# APES 230 Project status update

## Purpose

To provide an update to the Board on the progress of the APES 230 project in the following areas:

- Key stakeholder engagement.
- Fundamental principles of the Code and the remuneration methods adopted by financial planning practices in respect of financial advice.
- Remuneration practices in respect of Insurance and risk products.
- Practical example of a Fee for Service Firm
- International trends/developments and *FoFA* update.

## (i) Key stakeholder engagement

APESB has initiated a consultation process with respondents to APES 230 ED who have been identified as key stakeholders based on the analysis presented at the 31 January 2011 Board meeting. Key stakeholders were selected based on the following criteria:

- Organisation type;
- Different sizes of organisations to provide adequate coverage of different issues encountered based on size; and
- Breadth and analysis of the key issues in their respective submissions.

Over 30 key stakeholders were selected based on the above criteria. At the March Board meeting, the Board determined to invite the key stakeholders to present to the Board and to further discuss the key issues raised in their respective submissions. The following eight key stakeholders have been invited to present to the Board at the May 2011 Board meeting:

1. Roskow Independent Advisory;
2. Pitcher Partners Advisory;
3. KPMG;
4. Suzanne Haddan & Robert M.C. Brown;
5. Industry Super Network;
6. William Buck;
7. Hewison Private Wealth; and
8. Bongiorno Group.

## (ii) Fundamental Principles of the Code and the remuneration methods adopted by financial planning practices in respect of financial advice

The five fundamental ethical principles that Members of the accounting profession must comply with are in APES 110 *Code of Ethics for Professional Accountants:*

***Fundamental Principles***

100.5 A Member shall comply with the following fundamental principles:

(a) *Integrity* – to be straightforward and honest in all professional and business relationships.

(b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional competence and due care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent Professional Services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

(d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the Member or third parties.

(e) *Professional behaviour* – to comply with relevant laws and regulations and avoid any action that discredits the profession.

Other relevant sections of the Code to consider when considering remuneration practices of financial planning / wealth management firms are:

- Section 110 – *Integrity*
- Section 120 – *Objectivity*
- Section 200 – *Members in Public Practice Introduction*
- Section 220 – *Conflicts of Interest*
- Section 240 – *Fees and Other Types of Remuneration*
- Section 280 – *Objectivity – all services*
- Section 310 – *Potential Conflicts*

The various remuneration methods adopted by financial planning practices in respect of financial advice are:

- Commissions which are paid by product manufactures;
- Asset-based fees which are linked to Funds Under Management (FUM);
- Fee for Service (Flat or fixed fees based on services provided to clients which are unrelated to sale of products or FUM).

### Commissions

Due to the *FoFA* reforms to be implemented by the government it is unlikely that this form of remuneration will be used in respect of financial advice post 1 July 2012. However, it should be noted that the government reforms will be implemented on a prospective basis.

### Asset-based fees which are linked to FUM

*Arguments for asset-based fees*

Respondents who are supportive of asset-based fees which are linked to FUM argue that:

- A percentage of FUM is easily understood by the client;
- Allows clients to access financial advice;
- This method is widely used and consumers are familiar with it.
- Provides an incentive for a Member to grow FUM as then they will also get a higher remuneration and thus are rewarded if the invested funds perform well.

*Arguments against asset-based fees*

Respondents who do not favour asset-based fees argue that:

- Whilst there is an upside opportunity there is also a downside risk in having the Members remuneration linked to the performance of the market. The wealth management industry was one of the industries that suffered the most during the Global Financial Crisis (GFC).
- An asset-based fee approach has the potential to skew the behaviour of a Member to recommend investment strategies that accumulate FUM to the detriment of considering other investment strategies (i.e. Investment properties, lowering debt of a client, investments in cash in falling markets etc.).
- Accordingly, there will be a lack of objectivity and potential conflicts of interests in making recommendations to invest in FUM or to be invested in FUM as otherwise Members may not be able to earn remuneration (i.e. obtain a percentage of FUM).
- Another issue is transparency. “1% of FUM” may be transparent in a conceptual sense, but it may not be clear in an absolute dollar sense. To accurately predict the final fee of the proposed “1% of FUM” at the start of the year may not be impossible.

