

The Institute of Chartered Accountants in Australia Reinventing financial planning

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Foreword

Welcome to this position paper on the structure of the financial planning industry.

Reinventing financial planning has been written by financial planning specialist, Robert M.C. Brown to provide insight into the industry's structure, cultural origins, the meaning of 'profession', the role of the accounting profession and the remuneration debate. The recommendations he makes for moving the financial planning industry to a profession are considered to be both possible and indeed necessary to avoid future regulation by government.

I hope that this paper will assist in the understanding of these complex issues, and contribute to the resolution of an appropriate remuneration structure for financial planners for the benefit of the industry, planners themselves and their clients.

This paper is one of the Institute's leadership initiatives that look ahead, question, and positively influence the growth of our profession.

I trust you will find it both interesting and valuable.

Robert DiMonte

President

Institute of Chartered Accountants in Australia

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Executive summary

- 1) The central proposition of this paper is that there is a fundamental structural problem in the financial services industry, namely, the dominant remuneration models that rely upon the sale of products (or the existence of assets on which to charge a fee).
- 2) It suggests that these models must cease; and that until that occurs financial planning will not be treated as a profession (due to irreconcilable conflicts of interest), and the public interest will not be served.
- 3) The offending models, which generally are based on percentages of clients' 'funds under advice' (FUA), must be replaced by fully disclosed advice-based fee models. These fees must be calculated by reference to time, and/or by reference to a published scale of fees that is not based on a percentage or on the existence of assets.
- 4) The paper supports certain initiatives that have been taken, or ought to be taken, to assist with the reinvention of the industry. These include the development of a pro bono culture, improvement in educational standards for financial planners, and the creation of sceptical and informed consumers through financial literacy programs. However, it concludes that these initiatives will prove to be ineffective unless fundamental structural reform occurs at the same time.
- 5) The paper analyses the industry's structure, its cultural origins, the meaning of 'profession', the role of the accounting profession, and the remuneration debate. It points out that the financial services industry has a special responsibility to serve the 'common good' because the community has given it the privileged position of managing Australia's compulsory privatised national superannuation system.
- 6) All 'workaround' solutions (for example, a 'two-tiered' licensing system) must be avoided, because they accept that the basic structural problem of the industry is a 'given' that can never be changed. Such solutions, which may be viewed in the short run as less painful and more practical than fundamental reform, will never solve the industry's problems comprehensively and permanently.
- 7) The paper disputes the claim that the dominant remuneration models (particularly those based on commissions) must be maintained so that 'ordinary Australians' are not precluded from obtaining financial planning advice. It suggests that the real issue is not the affordability of the advice, but the low value placed on that advice due to the industry's fundamental structural problem.
- 8) Making the transition to a profession will be a liberating experience for most financial planners who will be able to build a long-term, independent and sustainable practice, rather than a 'book of trails' built on the vagaries of the market, the commercial necessities of dealer groups and funds managers, and the need to sell products or accumulate FUA.
- 9) Voluntary adoption of fundamental reform (as distinct from 'workaround' solutions) requires visionary leadership by the industry as a whole. In the absence of such leadership, the financial planning industry faces a bleak future, marked by a low level of public trust, and costly and increasing intervention and regulation by government.
- 10) The consequences of taking the position proposed in this paper will not be as difficult and impractical as many people might anticipate. This is because financial planners will become respected as true professionals, institutions and dealer groups will enjoy an improved public image, the cost and complexity of legislative regulation will be reduced, and the public interest will be served unambiguously. These are outcomes for which political leaders and regulators will be both relieved and grateful.

Introduction

There are many fine people working in the financial planning industry, yet the image that the industry enjoys in the community and in the media is less than impressive. This paper examines the causes of this paradox; and proposes actions that should be taken to enable transition of the industry to the professional status that so many of its participants desire.

The analysis and conclusions in this paper are not offered as a defence of certain interests or with a desire to criticise sections of the financial services industry. They are the result of a rigorous and independent journey of examination of the issues, and are offered with the objective of achieving genuine and permanent reform of the financial planning industry.

Adoption of the practical reforms in this paper will substantially assist in achieving public acceptance for financial planners as trusted advisers. Their adoption will also serve the public interest, an outcome that must always be the central objective of any group of people claiming to be 'professional'.

Background and objectives

Hardly a day goes by without a negative story in the trade and general media about 'financial planning'. Typically, the issues in these stories revolve around claims of 'product flogging', high levels of commission, biased advice, conflicts of interest and legal actions by regulators against advisers (including enforceable undertakings, bans and gaol sentences).

In order to put all of this into perspective, it must be recognised that there are many negative stories about other occupations as well, including the accounting and legal professions. The role of accountants in the Enron and HIH tragedies are just two high profile examples that have raised some uncomfortable questions for the accounting profession. Stories such as these have led to major legislative reforms (for example, the *Sarbanes-Oxley Act of 2002* in the USA) and the restructuring of service delivery models by accounting firms (seeking to achieve independence and to avoid conflicts of interest).

