

90% SALES 10% ADVICE

A SNAPSHOT OF THE FINANCIAL PLANNING INDUSTRY

ASIC REPORT EXPOSES CONFLICT OF
INTEREST IN THE FINANCIAL PLANNING
INDUSTRY AND UNDERSCORES
CRITICAL NEED FOR REFORM

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Industry
Super
Network

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About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Zachary May

Director of Regulatory Policy
Level 31, Casselden Place
Melbourne, 3000
03 9657 4321
zmay@industriysuper.com

| EXECUTIVE SUMMARY

Industry Super Network has long advocated for reform of the financial planning industry. This has been buttressed by a recent report¹ issued by the Australian Securities & Investments Commission (ASIC), which underscores the critical need for reform of the financial planning industry.

The ASIC report reveals that the advice provided by financial planners is tainted with conflicts of interest. The regulator concluded that nearly 90% of licensee (i.e. dealer group) remuneration is paid by product providers in the form of ongoing commissions, up-front commissions, and volume rebates or manager fee rebates. Only 10% is received in the form of client fees. ISN believes that reforming the financial advice industry should, at the very least, reverse this ratio: 90% of income generated by client fees and 10% by neutral product payments.

The ASIC report also demonstrated the critical need for consumers to be protected from being charged ongoing fees when no ongoing financial advice is being received, and that this should be accomplished by requiring consumers to regularly 'opt-in' to such fees (if asset-based fees are not banned altogether). The ASIC report found that 3.1 million Australians, or two thirds of all of the clients of the largest 20 financial planning firms, are not 'active' clients. The inference is that these clients are continuing to pay ongoing advice fees but are not actively engaged with their planner.

The facts set forth in the report support the position long held by ISN that ongoing commissions and asset-based fees for advice enable planners and dealer groups to earn 'passive' income at the expense of consumers and should be banned, along with all other forms of conflicted remuneration. If ongoing asset-based fees are permitted to continue, credible reform requires that these fees be subject to a regular 'opt-in' mechanism.

The ASIC report has pulled back the curtain to reveal the extent to which the structure of the financial planning industry impedes planners from being able to act in the best interests of their client. The Future of Financial Advice reforms are essential to restructure this industry to serve the interests of clients, who are relying on advisers to help them save for retirement, build wealth, and otherwise manage their financial lives. However, the financial planning industry has stridently opposed the key aspects of reform legislation that would clean up their industry. The ASIC report makes this opposition easy to understand: this is an industry built around conflicted remuneration and passive income charged to millions of unwary clients (often from their compulsory super) who receive no ongoing services.

¹ Australian Securities & Investments Commission, Report 251: Review of financial advice industry practice, September 2011.

Background of the ASIC report

The ASIC report describes the practices and form of remuneration for the 20 largest Australian financial services licensees - measured by the number of advisers (i.e. authorised representatives and employee representatives) under the licence. The data is based on voluntary responses to an ASIC questionnaire reflecting operational information from the 2008 and 2009 calendar years. ASIC undertook this research to better inform themselves of business models and risks facing the financial advice industry.

Conflicts of interest in the financial planning industry

The ASIC report exposed the significant degree to which the remuneration arrangements in the financial planning industry are subject to conflicts of interest. Moreover, the ASIC report highlights a number of harmful, anti-consumer practices that are incentivised by these conflicts. One example is that advisers overwhelmingly recommend related party products which generate higher profitability or remuneration for the dealer group or adviser. A second example is a preference for ongoing commissions or asset-based fees. These arrangements enable an adviser to continue to receive revenue which does not necessarily reflect the quantum of ongoing advice provided. It also creates a preference for advisers to recommend product-based strategies rather than other options such as paying off a mortgage. The incentive to exploit these compensation structures and engage in rent-seeking behaviour is particularly strong because many consumers – even those who do seek financial advice – appear to be passive after the initial advice is received.

