ASIC

Australian Securities & Investments Commission

The financial planning shadow shopping project – results and moving forward

An address by ASIC Commissioner, Prof Berna Collier, to the Australian Investors' Association Annual Conference, 12 June 2003

Introduction

Thank you for the invitation to speak at the AIA National Conference today. The topic on which I am about to speak is one which has sparked a great deal of interest around Australia. Investors are clearly a group with a stake in the results, as are members of the financial planning industry, some whom I understand have been present at the conference over the last few days.

My topic of course relates to the 'Survey on the quality of financial planning advice' – an ASIC research report undertaken jointly with the Australian Consumers Association on the quality of advice provided by financial planners, which was released on 11 February 2003. The survey is known colloquially as the 'shadow shopping survey' – hence the title of my paper.

This is the third time ASIC has undertaken a survey of this nature – we previously conducted similar surveys in relation to financial planners in 1995 and 1998.

Although the quality of advice survey is not the only work ASIC has done in this area, it has gained a level of public prominence that I think is unprecedented for the financial services sector. This report was released several months ago but it continues to spark what we consider a surprising amount of interest and concern in the media and public forum.

So for example, at the time of writing this paper in mid-May (three months after the release of the report) I was looking at a (then) current media clip from the Adelaide Advertiser of 17 May 2003, which was headed 'Avoiding the nongs', and which discussed the importance of selecting a good financial adviser.

According to our own research, at the time of writing this paper the survey has been mentioned in at least 194 Australian newspaper and magazine articles since February (and this does not include other forms of mention in the media). The survey seems to have struck a chord. It has resonated with many people, both inside and outside the consumer movement and the financial planning industry itself, and I believe it will be the catalyst for change.

Today I am going to talk about several aspects of this survey.

- I am going to look at why we undertook the survey.
- I am going to look at the general results of the survey.
- I am going to look at the implications of the survey for various elements of industry and regulator practice.
- Looking forward, I am going to talk about follow-up actions that ASIC is planning.

Why did we undertake the survey?

Importance

We all understand the demographic pressures arising from an ageing population that are creating a growing demand for financial planning. We also have a policy environment that is generating increasing demand for such services, some of this because people are being forced to take on greater responsibility for their own long-term financial wellbeing through compulsory superannuation.

Approximately 90% of retail managed funds are directed via advisers (not including employer and industry superannuation). Further, there are estimated to be 16,000 financial planners in the industry, and the FPA estimates that its 14,500 members service 5 million Australians and a combined value of $630 billion.

Accordingly, ASIC focuses a lot of attention on the financial planning industry and its impact on consumers, for the simple reason that **it is important** and we consider that it is vital for the financial services regulator to have an understanding of the quality of advice which is being provided by the industry. The majority of retail investments are undertaken through advisers.

Therefore the performance of financial planners has a significant impact on how much money people will have in their pockets during retirement.

Assessment of quality

Why then undertake a shadow shopping exercise to assess the performance of this industry? Why not use more conventional surveillance methods?

This leads to the second reason for undertaking the survey – there are significant difficulties involved in assessing the quality of advice offered by financial advisers without the use of such a technique. This is not necessarily a criticism, but rather an innate feature of complex service markets.

The product offered by financial planners is, generally speaking, intangible. It is long term and complex, involving typically a mixture of advice and complex investment products. It varies significantly depending on the individual circumstances of the consumers, in the way that a television, for example, clearly does not. It is therefore widely recognised that in service industries of this sort, actually shopping for the product directly must be part of the answer to determining quality. Looking at disclosure documents or client files is important, but will not tell you the full story of how the market works. A survey based on real shopping is one key device for doing just this.

Accuracy of information

Related to the above point, consumers have considerable difficulty assessing the quality of the advice on offer for the same reasons. There is what economists call extensive 'information asymmetry' in this market. In such markets regulators must play a more active role in ensuring that consumers are getting what they need. A key vehicle for doing this is via shadow shopping.

In other words, as a regulator we have to have more than one tool in the toolkit to deal with problems in this industry, to raise standards and to assess quality. FSRA gives us many tools, and will improve standards, but a survey like this can highlight how advisers are complying with these requirements, and identify problem areas that we should target.