The regularity of unflattering stories about financial planning leads inevitably to an enquiry about whether there is something wrong with the fundamental structure and culture of the financial planning industry as a whole. Alternatively could it be that the litany of negativity is simply a media campaign against an industry that is evolving, albeit slowly, into a true profession; and that all is well within the industry's structure and culture?

Most of the financial planning industry's spokespersons appear to be of the view that the industry is being treated unfairly, so that criticism is often met with defensive responses, including: 'Our independent surveys show that the community trusts financial planners', 'We're removing the minority of bad apples' and 'The regulator is being pedantic and is overreacting'.

It is not suggested that the industry has made no progress in terms of improving its image and standards. For example, the Financial Planning Association's (FPA) new 'Principles for Managing Conflicts of Interest' (effective 1 July 2006) is a laudable step in the right direction. In addition, the ongoing and sometimes emotional debate about the merits of remuneration models (commissions versus fees) is a healthy process in the life of the industry. The fact that a debate is even necessary on this subject, however, is an important clue to the nature of the industry's problems.

The industry has been in denial about its shortcomings for far too long, preferring to believe that they are mere growing pains. This paper suggests that the industry's problems are much deeper; and that the financial planning industry is in urgent need of some self-examination within a 'rhetoric-free' zone.

Adoption of the recommendations in this paper will act to reinvent the financial planning industry, transforming it into the profession that most of its participants would like it to be (but have hitherto been unable to achieve).

A basic assumption behind the analysis in this paper is that reinvention of the industry is a worthwhile project. The principal reason for this is not that most financial planners want to be treated as professionals but that the consumers of financial planning services deserve the existence of a source of advice that is (and is perceived to be) trustworthy and independent.

Putting it another way, reinvention of the financial planning industry into a professional occupation is a worthwhile project because it is in the public interest. In that sense, reinvention is not an option. It is a necessity.

What is financial planning?

According to the FPA's website: 'Financial planning is the process of meeting your life's goals through proper management of your finances. Your life's goals may include buying a home, saving for your children's education and planning for retirement'.

This implies that financial planners should be strategists, offering a process of independent professional advice to their clients to assist in the setting and meeting of financial and lifestyle goals. It suggests that financial planners will possess technical skills or some practical knowledge in a wide range of disciplines, including taxation, accounting, structures, pensions, annuities, superannuation, investment, risk management and estate planning.

Therefore, financial planning should not be reliant on the sale of products, although many people believe it to be exactly that. Regrettably, that belief is not without foundation, giving rise to charges of hypocrisy and the creation of an environment in which the wider community appears not to trust the financial planning industry.

Financial planners as professionals

Irrespective of considerable areas of disagreement, there appears to be one issue on which there is substantial unanimity among industry participants. They would like 'financial planning' to be accepted as a 'profession' by the wider community (in the same way that lawyers, accountants and medical practitioners are generally accepted, irrespective of their shortcomings). They submit that the description 'professional' best suits the advisory services that financial planners offer (or would like to offer) to their clients, and that the high standards of honesty, integrity and independence found in all but a few of their number deserve no less a description than 'professional'.

The problem for the industry is that the community does not appear to accept this proposition enthusiastically, even though a great deal of regulatory and marketing work has been done to improve the industry's image and to lift its standards of practice. That work includes the 'Dazza' advertising campaign mounted by the FPA, which is claimed to have been successful in raising the profile and positive image of financial planners.

This campaign has been countered strongly by Industry Superannuation Funds in their powerful and resonating 'Compare the Pair' advertising campaign in which it is suggested that commissions paid to advisers are unnecessary because they result in higher fees and poorer end benefits for investors. Recently, it became even more powerful in the light of the negative publicity surrounding an enforceable undertaking given to the Australian Securities and Investments Commission (ASIC) by one of Australia's largest financial planning groups.

Unfortunately, over the last 20 years the ideals behind what it means to be a professional person have been somewhat marginalised in the financial services industry (and elsewhere). Even among accountants and lawyers, it is not uncommon to hear members of those professions stating that the principal emphasis these days in their practices is 'making an acceptable return on equity' and 'running a business', rather than in the quaint notion of engaging in a vocation for the primary benefit of their clients and society as whole.

What is a profession?

In order to establish the likelihood of the financial planning industry achieving professional status, it is important to answer the question: what is a profession?

According to Suzanne Ross of St James Ethics Centre:

'The concept of a profession relates to the contract that professionals make with society. They agree to conscientiously serve the public interest, even when the public interest conflicts with self-interest. Based on this agreement society in return allows the profession certain privileges. The idea of self-regulation that most professions enjoy is one of those privileges. The core of this privilege involves accountability to, and sanctioning by one's professional peers — a professional web that has agreed to serve the common good' ('Money in Practice', June 2000).

The idea that a true professional serves the public interest is a recurring theme in the literature on this subject. The American legal scholar and educator, Roscoe Pound (1870–1964) put it this way:

'The term refers to a group pursuing a learned art as a common calling in the spirit of public service — no less a public service because it may incidentally be a means to livelihood. Pursuit of the learned art in the spirit of public service is the primary purpose' ('The Lawyer from Antiquity to Modern Times', West Publishing, 1953).

