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Independence: The New Gold Standard?

GLOBAL WEALTH SERVICES

In March 2010, the UK's Financial Services Authority published a long-awaited policy statement on how it expects advisers to implement a number of the key measures that have been covered in the Retail Distribution Review (RDR).

One element of this complex process has been a review of what it means to provide **independent** financial advice in the UK. In the recently released policy statement, the FSA has confirmed that it expects wealth advisory businesses to adhere to certain rules if they want to call themselves "independent" in the post-RDR world.

The rules will come into force at the end of 2012. In the meantime, wealth advisory firms will have to decide if they want to take the steps necessary to operate as independent players in the post-RDR world. At this important juncture, we wanted to take a step back and to ask both wealth advisers and private clients just how important independence is to them. And, more specifically, what does it mean in the context of a financial advisory relationship?

> "I think independence is the right standard, but you have to bear in mind that what wealth managers do is not brain surgery."

In conjunction with Scorpio Partnership, we carried out in-depth interviews with 25 UK private clients and 25 wealth management firms to seek their views on these critical topics.

What the research shows is that the term "independence" has different layers of meaning in the context of financial advisory relationships. Some relate to independence as a principle; some relate to actions taken by wealth advisers to demonstrate independence in their corporate behaviours; and some relate to requirements stipulated by the regulator.

What is perhaps most interesting, when you unpack client views on independence is that there are two themes that run consistently through individual responses.

Almost invariably, one element of client responses will make some reference to the UK regulatory framework. Phrases like "fee-based" and "whole of market" pop up here. This should leave no doubt that UK private clients are informed consumers of financial services.

On another level, clients define "independence" as receiving advice, or "the best solutions" for someone in their financial circumstances, regardless of who has manufactured the products or its compensation structure. Here, metaphors like "walking in my shoes" and "sitting on my side of the table" start to creep in.

> "Independence is very important, but it is not something I would expect from my private bank."

These two themes are central to the challenge posed by the RDR. If "independence" refers to the principle of giving clients the best solution for their circumstances, can it be codified into a set of business practices that are defined and regulated? If so, does codifying these practices raise the bar -- or dumb "independence" down to its lowest common denominator? Taking this argument one step further, is it worth the cost of compliance for a wealth adviser to be able to say they are independent? Or can they demonstrate that they are sitting on their client's side of the table as an "objective" adviser, without having to work through the challenges to call themselves "independent"?

This is undoubtedly a complex theme. We plan to publish two papers that look at different aspects of the argument. In this first paper, we look at the term "independence" in the context of the UK's current and expected regulatory frameworks -- and in terms of what clients expect from today's wealth adviser. This paper also examines the extent to which UK wealth advisers are ready and willing to do what's necessary to remain independent in the not-too-distant future.

In the next paper we will take "objectivity" as our theme and examine the client experience in more detail. We'll ask "how can wealth advisory firms prove to clients that their personal needs are at the heart of the adviser's service proposition?"

Hearts And Minds

When it comes to independence, the good news is that clients, wealth advisers and the regulator are more or less on the same page. On balance, most agree that independence is important.

The bad news is that it's just not that simple.

We asked clients two questions. How do you define independence in the context of your financial relationships? And, how important is to you? The responses suggest that clients have strong views that "independence" is either important or not important. There are few clients who sit on the fence on this issue.

> "Independence is choosing not to work with any of them. I am free to make my own mistakes."

However, most do not actually believe a wealth adviser can deliver an independent solution. As a consequence, they either manage their own wealth, or work with several providers to mitigate their risk. Or they simply accept that the services of a wealth adviser are inherently not independent. Even those who do believe a wealth adviser can deliver an independent solution exercise caution in their selection of their provider. Even for them, independence seems to be more of a hope than an expectation.

Representing this in graphic form, 73%* of the clients said independence is of high or medium importance to them. However only 32% believe independence is achievable in the context of a wealth advisory relationship.