Revealing systemic issues

A fourth reason for conducting such a survey is that ASIC has some well recognised concerns in relation to standards in the financial planning industry. Cross-industry issues such as disclosure and management of conflict of interest between advice and sales, appropriateness of advice for consumers, compliance controls, and the limited nature of some advice are areas where we are on the public record as conducting campaigns and seeking strong compliance.

In one sense this is not surprising – these are well recognised within the industry itself as significant challenges. But have these challenges been adequately addressed in recent years, in an industry that is still relatively young and has been growing quickly? During that period we have seen constant reshaping and rationalisation in the industry, battles for control over distribution channels, for control over ownership of clients, rapid development in software and product platforms.

In other words a question that has to be asked is whether during this time the *real* game, quality of advice, was neglected. Conflicts of interest in planning activities emerged in various forms during the growth of the industry as big producers swallowed up planning firms, as remuneration structures became more 'performance oriented'. Were the problems that these could generate too easily set aside during growth in the industry and growth in the market? This critical big picture question is one that the quality of advice survey was seeking to address.

Law reform

Finally, on the timing front, the transition period for the *Financial Services Reform Act* amendments is almost complete. ASIC believes it is important that we understand where quality levels are at now in the marketplace, prior to the introduction of FSRA. We want to assess how standards develop once FSRA has had a chance to 'bite', and a general shadow shopping measure is a useful vehicle for undertaking such a measure.

In summary, ASIC views the *quality of advice survey* as a vital tool for assessing the financial planning marketplace, identifying issues that need to be addressed, and tracking performance over time.

Objectives of the survey

The objectives of the survey were :

1. to assess the standard of written advice in the financial planning industry against :

- Good practice standards;
- Consumer expectations; and
- Regulatory obligations;

2. to report on the experiences of consumers in consulting with a financial planner, particularly on communications issues and the satisfaction of consumers with the service received; and

3. to measure any industry developments in terms of quality of advice provided by advisers by comparing results with the 1998 ACA/ASIC survey.

As far as standards are concerned, it is also important to keep in mind that

- The plans were judged on pre-FSR standards; and
- We also looked at industry standards. About 90% of the financial planning industry are principal members of the Financial Planning Association, which requires its principal members to comply with the FPA's Rules of Professional Conduct. The rules require, for example, disclosure of commissions on insurance products and margin loans.

Results of the survey

As you know, overall, the quality was disappointing. Too many plans were poor on core elements of advice. It wasn't just a 'few rotten apples'. The end product reflected the skill levels, the company processes and the remuneration drivers within the industry.

Methodology used

The methodology for the survey can be summarised as follows :

- Fifty-three consumers were recruited, to each approach three financial planners.
- Each consumer genuinely wanted financial advice, and sought a plan for their own financial circumstances.
- Each consumer specifically asked the planner for a *comprehensive* financial plan.
- The consumers did not reveal to the planners that they were part of a survey.
- We selected the consumers and the financial planners in order that their profile would accurately reflect the profile of the financial planning market place. Planners were selected first, and volunteers matched against the list to obtain an appropriate geographic spread.
- The planners were selected using a 'random stratified' sample – that is the same method used by research companies to determine voting intentions, brand preferences and so on. Within each industry sector, a number of firms were randomly selected with the chance of selection equal to the proportional size in the sector. This ensured an appropriate number of plans from each industry sector. So, for example, financial planning services employed by banks represent approximately 15% of the market share, and the plans we solicited represented from banks were 20% of the plans we received.
- The only group from the financial planning industry which was over-sampled was stockbrokers. This was done deliberately to get an adequate sample size, because stockbrokers came out poorly in the 1998 survey. These we selected randomly from the Yellow Pages, where the firm advertised itself as 'financial planners'.
- We had some difficulty identifying 'small' financial planning firms – that is firms with less than 12 planners. This is because, although we sought to randomly select the firms from the Yellow Pages, many of the firms which were approached turned out to be authorized representatives of medium-large dealer groups.
- Volunteer consumers were selected to reflect the population of consumers who seek the services of financial planners, based on Roy Morgan research data. So, for example, 42% of the plans received were from consumers with less than $100,000 in assets to invest. At the other end of the scale, 18% of the plans were from consumers with more than $500,000 to invest.
- The geographic spread of consumers and planners reflected the distribution of financial planners and clients, and was almost identical to the distribution of the population aged 20 and over according to data from the Australian Bureau of Statistics. Volunteers were also distributed proportionally between capital cities and regional locations in each State.
- Any up-front fees for the provision of financial advice were met by ASIC. If volunteers were offered a range of payment options by the planner – e.g. fee, commission or a combination – they were entitled to select the option they would choose for themselves. Up-front fees generally ranged from $400-$800. Consumers with larger sums to invest were typically charged higher fees – the highest fee charged was $6,000.
- In a number of cases the advice given did not satisfy the definition of a 'comprehensive financial plan' from the outset for a number of reasons, including
    - The consumer was of modest means and told by each planner approached that they could do nothing for her
    - The planner gave verbal advice but would not do a formal plan

