Big Themes Shaping Small AFSL Practices Over Next 2 – 5 Years

Tony Gillett ***CFP Fellow FPA and Director of AFSL Retirewell Financial Planning Pty Ltd (1/7/ 2019)***

The Great Advisor Exodus – Inversely Proportional to Practice Values?

A recent industry survey found that 30% of Advisers are likely to exit in the next 2 years, mainly due to the combined effects of the tough new FASEA educational requirements to be met by 2021/2024 and the forced removal of Grandfathered Commissions (GCs) by January 2021. Unfortunately for our emerging profession and for the Australian public, the majority of those leaving will be the most senior and experienced advice practitioners. Logic dictates that this will lead to an increased supply of financial planning practices and insurance practices for sale. The biggest buyers in the past have being the big vertically integrated Institutions, hungry for a new list of clients to whom they can sell and cross-sell their in-house products. Given that this business model is no longer acceptable or viable and these buyers have now vanished, it will be interesting to see how practice sale values hold up - and whether the buyers will be a new class of consolidators, with a business model which involves clipping the product ticket in a new way, possibly via MDAs or SMAs – or some new way facilitated by the rapid advances in technology and digitally enabled advice. The reality is that it is very difficult to upscale a business where 100% of the business's income, is payment is for personal Advice alone, paid directly by the client.

The Challenge

Those AFSL Principals able to make the necessary changes to their practices and business modus operandi, will end up being a vital part of a smaller but more professional and respected profession, post 2024. This will be a difficult journey for many, who historically have run "conventional" practices, where they are still reliant in some way on GCs and sometimes don't maintain consistent close contact with every client - often because the client does not consider it necessary. Many small AFSL models will need to change, since there will be no cross subsidies from product. The loss of Grandfathered revenue must see clients moved to a fee-for-service model, or be serviced on a pro bono basis – or be abandoned (surely not in the client's best interest?). To survive, many small AFSL practices must evolve quickly into the type of practice which will reflect the ASIC/FASEA post-2024 vision and model of professional financial planning and advice. By quickly, I mean within the next two years. Set out in the following paragraphs, are the important issues which need to be recognised, understood and dealt with, in order to make this transition and survive. As well, there are some personal and historical reflections. Those who can successfully negotiate this difficult and sometimes painful process of change and transition, can look forward to being part of a very busy, well-respected and well-paid new profession after 2024. Clients will have to accept higher fees – and AFSLs and Advisers will have to accept the need to pay higher costs and charge higher fees, to survive.

The Old 'Product' Mindset

Advice Practitioners must now adjust to a reality in which Product will finally be separated from Advice. '**Advice' will become the core product**, a new Business Model for many. For those who have many years of practice under their belts, this could involve a significant mental readjustment, since historically most remuneration structures have in one way or another, revolved around the sale of Product. An online poll of advisers December 2018 showed that 42% of advisers were still deriving more than 15% of their revenue from GC's. It is worth remembering that the entire regulatory regime since day dot has revolved around regulating the sale of investment Product – NOT the giving

of investment advice. It is worth asking the question, post the Hayne Royal Commission (HRC) – is the current regulatory system still "fit for purpose" – or should it be comprehensively reviewed and rewritten, around the central theme of regulation of advice? This central focus historically around Product has often ended up with the Advice seeming to be thrown in for free - or so it looked, to the client. If we didn't sell a Product solution, we didn't get paid and the client saw our remuneration as being tied to the sale of Product, not Advice.

Service Offerings and Pricing Structures

It will be essential for many of us, that we revisit, rethink and rewrite our basic Client Value Proposition. This will involve a major revision to the way our Service Offerings are worded and how they are priced, around the provision of Advice. This will likely be the most difficult, time-consuming and fundamental change that some (many?) of us will be forced to undertake in this whole difficult process of transition, since it is central to the change of mindset. Hiring an external consultant to assist in this process and to act as a sounding board, would seem a sensible idea and money well spent. Then begins the hard part, with individual discussions with every client about the necessity for change and how both the client the long-term advisory relationship, will ultimately benefit. This process could take between one and two years to fully implement – so the sooner the process is started, the better.

Commissions – to Be or Not to Be?