Developing this theme, the Australian Council of Professions issued a discussion paper in August 1993 seeking to distinguish a profession from 'more commercially minded associations'.

It asserted that a 'professional' (as distinct from other occupations):

'... must at all times place the responsibility for the welfare, health and safety of the community before their responsibility to the profession, to sectional or private interests, or to other members of the profession'.

Commenting on Roscoe Pound's definition (above), Simon Longstaff of St James Ethics Centre wrote:

'The point should be made that to act "in the spirit of public service" at least implies that one will seek to promote or preserve the public interest. A person who claimed to move in a spirit of public service while harming the public interest could be open to the charge of insincerity or of failing to comprehend what his or her professional commitments really amounted to in practice ... if the idea of a profession is to have any significance, then it must hinge on this notion that professionals make a bargain with society in which they promise conscientiously to serve the public interest — even if to do may, at times, be at their own expense. In return society allocates certain privileges.

These might include one or more of the following:

- > the right to engage in self-regulation
- > the exclusive right to perform particular functions
- > special status' ('Public Sector Ethics', QUT. Later published in Fisher's 'The Law of Commercial and Professional Relationships', FT Law and Tax, 1996).

Longstaff develops the 'public interest' theme, quoting Michael Davis and Frederick Elliston on the idea of a professional's obligation to seek the social good:

'One of the tasks of the professional is to seek the social good. It follows from this that one cannot be a professional unless one has some sense of what the social good is. Accordingly, one's very status as a professional requires that one possess this moral truth. But it requires more, for each profession seeks the social good in a different form, according to its particular expertise: doctors seek it in the form of health; engineers in the form of safe and efficient buildings; and lawyers seek it in the form of justice. Each profession must seek its own form of social good. Without such knowledge professionals cannot perform their social roles' ('Ethics and the Legal Profession', Prometheus Books, 1986).

Commenting on Davis and Elliston, Longstaff concludes:

'As noted above, an old idea is at work here. It suggests that professionals might need to develop a particular appreciation and understanding of some defining end, such as justice. It is as much for this and the disinterested pursuit of these ends that the community looks to the professions for assistance'.

In the light of this analysis, what are we to make of the financial planning industry's desire to be treated as a profession?

The industry would certainly claim that it has developed its own version of 'social good', in the form of advising its clients on building wealth and the achievement of financial independence. The trouble is that the behaviour of many industry participants and the structures within which they operate (including remuneration structures), send ambiguous signals to society about whether financial planners can be trusted to engage in a sincere commitment to the 'disinterested pursuit' of that social good.

As a result, society has not been willing to make a 'contract' with the industry. Instead of allowing the financial planning industry to self-regulate in the way that most other professions are able to do (to a greater or lesser extent), the financial planning industry is extensively (some say excessively) regulated, with little prospect of that external surveillance and control ever being significantly reduced.

At this stage in the development of the financial planning industry, there is no basis for it to qualify as a profession. Certain actions can be taken to achieve the professional status to which the industry aspires. This, however, will require a painful self-examination, followed by some serious changes in its strongly entrenched culture and in the distribution networks that have existed since the industry's inception.

Cultural origins

Financial planning emerged as a separate discipline in Australia in the early 1980s. Its culture is deeply rooted in the sales-oriented life insurance industry, with significant influence from the booming property trust sector. In those days, ownership of real estate was not counted for aged pension qualification purposes. Entrepreneurs who established unitised property funds to enable small investors to buy real estate and receive the full pension did exceptionally well. These funds evolved into what is now the multi-billion dollar managed funds sector of the financial services industry.

This was also the heyday of the small 'Mum and Dad' superannuation fund product, thousands of which were established under s 23F of the *Income Tax Assessment Act 1936*. In those days, superannuation funds were allowed to receive almost unlimited actuarially certified tax-deductible contributions. They were then allowed to immediately 'loan-back' (unsecured) up to 100 per cent of a fund's corpus to the sponsoring employer's business, enabling access to liberal amounts of tax effective working capital.

Naturally, this product proved to be very popular with accountants and their clients. It supported a vibrant industry of 'financial advisers' and 'superannuation consultants' who existed to sell the product and provide advice to an eager market (especially around 30 June each year).

Another factor that assisted in the growth of the financial planning industry was the 15 per cent tax on superannuation income, contributions and benefits, introduced by the Hawke Labor government in 1983. This gave rise to an army of specialist advisers claiming expertise in methods of minimising tax and maximising returns from managed funds. When combined with other complex retirement laws, the superannuation tax proved to be a minefield for retirees and a goldmine for financial planners.

Finally, for all practical purposes, the modern Australian superannuation industry was established in the 1980s with the introduction of compulsory superannuation, initially in the form of industrial awards requiring a 3 per cent per annum 'productivity' contribution; and then in the form of the superannuation guarantee system mandating up to 9 per cent per annum. In effect, the government established a privatised national retirement scheme.

