

Regular research papers and articles providing sector specific insights and issues analysis – Financial Services

May edition 2011 – Financial Services

Industry Intelligence Unit

Welcome to our third financial services sector IIU publication. As the year builds momentum, market sentiment is mixed but the first signs of optimism can be detected. This of course switches people's perspective from defensive to more growth focused. For those seeking personal financial growth, this often means seeking the advice of a financial planner. So with this in mind, this issue of the Financial Services IIU takes a look at the financial planning sub-sector.

We start with a general overview of the financial planning industry before focusing in on the proposed legislative changes that are affecting the industry landscape. Next we examine the make up of the industry and how its various components fit together around the dealer group model, and how it generates revenue. Finally we turn our attention to key issues for lenders to financial planning businesses.



Financial planning industry overview

The Financial Planning industry in Australia is worth \$4.9 billion in revenue and is made up of around 6,400 businesses. The largest firms comprise the wealth management arms of large financial institutions including banks and the dealer groups. There are about 15,810 financial advisers and about 158 dealer groups in this industry.¹

The industry has experienced negative revenue growth (-3.9% p.a.) over the last five years, but this is expected to improve. According to a survey commissioned by the Financial Planning Association (FPA) in early 2008, three out of every 10 Australians use a financial adviser, and this figure is growing. The ongoing growth of this industry is supported by demographic trends. The population is ageing, living longer and having fewer children, increasing the importance of retirement savings. The inflow of new funds into superannuation assets is expected to continue to increase given demographic trends and legislative requirements supporting industry growth.

However the last few years have seen the financial planning industry rocked by the Global Financial Crisis (GFC). Many dealer groups were left stunned at the enormity of it.

A drop in the value of assets under advice as share markets plunged, coupled with a fall in new fund inflows as investor confidence withered, saw both revenue and profit fall in 2008-09. This was in contrast to the previously strong growth experienced by the industry due largely to the changes in superannuation legislation. In the five years to 2010-11 industry revenue is expected to decline

It is fair to say that the industry faces even greater upheaval in the form of regulatory and structural change.

by an average of 3.9% a year to reach \$4.87 billion.¹

Many advisers had invested their clients' funds (often borrowed) in Managed Investment Schemes (MIS), such as Great Southern, Timbercorp and Rewards group. The high commissions (10% on average) being paid to advisers were a honey trap and dealer groups were generally supportive of such MIS. The large players, including those mentioned above, were regular sponsors of large dealer group annual conferences: the relationship was strong.

Some advisers had also recommended clients place funds into property trusts (also paying commissions). Many of these trusts collapsed when the credit crunch hit, therefore preventing them from funding their aggressive gearing strategies or some were frozen from all redemptions indefinitely.

Few Australians could have missed out on hearing about the Storm Financial debacle, which has squarely put the spotlight on gearing to invest. It also painted ASIC in a poor light, with claims they had been warned numerous times that the investment strategies Storm were implementing were fraught with danger and would eventually fail.

Overall the GFC has caused the industry to look inwards and learn from

its mistakes. Dealer groups have become more compliance savvy, which in turn has meant that advisers have had to become the same. The GFC also brought about increased Government intervention and regulation of the industry. Full disclosure of all fees and commissions as a percentage and dollar figure is now law rather than an option. And switching between financial products now requires formal advice as to the advantages of doing so.

While funds under advice per adviser fell during the downturn, costs for this industry remained relatively fixed. As a result, adviser productivity and profit also dropped over 2008-09. Some financial planning firms reduced staff in early 2009 as the demand for financial planning services dropped.

Generally, however, there is a recognised lack of qualified financial advisers in the industry. Accordingly, many firms were reluctant to cut back on financial adviser numbers for fear of being unable to attract experienced staff back once industry conditions improved.¹

A lack of financial planners has also been a motivator for consolidation, which has been prevalent in the industry. Prominent examples include Asgard merging with BT and NAB trying to buy AXA, which was subsequently acquired by AMP.

Legislation

Introduction – FOFA

A big issue faced by the Financial Planning industry in recent times was the *Future of Financial Advice* (FOFA) review. Following a swathe of advisory disasters the Government announced an overhaul of the industry, addressing the issues of conflict of interest, transparency and duty to clients. The industry has generally welcomed the impending regulation.

