Polarization

Back to the future

The face of financial advice is about to change again. Parts of the new régime may sound familiar, but Claire Labrum warns that the consequences could be far-reaching.

Independent financial advisers (IFAs) have traditionally[1] worked rather like a cottage industry: a disparate collection of individuals with widely-divergent working styles and practices, brought together as a result of force of circumstance. This is still the case, and it is very difficult to talk collectively (although most people do!) and meaningfully about the IFA market and the views and opinions of its members.

However, the recent regulatory changes (depolarization in particular, but also the low-commission environment), as well as the creation of the Personal Finance Society (from the merger of the Life Insurance Association and the Society of Financial Advisers) may herald the emergence of this collection of "advisers" into a more coherent, organized and professional sector – one that can perhaps rebuild consumer trust (currently at an all-time low); be much more responsive to criticism (preventing, for example, a repetition of the slow progress on the second phase of pensions mis-selling restitution); and have a single and coherent lobbying voice.

But what do all these changes mean for individual advisers and their relationships with the providers?

Second wind

The IFA market is currently going through its second major upheaval – which seems to be taking the industry full circle to where it first came from! The independent financial adviser was created by the Financial Services Act 1986, which was introduced partly because of increasing concern about several high-profile frauds, and more general concern about – at best – inappropriate selling. One of the key decisions was to "polarize" the market between IFAs (required to recommend, under "best advice", the most suitable product from the whole range of providers in the market) and "tied agents", able only to recommend the products of the company to which they were tied.

Before this, anyone could call themselves a broker and claim to be "independent", and then sell life and pensions products, with no requirement for formal training or any disclosure to the client of the remuneration that would be received from the product provider. Historically the system had appeared to work reasonably well *for most people* – but that was scant comfort for the minority that had been very poorly served. There was also real concern that the scale of abuse might escalate, as the industry was forced to recruit large numbers of new brokers to cope with the effects of the huge growth in the housing market and moves to popularize personal pensions.

In many cases, the relationship between the life company and the independent broker was everything. The broker would be schmoozed by the life company inspector, and business would begin flowing in. As long as the products and prices were not absolutely dire, generally it was a case of the more schmoozing, the more business. The quality of that business was of little importance – the inspector was remunerated on business won, and the broker on commission.[2]

Polarization changed this situation overnight – although the changes to the relationships emerged rather more slowly – more evolutionary than revolutionary.

Initially, many brokers became tied – effectively a self-employed direct sales force for the providers. At the time, there was a lot of jostling for position amongst the providers to gain the largest tied-agent base.[3] Providers were effectively responsible for the competence of their tied agents, and significant sums were invested in training and servicing them. Some offices introduced broker consultants specifically dedicated to meeting the needs of the tied-agent field force. However, over time it was seen that the volumes and quality of business did not justify the cost of maintaining and regulating the salesforce – and, outside the banking networks, many tied agents quietly "moved on".

> Disclosure turned out to be perhaps the biggest non-event in the history of the financial services sector.

The IFA was also courted by providers, of course. Initially it had been predicted that the IFA share of market would decline significantly after polarization, but this never really happened. Providers realized the value of maintaining these relationships, and initially tried to continue to build them through personal contact. However, the LAUTRO[4] rules on IFA spend, together with the best advice concept, meant that providers could no longer provide the "little extras" that had worked in the past, and the relationship focus changed to a more professional servicing- and training-based one – designed to help IFAs cope with the increased legislative burden and make their business more effective.

IFAs have also changed – with the introduction of professional accreditation and the FPC and AFPC qualifications, the quality of the sector increased overall. Only those seriously interested in the business and who were prepared to take the regulator-approved exams were able to practice.

Still selling

However, the IFA base has remained largely sales-orientated and, even if they are unwilling to admit it, influenced by remuneration that ultimately depends on sales success. The furore surrounding disclosure[5] seemed to prove the point – providers and IFAs were extremely worried about the likely effect on sales, but it turned out to be perhaps the biggest non-event in the history of the financial services sector. Consumers welcomed the

transparency (when they understood what it meant!), but other than that, there seemed no immediate adverse impact – helped of course by a booming economy and a bull market.

