

Why financial advice can never be free

So much choice, but very little time, inclination and understanding?

The world is awash with financial products. In the UK alone, there are hundreds of companies marketing thousands and thousands of investment, mortgage and insurance products. At first glance, some seem almost identical — and indeed are — while others appear to be clones and most certainly aren't. In terms of functionality, some products cancel each other out, some overlap and some are complimentary. Every now and then you might think you should have one or more of these products, but if so, precisely when and which one (or more) should you buy?

Then there are all the rules, regulations and variations to contend with. How much you can invest in (or withdraw from) this and that and when. What you can and can't do with a pension, an ISA or a discretionary trust. And are *income protection*, *mortgage protection* or *accident, sickness and unemployment* policies one and the same? Even if you do succeed in sorting the wheat from the chaff, you then have to contend with the language used by many of the product providers, which on occasions can be light on detail, ambiguous and/or nothing short of opaque (not to mention the small print...)

So all in all, it's hardly surprising therefore that many people find that there's just too much to take in. Or put another way, choosing which financial product to buy can be confusing, frustrating and time-consuming.

Enter the financial adviser.

A little bit of background

About personal financial advice

At its most rudimentary, financial advice helps you decide on the financial products you need, when and if you should buy them and which particular products may be best for you. Financial products are things like investments, pensions, mortgages and insurance policies of which many people acquire at least one or two of in their lifetime. When you take out a mortgage, most lenders insist that you set up buildings insurance to go with it. Having 'bought' those two financial products, you might then decide to establish a life insurance policy which would pay off what you owe on the mortgage in the event of your untimely death. Although you've now acquired three financial products — with or without taking financial advice — it's still relatively simple stuff. At the other end of the personal financial advice spectrum is something known as 'lifetime financial planning'. Lifetime financial planning involves the production of an all-encompassing, highly detailed and adaptable personal financial plan. The aim of such a plan, which takes into account many different issues and possibilities, is to help a person achieve their long term personal financial goals. In the main however, the majority of would-be clients for financial advice seek something between the two extremes.

Why personal financial advice is worth paying for

Taking professional financial advice could help identify the kind of investments that 'suit' you. A suitable investment could be described as an investment you're comfortable with and understand, but not necessarily a profitable one — that's in the lap of the markets, not the adviser. Then there's the dreaded subject (for some people) of pensions. Pensions come in all sizes, shapes and forms — personal pensions, stakeholder, SIPPs and SSAS's, AVCs and FSAVS to name just six. How do you choose between them? And can they be mixed together? Or take something as straightforward as a mortgage of which there are literally thousands. Why are there so many? After all, a mortgage is a mortgage, isn't it? Well, no it isn't. The fact of the matter is that certain mortgages are more appropriate for certain individuals in certain circumstances than others: of that you can be certain. And what could be simpler than setting up a life insurance policy? It doesn't take a genius to do that. Or does it? Once again, it's not that clear-cut. You may have an idea of how much life insurance cover you need but would you know whether a term assurance policy or a whole of life policy was the better option for you?

Irrespective of the subject, the point to remember is that taking expert personal financial advice should at the very least help you make more right financial decisions than wrong ones.

How often and how much advice?

Some individuals require financial advice only occasionally: others need it on an on-going basis. As a rule of thumb, the more complicated your financial affairs are, and the more financially ambitious you are, the more frequently you may have to take personal financial advice.

Qualified, accountable and equipped

Financial advisers, the industry regulator, product providers and other interested parties are investing substantial time and other resources into raising professional standards within the advice industry. What advisers and regulators have grasped is that so complex are some of the products and subjects advisers advise on, that the knowledge an adviser needs to acquire to provide accurate and appropriate advice equates in terms of complexity to that of a lawyer or an accountant.

Now all advisers, including those who have been practising for many years, are required to clear a series of intellectual and other hurdles if they wish to stay in business as indeed must new entrants to the advice profession.

It is important to remember that advisers are only allowed by law to recommend products which meet the client's requirements — not the adviser's! If an adviser fails to do that, then he or she risks losing their business and their livelihood.

What advisers have to do to practice their profession

Advisers need to be authorised by the FSA

The first thing you should know is that apart from a few exemptions¹, any firm or individual engaged in a regulated financial service market activity in the UK **must be authorised by the Financial Services Authority (FSA)**. It is no longer possible for anyone to set themselves up in business as a financial adviser. In order to dispense financial advice — of more or less any type — the individual or the firm offering the advice must be 'authorised' by the FSA. Once authorised, firms and individuals are monitored by the FSA on a regular basis — through on site visits and other processes — to ensure they continue to meet the required standards. The FSA, which has been the single regulator for financial services in the UK since December 2001, is an independent body funded entirely by the financial services industry — i.e. the firms it regulates.