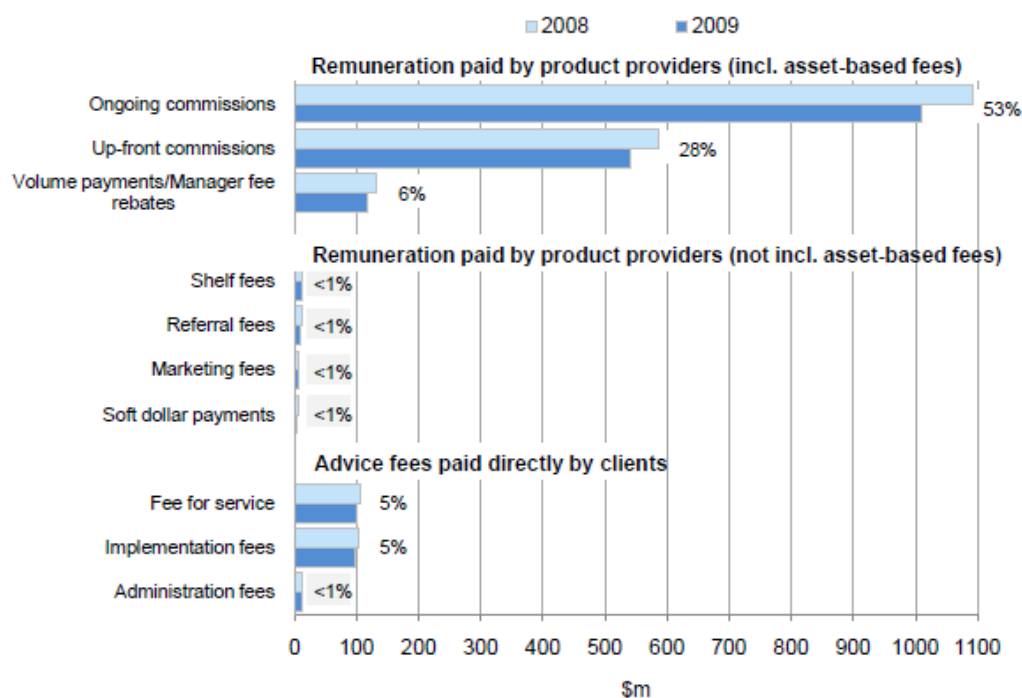
Significant amounts of remuneration are paid by product providers, including asset-based fees

The financial planning industry has long been characterised as performing two roles: providing advice to clients, and acting as a sales and distribution channel for product providers.² These two roles are intrinsically in tension, and the recent ASIC report makes clear which role financial planners are paid to perform. The report found that the majority of advisers were remunerated based on the volume of financial products sold, which included ongoing commissions, up-front commissions, and volume rebates. For the financial services licensees themselves, nearly 90% of revenue streams were paid by providers and linked to volume, with 53% of remuneration coming in the form of ongoing commissions, 28% in the form of up-front commissions, and 6% from volume rebates or manager fee rebates. The complete table in the ASIC report setting out sources of remuneration to dealer groups is reproduced below.

² See, e.g., Parliament Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services in Australia, November 2009

Conflicts of interest in remuneration are well-understood to present a clear risk of undermining the quality of advice.³ ISN research has previously demonstrated, in the context of superannuation, how fees and conflicts of interest are harming millions of Australians by eroding their superannuation returns.⁴ Moreover, because of the nature of the conflicts and the structure of the financial advice industry, the conflicts in remuneration often are not clear to consumers and clients.⁵

Figure 1: Licensees' remuneration paid by product providers and directly by clients



Note: Figures are based on information provided by the top 20 licensees.
Source: ASIC

³ ASIC noted that ongoing commissions also create a conflict of interest in the 'buyer of last resort' context. When an adviser decides to retire, the dealer group in such a program will buy the adviser's business and the adviser will receive a payment based on a multiple of recurring revenue. Where the multiples used to calculate payments are higher for products issued by the dealer group, these arrangements create a conflict of interest and an incentive for the adviser to recommend group products. See, ASIC Review of financial advice industry practice, at 13.

⁴ For example, Rainmaker Information, a leading research provider in the finance sector, estimated that during the five years ending 2010, super members paid approximately \$8.4 billion in commissions to financial advisers. Commissions on compulsory Super Guarantee contributions totalled nearly \$3 billion. See, *Commissions Revenue Report 2010*, by Rainmaker Information for Industry Super Network, August 2011, and *Commissions Revenue Report*, by Rainmaker Information for Industry Super Network, April 2010.

⁵ See, PJC Inquiry into Financial Products and Services in Australia, at 70.

Advisers tended to concentrate on a small number of products, often issued by related parties

Consistent with an industry that is, operationally, a sales and distribution channel, rather than an impartial source of advice, the ASIC report revealed that advisers concentrate product recommendations into a few products, often issued by related parties. ASIC found that the top three products on many dealer groups' approved product lists "dominate and concentrate most of the asset allocation."⁶ The regulator also concluded that it was apparent that high levels of funds under advice were concentrated in products issued by companies related to the dealer group.⁷ In some cases, this concentration was in high-risk products, such as tax-effective agricultural managed investment schemes.