| Key Advantages | Key Disadvantages |
|---|---|
| • In a sense easy to understand.<br>• Upside Opportunity for Member if FUM grows.<br>• Alignment of client interest to grow FUM and FUM performance with the Member’s interest of earning a higher remuneration. | • Actual dollar amount may not be clear to a client.<br>• Risks of Member’s objectivity and conflicts of interests.<br>• Downside risks.<br>• Rewards FUM growth not whether the client’s best interests are served.<br>• Biased towards asset-rich clients. |

*Please see Appendix 1 for Advantages and Disadvantages of asset-based fees which are linked to FUM and Fee for Service remuneration comparison table.*

**Fee for Service (Flat or fixed fees based on services provided to clients which are unrelated to sale of products or FUM)**

*Arguments for Fee for Service*

Respondents who favour Fee for Service argue that:

- When a Fee for Service remuneration approach is adopted the Member's commercial interest are not linked with the sale of products or accumulation of FUM;
- This remuneration method complies with the fundamental principles of the Code and minimises conflicts of interest (which are present in the commissions and asset-based remuneration methods).
- Allows the Member to provide objective and unbiased financial advice which is in the best interests of the client.
- Transparent to the client and provides them with an actual dollar amount upon which they can evaluate whether the benefits of the intended purchase outweighs the cost.

*Arguments against Fee for Service*

- It is difficult to implement Fee for Service.
- It is difficult to price fees as more complex advice may have higher variability in outcomes.
- Adoption of Fee for service will mean higher fees which may make it difficult for ordinary Australians to access financial advice.

| Key Advantages | Key Disadvantages |
|---|---|
| • Transparent<br>• Simple to understand and it is clear to the client what the cost of the service is.<br>• Allows for modular / piecemeal approaches.<br>• Encourages efficiency.<br>• Does not create conflicts with the Member's commercial interests and the best interests of the client.<br>• Scalable (with the right set up) | • Performance risk.<br>• Some respondents note that it is difficult to implement Fee for Service. |

*Please see Appendix 1 for Advantages and Disadvantages of asset-based fees which are linked to FUM and Fee for Service remuneration comparison table.*

*Technical staff note*

Some respondents incorrectly interpreted Fee for Service to mean **hourly rates** and argued that **hourly rates** are inappropriate and will lead to inefficiencies. Please note that the definition of Fee for Service <u>should not be read</u> to mean **hourly rates**.

The definition of Fee for Service from APES 230 ED is reproduced below:

***Fee for Service*** *means fees determined by taking into consideration factors such as the complexity of the Financial Advisory Service, the required skills and knowledge, the level of training and experience of the Member and the Member's staff, the degree of responsibility applicable to the work such as risk and the time spent on the Financial Advisory Service.*

*Fee for Service does not include Commissions, percentage based asset fees, production bonuses, or other forms of fees or remuneration that are calculated by reference to product sales or the accumulation of funds under management, whether paid by the Client or a third party such as a product manufacturer.*

### (iii) Remuneration practices in respect of Insurance and risk products

The most common remuneration method in respect of insurance and risk products is commissions. However, Members who have adopted a Fee for Service approach are charging their clients on a Fee for Service basis and rebating the commissions they receive from the insurance companies.

*Arguments for Commissions based remuneration*

Respondents who want to maintain a commission based remuneration structure for insurance and risk products argue that:

- The insurance company sets the commission based remuneration structure and therefore, Members have no say in the remuneration methods;
- Clients may not want to engage a financial adviser who adopts a Fee for Service approach; and
- In Australia there is an under insurance problem and by charging clients an upfront fee for service it will only exacerbate the underinsurance problem.

*Arguments for Fee for Service based remuneration*

Key stakeholders who argue for a Fee for Service approach for insurance and risk products argue that:

- the current embedded commission based remuneration is a vicious cycle and actually contributes to the ongoing problem of underinsurance.