Investment Products – The payment of remuneration for the sale of new investment products by way of upfront or ongoing commissions, has been prohibited under Future of Financial Reform (FOFA) since 2013. However, a transitional arrangement was allowed whereby AFSLs were allowed to continue receiving trail commission payments on investment products which had been sold prior to 2013. The HRC recommended and it has been accepted, that all ongoing trail commissions will either cease to be paid, or must be fully rebated back to the client, by January 2021. The elimination of payment by commission (whereby the Adviser received their remuneration by way of a percentage based payment from the provider of the investment product being sold) was by far, the single biggest positive contribution towards the professionalisation of financial planning, to come out of the 2013 FOFA changes. Now that the day of reckoning is in sight (18 months away), those of us who must, need to plan for the loss of that income. Some practices have done it long ago, by moving to some form of fee-for-service remuneration and either rebating trailing commissions or deducting them from the client's annual fee. Where the percentage of total revenue presented by ongoing trails is less than 10%, the problem should be manageable.

Insurance Products – The big problem lies within those practices which have a big insurance (risk) base, or are a full standalone specialist risk businesses, where sometimes between 40% and 80% of total revenue, is derived from annual renewal commissions of risk based products.

Risk insurance and financial planning are quite different businesses, which require different mindsets and quite different skill sets. Good Insurance cover is sold, by a trained and skilled insurance professional - not bought, by a client who wouldn't know the difference between a TPD policy and a trauma policy. The current ideological push by regulators and others, who seem to have very little understanding of the different businesses of selling insurance and providing investment advice, to get rid of commissions out of the risk/insurance business, is clearly ignoring how consumers would prefer to pay for their insurance advice. When asked, the vast majority are happy to see the risk adviser paid by commission, rather than the client having to pay \$2000 to \$3000 out of their own pocket, for the service. The concept and practice of sales commissions being paid out of product

developed because the consumer could not afford to pay or would not pay for the advice upfront. I may draw the ire of some of my fellows, but I do not believe that all risk commissions are bad or conflicted. Provided there is a legal requirement that the product advice is genuinely 'best advice', the level of commission is reasonable (perhaps subject to a legislative cap), is clearly known, understood and signed off by the client and the client is happy - that's all that matters.

It is interesting to look at the 16 page guidance paper issued by the U.K.'s Financial Services Authority (FSA) in June 2012 "Retail Distribution Review: Independent and Restricted Advice" (see: http://www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg1215). In relation to the payment by Commission, their approach was: "**Commissions**: The rule on inducements bans the payment of a fee or commission, or the provision of the non-monetary benefit, unless certain conditions are met; namely that it does not impair compliance with the firm's duty to act in the best interests of the client, is clearly disclosed to the client before the provision of the service, and is designed to enhance the quality of the service to the client" In other words, commissions were not banned, provided the conditions as set out (i.e. acting in the client's best interests) were satisfied.

Retention of an 80/20 split (with charging of reasonable additional fees allowed, for difficult or more time consuming cases) with the present 2 year clawback brought back to 1 year, could keep the Australian risk insurance business viable, thus serving the long-term best interests of the community.

It would also greatly help if the risk insurance product manufacturers had a legal obligation to provide a true zero commission product, together with a same brand commission product. This would enable the Adviser to show costs/value over 5 years A risk advice consumer would be able to see whether they were paying more for zero commission + a fee for advice, versus an upfront fee with ongoing commissions. The risk product manufacturers are definitely not keen to do this.

I have no doubt that if ASIC's review of the Life Insurance Framework scheduled for completion in 2022, pushes for the complete removal of remuneration by commission for all life risk products, the Australian public will be far worse off, the current high level of underinsurance in Australia will become even worse and the ultimate cost to the taxpayer will be significant, because of the lack of insurance cover and insurance payouts to support the dependents of many more uninsured, unfortunate deceased or disabled individuals. The cost of supporting them will fall back to the government, i.e. the taxpayer. A final comment here – where insurance commissions were forcefully phased out in the UK, the result was the almost complete disappearance of quality standalone insurance advice businesses. This same result will happen in Australia - surely the triumph of ideological purity over common sense and pragmatism.