- The planner provided a brief strategy document or educational material but not a financial plan which could be assessed.

While we note that not all planners may have the skill to address, for example, complex needs or prepare a comprehensive financial plan, we take the view that in such a case the client should be referred to an appropriate planner or the advice declined.

Scoring

The plans were divided between 3 panels of judges. Each panel was made up of two experienced financial planners and a compliance professional. Each consumer completed a document listing their needs and objectives at the beginning of the survey, which was provided to the relevant assessment panel.

A score was awarded for each of twenty-six items. The score for each item was based on assessment against three broad criteria, i.e.

- The quality desired by an interested, reasonable consumer
- Good practice standards, using the FPA Rules of Professional Conduct where applicable.
- Legal requirements, where applicable. As I mentioned earlier, pre-March 2002 standards were used.

A plan was failed if the plan clearly did not meet any of the three criteria.

Each plan was given an overall grade ranging from 'Very Poor' to 'Very Good' based on the total score.

Plans were downgraded if they 'failed' on a particularly critical item – for example plans were downgraded overall to 'Poor' if they did not provide an Advisory Services Guide because this was deemed to be a 'critical error'. Indeed, 14% of planners surveyed did not provide an ASG. Banks were the worst offenders in this regard – of the Banks, 20% scored a 'Fail' for this item.

ASIC has received methodological criticism for downgrading planners for failure to provide the ASG. We reject that criticism for the following reasons :

- It is a legal requirement to provide an ASG under the pre-FSR position. I reject claims that planners should not have been disadvantaged for their failure to comply with a clear legal requirement.
- In addition to the legal requirement issue, it is important to note that after 11 March 2004 failure to provide an FSG will be an offence.
- An ASG contains basic information which retail clients are entitled to receive as a retail client as does an FSG for licensees under FSR (sections 941A and 941B *Corporations Act*), such as information about remuneration received by the provider of the financial service and information about any associations or relationships between the adviser and the issuers of any financial products. This is information

which one would reasonably expect the adviser to supply, and we reject claims that the ASG should not have been given the weight it was.

Plans were downgraded to 'Very Poor' if they did not show the suitability of specific investments in relation to the client's needs and goals, or to show an appropriateness of advice overall.

Key results

Overall the results can be summarised in the following table :

Grade	Score	Number of plans	Percentage of plans
Very Good	75-100	2	2%
Good	65-74	23	19%
Ok	55-64	36	29%
Borderline	45-54	30	24%
Poor	35-44	21	17%
Very Poor	0-34	12	10%
Total		**124**	**100%**

Putting this table into context – over a quarter of the plans failed and a quarter of them were 'Borderline'. Therefore, slightly less than half the planners provided a financial plan which was clearly judged to be acceptable according to the criteria of measurement against good practice standards and the consumer's request for a comprehensive financial plan..

In addition to these results,

- Stockbrokers had significantly lower scores than other industry sectors. Of the thirteen plans prepared by stockbrokers, six were 'Poor' or 'Very Poor'.
- Thirty percent of bank plans were 'Poor', partly due to the frequent absence of an ASG.
- Medium-large planners had better results.
- Results for capital cities were slightly better than regional locations.
- There was no correlation between length of experience and quality of plans. Over a quarter of the long term authorised representatives (i.e pre-1997) were in the 'Poor' or 'Very Poor' range.
- Planners with higher qualifications had slightly higher scores on average. Certified Practising Accountants and Certified Financial Planners had higher average scores than those with no additional qualifications.
- The overall result was worse for planners who were paid only by commission. Forty-four percent of the 'commission only' plans were in the 'Poor' or 'Very Poor' categories. Further, fifty-two percent of the 'commission only' plans scored 'Poor' or 'Fail' for the scoring item 'Overall appropriateness of advice', compared with twenty-one percent of 'fee only' plans and twenty-six percent of 'fee and commission' plans.
- The amount paid for advice was no guarantee of quality. Twenty-four percent of the

plans costing over $4,000 were 'Poor' or 'Very Poor'. The most expensive plan – i.e. $17,000 in commission – was 'Very Poor'.
- There was no significant relationship between the amount of assets for which the consumer sought financial advice and the quality of advice received.
- Some people with modest savings had difficulty getting any written financial advice at all despite being willing to pay a fee for advice.

