

I F A F E E S

the myth
& the reality

IFA FEES – THE MYTH AND THE REALITY

For the last 21 years I have been watching a war unfolding. A war between commission and fees, and right now it looks set to explode!

Aside from a few skirmishes the commission lobby has been winning the war virtually unchallenged. Let's face it, with the country's largest financial institutions on the side of commission, and consumers seemingly unwilling to pay directly for financial advice the commission lobby was unlikely to lose. But all this could be about to change.

The Retail Distribution Review (RDR) currently being undertaken by the Financial Services Authority (FSA) has convinced enough people to believe that fee based advice is likely to be the only option for those firms wishing to call themselves Independent Financial Advisers.

It will be several months before we know the results of the review (due in October 2008) with implementation several months beyond that, yet we are already witnessing an increasing number of IFA firms promoting their switch to a fees model, even if in many cases the fee is offset by commission. Yet despite talking up fees as the way forward are these firms adopting a real fee model or are they shaping their fee structures to simply replicate commission?

Which brings me to the title of this paper: **"IFA fees - Exposing the myths and the reality"**. This isn't a discussion paper on the merits of fees over commission; that argument has been rolling for years and looks like continuing for a few more years yet¹. Yet in order to understand some of the myths surrounding fees we do need to consider exactly what commission is and how it is paid. Take a look at the following dictionary definition:

Commission - a fee paid to an agent or employee for transacting a piece of business or performing a service; especially : a percentage of the money received paid to the agent responsible for the business, usually increases with the quantity of the goods sold.

I am particularly taken with the second half of the above entry **"a percentage of the money received paid to the agent responsible for the business, usually increases with the quantity of the goods sold"** because when I look at many of the fee arrangements being proposed they seem to do the same thing.

¹ If you have a burning desire to look at the original research undertaken on behalf of the Financial Services Authority by Charles River Associates Limited (published January 2002) it is available to download as a pdf from the following URL: http://www.fsa.gov.uk/pubs/other/pol_res1.pdf

Here are few examples taken from the websites of several fee based advisory firms:

Firm A

We impose a 1% initial charge and 1% annual management charge for assets over £100,000 within our Wealth Management service.

Firm B

Our typical charges are:

- **Portfolio Management Clients**
 - Portfolio Set Up Fee (for initial investment) up to 1% of initial portfolio value
 - Annual Management Fee up to 1% of portfolio
 - New Investment Fee (for additional funds) up to 1% of funds invested
- **Non Portfolio Management Clients**
 - Cash Investments 3% of funds invested
 - Transfer Advice 3% of funds transferred

Firm C

- For lump sum investment solutions we would expect to charge an implementation fee of between 1% & 5% of the funds invested
- For regular savings or protection-based solutions, we would expect to charge an implementation fee which is broadly in line with the average market commission rates
- Our normal annual servicing fee would be 0.5% pa of funds under management for investment clients and 2.5% pa of the amount paid for any regular premium contract
- For ongoing planning & advice reviews our fee would be up to an additional 0.5%pa of the funds under management

Clearly any amount payable by the above fee arrangements is dependent on the size of any investment being made - is it really ten times the work to invest £1million than to invest £100,000? The ongoing fees are dependent upon the portfolio remaining invested and are directly linked to the amount under management.

So if single lump sum investments have fee structures that look much like commission, what about regular premium contracts such as life assurance? The next firm's fee explanation might shed some light.

Firm D

A fee of between £100 and £290 for advice on insurance payable prior to the advice, plus between 12 and 24 times the monthly insurance premium (e.g. for a £100 per month premium, between £1200 and £2400) on application, and we will use any fee [surely that should read commission] received from the provider to offset against your fees.

So, a fee structure that looks remarkably similar to the commission option for products of this nature. The size of premium has a direct impact on the size of the fee, and in addition the term of the contract also changes the amount of fee charged. Again, does it really involve ten times the work to arrange an insurance contract for £1 million than for a £100,000?

Much of the research into the provision of financial advice concludes that commission creates bias in the provision of financial advice². Might it be logical to assume that some bias could also exist if a fee was structured to act like commission?

MYTH - Fees remove bias from financial advice.

REALITY - Fees that act like commission create incentives for the adviser to acquire funds to manage, the bigger the better. Ongoing fees act as a disincentive to let these assets go.