The Federal Government released its FOFA reform package in April 2010. This included:

- a prospective ban on commissions and volume-based payments
- the introduction of a statutory fiduciary duty, increased transparency and flexibility of advice payments
- percentage-based fees only to be charged on select products
- expanding intra-fund advice
- increasing the powers for ASIC
- a statutory compensation scheme

In May 2010, Treasury Secretary Ken Henry handed down his Review of Australia's Future Tax System, which encompassed 138 recommendations. Under the Government's response to the Henry Review, Australians aged 50 and over would benefit from a revamp of concessional caps, with the superannuation guarantee (SG) to be boosted from nine per cent to 12 per cent by 2020.² It has also been announced that the SG age limit would be raised to 75 from July 2013, with 33,000 employees expected to benefit from the initiative.

Fees

In August 2010, the Government said it would introduce a number of standards that the My Super product must comply with, including no entry fees, exit fees limited to cost recovery, a ban on commissions in relation to retail distribution and advice, a single and simple investment option, and standardised reporting requirements.

Ongoing, annual commissions of advisers will still be allowed, however the client must sign a commission release form on an annual basis. This allows the client to have the final say on whether or not the adviser has earned the right to receive their commission/s.

For years the independent financial

advisor (IFA) industry (as opposed to those aligned to a particular dealer group) has argued that financial advice be charged under a 'fee for service' model only. Whilst this is perfectly fine for people who can afford it, such as sophisticated investors, it would make it very difficult for low income earners to receive any advice at all. There is an argument that these are the people who need the advice the most.

The reason the IFAs want a fee for service model is that they aspire to be viewed in a similar light to lawyers and accountants in terms of professional advisors. Common sense, however, would look at somewhere in the middle of commissions and fee for service.



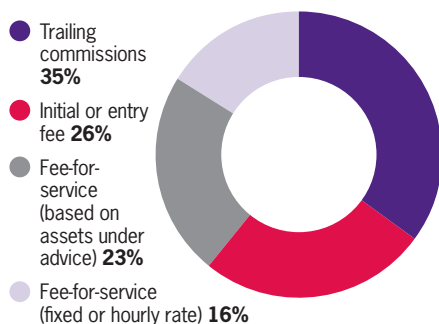
Segmentation of products and services fees 2011

The introduction of clients having to sign an annual release form to allow the adviser to charge a trailing commission means that people who cannot afford to pay fee for service still receive valuable advice to help them in retirement and/or the event of death or serious injury. It also means that if the adviser is not providing the level of service promised, they remain accountable. It shifts the onus onto the adviser to be pro-active in advising his or her client.

These changes will not affect most IFAs, as many of them are already using a fee for service model, and the ones that are not are moving that way.

Segmentation of products and services fees 2011

Source: www.ibisworld.com.au



Education and qualifications of planners

While the governing bodies such as the FPA have been talking about legislative changes, as opposed to voluntary change in the industry, for many years the Government has declined to act. The coming round of legislative changes may include the raising of education standards such as requiring that every Financial Planner be degree qualified (most are these days) before they may advise under an Australian Financial Services Licence (AFSL).

This is seen as controversial, as there are many older advisers who began their careers years ago, who have only undertaken the minimum education requirements to practice under their dealer group license. Forcing them to complete an undergraduate degree by a set date, may have the unintended consequence of forcing many good and experienced advisers to exit the industry. However, some argue that this is the price we must pay in order to lift Financial Advisers to a similar professional standing as accountants and lawyers. Regardless, it is expected that there will be an increase in the number of financial advisers exiting the industry over the next few years. The average age of financial advisers is around 55 and some may be unwilling to make the transition to a new remuneration model.¹