Dealing with FASEA

We will all have to meet higher professional, educational and ethical standards in the future, as an outcome of the changes arising from FOFA and the Hayne Royal Commission (HRC). We must all sit and pass a 3.5 hour FASEA exam (mainly closed book) by January 2021, in order to keep practising as a Financial Adviser. Then, for many, there will be years (and lots of precious time, dollars and lost weekends) of additional study to achieve an approved Industry relevant (Financial Planning) degree (or equivalent) by January 2024 - just to stay in business as a practising Financial Planner.

There will also be introduced a new system of Licensee self-reporting to FASEA, by AFS and Credit Licensees, of contraventions of the FASEA Code of Ethics, by their Authorised Representatives. It is mooted that these breaches will or may be added to the Adviser's record on the Financial Advice Register (FAR), the publicly available Register maintained by ASIC, of all persons who hold an

Authority to provide financial planning advice – a new form of regulatory hair shirt for the careless or unwary.

The refusal by FASEA to recognise years of experience and prior learning by many of the most senior and experienced financial planners in Australia, is a travesty of common sense and justice. Australian consumers and our emerging profession will be much poorer as a result, as much of that experience and invaluable mentoring capability reluctantly walks out the door into an early retirement. For what good end?

Stronger Compliance Scrutiny – and Higher Costs

Beginning in the early 1990s, the 'Big End of Town' (BEoT - the 4 Big Banks, AMP and to a lesser extent, IOOF) built up huge 'wealth management' businesses. The business model was built around cross-subsidising the cost of advice through the sale of in-house product, disguised as advice, through a vertically integrated structure where the bank's in-house advisers sold or cross- sold the bank's own platform, investment, insurance and superannuation products, to their customers. The introduction of a 'best advice' requirement under FOFA could not be reconciled with the banks' obligations to maximise shareholder profits, through maximising sales of in-house products.

Because of their miscreant actions in pursuing profits above their best advice obligations - as well as other misdemeanours, publicly aired in the HRC - they now can't get out of their wealth management businesses quickly enough. However, those dedicated advice professionals amongst us who remain, will suffer the consequences of a legislative and regulatory backlash, which in many instances amounts to overkill. We can look forward to considerably higher compliance costs for our businesses, through greater and more intrusive overview by an increasing number of regulators and rule-makers. We have multiple masters – there are at least 7 bodies presently exercising some level of control over the activities of an AFSL: ASIC, Austrac, the Tax Practicioner's Board, The Australian Financial Complaints Authority (AFCA), our professional body the FPA (or for some, the AFA), FASEA, the new Code Monitoring Body (from January 2020), as well as needing to observe the requirements of specialist bodies such as the SMSF Association and the Boutique Financial Planners group. Many of the above bodies have to be funded through annual payments from AFSLs or Advisers – or both. There is also active discussion about the establishment of a Compensation Scheme of Last Resort - what's the bet if this goes ahead, the costs of funding it will be sheeted back to AFSLs and their Advisers - as will the running costs of FASEA and the new Code Monitoring Body. That's an awful lot of hungry mouths for a small AFSL advisory business to feed.

A little more needs to be said about 2 of these bodies:

New Code Monitoring Body – From January 2020, we must all become a member of an independent Code Monitoring Body (yet to be established) which will have responsibility for undertaking a high level of scrutiny of our observance and compliance with the new FASEA Code of Ethics. The very helpful booklet put out by our professional industry body, the Financial Planning Association of Australia (FPA) called 'Helping You Understand the FASEA Code of Ethics' runs to 62 pages. We are unaware of how this new Code Monitoring Body will be funded – it will probably end up as another user-pays cost impost on our small businesses.

Australian Securities and Investment Commission (ASIC) – Our beloved regulator will definitely become more active (aggressive?) in their surveillance of the activities of Advisers and their AFSLs. As a result of the HRC, they have been given a bigger budget for the task, with significant additional human resources. They have also been split off legally from the Public Service, which will enable them to compete better in the salary stakes with private enterprise. We think that ASIC has been

unfairly maligned in the HRC - it has always done a pretty good job, given they have been perennially starved of the necessary resources to do their job properly. However, their bigger baseball bat is a significant worry for the 99% of advisers and their AFSLs who do their best to provide compliant, 'best advice', but constantly worry about being caught out and publicly vilified for the other 1% they missed or got wrong. Oh, I almost forgot – ASIC has joined the ranks of those once publicly funded service bodies, who now charge us for their services under a new user - pays basis. Most small AFSLs last year paid ASIC a few hundred dollars. This year the typical bill was between $5,000 and $10,000. Ouch!