Advisers must have sufficient financial reserves

Every authorised firm and individual must have sufficient capital and reserves to be able to meet their financial obligations at all times and must submit a report every six months to the FSA proving that to be the case. Financial advisers must have between £10,000 and £50,000 of their own funds in reserve. If the firm also advises on mortgage or insurance products — and depending on the amount of income generated by those activities — the firm will also have to set aside 2.5% - 5% of that income each year. Firms holding client monies are required to maintain more financial reserves than those that don't. Mortgage advisers and insurance intermediaries must have reserves equivalent to 2.5% - 5% of their annual income. Firms or individuals that fail to meet the FSA's requirements in this respect risk losing their permission to conduct business.

Advisers must be insured

Authorised firms and individuals are legally required to have Professional Indemnity Insurance (PII). PII is intended to cover claims arising as a result of mistakes made by the firm itself, or any individual who is employed in connection with the firm's business including partners, directors, self employed individuals and any appointed representatives.

Advisers must have recognised qualifications

Advisers must prove — in the form of FSA-recognised qualifications — that they have the technical knowledge to provide financial advice. To attain the qualifications they need, advisers have to study (in their own time) and sit classroom-style examinations. Even when qualified, advisers are duty-bound to monitor and keep up with industry changes: an obligation that's officially referred to as 'continuous professional development'. As well as enabling the adviser to practice, attaining the right qualifications makes him or her eligible for membership of a professional body, obliging the adviser to adhere to a specific code of conduct.

¹ Solicitors, accountants and actuaries which carry on certain regulated activities that are incidental to the firm's main business are exempt, as indeed are local authorities or certain types of housing bodies engaged in insurance mediation or mortgage activities.

The advice process or where an IFA's time goes...

Although some aspects of the advice process can be automated or delegated, when an adviser first meets a client, they're required to invest time — and sometimes substantial amounts of it — asking questions and obtaining information. For a client to gain full value from advice, they must be prepared to provide frank and honest answers to the questions and the points raised by their adviser...

Stage 1: information

Before making any recommendations to a client, the adviser must first of all collect as much relevant information as possible from their client: what's known as a 'Fact Find'. That information enables the adviser to assess the client's needs, goals, resources, circumstances, their current financial position and their views and opinions on investment risk and other important matters and any debts or other 'negative' issues that may exist. Once the adviser has gathered all the information they need, he or she will then be in a position to make their recommendations, which may be itemised in a written report. Whether the client decides to follow those recommendations is for the client to decide. The adviser may or may not charge the client for this aspect of their work.

Stage 2: execution

Assuming the client formally agrees to the adviser's recommendations, the adviser will then implement them.

Stage 3: management

Once set up, and depending on the complexity of the client's personal financial affairs, the adviser will review the client's arrangements usually annually or more frequently if necessary. As and when changes need making, the adviser will expedite them usually in consultation with the client but not always.

How advisers get paid

Independent and multi-tied advisers can choose how they are to be remunerated. They can charge (the client) a fee, or take a commission from the product provider, or a combination of the two. Tied advisers are usually paid directly by the product provider they work for. Fee-based advisers can elect to charge a fixed price, by the hour, or in the case of financial advisers, on the basis of the value of the portfolio they advise on or manage. Any commission payments a fee-based adviser receives may be rebated to the client or added to the client's investment portfolio.

More about commission

When a client follows their financial adviser's recommendation and makes an investment in a collective fund, an investment bond or sets up a pension, the adviser gets paid commission from the investment or pension provider. There are two types of commission - initial commission and renewal commission. Initial commission is, as the term suggests, paid to the adviser (via the fund's Annual Management Charge) when the investment is first set up and can be up to 8% of the amount invested, depending on the type of investment. Renewal commission of between 0.5% and 1% of the investment's value at the time is paid to the adviser every year. Commission on monthly contributions made to a personal pension may be up to 75% in year one depending on the amount paid in to the plan.

Financial advisers (as distinct to mortgage advisers and insurance intermediaries) must tell their clients if they are going to receive any commission from their investment recommendations.

Summary

- Any individual or firm which provides regulated financial advice must be authorised to do so by the *Financial Services Authority* (FSA). Authorised advisers are only allowed by law to recommend products which meet the client's requirements — not the adviser's. Otherwise the adviser risks losing their permission to do business and their livelihood
- Every authorised firm and individual must have sufficient financial capital and reserves to be able to meet their financial obligations at all times and must submit a report every six months to the FSA proving that to be the case
- Authorised firms and individuals are legally required to have Professional Indemnity Insurance
- Advisers must prove — in the form of FSA-recognised qualifications — that they have the technical knowledge to provide financial advice
- There are three distinct types of advisers: financial advisers who primarily dispense investment advice; insurance intermediaries who advise specifically on insurance-related matters and mortgage advisers who specialise in mortgage advice
- Independent advisers derive their recommendations from the whole of the market: a multi-tied adviser's recommendations are derived from a selected range of product providers' products; a 'tied' adviser is only able to recommend the products of one company
- Advisers — firms and individuals — are either directly authorised by the FSA or appointed representatives of a firm which is directly authorised by the FSA
- Independent and multi-tied advisers can either charge (the client) a fee, take a commission from the product provider, or a combination of the two. Tied advisers are usually paid directly by the product provider they work for