Since then, several key events have influenced the market and will undoubtedly affect how IFAs think, and their relationship with providers.

Firstly, we are now in a low inflation environment. Unfortunately, the ramifications of this are poorly understood by consumers; they tend to revise their expectations very slowly, and there is also the issue of money illusion – people tend to focus on nominal rather than real values. This means that consumers do not look at the value of their products and policy decisions in the same way as they did previously – and this is undermining the perceived value of financial services, and within this, providers and advisers.

Arguably, the effects of disclosure are more apparent now than when it was first introduced. In the light of reducing returns and overall mistrust of advisers and the industry (including the regulator!), consumers I speak to in research are becoming (relatively) more aware and demanding of the advice they receive, and of how much they are paying for it. In response, many advisers now rebate commissions (effectively moving nearer to a fee-based model) on product sales.

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More rules

Over the last few years, the government has created rules for investment products with set, low rates of commission – particularly on pensions – which have directly affected how and when advisers are prepared to give advice to consumers. Low commission models have meant that IFAs are already excluding themselves from low-remuneration markets or having to be more selective about the business they are prepared to accept[6] – a huge turnaround from the days when brokers could and would place anything on the books! Again, this means that the individual IFA is not just selling but is also making business value judgments – a totally different mindset from before.

The various scandals that have hit the industry have resulted in levels of consumer trust that are at an all-time low, and this will take years to rebuild. You need only talk to anyone on the street or listen to the first five minutes of any discussion group to realize that consumers really don't know where to turn, or whom to trust, in an industry that has patently failed them.

The danger is that they will seek shelter and comfort from a known brand – probably a high-street bank, as no consumer brand exists (at least yet) in the IFA market.[7] The IFA sector cannot afford to dismiss or ignore this threat. Many tell me that they target the high net worth (HNW) sector and so are not worried if banks mop up the mass market. But this is simply unsustainable – banks also offer personal financial planning services to their wealthier customers, and some of the mass market of today will become the HNWs of tomorrow. Will they then automatically switch to an IFA "because that's what HNWs do" – or stick with the provider who had stuck with them? And pragmatically, with about 36,000 IFAs in the market, there are simply not enough high net worth customers to sustain them all in the long-term.

This means that IFAs will have to change in order to distinguish themselves – in terms of both how they represent (or brand) themselves as an industry and individually, and how they treat customers.

The end of all the exploring?

Which brings us on to depolarization, the most recent and most fundamental change to hit the industry since 1988. This introduces the option for advisers to become multi-tied – selling only the products of a defined group of providers. Some suggest that this will be little different from the existing permitted practice of "provider panels", except that the removal of any requirement to review the panel regularly will encourage insurers to invest more in developing the relationship. Others see it as the thin end of the wedge.

Most IFAs claim that they will maintain independent status post-depolarization – but many industry commentators predict that the number doing so is likely to reduce over time.

And independence brings with it a change in business model – IFAs must now allow the client the option of paying a fee for the advice. Some already do this, of course, but for the rest this will mean over time a big change in the very nature of their business and their approach.

The obvious concern is that the explicit fee may put some clients off, but there may be a positive effect in making the whole process seem more professional and genuinely adding value to the IFA–customer relationship. Whilst fees (or commission rebate arrangements) are likely to appeal to a small proportion of customers initially, again it is predicted that more people will shift towards fees as the cost and value of advice become more transparent. This in itself is likely to change the IFA–customer relationship, as the IFA will need to seek greater on-going

association, rather than relying on a one-off event-based sale (which may cost more to process than the fee/commission generated). If this happens as the FSA would like, consumers will be in a better position to demand more of their adviser and to judge whether they are getting value for money. This is obviously a big shift for consumers and will take time, but it is also a huge challenge for IFAs.