Leaving all that aside for the time being, there is another trend emerging, and that is the offsetting of fees by commission. On the face of it this does not seem to be anything to be concerned about, but I think otherwise.

My first comment is about something known as “trail”, sometimes called a trail fee or a trail commission. It is the amount paid to the advisory firm for the ongoing “management” of the investment portfolio, usually ½% p.a. but can be as high as 1%. In most cases the payment is actually made by the investment company. That looks like commission to me. The cynic in me would go so far as to say it was the reward for ensuring the money remains invested in funds?

If the investment funds control the payment of the fee, then I would suggest this creates some bias in the ongoing advice of those funds. Having received a regular quarterly payment from the fund manager how proactive is the recipient going to be to turn off the money tap by suggesting you invest in assets that don't pay trail, like cash for example.

² In addition to the Charles River Associates study on behalf of the FSA the same conclusion was reached by the Sandler report (Medium & Long term retail savings in the UK for HM Treasury by Ron Sandler). The full report can be accessed from this URL: http://www.hm-treasury.gov.uk/documents/financial_services/savings/fin_sav_sand.cfm

Imagine the conversation; “John, your portfolio’s done well but it’s time to bank the profits, in fact it’s probably time you bought the holiday cottage you said you wanted. Oh, and by the way, I want to charge you ½% of the value of the cottage to replace the income I’m losing from your portfolio”. I can’t see it happening, can you?

Of course, that raises the discussion about what fees are actually paying for, and what they should be paying for. This isn’t something I want to discuss here as it warrants a separate and deeper discussion elsewhere.

The bigger issue I have with commission being used to offset fees is the implied bias that this creates. When meeting new clients for the first time the conversation eventually comes around to the way we are paid. Unused to paying for advice on a fee basis a significant number of people ask whether we would consider using commission to offset the fee. When pressed a little harder as to what their expectations are around this I am usually told that they don’t expect to physically write out a cheque to pay for the advice, and that they fully expect the eventual product to meet the costs of advice.

When I counter with a something along the lines “what if I find that the best course of action for you does not involve any commission paying products, are you willing to underwrite the payment of my fees?” some of these seemingly pro fee clients decline. As a financial planner I do not want to be placed in the position of having to recommend a particular course of action in order to guarantee that I will get paid for my time and expertise.

Conversation with people who are expecting commission to be used as a fee offset are really negotiations about the amount of commission that the individual is prepared to pay. The underlying assumption is that one or more products will be put forward, and that feels like bias to me.

MYTH – There is no difference to the advice whether the fees are paid direct by the client or whether commission is used as an offset.

REALITY – Commission offset is really a discussion about how much commission is acceptable for the given transaction. It is a transaction based relationship not an advisory relationship.

It might also be helpful to explain how some commission arrangements work. For example, regular premium contracts like life assurance can have earnings periods of up to 4 years. What this means is that the commission, although paid out on day one, is actually earned over the first 4 years of the contract. Therefore if the policy is stopped or cancelled within that period some or all of the commission will be recovered.

If you stop to think about it, this can lead to all kinds of problems. Imagine for example that your IFA has agreed to rebate any excess commission to you over an above the agreed "fee" subject of course to having an agreement in place to come back at a future date and recover the commission if you cancel the policy inside the earnings period. Not a nice position to be in for either party

On the other hand the IFA may agree to offset these excess commissions against future advice, a common suggestion put forward by advisers to avoid some of the problems outlined in the previous paragraph. So what if they were to become insolvent, or alternatively you wanted to appoint another firm, and is the firm even permitted to notionally hold what is in reality client money.

Commission offset against fees is fraught with problems, not just the potential for biased advice, but who really is the paymaster and what do these arrangements commit you to in the long term?

Because the commission versus fees argument has overshadowed all other discussions about adviser remuneration there has been little or no real debate the fees themselves. Our belief is that many of the current fee options being touted by firms are nothing more than commission and therefore, like commission, creates the potential for biased advice.

Our position therefore is to provide our clients with fee options that are completely free of any commission, and which are not geared to the sale of a product, nor the amount of funds under management. We are not alone in this position but we are in a minority. New figures collected by Charles River Associates for the Association of British Insurers indicates that only 13% of advisers charge fees without commission offset (source CRA International).