The life insurance companies and other financial institutions that manufactured the expanding multitude of managed products (both superannuation and non-superannuation) needed to distribute their offerings in a competitive and booming marketplace. Principally, they looked to financial planners to do the job. Given that many early 'planners' had a strong background in life insurance sales, the establishment of a transaction-driven, commission-based relationship was a natural development. For much of the financial planning industry, this same basic relationship, or sophisticated versions of it, continues until the present day.

The selling of life insurance is an activity that requires excellent interpersonal skills, but it does not usually require a wide range of technical competencies. On the other hand, comprehensive financial planning requires knowledge in a wide range of disciplines, including tax, accounting, structures, pensions, annuities, superannuation, investment, risk management and estate planning.

As a result, it is a process that should be based on independent advice from a professional person, not on the sale of product from a person who is paid to facilitate transactions. This is the core of the problem. The financial planning industry is still substantially a transaction-based industry, rendering it unsuitable for the advice-based needs of its clients.

The role of the accounting profession

Throughout this time, the accounting profession simply looked on, with a somewhat superior and elitist attitude. A number of unsuccessful attempts were made to engage the Institute of Chartered Accountants in Australia and CPA Australia in serious strategic thinking about financial planning and how their members should be involved in this growing industry.

The view from most of the profession's influential 'visionaries' was that financial planning should remain the province of what were viewed as salespeople. It was said that accountants, if involved at all in financial planning, should simply be referrers of business.

This shortsighted disengaged attitude is still widespread in the accounting profession. It is a significant contributing factor in explaining why the financial planning industry has failed to transform itself into a professional occupation.

In an ideal world, financial planning should have become an important subset of the accounting profession and a principal activity of all general practitioners. The fit is obvious. Instead, the accounting profession was so distracted by the complexities of taxation and compliance, and so convinced of the unprofessionalism of financial planning, that it 'missed the boat'. The development of the financial planning industry over the last 25 years is a perfect example of the old saying that 'nature abhors a vacuum'.

The accounting profession continues to play 'catch up', however, its recently published professional standard on financial planning (APS12 Statement of Financial Advisory Service Standards) which states that commissions are inconsistent with professional practice, places the accounting profession ahead of the rest of the financial planning industry in terms of the evolution of ethical standards.

The fact that the financial planning industry as a whole seems unwilling to match this uncontroversial statement by the accounting profession, preferring instead to obscure the debate with statements about the importance of consumer choice, speaks volumes about the industry's fundamental structural problem.

Industry structure- the key issue

It is an unavoidable conclusion that the financial planning industry's structure has created a transaction-based sales culture, which often improperly influences the process of offering financial planning advice. That is the core of the industry's problem, both real and perceived.

The management of conflicts of interest and striving for independence are central to a professional's life. As indicated earlier in this paper, the FPA has taken a significant step with the release of its 'Principals for Managing Conflicts of Interest', but this must be viewed as part of an evolutionary process.

It is not suggested that the financial planning industry is the only group with serious problems to address concerning conflicts of interest and independence. We are all familiar with allegations of suspect dealings between doctors and drug companies, as well as unacceptable relationships between the auditors and management of public companies.

These problems should not be marginalised as they go to the core of what it means to be a professional person. They raise serious issues of trust, credibility and the efficacy of the 'contract' made between the relevant profession and society as a whole.

In the case of the financial services industry, however, of which financial planning is an important component, the offending structure is the rule, not the exception. There is a great deal of talk about the importance of independence, honesty and integrity, but in the final analysis the sale of a product is what counts for most financial planners.

Financial institutions design and manufacture products, and then establish relationships with salespeople to sell them. These relationships range from simple employment arrangements, to licensing via so-called independent dealer groups to ownership in distribution networks.

The financial arrangements are many and varied, but most of them are designed to achieve one outcome, that is, the sale of products on behalf of a financial institution.

This imperative must always act to influence the independence of advice that clients are offered by financial planners, or at least create a strong perception that it might do so. The mere existence of such a perception is enough to shape a relationship in which the client will not treat the planner as a trusted professional adviser. This is an undesirable outcome for both the planner and the client.

It is unrealistic to expect that individual institutions would voluntarily divest themselves of interests in distribution networks and terminate all their advisers. It is also unrealistic to expect that individual dealer groups and planners would be altruistic enough to extract themselves from close financial relationships with product manufacturers, even though they might privately accept that these arrangements are inimical to the development of the financial planning profession.

It is also unlikely that the current government would legislate to force the issue, unless voter backlash about the industry becomes irresistible. In that regard, a few more 'Westpoints' might be all that is necessary.

Short of legislative fiat, the first and most important step towards the reinvention of the financial planning industry is a simple, but apparently difficult, one. The industry's leadership must publicly admit to the depth, seriousness and consequences of the industry's structural problem. Its reticence to do so is severely holding back the transformation of the financial planning industry into a profession.

The remuneration debate

The debate about remuneration in the financial planning industry has been a long and emotional one.

Some supporters of commission-based arrangements take exception to the proposition that their advice could be biased, even though they must sell a product to make a living. It appears that they do not accept that receipt of commission puts a financial planner in an impossible position of conflict, or an appearance of conflict.