- A stakeholder points out that one of the major factors in determining how insurance premiums are priced is the embedded, up-front advisor commissions where the commission payment is factored into the cost of the premium charged to consumers. A Survey of initial commission reveals that they can be in the range of 100-130% for the first year and around 11% on an ongoing basis. These commissions are paid by the insurer to financial advisers which are then factored into the amount of premium charged to the consumer. When an insurance company pays a financial advisor these commissions, it will mean that the client will have to stay with the insurance company for at least five to six years to make it sustainable for the insurance company. However, if there is a high churn rate then this will lead to the insurance companies pushing the cost of premiums higher. This in turn contributes to higher insurance premiums and may be contributing to the under insurance problem in Australia.

- As price is a determinant factor for consumers when choosing an insurance policy, if the cost of premiums is lower then it may lead to more consumers being attracted to obtaining insurance. Fee for Service advisers state that they can save clients up to 30% of annual insurance premium costs.

- The underinsurance problem has existed in Australia for several decades and the existing practices do not appear to have solved it.

*Refer to Appendix 1 for Quantum's submission to the government on this issue - Confidential*

**(iv) Practical example of a Fee for Service Financial Planning Firm**

APESB technical staff visited a financial planning firm that fully complies with the requirements and guidance proposed in APES 230 ED.

This financial planning firm provides holistic financial planning services in the following areas:

- Wealth accumulation strategies;
- Retirement planning and aged care;
- Superannuation advice;
- Investment advice;
- Salary packaging;
- Centrelink;
- Income protection, risk insurance;
- Estate planning; and
- Accounting services.

Characteristics of this independent financial planning firm are:

- Complies with *Corporations Act 2001* section 923A;
- Fee for Service based on complexity and scalability of the service;
- Fee for Service is applied to all clients;
- Has Legacy products where commissions are rebated back to clients;
- Annual Service Fee letter to notify client of fees payable and any rate increases;
- Do not have ownership affiliation with product manufacturers; and
- Do not charge commissions or asset-based fees.

The basic fee structure of this firm outlines a structured process in Client management and sets out clear fee collections points which are on a Fee for Service basis. The firm has a detailed process for new and ongoing clients with regarding to fee collection points and the structure of their financial advice offerings.

As not all clients are seeking holistic advice, provision of one-off services is also available on a Fee for Service basis. The firm notes that this enables a lower entry point for the public to access financial advice.

The firm also provides advice in respect of insurance and risk products which are charged on a Fee for Service basis. Commissions on insurance and risk products, loan products are all rebated to the customer. The firm has provided us with their *Commission Rebate Procedure* which detail the process adopted by the firm which in effect fully complies with APES 230 ED.

Another issue raised by some respondents relates to the difficulty in applying Fee for Service for loan products (e.g. financing arrangements). This service is also currently provided by this firm who are being remunerated on a Fee for Service basis

The firm provides an annual review of the fee structure to clients and provides their clients with a letter annually which outlines the services provided and fees payable for the year.

The firm notes that legacy products do trigger issues relating to CGT, Annuity and Insurance Bonds and in some instances it is not practical or in the clients best interests to unwind these contracts. They have a number of clients with legacy products and in these instances the relevant commissions are rebated to the client. The administrative effort to handle these legacy matters on a quarterly basis is estimated at not more than half a day for one person.

When the firm transitioned to fee for service they had less than 1% drop off rate from clients. The key obstacle for them during the transitioning process was a lack of available support material and implementation support in the market place on how to transition to Fee for Service. However, currently there are a number of books published on the transition process as well as consulting firms that offer transition services in this regard.

The firm stated that from the commencement day of the transition process to the completion date, the whole process took less than 2 months to complete.

## (v) International Trends/Developments and FoFA Update

<u>*International Trends/Developments*</u>

***United Kingdom***

The Financial Services Authority, the regulator for financial services in the UK (organisational equivalent to ASIC), has performed a similar review to Australia. This has resulted in the ***Financial Services Act 2010***, which was passed by the British Parliament on April 8th 2010, in respect of remuneration the act focuses on:

- The banning of commissions;
- Setting explicit agreement of “adviser charges” that must be agreed to by customers and financial planners, and the default position is that no fees will be applicable; and
- Establishing clearer description of financial advice (as “independent” or “restricted”).