Tax deductibility of advice

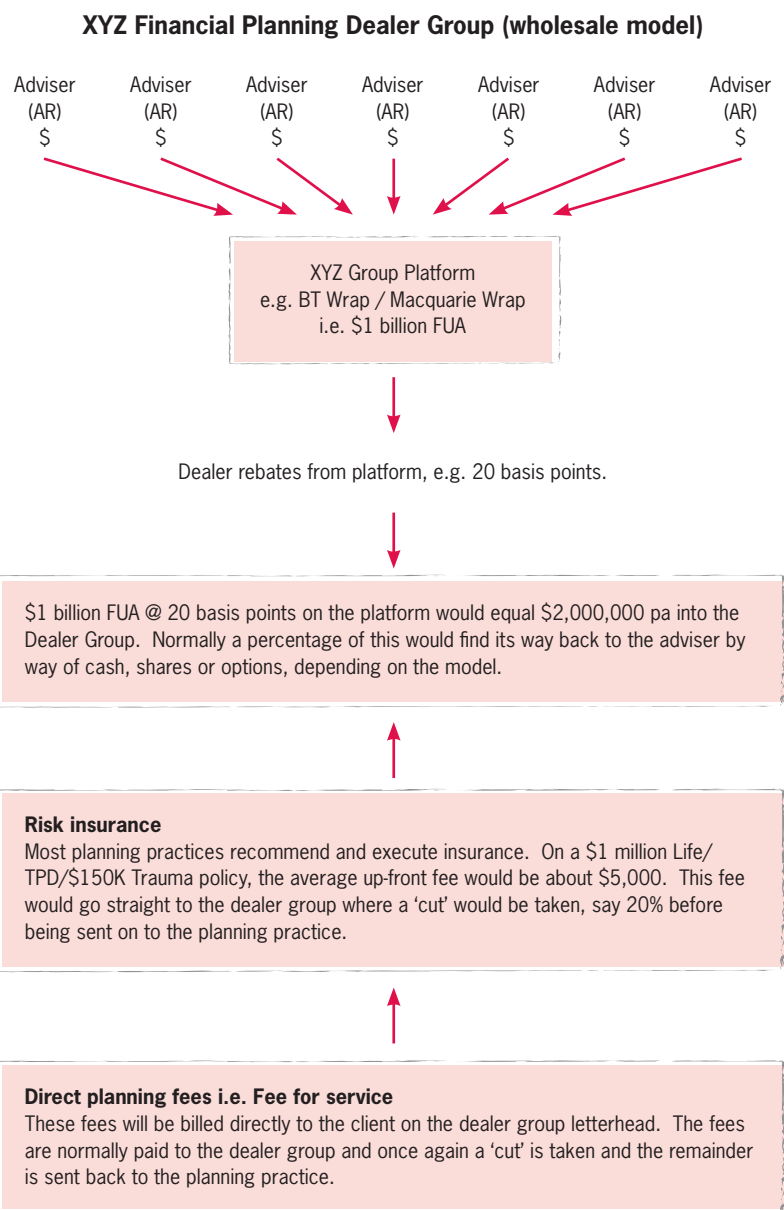
Another concept to emerge recently, was the Government's consideration of the implications of making the cost of financial advice tax deductible. This could occur in a manner similar to the way in which taxation advice is deductible. Any such change would provide an ongoing boost to industry revenue by increasing the number of people seeking financial advice and possibly increasing the price people are willing to pay for advice.³ Although there are currently no plans by the government to make financial advice tax deductible, the industry is likely to continue to press for consideration of this proposal.



Industry structure

Dealer groups

The financial planning industry is predominantly structured in the form of dealer groups. Dealer groups provide financial planners who are part of the group with a range of support services including the management of compliance and regulatory matters, administration, provision of product research, and information technology. Affiliated dealer groups also provide their clients with access to the master trust or wrap platforms of the group with whom they are affiliated.



Most dealer groups will charge somewhere between \$10,000 and \$15,000 per year, per Authorised Representative (AR). A large dealer group with 100 ARs, would generate between \$1,000,000 and \$1,500,000 a year from these fees. In return for those fees, a financial planning practice receives from a dealer group:

1 **Benefit of the dealer group's AFSL**

The process of applying for and maintaining an AFSL is quite onerous. Financial planners belonging to a particular dealer group will enjoy the benefits of the AFSL maintained by the dealer group.

2 **Compliance audit**

Whilst it is up to the practice to keep their files in a compliant manner that would satisfy ASIC, it is up to the Dealer Group to provide internal annual audits of every AR. This not only protects their license but it also ensures that the clients are being advised properly.

3 **Professional development (PD) training**

It is a licensing requirement that a dealer group provides enough training to allow ARs to meet the minimum ASIC requirements. At present this is 30 hours per year, divided amongst the ARs competencies. The training is normally delivered by way of Professional Development days, online training and Annual conferences.