The conflict exists at several levels. The first level is that a third party is paying the remuneration, not the client. The nature of this relationship is best described by the old proverb that 'he who pays the piper calls the tune'. The second level is that a product must be sold to receive remuneration in the first instance. The third level of conflict is that advisers may be tempted to recommend the product that pays the highest level of remuneration. As a result, commission must always be inconsistent with being a professional adviser.

As an alternative to commission, some financial planners rebate commission to their clients, and charge an annual amount pursuant to a so-called 'fee for service' scale that is based on a percentage of FUA. This is preferable to a commission, although it still requires that a product be sold (or that a client has assets on which to apply the scale).

A minority of financial planners have improperly used both of these remuneration models. Some planners have arranged margin loans to 'create' FUA, others have advised clients to liquidate real estate in order to invest the proceeds in managed funds, and others have even advised clients to commute government-funded indexed superannuation pensions in order to free up capital for investment in products.

The simple fact is that a person's behaviour will be determined by the manner in which he or she is financially rewarded. Therefore, any remuneration model that is constructed around the sale of products is likely to result in the sale of products. This is hardly a surprising outcome.

On the other hand, a 'fee for service' that does not rely upon the sale of a product or upon the existence of assets avoids all the conflicts outlined above. This form of fee does not have to be based purely on an hourly rate, although it would certainly be expected that time would be a significant factor in its derivation. The main issues are that the fee is not based on FUA, that it is disclosed, and that its quantum and/or calculation methodology is agreed by the client in advance of the work being performed.

Of course, this form of 'fee for service' can be abused. It is just that the opportunities for doing so, both real and perceived, are substantially reduced with this remuneration model. Conflicts of interest are minimised and independence is enhanced.

Some will argue that clients should be offered the option to remunerate their financial planner by any one of the above methodologies. This is the 'let the client choose' model adopted by most of the industry. Others will argue that poorer people will not receive much-needed advice unless it is via a planner on a commission. The argument here seems to boil down to the questionable proposition that some advice is better than no advice.

These arguments obscure the fundamental issue of principle. That is, if the financial planning industry wants recognition as a profession, then a fee for service model that does not rely upon the sale of a product or the existence of FUA is the only acceptable option. Any model that relies on product or FUA is inconsistent at all times with professional practice.

Advising 'ordinary Australians'- the worth of advice

The continuity of the dominant commission or percentage-based fee culture of the financial planning industry is often justified on the basis that many 'ordinary Australians' would not otherwise obtain the advice that they need. It is claimed that such people are either unwilling to pay a professional fee direct to a planner (presumably because they are misguided) or are unable to do so because they do not have the necessary income or liquidity from which to pay a fee (for example, a person may have an income but most of the family's wealth may be tied up in real estate and superannuation).

This line of argument sounds reasonable, at least on first examination. However, this paper proposes an alternative argument. It is suggested that the reason most of these people do not wish to pay a fee direct to a planner is because they are not convinced that the 'advice' is worth much (or anything), believing it to be motivated principally by the imperative to sell a product. This point was even reflected in the title of a recent Centrelink Seminar, which was tellingly called; 'Financial Seminar — Free of Sales' (6 September 2006).

Another dimension to this discussion is that it is vital for commission or percentage fee -based financial planners that clients have what are often referred to as 'investable funds'. These are funds on which a commission can be earned or a percentage fee can be levied. Without 'investable funds', or a cash flow to create some, even wealthy clients are of little immediate interest to this type of financial planner. In worst -case scenarios, clients are prevailed upon to liquidate assets in order to create assets on which a percentage can be earned or levied.

The key issue here is the worth of advice offered by financial planners. If the industry persists with the proposition that commissions and percentage-based fees must continue so that 'ordinary' people are not discouraged from seeking advice, then the community will continue to undervalue the worth of financial planners and their advice.

It is accepted that adoption of a fee for service model that does not rely on the sale of a product or the existence of FUA may mean that in the short term certain people will not seek advice at all. It is submitted, however, that this will be offset by a much greater number of people who will feel comfortable about talking with a financial planner. In such an environment, clients will seek out and willingly pay for advice that they can afford, value and trust, and financial planners will feel that they can be open (and honest) about advising clients, in the knowledge that their jobs or livelihoods do not depend on the sale of products or on the existence of assets.

In addition, due to a much less intrusive regulatory and compliance regime, fees for advice will be reduced in many cases, providing more encouragement for people to seek advice. Most Australians do not have complex financial affairs, so that offering simple professional guidance to them does not need to be an expensive exercise. This cost should be measured in the hundreds of dollars (or less), not in the thousands of dollars as is often suggested in the current compliance-driven environment.

Ironically, this reform may also mean that institutional product sales will actually increase, because clients will be more inclined to trust financial planners and the institutions that they represent. This would be an excellent outcome for clients, financial planners and institutions alike.

The alternative is to continue with the ambiguity, the conflicts, the lack of trust and the hypocrisy inherent in the 'status quo'. In that case, financial planners will never receive the professional recognition that they desire, and the industry's image will continue to suffer.