Reaction to the survey

There were many reactions to this result. On the positive side, we at ASIC have been impressed by how many industry people have read the report and provided support or constructive feedback.

Broadly, however, we saw two reactions within the industry to the media reporting of the survey.

One reaction was 'Why is anybody surprised? These are problems that the industry is well aware of.' In particular, the areas of weakness identified by the survey are very similar to those identified by the FPA's National Quality Assessment Program.

Another common reaction was 'I work hard and do the best for my clients. This publicity denigrates the whole industry.' But it is important that all stakeholders get real insights into the strengths and weaknesses of the industry. The reality is that the weaknesses are always going to attract more publicity than the satisfactory aspects. However, if we don't face up to the real problems in the industry as a whole, the problems cannot be progressed and the industry will not progress.

Comparison with the 1998 survey?

ASIC and the ACA conducted a similar survey in 1998, although the surveys are not strictly comparable because of modifications to the assessment criteria and different grade categories.

Having said that, we can broadly say that it seems the overall quality of advice has not changed significantly since 1998. Factors which remained unchanged include :

- A significant proportion of plans still received unacceptable grades
- Stockbrokers again rated poorly
- Disclosure beyond basic components remained weak (although on the positive side basic disclosure of commissions has improved and there appears to have been a small improvement in the explanation of investment risk).

Broader issues – quality of advice and compliance

I would like to touch on a few of the implications that arise from the survey:

1. Quality control & compliance issues from the licensee's perspective
2. How to demonstrate to consumers that advice adds value
3. Conflict of interest issues.

Quality control and compliance

One of the surprising results of the survey was how much quality varied within most firms. Far too many companies produced both widely varying good and poor plans. More attention is obviously needed on quality control and compliance systems.

ASIC is doing follow-up compliance work where the problems revealed in individual plans may be systemic. You will hear more about this in coming months.

It is also of concern that a large number of the plans were not comprehensive financial plans as requested. One implication we drew from this was that planners are now more selective in their targeting of market segments – consumers of, for example, modest means appear less likely to receive a comprehensive plan early in their relationship with the planner.

Demonstrating value to consumers

Quality is also an important issue from the perspective of consumers. Consumers have difficulty assessing whether they have received good advice or not for the reasons I've touched on above – complexity of service, intangibility etc.

In our survey we saw a lot of plans that did not show ***why*** the recommended strategy was good for the client.

In our view, advisers should be able to show how they have protected the client's interests and increased the probability of wealth, compared to the other options available. This is good business sense in the adviser showing that it has added value, although this is particularly difficult during a market downturn.

In our survey, many plans were unclear about what service they were providing. Many gave limited advice (which may be fine), but did not disclose that the advice was limited. Some were vague about whether the adviser would provide an ongoing monitoring and review service. Potential misunderstandings like this are bad for the consumer and a recipe for future complaints for the adviser.

Conflict of interest

Of all the issues thrown up by the quality of advice survey, the most difficult is the issue of conflict of interest. Here I am going to speak on some issues that go beyond the immediate legal requirements. As ASSET magazine also recently stated:

> 'so many of the industry's strengths lie in the intangible ethical characteristics of the service it is offering, such as doing the right thing by the client, relationship building and providing good customer service.'

The conflict of interest issue, while it is reflected in the FSR law in terms of disclosure and appropriate advice requirements, also goes beyond what any law could contain.

About 70% of financial planners have ownership links to product suppliers. Perhaps 95% accept commissions in some form from product suppliers. The perception at present in many circles however is that fund managers do not own financial planning groups because they want to be in the *advice* business. They want to be in the *distribution* business. If there is no difference between the two then I suggest that the criticisms of this industry will continue.