***United States***

The proposed ***Restoring American Financial Stability Act of 2010*** aims to resolve some of the problems highlighted by the Global Financial Crisis, and proposes:

- A fiduciary standard of responsibility on brokers offering financial advice;

- Registration with SEC of financial planners; and
- The creation of an Independent Investor Advisory Committee.

*Future of Financial Advice (FoFA)*

The Australian government has released the *Future of Financial Advice* Information Pack on the 28 April 2011. This Information pack includes a number of key measures on a number of areas. Please refer below to a summary of the *FoFA* reforms released on 28th April 2011:

| ***FoFA* Measure** | **Description** | **Scope/Application** |
|---|---|---|
| Ban on conflicted remuneration | A ban on conflicted remuneration structures, including commissions and volume-based payments. | Provision of general and personal advice to retail clients. |
| Compulsory renewal (Opt-in) | A requirement for financial advisers to renew client agreement to provide ongoing advice every two years.<br><br>In the intervening year a financial adviser must advice the client in writing off the fees for the next year. | Provision of personal advice to retail clients. |
| Best Interest Duty | Requirement for adviser to act in the best interest of their clients. | Provision of personal advice to retail clients only. |
| Ban on soft dollar benefits | A ban on soft dollar benefits over $300 per benefit. | Includes provision of general and personal advice to retail clients. |
| Basic banking products carve-out | Relief from best interest duty and ban on conflicted remuneration where employees of ADIs are selling their employer's basic banking products. | The carve-out will apply in relation to general and personal advice in relation to the products mentioned. |

*Source: Future of Financial Advice 2011 - Information Pack 28 April 2011 (Refer Appendix 8)*

**Appendix 1 – Comparing Advantages and disadvantages of assets-based fees and Fee for Service**

| Fee Model | Advantages | Disadvantages |
|---|---|---|
| Fee for Service | • **Transparent** – Fees can be easily broken down and compared.<br><br>• **Simple to understand** – Fee for Service are easily understood by the lay consumer.<br><br>• **Client certainty** - Certainty of price instils confidence in clients.<br><br>• **Piecemeal –** Fee for Service allows smaller increments of work to be conducted for the client.<br>• **Encourages efficiency –** Fee for Service encourages planners and practices to innovate and improve the efficiency and effectiveness of the delivery of their services to ensure profitability on fixed price arrangements.<br><br>• **Not conflicted with the best interests of the clients –** Fees are paid purely by the client, with services delivered purely at the request and in the interest of the client.<br><br>• **Scalable –** Given the appropriate services and an efficient mechanism for delivering specified services, Fee for Service is a significantly more scalable approach versus time-based models. | • **Performance risk -** Planner and practice carries the risk of delivering advice services in a non-profitable fashion, i.e. with minimal variances, delays, inefficiencies, etc.<br><br>• **Challenging to implement** - Some respondents note that it is challenging and not possible to implement Fee for Service. |

| Fee Model | Advantages | Disadvantages |
| --- | --- | --- |
| Asset-based fees which are linked to FUM | • **Explicit –** An explicitly agreed alternative to commissions that is opt-ed "in" to by the client.<br>• **Market-linked –** Planner shares in upside or downside asset performance. | • **Moderately opaque –** with asset-based fees it may be difficult for clients to determine the true, underlying cost of advice.<br>• **Risk of conflicts** – Requires a focus on "investable assets", and a bias towards placing clients in products or platforms which generate revenue for the planner but which may not be appropriate for the client. The temptation to "upsell" to a client.<br>• **"FUM Chasing**" **–** Rewards business performance based on the building up of FUM, as opposed to client service.<br>• **Market-Linked -** Revenue is linked to asset performance resulting in revenue loss in adverse markets.<br>• **Misalignment of expectations –** Creates an expectation that the planner is responsible for asset performance. |