Many IFAs already claim that they deliver a relationship-based service, but every piece of consumer research I have ever done indicates that the majority of people who have received advice from an IFA (or, indeed, other advisers) do not consider that they have a relationship with them. Indeed, when challenged, even the IFAs admit that they are unable to offer the claimed level of service to their entire customer base.

Changing perspectives

If the fee (and by implication, relationship) model does take off, IFAs will need to be less salesman and more adviser. Many IFAs who have grown up in a sales environment may find this a difficult shift to make, as it requires a very different approach. And, as an interesting aside, if IFAs become fee-based, what will this mean for the design of products and charges and, taking this to its logical conclusion, the traditional provider consultant who is remunerated on sales turnover?

Depolarization also has implications for the provider and IFA relationship. Multi-tied advisers – by their very nature – forge closer technological and relationship links with their selected providers. Whilst they are technically able to change the provider mix at will, in practice it may be a huge issue to do this – in terms both of technology and contractual obligations. And, over time, surely the closer relationship in the multi-tied area of the IFA's portfolio will impact (however unconsciously) on those product areas in which the IFA remains independent or "whole of market". How can new providers gain a foothold into an IFA firm which has established links in place?

Indeed, the move towards greater technological integration between providers (driven by low commissions and, to some extent, depolarization) and IFAs overall may have the same effect – the relationship is changing already, and decisions about whether a particular provider is "on the panel" for certain products often include a large element of technology. This means that, in the future, IT professionals – or those who specify their systems – may have as much to say in the selection process as the panel makers. This will not be a problem, of course, if there is to be total compatibility between all the providers' systems, but is this likely to happen? Even if the insurers avoid the "VHS/Betamax" type of debate, will they be able to resist the opportunity to seek some competitive advantage by building in system "enhancements" that shut out competitors?

Size matters, attitude matters

Small IFAs in particular face real challenges – they have rising costs and liabilities and, potentially, may receive a second-tier service from the providers they support. In any market you care to look at, major retail outlets receive the heaviest investment, whilst smaller players take second best – they simply do not generate the levels of business required for each provider to justify the time or money.

This in a market that is becoming increasingly complex to work in. How can smaller firms continue to generate business with the added pressures of keeping up-to-date in all areas? Surely this indicates that smaller IFAs may be likely to specialize, go out of business or become part of a larger franchise (formal, via networks or consolidation, or informal).

For some time, there have been claims that most IFAs are over fifty. I don't know how true this is, but certainly there does appear to be a skills gap in the market. This may make the market appealing to younger, ambitious advisers keen to meet a clear demand in an under-resourced area – but who will these IFAs be? In the depolarized world, I believe that there may well be a demand for a different type of IFA – more qualified, more conscious of branding and of maintaining a client profile, and taking more of an advisory (rather than sales) role – and charging a fee for it. IFAs, as a sector and as individual practitioners, will need to demonstrate different skills to meet this demand, and to continue to maintain their market share of the overall distribution of financial services sales. ◻

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[1] The seventeen years that IFAs have formally been in existence is perhaps not long enough for a tradition, but the lineage can be traced back through the plain "brokers" who preceded them, although they did not need to be "independent". Ed

[2] Which also created the problem of very low surrender values in the early years if customers lapsed policies that turned out to be inappropriate for them, because any investment earnings were wiped out by the need to "repay" the commissions. Ed

[3] Most large insurers aimed to tie with a large building society (still at that time dominant within the mortgage market) and perhaps a few local societies; and also to recruit a network of small local brokers to sell their products (and in particular the non-housing related ones) direct to the public. Ed

[4] The Life Assurance and Unit Trust Regulatory Organization, whose name has lived on much longer than the organization itself, in the context of both "allowable support" and commission levels.

[5] In 1995, new rules were introduced that required all sales documentation to include a standardized statement of the remuneration that the adviser would receive as a result of the sale.

[6] Uptake of these stakeholder products has been very low across the board, not just through IFAs, and many providers have in fact withdrawn from this market.

[7] But some are trying – see, for example, *Origenal thinking* in *Argent 3.4*, July 2004, pp30–33, which described the creation of a new IFA brand. Ed