Tax deductibility of financial planning fees

Generally speaking, fees paid for the preparation and implementation of a financial plan are not tax deductible. The Australian Taxation Office argues that such fees are of a capital (or private) nature. It is not proposed to canvass in this paper the sometimes tortuous technical arguments concerning the circumstances in which such an outlay should be characterised as capital, private or revenue.

Nevertheless, an obvious parallel lies in the treatment of tax return preparation fees. While it may be technically arguable that these fees are of a capital (or private) nature, the law allows a specific tax deduction for this cost, presumably on the basis that it is good public policy to do so. It is suggested that it is also good public policy to encourage taxpayers to seek independent advice from a financial planner. The tax deductibility issue of these fees should be reconsidered and supported in that context.

Developing a pro bono culture

There are many people who have no assets and little cash flow. These people are often the most vulnerable members of our community. As a consequence of their circumstances, many of them have a need for professional guidance, if not independent financial planning advice.

A large part of the solution to the problem of assisting genuinely disadvantaged people is for the financial planning industry to develop a widespread culture of pro bono community service. As discussed earlier in this paper, a principal hallmark of a profession is a commitment to working for the 'social good', and placing 'the responsibility for the welfare, health and safety of the community before their responsibility to the profession, to sectional or private interests, or to other members of the profession' (Australian Council of Professions, August 1993).

It is in this area that the financial planning industry has a unique opportunity to 'make a difference' in the Australian community. This does not suggest that financial planners, as individuals, do not already assist disadvantaged people. It is understood that bodies such as the FPA already seek to formally recognise significant pro bono work performed by worthy members.

This program must be significantly expanded, resourced and imbued into the industry's culture. In so doing, the industry will be asserting in a positive and practical way its claim to be regarded as a profession, rather than as a sales force.

The education of financial planners

Much progress has been made in recent years in terms of the technical qualifications required to become a financial planner. Nevertheless, it remains relatively simple to qualify at 'entry level' via a short product-oriented course approved by ASIC under *Practice Standard 146* (known simply as PS 146).

Academic standards in the industry should continue to be broadened and lifted (subject to the caveat below), so that all new entrants should eventually need an undergraduate degree. This will assist in improving the standard of advice and the standing of the industry in the community.

It is not necessary, nor is it desirable, for tertiary qualifications to be limited to an undergraduate degree in financial planning. That would fail to recognise the discipline lends itself to a wide range of persons with other qualifications and life experience (for example, accountants, lawyers and engineers).

The significance of higher academic standards must not be overstated. It is misguided to suggest that they alone will solve the industry's problems. Higher academic standards must be accompanied by compulsory training of all new entrants in a solid ethical framework in which the industry's leadership and participants truly believe and carefully apply in their relationships with the community.

Reaching that point requires the 'rhetoric-free' self-examination and reinvention referred to earlier in this paper. Without that step, introducing higher academic standards for financial planners is a hollow gesture. It may sound like a desirable initiative, but it will mean very little in terms of lifting the industry's professionalism and community acceptance.

The importance of financial education

The importance of independent financial education of the community at large cannot be over-estimated. In recognition of this imperative, the Federal Government has set up a new body within the Treasury called 'The Financial Literacy Foundation' (www.understandingmoney.gov.au). It is to be commended for this move.

Its purpose, inter alia, is to encourage the establishment of financial literacy programs within schools and employers and to 'facilitate an ongoing social marketing campaign to embed a key consumer financial literacy message within the Australian culture (the financial equivalent of "slip, slop, slap" or "don't drink and drive" ...)' (Preliminary Recommendations to Government of Consumer and Financial Literacy Taskforce, Paul Clitheroe, 31 August 2004).

It is an understandable reaction to produce legislation to solve every problem that arises in the industry. Legislation that imposes 'bans and tough controls' is popular with some politicians and the tabloid media because it gives the appearance of 'doing something to stop the crooks'. Of course, legislation has its place in driving behaviour, but it is never the complete answer. The current Financial Services Reform (FSR) legislation is a good example of that. FSR has made a contribution to improving the industry's behaviour, but it has failed to remove the type of behaviour and culture that have been outlined in this paper. Alone, it was never likely to do so.

That is why the FLF is an excellent initiative. It must continue to be supported and expanded indefinitely by governments and the financial services industry at all levels. The FLF is not a 'nice to have'; it is a 'must have'.

One of the FLF's most important long-term aims must be to facilitate the transformation of consumers, so that they become sceptical, well informed and confident. Hitherto, consumers have been confused and ill equipped to ask hard questions about qualifications, expertise, conflicts of interest, commissions and fees. Sceptical, well-informed and confident consumers will drive desirable and fundamental changes in the financial planning industry.

Consumer financial literacy education is not a soft option. Certainly, it does not grab the headlines in the way that tough talk, legislation, bans and enforceable undertakings do. It will work, however, provided there is a serious commitment to the cause. The longevity and size of that commitment will be a significant test of the government's resolve and leadership on this most important consumer issue.