It is worth noting that last year ASIC cost around $480 million to run. Yet it brings in revenue to the Commonwealth Government of close to $800 million per annum. Given that ASIC is such a solid positive contributor to Consolidated Revenue, one has to ask why small AFSL businesses are being hit with such substantial cost increases - costs which should be covered out of the substantial revenue ASIC already contributes to the Commonwealth Government's bottom line. The reason we all pay our taxes, is to ensure the Government has sufficient funds to carry out the duties of Government, which includes enforcing the law and protecting the Australian consumer of financial services - without resorting to double dipping by hitting up small businesses twice under the guise of "user pays". The Australian personal and business taxpayers have already paid.

Section 923A of the Corporations Act

If ever there was a case of overkill, it has been the extraordinary extension by ASIC of the meaning of the words used in Section 923A, to kill off the ability of the majority of small AFSLs to differentiate their services in the minds of the Australian public, from the vertically integrated business models of the BEoT (that's the Big End of Town – pay attention). This has highly favoured the competitive position of the BEoT against most small AFSLs - a huge free kick, sanctioned and encouraged by ASIC. We've seen how that ended up – thanks to Kenneth Hayne. Small AFSLs, unless they comply fully with the extended, ASIC imposed interpretations of Section 923A since it was brought in (not receiving a single dollar of any form of commission, unless rebated, amongst other things) are prohibited from saying they are 'ïndependent', 'independently-owned', 'impartial', 'unbiased', 'non-aligned' or 'unaligned' businesses or AFSLs - their greatest competitive advantage.

A further problem with S923A lies in the fact that our PII insurers insist that an AFSL maintains a well researched Approved Products List (APL) – the smaller and tighter the better. Yet S923A requires that Advisers must have a non-restricted Approved Product List [APL] under which to operate. Product failure is a major concern for PII Insurers post the GFC and a low risk, well researched APL must be maintained - or cover will be refused by the Insurers. Considering it is mandatory for all AFSL holders to have adequate PI cover to maintain their AFSL and stay in business, this condition is commercially unrealistic. So even an AFSL who doesn't receive a cent of commission, but maintains a restricted APL, will fail this S923A condition.

This outcome (particularly extending the meaning of 'independent' to prohibit the use of such terms as 'independently-owned', 'non-aligned' or 'unaligned') is a practical nonsense and Section 923A should be revisited and rewritten, with more flexibility to distinguish between different, legitimate business models - for the good of the Australian investing public. This need for change will become particularly pressing if commissions on insurance products are retained post the 2021/2 review. Section 923A is not fit for purpose. Its extended definitions are too inflexible and too narrow and the legal meaning of the word 'independent' has been tortured into confessing to meanings never intended under any Oxford Dictionary definition. The belief that any form of payment by commission is inherently evil, has been the ideological underpinning of the regulatory approach to date.

We strongly agree this has been a good thing when applied investment products, but we do not believe it should be applied to the sale of risk/insurance products. ASIC's attempts to extend the legal meaning of the word 'independent', though well-meaning, have stultified and unnecessarily restricted competition. Section 923A clearly does not operate in best interests of consumers and has caused great detriment to the Australian investing public.