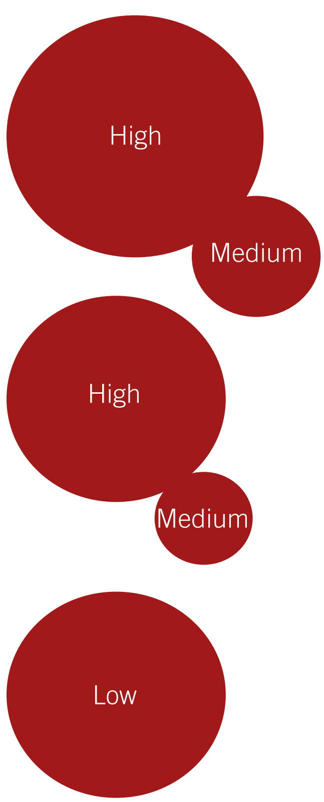
The remaining 68% believing it is not achievable at all or through a single adviser.

41% of those are less idealistic in their approach to independence. Typically, they manage their own money or work with several advisers to ensure they are accessing the most relevant investment services.

Meanwhile, 27% put a low value on independence, mainly because they do not feel it is achievable.

*Percentages are rounded

Figure 1: How important is independence to you? (private client responses)



Independence is important.

That is why I manage my own money or work with several providers.

41%

Independence is important.

I have selected my adviser carefully and trust them to deliver an independent service.

32%

Independence is not that important.

It is also unattainable.

27%

1. Broad-based sample of 25 wealthy UK clients
2. Bubble sizes represent number of responses

Moreover, when you ask clients to compare financial services with other industries, most do not regard independence as a principle to which any profession can adhere consistently. Only nine of the 25 clients could identify any profession they felt was independent and there was no commonality in their responses, as to which industries.

What this tells us, very simply, is that clients recognise that it is important to access the best investment solutions for their circumstances, but most view that this kind of independence is not so simple for wealth advisers – or anyone – to deliver.

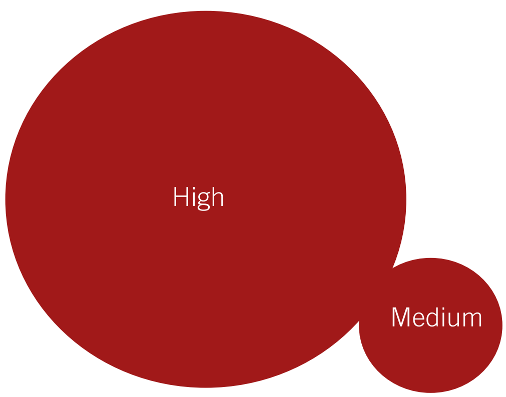
> "I don't think the financial industry should be focused on independence – it should be focused on its customers."

Indeed, closer attention to the language of private clients also tells us that they are conscious of the regulatory framework in which UK wealth advisers are operating. They are not convinced that independence can be codified. Instead, they speak of a service where client advisers act in the best interests of their clients as a matter of principle, not regulation.

As one client observed: "There are two aspects to independence. There is intellectual independence, which is a commitment to giving the client the very best advice. Then there is regulatory independence."

Meanwhile, the wealth management industry has undoubtedly picked up the FSA's gauntlet. Almost all wealth advisers who commented on the importance of independence gave it a high ranking; although several felt unable to comment further because the regulatory definition still remains in flux.

Figure 2: How important is independence to your business? (wealth adviser responses)



Independence is important.

It is essential that clients see us as independent and we aim to put their needs at the centre of our process.