The industry's special responsibility

An important factor considered in reaching the principal conclusion in this paper is the unique and privileged position of the financial services industry in the Australian marketplace. The industry sells a tax-effective product that the public must buy (compulsory superannuation).

As a result, the industry contains a multitude of individuals who have benefited far beyond their wildest dreams from what amounts to a privatised national superannuation scheme. Therefore, the industry has special responsibilities to the community that has handed it a 'licence to print money'. Those responsibilities include the creation of an industry that the community can trust to deliver on the 'common good'.

Reinvention into a profession- the solution

Solving the problems of the financial planning industry first of all depends upon reaching agreement about what exactly the problems are. This paper submits that the principal problem is the industry's fundamental structure, especially the nature of its predominant (product-oriented) remuneration models. All the other problems flow from that.

There is a symbiotic relationship between the product manufacturers, who must sell products, and most of the distributors, whose remuneration models (usually a commission or a percentage-based fee) are designed to do

likewise. Therefore, the financial survival of most of the participants at every level in the industry depends upon transactions.

This 'modus operandi' is in conflict with the community, which needs and deserves a trustworthy source of financial advice. The community does not want a financial planning industry that says one thing and does another. Unfortunately, with many financial planners (whatever their form of employment), clients are never quite sure what the agenda is. That is an untenable position for planners and clients alike. It is a position that must be changed for the benefit of the community and for the integrity of the financial planning industry and its participants who desire professional recognition.

Many articles have been written on this subject. Most of them are predicated on the assumption that certain things (especially commissions and percentage-based fees) are 'set in stone', and can never be changed. Should that be the case, the industry can look forward to an intensely regulated future in which professional recognition will never be achieved, and the public interest will never be served.

This paper does not accept that the 'status quo' can never change. There is an urgent need for the financial planning industry to construct a future in which commissions and percentage-based fees do not exist; and in which financial planners charge for their advice on a fee for service basis (without the need or requirement to sell any products at all).

Whenever a planner's income (however it is calculated) depends upon the sale of a product (or upon the existence of 'investable funds'), that arrangement must stop. This is a rule that must be applied industry-wide and irrespective of place of employment.

In reaching this conclusion, consideration was given to the merits of alternative solutions. These include the government's recently proposed 'two-tier' licensing system (one tier for salespeople, and another one for advisers). This was contained in a discussion paper entitled 'Corporate and Financial Services Regulation Review' (November 2006). Another is a special (non-product) 'gatekeeper' class of licence for accountants. These solutions (or variations of them) may be adopted in due course, but they will not work comprehensively and permanently. This is because they accept the industry's basic structural problem as a 'given', and then propose actions to work around it.

'Workarounds' will also require complex regulations and definitions that will prove to be confusing and impractical, adding to the compliance burden throughout the industry. 'Workaround' solutions do not work. If the history of the financial services industry over the last 30 years teaches us anything, it teaches us that.

It is accepted that the solution proposed in this paper will not remove all conflicts of interest. They will continue to exist in areas such as institutional ownership of distributors, but they will fade in significance because financial planners will no longer be required to sell products. This may mean that institutions will no longer wish to own distribution networks, and it may mean that dealer groups and individual planners will have to make some very hard decisions about their futures. So be it. This proposal will only succeed if the leadership and all the participants in the financial services industry (institutions, dealers, financial planners and their professional associations) are united and committed to make it work.

It will be suggested by opponents of the new remuneration model that some financial planners may be tempted to 'pad timesheets' or abuse their fee scales in some other way. That is so, and it is a risk that exists at present with other professions.

Regrettably, this proposal does not guarantee that financial planners will be honest at all times. No-one can do that. What it does guarantee is the substantial alignment of the interests of financial planners with the interests of their clients. It also guarantees that after a relatively short period of readjustment and commercially-driven restructuring, the financial planning industry will be well on the way to attaining its goal of acceptance as a profession.

Other steps must also be taken in areas such as academic and ethics education, the establishment of a pro bono culture, and a commitment to financial literacy programs. All of these initiatives are important to the future of the financial planning industry's aspiration to professional status, but they will be to no avail if the industry cannot admit to its fundamental structural problem, and then act voluntarily and decisively to remove the offending remuneration models.

It should be noted that this change does not require any new legislation (an outcome that should please the government), nor does it require wholesale deconstruction of the financial services industry. In fact, it could be called 'the minimalist approach', because its principal requirement lies simply in changing the way people think.

There is no denying that reinvention of the financial planning industry in the manner proposed in this paper will have some important and inconvenient practical consequences for many participants in the industry. As a result, there will be a natural reaction to dismiss fundamental structural reform as impractical, because the perceived consequences of such a change will be too painful and uncertain to contemplate.

This reaction must be understood in the context that failure to make the reform proposed in this paper (on the industry's terms) may well lead to consequences (imposed by legislation) that will prove to be even more unpalatable. It is not suggested that certain forms of remuneration should be banned by legislation, although that possibility has its attractions and may prove necessary in due course.