The Lobbying Strength of the Big Banks – versus Small AFSLs

Past ASIC decisions which favoured the BEoT against the interests of small AFSLs, have a long history. Prior to the implementation of FSR (Financial Services Reform Act) in 2002, it was a necessary requirement [see PS117 *(3/3/1997)* – 117.56 to 117.77, as well as Practice Note 18] that every financial planning business (not being the holder of an AFSL) had to identify their AFS Licensee in their FSG, on their letterhead and other public marketing material, "in the same size font and in a manner no less legible" than their own business name. This gave the average punter a chance to identify whether advice from a BEoT- owned AFSL, might be biased towards the financial interests of the AFSL's product manufacturer/owner. This legal requirement was quietly dropped, without any fanfare, post FSR in 2005. The cynical amongst us put this down to the serious lobbying power of the BEoT. Thereafter, overt mention of the institutional owner relationship mostly disappeared from letterheads and was usually relegated to the fine print at the bottom of page, or the end of the document. This had the effect of providing a very material competitive financial advantage to the 34 AFS Licensee businesses (list available on request) whose BEoT owners had infinitely deeper pockets than any small AFSL, to pursue their primary purpose of maximising distribution of their own product. Some of these (sometimes very large) conflicted AFSLs even got away with calling themselves 'independent' in their marketing. Given that at least 50% (some estimates say 70%) of Advice Representatives (Employee or Authorised) in Australia held their Authority, directly or indirectly (through these BEoT - owned AFSLs) from the BEoT, it is difficult to gauge the financial benefit of the 'free kick' quietly handed to the BEoT, by the removal of the requirement to clearly identify the ultimate product manufacturer/distributor owner, on the letterheads and marketing material of AFSL businesses ultimately owned and licenced by the BEoT. In a number of surveys conducted post FOFA, typically over 50% of the clients of these BEoT - owned AFSLs, believed them to be "unbiassed" or "independent"- thus showing just how successful this strategy had been. This allowed potentially conflicted advice to flourish. Institutionally aligned advisors could conceal their institutional ownership, whilst offering the owner's products to consumers, regardless of their quality. Any reference to institutional ownership usually appeared in the small print of the FSG, effectively camouflaging it from consumers. Hopefully this era is now over.

Annual Service Contracts

True and proper financial planning is not a one-off event, but the result of a long-term advisory relationship - a relationship which can be lifelong. Yet thanks to the abuse of clients by the BEoT through charging annual fees whilst providing no service in return, we will now legally prevented from entering into a long-term client advice relationship with our clients. The BEoT, having suffered huge reputational damage, have been forced to acknowledge they can't make a profit out of just giving Advice and as a result, can't exit their 'wealth management' businesses quickly enough. Yet those of us who remain, are now being forced to re-sign Advice clients every year – even if the client finds this tedious and upsetting. Just like not being able to use the term 'non-aligned', this is imposing a costly and unnecessary solution, to close the gate after the BEoT horse has well and truly bolted. Implementing this new requirement for the re-signing each year of an Annual Service Contract will cause significant additional and unnecessary costs to small AFSL businesses, which in many cases are difficult to pass on. All clients are already provided with a Fee Disclosure Statement

(FDS) every year, telling the client what services have (and have not) been provided and what fees have been paid. As well, all post- 2013 clients already have to sign an Opt-In Agreement every 2 years – that is, they must agree in writing, to continue receiving the Advice services provided, and to continue paying Advice fees. Small AFSLs and honest advice businesses are being unnecessarily punished for the sins of the BEoT. The present 2 year Opt-In requirement could easily be extended to all clients, rather than just post 2013 clients - after all, in any fair Service Agreement, the client is at liberty to leave the relationship, generally with no more than 30 day's notice. No client is 'locked in' – he or she can leave whenever they choose.

Substantial Increases in the Costs of Providing Advice

There can be absolutely no doubt that there has already been and in future there will be further significant increases, in the operational costs of running an AFSL – and in turn, the costs for an Adviser to run a financial planning practice. The delivery of compliant 'best advice' now requires input from many specialist humans – the Adviser, Para planners, Client Services Officers, internal Compliance staff, Practice Managers, and often external (Licensee appointed) Compliance Managers - as well as other support staff.

It is ironic that one of the primary touted aims of the introduction of FOFA in 2013, was to make advice available to more Australians, at a more affordable cost. Well - that didn't work out too well, did it? After 2024, unless things change, only the well-off, well-heeled High Net Worth (HNW) clients will be able to afford full holistic advice, delivered by a Financial Planner in a face-to-face relationship. The minimum client portfolio will start at $500,000. This is likely to be no more than 15% to 20% of the Australian population. The other 80% (that is, clients of more modest means, but who still have the same needs for professional advice) will not be able to afford the cost. Unfortunately, they will just have to get by in some other way. It is most likely that the only way to provide advice to average Australians will be via digitally-enabled (Robo) advice, which will replace the heavy costs of support staff in the traditional face-to-face Advice model. This might be okay for the young and computer literate. God help the older folk without computer literacy – they'll be on their own. Whether the Big Banks will be able to provide some form of Robo advice, selling their own products and services, will largely depend on the outcome of the current ASIC review of the definition of General Advice, which allows advice to be given without having specific regard to the customer's personal circumstances. This is far less onerous than Personal Advice, which requires a Statement of Advice. It would be sensible to allow the Big Banks to continue selling product through General Advice in some form. Or perhaps the Government who helped create this situation, could make the cost of Financial Planning advice, tax-deductible? That would really help - we can but live in hope.

