying off the home; trying to put a bit aside for long term saving; chronically in debt and a few others.

Once their situation is ascertained then generic advice may do for them. Is all the detail of a full fact and product comparisons and fund analysis really necessary for all people?

Is advice too expensive?

I recently heard an anecdote of a man who had $8,000 spread among 8 different superannuation funds due to having worked for a number of employers. He approached 4 different financial advisers and got the same response from each one.

They would have to do a full fact find and then do a detailed analysis of each of the 8 superannuation funds, plus any alternatives to be considered and then produce a very detailed statement of advice. The cost of this would be around $5,000. Not surprisingly, this gentleman is yet to receive any financial advice in relation to his problem and is continuing to pay the excessive fees and large volume of paperwork associated with having 8 separate funds.

In many cases advice can cost more than the potential value to be added from that advice. Given the intangible nature of advice, and the very high discount rates that most individuals use in evaluating present consumption versus future spending, it is not surprising that many people do not see the taking of financial advice as a rational thing to do.

Have we designed a Rolls Royce advice system that prevents many people from accessing advice at all?

Another part of the advice and compliance regime whose costs are somewhat hidden but are real nonetheless are the product disclosure rules. Huge amounts of data about each product examined by the customer and adviser is given to the consumer. How much is this read and understood? In the recent Westpoint case, PDSs were issued and these were of little help to those who still found themselves misled about their investment. A factor here was also the very high level of commissions paid which may have influenced advisers' recommendations.

6 Fee for Service or Commissions?

There are two main models for financial adviser remuneration: fee for service or commission.

Commission has traditionally been the main source of income for financial planners. Over the years it has changed from very high levels of front end commissions on regular premium savings plans to being predominantly smaller commissions on single premiums, usually with a trail component based on the assets in force. High initial commissions are still usually paid for protection policies.

This change in commission structure triggered a reduction in the number of financial planners and sales people in the industry. There was an increase in the quality and professionalism of the industry as marginally competent people left.

Fee for service for financial advice largely takes two forms:

- Services are charged at an hourly rate in the same fashion as lawyers and accountants. This has the advantage of being a common and transparent manner of charging for services. One disadvantage is that many people will hesitate to use the planner on a day to day basis because of reluctance to incur additional expenses. This may mean that they don't take timely advice on a day to day basis.

- An annual service fee. This may be related to funds invested or to some service level. This means that there are no marginal costs to the customer for talking with his adviser. From the adviser's point of view there is an assured income for the year. Also, there is only one sale to be made to the customer each year, assisting with continuity of income. An annual fee of this type may only be justifiable for people with significant assets to be invested. This may shut out many people from receiving advice.

Whether fee for service ends up being beneficial for the client needs to be considered. If a zero commission product is chosen then product fees will be lower. The adviser will have been paid directly by the customer, which will offset some or all of the lower fees. The tax treatment of the advice fees needs to be allowed for too.

Refunding of commissions to clients may have different effects to using a zero commission product as the full loading for commissions may not be passed on. Also, the tax effect for clients may not be symmetrical as they may have to pay tax on the rebates at their top marginal rate.

7 Conflict of Interest

The Financial Planning Association has recently adopted principles for managing conflicts of interest.

The principles are:

Principle One:

The cost of financial planning advice should be separately identified as a financial planning advice fee in the Statements of Advice provided by FPA members to clients, and the total fees paid for ongoing advice should be disclosed to clients on a regular basis.

Principle Two:

Where it is appropriate to recommend a product to a client, all FPA members will undertake the due diligence necessary to offer products which suit the needs of the client and do not bring the industry into disrepute.

Principle Three:

No remuneration or benefits paid by a FPA Principal Member to one of their financial planners should be biased against or not in the interests of the client.

Principle Four:

Separate corporate governance arrangements should govern FPA Principal Members and all or any related financial services provider and/or entity.