Some practical consequences of the transition

An important practical consequence of the change proposed in this paper is that financial planners (whatever their form or place of employment) will be presented with the opportunity to gain increased or complete control of their professional destinies. No longer will they be controlled by the vagaries of investment markets, by the commercial necessities of dealer groups or funds managers, or by the need to sell products and accumulate 'funds under advice'.

As a result, financial planners will gain the freedom to build professional practices for themselves (or for their employers) based on legitimate fee for service remuneration models. Some planners will be unable to make the transition due to a lack of professional qualifications and skills; others will not be able to make it due to their inability to operate a professional practice (as distinct from a product sales business); and others will be unwilling to make the transition because of their established and comfortable income streams flowing from product 'trails'.

Those financial planners who are willing and able to make the transition will gain a level of professional satisfaction and independence that they have never experienced before, mainly because they will no longer be required to advise clients in the knowledge that a product must be sold (whether or not the client actually needs one).

Many planners expect that their 'book of trails' will be a valuable asset on retirement. Multiples of two to four times (gross) trail revenues are often mentioned, which is considerably more than the expectation of most accountants (who would be fortunate to achieve a multiple of one). There are a number of reasons for this substantial difference. The principal one is that, unlike regular accounting fees, there is a perception on the part of buyers that little work is required to justify and increase the income derived from a 'book of trails'.

This is one of the biggest issues for financial planners to address in making the transition to a truly professional practice. It is best illustrated by an example of a fictitious financial planner with a 'book of trails' deriving income of \$500,000 per annum (represented by 100 clients, with an average FUA of \$1m each, from which is earned 0.5 per cent in trailing commissions). This 'book' provides a comfortable income that increases (or occasionally decreases) with movements in financial markets. On average, each client is paying the planner \$5000 per annum (at least). Little professional and administrative work is required to collect the trailing commission, as most of the clients would be relatively unaware that the payments are being made automatically out of their funds.

In a proper professional environment, the fee of \$5000 per annum would need to be justified annually to each client by way of an accounting of actual professional services rendered, backed -up with regular invoices or a formally agreed retainer arrangement, in much the same way as any other professional services provider is required to do.

While the professional fee of \$5000 need not be directly calculated by reference to time, it is understandable that when clients are confronted (as they should be) with a decision about whether the financial planner is worth that much, they will think about time spent and the value of services rendered. So that where a planner has spent 15 – 20 hours per annum of 'value-added' consulting time with a client, transforming a trailing commission of \$5000 per annum into, say, a quarterly retainer fee of \$1250 (unrelated to FUA) should present no significant problems.

It is only where little or no time is spent, or a planner has inadequate professional expertise, that clients should quite reasonably balk at paying for the planner's services. Put simply, where the remuneration to the planner cannot be justified, it should not be paid in any form (and never should have been paid).

For some (older) planners, particularly those with very high financial expectations on retirement, this analysis and transformation of their 'book of trails' will prove to be an impenetrable barrier to transition; but, for others (who understand that the current situation is inherently unstable), initiating a program of transforming 'trails' into 'fees

for service' will prove to be a liberating process, undertaken in the interests of longer term viability, independence and sustainability.

The change may have a detrimental impact in the short term on businesses that are based on product sales. In the longer term, however, the viability and value of financial planning practices will be justified and sustainable because they will be viewed as legitimate professional firms in which the participants are earning a 'fair day's pay for a fair day's work'.

Some dealer groups and institutions that own, partly own, or have significant financial arrangements with distribution networks may find the transition very challenging. This is because their cultures, expectations and structures are designed around the sale and distribution of products, rather than the provision of advisory services. Inherent in these structures is a strong control mechanism that exercises considerable power and influence over the decisions and recommendations of financial planners.

In the restructured environment, this power and influence will be considerably reduced or removed. Therefore, it is understandable that a fundamental change of this nature will be resisted, although it is likely that some 'product manufacturers' will view the change as an opportunity to achieve some direct access and influence over financial planners who might otherwise be inaccessible.

It is beyond the scope of this paper to analyse the multitude of financial and employment arrangements that exist in the industry. Suffice to say that, in any restructuring of the nature proposed in this paper, there will be winners and losers. The losers will be those organisations and individuals that do not accept the serious detrimental consequences of maintaining the 'status quo'. The winners will be those that understand the depth of the problem, and realise that it must be solved once and for all, without resort to 'workarounds'.

Serving the public interest- the need for visionary leadership

More than anything else, reform and transition of financial planning into a profession requires visionary leadership. Without it, the industry is consigned to a future of unworkable 'workarounds' and an increasingly complex and costly compliance regime. That outcome is undesirable for those financial planners who want the freedom to service their clients on a professional basis; and it is certainly not in the public interest.

A satisfactory outcome will never be reached until the industry's leaders openly accept the existence, the depth and the unacceptable consequences of the structural problem; and then make a commitment to deal with it once and for all.

The consequences of taking this position will not be as difficult as many people might fear and anticipate. This is because financial planners will become respected as true professionals; their practices will gain legitimacy, sustainability and longevity; and institutions and dealer groups will enjoy an improved image and reputation. Most of all, the public interest will be served unambiguously, for which our political leaders and regulators will be both relieved and grateful.

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