4 **Professional Indemnity (PI) cover for the ARs competencies**

5 **Research**

Normally this would include multiple research companies, such as Lonsec, S&P, etc.

6 **CRM software**

7 **Other – Including business development advice, coaching, strategy support and practice management support**

The wholesale model can be relatively straight forward. The illustration on page 5, although simplified, shows how a dealer group derives its income.

A dealer group's success is contingent upon having a large number of advisers, as well as scaling Funds Under Advice (FUA). It is also important that the arrangement between dealer and adviser is fair and equitable, to retain and incentivise the advisers.

When the markets are growing, as was the case pre-GFC, many wholesale groups were thriving, as the fees were derived as a percentage of FUA (i.e. \$1,000,000 invested may have cost the client \$10,000 per year in fees i.e. 1% of FUA).

With positive organic growth, the FUA could have reached \$1,500,000 at the top of the last equities boom, therefore the adviser would have been paid \$5,000 per year more, for no extra work.

If we extrapolate that out to the XYZ Dealer group illustrated, they could have gone from \$1 billion to \$1.5 billion FUA, without greatly increasing resources, adding \$1,000,000 to the bottom line from rebates, not to mention the extra income they would have derived from other services.

Retail-based (commission) financial planning practices would not have fared nearly as well, simply because their model is based on commission from product placement and not as a percentage of FUA.

Platforms

About 80% of retail investment money in Australia enters the market through platforms.¹ There is likely to be more consolidation in the financial planning industry over the next few years. The main platforms in the market are:

- BT Wrap
- Macquarie Wrap
- Asgard
- AMP
- Tower
- AXA North

There are many smaller platforms that are actually very good, however time will tell how well they survive.

Platforms have become an integral part of how dealer groups manage their advisers. Distributors of different wrap and master trust products compete for the assets under advice of financial advisers. Competition for funds is based in part on the number of financial advisers distributing the product. Increasing the number of financial advisers distributing an investment product may be achieved by increasing the number of financial advisers directly employed, acquiring existing advisory or wealth management firms, or increasing the number of dealer groups with which there is a distribution agreement.

Clients have also benefited, with most major platforms providing internet access and consolidated reporting, which in turn makes lodging annual returns easier and, in some cases, cheaper.

Platforms however, have also had their detractors over the years as fees and volume bonuses have been scrutinised. Pre-GFC, many large dealer groups could have been receiving volume bonuses in the hundreds of thousands, maybe millions, of dollars. Most of these bonuses would have been returned to the adviser, which the detractors say should in turn be paid back to the client. In reality though, this would not generally have occurred.

Detractions aside, platforms are likely to be here to stay. Like any other product they will morph over the years and should become more user-friendly and more sophisticated. In order to ensure platforms benefit not just the adviser but the client as well the platforms must develop to a point where it is more expensive to have a portfolio off them than on them.

The financial planning practice

Financial planning practices have certainly had to change over the last few years. This is particularly true for practices that have shifted from commission-based to fee-for-service revenue models.

The old school practice, which is solely commission based, has more than likely dropped in value as the industry starts moving forward. A practise is only worth what someone is prepared to pay for it. However, a general rule of thumb is that a retail (commission) only practice is worth about 1.5x to 2.5x earnings and a wholesale (fee for service) practice is worth about 2.5x to 3.0x earnings.⁴