100%

1. Broad-based sample of 25 UK wealth advisers
2. Bubble sizes represent number of responses

More specifically, wealth advisers try to demonstrate independence in three main ways (see Figure 3):

- Delivering the investment proposition through open architecture
- Controls within the business to separate the wealth advisory from other internal businesses that may seek to influence investment decisions or product selection
- Demonstrating transparency in the investment process

Figure 3: How do you demonstrate independence to your clients? (top 3 wealth adviser responses)

1. Broad-based sample of 25 UK wealth advisers
2. Weighted responses based on a top 3 ranking

What most firms have yet to grapple with – and this goes to the heart of the RDR debate – is delivering advice on a fee basis. Under RDR, the FSA will introduce a clear separation between independence and adviser charging, but in the past these two issues have been more closely intertwined. Indeed, in the minds of many clients, and many in the industry, these two issues are regarded as inseparable. It is regarded as difficult for an adviser to be truly independent if he or she receives financial incentives in the form of product commissions.

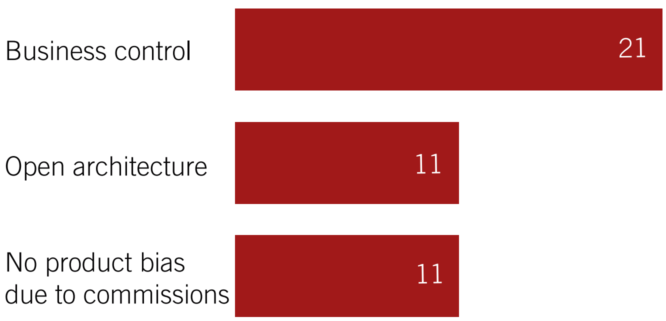
By contrast, if clients pay fees for advice this effectively separates the wealth strategy from the product selection. Thus, advice-based fees allow advisers to focus on constructing independent investment solutions for clients because the business is then neutral to any commission that may be offered by product providers.

Yet, advice-based fees are rarely mentioned by advisory firms as a way that they can demonstrate to clients that they are acting independently. This is mainly because wealth advisers find it tough territory upon which to win new business. Even comparatively wealthy clients do not like paying fees, so how do you make a fully fee-based model look more appealing than a commission-based or -offset model where costs are not as transparent?

Removing commission entirely from the equation – for example, by banning it – then you level the playing field altogether. This is precisely where the FSA is heading with the RDR. Commissions and commission-offset will be phased out from 2012. Clients will simply have to accept that paying fees is good for them.

Interestingly, based on this research it seems some clients are moving in favour of advice-based fees. Several clients specifically pinpointed concerns about commission-bias in the product selection as an inherent contradiction to independence. More tellingly, the avoidance of commission-bias appears among the top three responses from clients when asked, “How a wealth adviser can best demonstrate independence?” (see Figure 4).

Figure 4: How could a provider best demonstrate independence? (top 3 client responses)



1. Broad-based sample of 25 wealthy UK clients.
2. Weighted responses based on a top 3 ranking

In the wake of the recent financial crisis, the issue of fees versus commissions was overshadowed by other concerns, such as how wealth advisory businesses are controlled and managed. Indeed, the client responses once again ring with the realpolitik of business ownership: of remuneration, bonuses and conflicts of interest. These issues dominate the debate far more than the technicalities of where in the value chain the revenue is extracted.

Once again the client responses nod in the direction that the RDR is going. But there is by no means a groundswell of consumer opinion calling for the swathing changes that are coming into force.

> "Independence is driven by remuneration and the bonus structure. But unless you are generating revenue, you are not doing what your employer expects of you. You need employers to encourage independent behaviour as a principle."

Catch-22 says you've always got to do what your Commanding Officer tells you

So where do wealth managers stand in all of this? In a word, snookered.

How can a wealth advisory business serve three masters: its shareholders, its clients and the regulator, when the demands of each pull in different directions?

As the RDR looms on the horizon, many are questioning whether it will be practical in the short term to remain independent within the proposed framework.

> "Independence is not high on my list for a private bank, but it is for a wealth adviser."