The judges in our survey commented that many plans looked like commission driven product selling, not impartial advice. 'Commission only' plans did much worse than others in our survey, with 44% graded 'Poor' or 'Very Poor'. The remuneration system is not just a theoretical argument if it is affecting the quality of advice or reducing the industry's efficiency. Some people argue that commissions are irrelevant, as commissions are similar between comparable products. However, strategic and product recommendations can have a big impact on commissions.

Advice that can generate or magnify an adviser's benefit includes:

- Gearing (to increase investment amount)
- Margin loans (to get commission on loan)
- Recommending in-house products
- More aggressive risk profile (higher commissions from growth products & gearing)
- Self-managed super funds (to get on-going administration work)
- Direct share ownership (to get on-going share brokerage)

A lot of appropriate advice may not generate commissions:

- Paying off home mortgage or personal credit faster
- Salary sacrifice
- Index funds
- Non-profit industry, corporate or government superannuation funds
- Bank accounts or cash funds
- Reduce discretionary spending, increase income or increase years to retirement.

This leads to several challenges.

First, the current legislative framework deals with conflict of interest by disclosure. The challenge is that many of the disclosures seen in the survey do not allow the consumer to tell whether the conflict of interest *has affected the advice or not*, as the alternative options are rarely spelt out.

Another part of the commission issue is that the cost – and value - of the advice is blurred by bundling it in with the product cost. The blurring can be a problem because most of the value added by planners is in the strategy, not the product selection. This is not an issue that ASIC can fix on our own. The industry has to decide how to make this distinction to its clients and demonstrate that it adds value. This is an important point. If there is no distinction between advice and distribution then this survey will have the same results in a few years time. If a financial planner wants to be called a financial planner, but cannot clearly demonstrate to consumers that they earn your money through sensible and strategic advice, and that instead they simply exist to distribute commission-paying products, the problems of conflict of interest will not go away.

Given the structure and economics of the industry potential conflicts will always exist and must be managed. The survey suggests that they are not in many instances being managed well, both practically and from a perception viewpoint.

Improving standards and building trust

In summary, the various problems we observed in the financial planning industry have the potential to be running sores unless they seriously addressed. ASIC therefore intends to be on the front foot in ensuring that FSRA standards are rigorously implemented, and that we continue to target problems areas in the industry.

But at a more basic level, it is worthwhile noting that industries like the financial planning industry rely on trust that they need to earn from consumers. Once trust is undermined, it is hard to rebuild. As Robert Gottliebsen recently pointed out, the problems in the banking industry in the 1990's are a salutary lesson for the wealth management industry.

Finally, it hardly needs pointing out that if the financial planning industry does not address these issues itself, then the government may step in. Given the major effort involved in implementing FSRA, I do not want to contemplate further changes at present. But it is likely that no government will put up with low standards in this industry over the long term.

Moving forward – ASIC action

So what is ASIC's role going forward in relation to these issues? Given their importance we will continue to use a range of tools to assess the quality of advice, improve compliance standards, take enforcement actions, and educate consumers.

Licensing is a big part of our work at the moment with the new FSR requirements coming in next year. We are looking at whether license applicants have the systems in place to operate honestly, efficiently and fairly. We will be conducting both random and targeted surveillance visits to ensure that systems are actually implemented in practice, and are not just a manual on a shelf. Further, we are requiring some licensees to certify their compliance with relevant legal obligations, including the 'know your client' rule and commission disclosure.

Surveillance campaigns will be part of the picture. ASIC recently released the results of a targeted campaign that looked at advice on agricultural schemes. We are also part way through looking at sales of products by some large financial planning institutions. Given the clear issues with the stockbroking industry, we have also announced a campaign to improve advice standards in the industry, and we are continuing to pursue this.

Our policy work will be relevant to financial planning. For example, our recent consultation paper on advice seeks feedback on ASIC's efforts to clarifying licensees' obligations about advice under FSR. This includes perennial topics such as limited advice, appropriate advice and the distinction between personal and general advice.

We will continue enforcement work as the need arises. We will be doing more in-depth investigations where the Survey found firms may have systemic problems, and indeed we have spoken with every firm which received a 'Very Poor' rating.

We will continue our education work, sometimes in partnership with industry organisations like the FPA. For example, the survey showed how important it is for consumers to have an idea what financial planning potentially provides for them before they look around for a planner.

And finally we are planning another Quality of Advice survey in 2005 and look forward to your continuing interest in both the process and the outcomes.