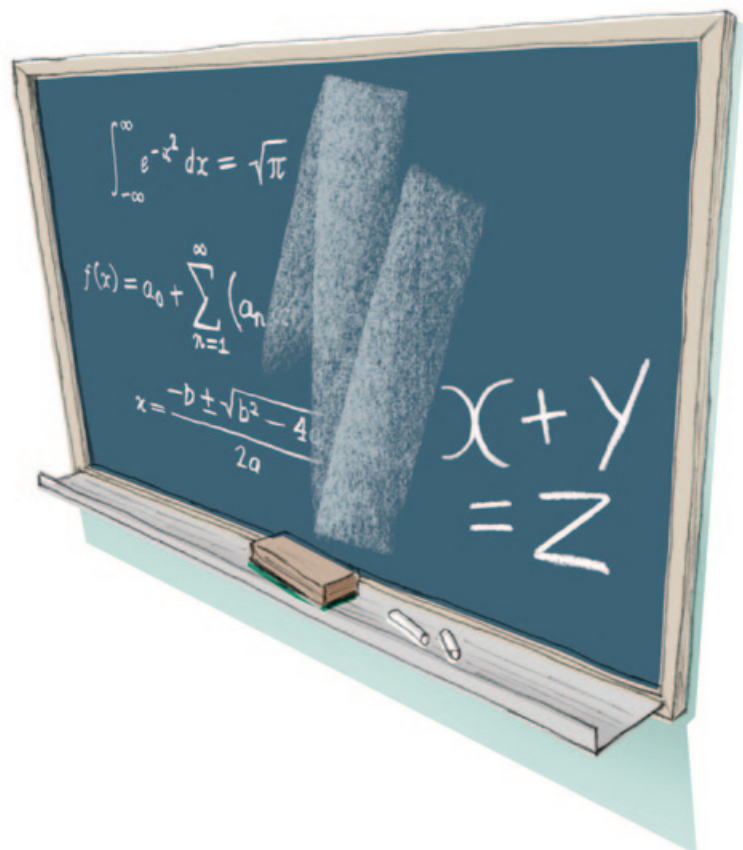
For a practice to be strong and therefore attractive to a lender or JV partner it must have both a strong growth history and strong forecasts. A growth rate generally considered “good” is an increase in fees annually by 20%. Many firms will base their growth targets on Funds Under Management (FUM), but this can be misleading as an increase in FUM may not necessarily lead to an increase in income, especially if the practice is fee for service.

In order for a practice to be valuable its practitioners need to have the skill set to cover all aspects of financial services. The services that need to be offered are:

- Retirement planning, inclusive of Self-Managed Superannuation Funds (SMSF) audit and compliance
- Estate planning including asset protection
- Portfolio creation and management
- Tax planning

- Risk insurance
- Lending
- Corporate superannuation

Changes in legislation may very well add significant value to a practice that has a model that includes all of the above and operates on a fee-for-service model.



Lending to financial planners

At the end of the day, any stand-alone lend to a financial planning business will be a “cashflow lend”.

The below diagram summarises some of the key issues in the industry from a lender’s perspective:



The Lender must have confidence in the reasonableness of the financial forecasts and the underlying assumptions that support it.

Like any professional services business, the intrinsic value is locked up with the key individuals, in this case the ARs. Clients loyal to their advisor are likely to follow him/her to his/her next employer. The ability to lock in key staff and have senior advisors agree to non-compete arrangements for six to 12 months after they depart is critical.

Similarly, commission trail agreements with counterparties will have most value in a going concern environment. Most commission trail agreements will provide the counterparty the right to terminate the agreement if the financial planner enters some form of insolvency.

In summary, it is important as part of any borrowing arrangement for a lender to understand the financial planners:

- Mix of fee for service versus trail commission income
- AFSL licence and compliance regime and history
- Key man risk and steps taken to lock-in senior ARs
- PI limits and claims history – understanding the integrity and reputation of the business owners is critical in a service business that requires clients to place significant trust in their selected advisor.

The proposed legislative reform combined with a number of war scars from the GFC has made the financial planning industry ripe for change.

As with any borrower facing a changing landscape, lenders must ensure they are actively monitoring and reviewing their financial planning clients to ensure they have appropriately prepared and adapted to the changes in the competitive and regulatory framework.



1. IBIS World.
2. Having an SG of 12% is of little surprise: When SG was introduced in 1992 by then treasurer John Dawkins it was 3%. Mr Dawkins suggested at the time that in order for SG to be effective and take the retirement burden off the Australian Government it needed to be 15%.
3. Recommendation of the 'Ripoll Review' (in February 2009 a Parliamentary Joint Committee launched an inquiry into the Financial Planning and Investment Advice industry, 'the Ripoll Inquiry').
4. There are of course many variables that will change the practice value such as client/fee portability, the average investment amount, the quality of the advisers, which platform is used, annuity work vs. one off pieces of work, insurance and lending books, etc.

Industry Intelligence Unit

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- Aged Care
- Automotive
- Hospitality
- Financial Services
- Professional Services

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