This pattern of concentrating funds under advice into a small number of products holds true whether one looks at product recommendations as a whole, or product recommendations within a class. For example, ASIC found significant concentration for the class of products sold through platforms. Indeed, 95% of the funds invested through platforms with a wrap structure were concentrated in three products.⁸ Platforms with a master trust structure concentrated over 80% of the funds under advice into just three products.⁹ This concentration is particularly acute when one considers that funds invested through platforms comprise the vast majority of client money.¹⁰ Dealer groups also concentrated 60% of funds under advice in the superannuation class into just three funds.¹¹

We note that these high levels of concentration occurred in the context of approved product lists (APLs). It is well understood that APLs constrain choice.¹² All of the dealer groups covered in the ASIC report used an approved product list.¹³ Notwithstanding that many of these lists included hundreds of products, funds under advice were concentrated in a relatively small number of products.

It is difficult to reconcile the remarkable degree of product concentration with the notion that financial advisers provide personal advice that is tailored to the particular facts and circumstances of a client. ASIC itself expressed scepticism, stating that "if advisers are recommending high levels of a few products, then the reasons need to be explored and justified."¹⁴

Given that adviser recommendations are highly concentrated, it would be worthwhile to carefully examine these recommendations to determine whether the products are objectively good performers. Are the few products that hold such significant amounts of all funds under the advice of a dealer group really the best in class, or are they simply highly profitable to the adviser and the dealer group? Unfortunately, the ASIC report does not identify the products. Aspects of the ASIC report, including its statement that recommending high levels of a few products needs to be explored and justified, may lead one to infer that clients are being concentrated in related party products because of conflicted remuneration structures.¹⁵

⁶ ASIC Review of financial advice industry practice at 23.

⁷ See, *id.*

⁸ See, *id.* at 12.

⁹ See, *id.*

¹⁰ See, e.g., Robin Bowerman, "Money pouring into master trusts and wrap platforms," *The Age*, 10 November 2002.

¹¹ See, ASIC Review of financial advice industry practice at 12.

¹² See, e.g., "Opinion: The best interests of clients," *Financial Planning*, 10 November 2010.

¹³ ASIC Review of financial advice industry practice at 7.

¹⁴ *Id.* at 8 and 25.

¹⁵ *Cf.*, Sally Patten, "Advisers flouting rules: Watchdog," *Australian Financial Review*, 14 September 2011 at 6 (observing that "Investors are being channelled into products, with the inference being that many of these products are manufactured in-house.")

Given the comparatively poor performance of the retail super sector,¹⁶ and the high levels of product concentration in funds under advice, ISN believes ASIC should examine the products in which funds under advice are concentrated and publish the results of its investigation.

A substantial portion of advisory clients were not 'active,' which necessitates an opt-in measure if asset-based fees are not banned

The ASIC report also uncovered that, of the 4.6 million clients of the surveyed dealer groups, over three million (i.e., two thirds) were not active. The report did not define 'active' client and ISN is cautious about arriving at a final interpretation of the data. However, one inference that seems reasonable to draw is the clients are not subject to active engagement by the advisor. Existing evidence has shown that a significant majority of clients do not receive ongoing and active advice from their planner. Roy Morgan Research estimates issued in June 2011 found that 72% of retail super fund members do not have regular communication with their financial planner.¹⁷ Research by the consultancy firm Radar Results considered a sample of 71 planning firms and found that the ratio of inactive clients to active clients was up to 5:1.¹⁸ The finding in the ASIC report that over two thirds of the clients of the 20 largest dealer groups were not active appears consistent with the existing evidence.

The implication for public policy in connection with the Future of Financial Advice Reforms is clear. Ongoing asset-based fees are a form of remuneration that is well-recognised as presenting a conflict of interest, and were categorised as such in the ASIC report.¹⁹ Moreover, these fees slowly erode the savings and wealth of Australian consumers.²⁰ ISN supports banning all forms of conflicted remuneration in the financial advice industry. Short of that, it is essential that consumers be protected from being exploited by passive ongoing fees by requiring financial planners to regularly obtain an affirmative 'opt-in' from clients. Otherwise, millions of clients will continue to pay ongoing fees and receive nothing in return. The opposition of the planning industry to an opt-in measure can be understood better if two-thirds of their future client base is not active and unlikely to opt-in if required.

ISN takeaways from the report

Conflicts of interest in the financial planning industry are a serious and longstanding public policy issue. ISN applauds ASIC for undertaking this research and publishing the results.²¹ The information presented in the ASIC report is not only useful to inform policymakers, but demonstrates a significant gap in public information about the business models of the financial advice industry. While the existence of conflicts of interest was known, the magnitude – that 90% of remuneration is paid by product providers – was a significant revelation.