Note that the principles are about managing conflicts of interest, rather than eliminating them. They should eliminate the most obvious conflicts. The push for greater transparency and independence of dealer groups will continue to force change in how advisers are renumerated and the fees that they charge, either directly or indirectly.

Steps such as this are useful steps that must be taken if the financial advice industry wishes to maintain its self regulation.

8 Pressure for change

There is considerable pressure for change in the financial advice industry. Commission based remuneration is criticised for its potential for bias and conflict of interest. Fee for service is suggested as the way forward but this has a number of difficulties.

- The marginal economics of dealerships,
- Reluctance of consumers to pay explicit fees sufficient to cover the full cost of advice
- The lack of tax deductibility for initial plans
- Lack of clarity around the value proposition that advisers offer.

Overall, although customers are, in practice prepared to pay for advice when the costs are largely embedded within product pricing, few are willing to pay the full costs of advice when this is presented explicitly.

Fee for service may become easier for advisers to implement as a greater range of commission free products become available. This will eliminate the complexity of commission refunds. Also, if it reduces the average cost of advice then the numbers of customers accessing advice should increase.

Fee disclosure may reduce the relative advantage of embedded commissions by showing commission costs explicitly.

9 Conclusions

The current model makes financial advice inaccessible to many

The overhead related to the provision of financial advice makes it too expensive for many people to access. The cost of advice is greater than the likely benefits to be obtained.

Some mechanisms need to be developed to make financial advice more accessible

The current model of financial advice is too expensive for many people. Presently, attempts to provide cheaper financial advice require a fine line between providing financial information and providing financial advice. This requires careful scripting and compliance regimes. This makes it more expensive to provide and the customer is largely left to do their own analysis and determine their course of action. For many people this will result in poorer outcomes than if they were advised. Lacking proper financial advice many people will end up with a geared property investment, which is risky, and equally generates fees for mortgage brokers and real estate agents.

Some streamlining of the process, or the ability to give more standardised advice to people who's situation falls into generic categories may be a useful solution. Accepting that this might not be as good as a full fact find and financial plan it may still be better than nothing. We don't, after all, insist that only cars with 5 star safety ratings can be sold.

Independence of financial advice is over-rated

People's choices in the market and theoretical analysis shows that the independence of financial planners is not very important.

In a largely commoditised market, given that products pass reasonableness test, then the choice of which company's products to use won't make a huge difference to the client. Many of the differences in outcomes from different fee levels may be eliminated by the cost of paying an adviser directly rather than indirectly through commissions.

Many of the requirements around superannuation fund analysis seem to be over-reactions to the UK pensions mis-selling experience. The very different structure of Australian superannuation funds makes a repeat of this quite unlikely.

Tax treatment of financial planning fees should be altered to give a level playing field

If all financial service fees were made tax deductible then there would be equitable treatment between direct payments to financial planners. This would improve the position of fee for service against commissions.

Transitioning to fee for service will be a shock to the financial advice industry

Fee for service will, on average, reduce average revenue per customer. This will result in advisers having to become more efficient and productive. Entry paths into the industry will become more difficult as it will become harder for new advisers to generate income as they start out. Australia's financial advice work force is already relatively old, with a significant proportion likely to retire in the next 5 to 10 years. There will be challenges in producing the next generation of advisers.

10 How can Actuaries Contribute?

Actuaries are very involved in all aspects of this industry. They have the ability to help in the improvement of the advice process, particularly in developing simplified processes for people who can't afford the full advice process. They can also be involved in developing regulation around the advice process, to ensure that regulations deliver protection to consumers without creating unnecessary cost, which can have the effect of denying access to financial advice.

11 Summary

The Australian financial planning industry is a state of transition. Various cross subsidies that have sustained the industry's current structure are breaking down and will change.

At the same time the combination of industry practice and regulatory requirements has made financial advice inaccessible to a large proportion of the Australian population. New methods of advice delivery and changes in regulation are required.

Conversely, there are huge gaps in the regulation around advice, particularly for property and mortgages.

References

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