The Cost of SOA's – and the Legal Uncertainty

There is a major ongoing problem, in the provision of compliant Advice to a retail client. The problem is this: most AFSL Principals and Advisors, still labour under a great deal of uncertainty as to exactly what is needed to provide "compliant" advice. There is continuing uncertainty about what must be put into a Statement of Advice (SoA) and what can be left out and still be compliant - or whether the lesser Record of Advice document will suffice. There are now serious suggestions that the 7 "Safe Harbour Provisions", which when satisfied within an SOA, can provide some element of protection for the Adviser - are going to be removed. Our regulators have meant well, but in their efforts to protect the consumer, they have created a hugely complex environment of great uncertainty, around the provision of "compliant advice". Even the most experienced of planners worry that their 30 to 50 page Statement of Advice, which has taken a week and 10 to 20 hours to

produce, will be found wanting, because they have unwittingly failed to tick all the necessary regulatory boxes, to provide a compliant SOA. This obsession with compliance and the uncertainty which surrounds it, is a blight on the delivery of financial planning advice by sensible Advisors to sensible Australians. It should be called out for the nonsense situation that has evolved. It has created a thriving, expensive, nit-picking industry in Compliance Management and provided a happy hunting ground for litigation lawyers. It's time to introduce some common sense to standards of written advice, to lower the costs of providing advice.

Areas Where Costs Will Increase (or Have Already)

Where do we start? Here's a few areas, for a small AFSL:

- ASIC's "User Pays" levy – e.g. a small AFSL with 6-7 employees (including Advisers) - $7,000+
- Professional Indemnity Insurance - same small AFSL - $40,000pa, plus a week to prepare the PII submission. (We remember with nostalgia, complaining when PII costs hit $10,000 pa).
- Tax Practitioner Board registrations - $1,600 (nil a couple of years ago)
- Compliance costs - difficult one here - $30,000 to $80,000 pa and up.
- Accounting/AFSL auditing costs - $10,000 pa+
- Fees for Membership of Professional Bodies and Associations - $5,000 pa + (practice + individual memberships)
- Additional Costs for Annual Client Renewals - hard to estimate, perhaps $20,000–$40,000 pa
- Cost of sending out Annual FDSs – 2 staff, 2 weeks - $6,000
- AFCA Membership - < $1,000 (cheap – unless there is a claim made against your business. Even if you successfully defend the claim, next year's PII costs will go through the roof).
- Cost of FASEA - yet to be determined.
- Cost of new Code Monitoring Body - yet to be determined.
- Possible cost of future Compensation Scheme of Last Resort – unknown, but it will cost a bomb. We have heard estimates that the costs, if fully loaded on to the poor sods who choose to remain in the business, could be greater than our ever-growing annual PII costs. This will surely be the last straw for some long-suffering, small AFSL

Conclusion

From all the above, you couldn't blame anyone from wondering why any sane person, based on a risk/reward assessment within such an unfriendly business environment, would want to be the Principal of a small AFSL, given that the risk/return assessment is clearly suboptimal. There is also no doubt that many AFSL Principals are seriously under-pricing the cost of providing an Authority to their Representatives. A recent estimate of the cost to the AFS Licensee to service an Adviser was $38,000 to 45,000 per Adviser. One aligned AFSL quoted $70,000.

Of course, we can go on and tell you why they do - true and committed small AFSL financial planning professionals already know and understand why they go on accepting the risks. They love the business, they love the challenge, they love the freedom to control their own destiny, they love their loyal clients and staff and they love the immense sense of satisfaction that doing their job brings them. They wouldn't be dead for quids – but then ASIC, FASEA and the new Code Monitoring body might have something to say about that.

Anthony D (Tony) Gillett is the Director and Principal of Retirewell Financial Planning Pty Ltd, a privately owned AFSL based in the Brisbane CBD. Tony has been licenced to provide advice since 1981, was an inaugural Director of the FPA and has been an Executive Member of the Boutique Financial Planners Principals Group (BFP) since its inception in 2002. The opinions expressed herein are his own.