¹⁶ See, e.g., ISN Research Report: A Comparison Of Long Term Superannuation Investment Performance, Industry Super Network, September 2011 (finding that over a 14 year period retail funds have returned, on average, less than other categories of superannuation funds and failed to eclipse the risk-free cash rate).

¹⁷ See, e.g., *Estimating Super Members Paying For Advice Which They Don't Receive: An Extension of Roy Morgan Retirement Planning Research June 2011*, Industry Super Network, August 2011.

¹⁸ See, Elise Burgess, "Inactive clients trouble planning industry," *The Financial Standard*, 16 September 2011.

¹⁹ In addition, ASIC's consumer-oriented website, Moneysmart, has recommended that consumers avoid asset-based fees for these reasons (stating that "You may be offered advice on a commission basis or on a fee-for-service basis. In our opinion, the fee-for-service model is generally a better way to pay for advice. It reduces the chance that the adviser's recommendation will be biased. A 'flat dollar' fee, rather than a 'percentage of assets' fee, will give you more certainty and reduce conflicts of interest. It is better if the adviser does not have an incentive to recommend that you invest larger amounts of money.")

<http://www.moneysmart.gov.au/investing/financial-advice/choosing-an-adviser>

²⁰ See, *Inquiry into Financial Products and Services in Australia*, at 71-2.

²¹ ASIC expects to commence a second phase of this inquiry in the first half of the 2011-2012 financial year. This phase would survey the 30 next largest financial services licensees that provide financial product advice to retail clients with a reduced and more targeted questionnaire. See, ASIC Review of financial advice industry practice at 9.

Accordingly, ISN calls for ongoing reporting on matters related to those considered in the ASIC report, including: (i) the business models; (ii) ownership structures; (iii) remuneration practices; (iv) assets under management; (v) client demographics, behaviour, and service provision, including frequency and type of services provided, and their relationship to fees charged; (vi) product concentration; (vii) qualifications and number of advisers; (viii) risk management; and (ix) practices related to approved product lists.²²

Recognising that payments from product providers are often business-to-business within vertically integrated enterprises, the only credible source of this information would be ASIC. Armed with this information, ASIC also could perform an assessment of the relative value of different fee models used in the industry for common advice scenarios. To ensure that the information collected and reported adequately serves the public interest, development and consultation regarding a reporting model would be needed, as well as appropriate supplemental resourcing for ASIC.

ISN also calls for prompt and robust implementation of the Future of Financial Advice reforms. After reviewing the findings, ASIC observed that the “management of conflicts of interest remains the critical risk that requires more attention from licensees.”²³ ISN agrees and believes core elements of the reforms will make inroads into these conflicts of interest. For the reforms to successfully address the persistent problems arising from conflicts of interest, they must include: (i) a watertight best interests obligation, (ii) a comprehensive ban on conflicted remuneration, and (iii) a requirement that clients ‘opt-in’ to any ongoing fees (assuming they are not banned outright). A watertight ‘best interests’ obligation will require priority to be given to the interests of a client over the interests of the adviser, the licensee, and any related party product providers, and require product recommendations to be drawn from an unbiased review of available products and offer superior performance on the basis of expected risk-adjusted net returns.

Conclusion

On the surface, financial planners seek to convince their clients that they have the client’s interests at heart. But underneath this appearance is a compensation system that, at least for the largest dealer groups, structurally divides the loyalty of financial planners by compensating them substantially on the basis of their sales of financial products, especially related-party products. The recent ASIC report exposes the degree to which the financial planning industry is a sales force, and the degree to which conflicts can reasonably be expected to inhibit the provision of advice that is in the best interests of clients, resulting in consumers purchasing products and engaging in other financial activity that may undermine their economic wellbeing, and that places greater burdens on Australia’s safety net.

ISN, joined by The Australian Institute of Superannuation Trustees, CHOICE, accounting bodies, and independent financial planning groups, is engaging with the Government on behalf of industry super fund members to remove these conflicts of interest. ISN supports banning conflicted remuneration, and requiring financial advisers to place the interests of the client ahead of their own. If ongoing asset based fees are permitted to continue, ISN believes credible reform requires that these fees be subject to a regular opt-in. The empirical evidence clearly shows that the vast majority of financial advisory clients are not active and this passivity has been exploited by financial planners - potentially to the detriment of individual clients’ accumulated wealth and savings.

²² In addition, ASIC should continue to undertake follow-up surveillance work to ensure survey responses are accurate. As ASIC noted, its follow-up surveillance work in connection with the report discussed in this Briefing Note revealed that what had been reported in the questionnaire did not always match a licensee’s on-the-ground practices.

²³ ASIC Review of financial advice industry practice at 7.