The core principles of independence contained with the RDR are that wealth advisers "make recommendations based on comprehensive and fair analysis of the relevant market, and to provide unbiased, unrestricted advice." Sounds simple enough, but look into the detail and the price of independence is quite high.

For even a simple cash management mandate, wealth advisers have to consider all solutions, from national savings accounts to structured notes. Many firms lack the expertise in-house to sweep right across the product spectrum. For those who would plug the gap using panels or product platforms, the regulator has made clear that such panels must be broad.

It will no longer be good enough to assume a client is comfortable with their wealth manager's standard in-house selection of the best-of-breed third-party offerings. Providers will have to confirm that their own open-architecture solution meets client needs vs. a wider range of products and solutions available in-market.

Bear in mind that these independence strictures are being introduced in the RDR alongside a raft of other proposals, including the phase-out out of commissions and enhanced adviser training. Against this backdrop of major change, firms are judging the benefits of maintaining their status as independent.

Interestingly, an informal show of hands at two recent industry meetings – one for independent financial advisers (IFAs) and one for private banks, private client asset managers and multi-family offices – the response suggested that it was the IFAs who are most likely to push ahead with independence. Private banks and private client asset managers are not so sure. Judging by the half-raised hands, the "yes" voters in this camp number somewhere between 50%-70%.

This is significant because some IFAs would bear the 'gold standard' of independence while many private banks and PCIMs would carry the restricted label to their solutions. This would be an historical market shift, given that we are not so many years on from a model where financial advisers were tied to one or other of the large insurance providers. Private banks, on the other hand, specialised in providing more complex and wide-ranging financial solutions.

The question is, is it worth developing offerings for the sake of being able to tell clients they are independent? Our research suggests that most knowledgeable clients accept that regulatory independence is different from objectivity or impartiality, when referring to how an investment portfolio is constructed and managed.

> "Independence is not why I make my decisions. I don't mind a firm not being independent or only offering limited solutions, if those products have the attributes I want."

Ref: Financial Services Authority: "Distribution of Retail Investments: Delivering the RDR – feedback to CP09/18 and final rules. March 2010.

Is Independence Worth It?

So, "is it worth it?" is a conundrum. It is exactly the sort of conundrum that Joseph Heller found when he looked at the tautology of military health and safety policy in Catch-22. Heller wrote: "There was only one catch and that was Catch-22, which specified that a concern for one's own safety in the face of dangers that were real and immediate was the process of a rational mind." Thus, to fly a bombing raid would be a sign of insanity, for which the pilot should be grounded as unfit for military service; but not to fly would be a sign of sanity and the pilot would be declared fit for action. It does not take much imagination to substitute "business" and "rules" into this famous quotation and stretch this analogy to the new independence regime.

On the other side of the political divide from Heller, Henry Kissinger said in retrospect of the Vietnam War that: "[it] required us to emphasize the national interest rather than abstract principles."

Similarly, the RDR has the potential either to force wealth advisory firms to lay out their business interests openly to clients as restricted advisers or to pursue the abstract principle of independence.

And, as with any campaign centred on principles, we can expect a fair amount of heroism, absurdity and sophistry in the process.

Short term, our view is that some IFAs in the UK will do more or less whatever it takes to remain independent. Meanwhile private banks, and the like, will probably ring fence parts of their business, offering an independent solution to a small and manageable number of clients. Or, they may veer towards using the language of objectivity and impartiality in describing their approach while continuing, in purely regulatory terms, to provide a restricted advisory service.

Longer term, clients and wealth advisers of all types are also agreed that the RDR makes sense. It will raise standards. It will deliver a better service.

More than that, over the last five years the FSA has already demonstrated that delivering a consistent message about the qualities of independence has had an impact on client behaviour. Most clients in our research identified the principles of independence, whether or not they felt they are an achievable goal.

This strongly suggests that within a five-year horizon the FSA's new gold standard will be well-established in the minds of wealthy clients and pumping into the bloodstream of the UK retail market.

Important Information