Unpacking RDR: IFA Remuneration

The RDR Proposals distinguish between the different types of activities which are performed by financial advisors and seeks to ensure that the person/s who receives the benefit of the different types of activities must pay for those activities.

Income is the lifeblood of any business – after all, this provides the cash flow. The most pressing question, therefore, is how will the RDR Proposals affect an advisor's ability to earn a sustainable income which is sufficient to meet expenses and maintain current lifestyles both in the medium and longer term.

To answer this question, one needs to understand the different ways in which it is proposed that an advisor can be paid, by whom and how this differs between product types.

In the current model, for the most part financial advisors earn regulated commissions paid for by the product suppliers which may vary depending on the product type. It is broadly accepted that this commission remunerates the advisor for the activities performed both directly to the customer as well for those services which link the customer with the product supplier. For the meantime we will exclude from this discussion any service delivered directly to a product supplier and focus only on those services which include some type of interaction with the customer.

The RDR Discussion Paper proposes that a financial advisor can earn, *in respect of customer interaction*:

- A fee for financial planning
- A fee for product advice, both upfront and ongoing
- Commission from the product supplier for selling the product (upfront) and maintaining the product (ongoing), except for investments where no commission will be allowable.

Financial Planning is a professional service which an advisor provides to assist a customer to structure resources to meet life goals and plan for risks and will be formally defined in the Regulations. As such, it is the ***customer who must pay*** for this service.

- Any fee must be agreed with a customer ***before*** providing the service. The charging structure must be clear and a customer must know what they are paying for and what they can expect to receive in return. Therefore it is important for advisors to have a good handle on their own fee or charging system – see later in this article.

- All indications are that the Regulator will not prescribe the fee/s which can be charged but may provide a benchmark against which the fees can be measured. We would welcome the development of a guideline or benchmark that will help advisors and customers assess appropriate fee levels.

This will require a new approach by most financial advisors who must be able to identify what financial planning activities they do or can offer to their customers across the different product types.

Product Advice is the most common form of advice and is the advice consistent with the definition as set out in the FAIS legislation. As this advice is provided to a customer, it must be ***paid for by the customer***.

- All fees must be *motivated, disclosed and agreed* upon both in regard to upfront and ongoing advice.
- There may be limitations on the extent to which product advice may vary between product types. The Regulator may publish tariff guidelines or safe harbor benchmarks.

Product advice is a regular feature of an advisor's business. We believe that product advice is a natural part of the financial advice process in that it naturally rounds off the process of financial advice. After all, it's the financial vehicle that will help a customer to achieve the goals that were discussed in the advice process. A clearly defined value proposition will help advisors to motivate a product advice fee and to educate customers about the value which is provided. An advice fee can be charged in respect of investments, life insurance, short term insurance and medical aids. It is recognized that advice is provided in respect of all product types.

In the world of Investments advisors already negotiate investment "fees" with customers (both upfront and ongoing) even though these are paid by the product supplier. In the new dispensation it is proposed that the fee be agreed to ***and paid by*** the customer. In our view this is not a big deal because the change is more technical in nature rather than substantive. Collection of fees can be facilitated by the product supplier either as a once-off deduction from the investment value or deducted from the monthly contributions. Advisors may need to change their approach in order to motivate the activities/services which will be performed in return for the agreed fee but we anticipate that the transition to the proposed model under RDR should not present too many challenges. An added benefit is that the fee agreement remains between advisor and customer irrespective of a product supplier contract and we believe that this should strengthen the advisor-customer relationship.

It is proposed that the additional fee charged in terms of Section 8(5) of the Short Term Insurance Act be replaced with an advice fee which the short term advisor is able to charge over and above commission earned. Something to note here is that we can expect that there will be a review of commission rates so that the combination of advice fees plus commission should be similar to the current rates and should not cost customers more under the new dispensation. Again, we need to reinforce the view that in order to charge customers fees and justify the charging of commission, advisors should be reviewing their total value offering to customers and be clear about what and how they wish to charge.

Intermediary Services connecting the customer and product supplier are services which would otherwise be performed by the product supplier and must therefore be ***paid for by the product supplier***. Remuneration will take the form of upfront and ongoing commission (except in the case of investments where any form of commission will be prohibited). This form of remuneration will in all likelihood present the least challenges to an advisor, although commission payable under the proposed RDR dispensation ***will be reduced*** in respect of life insurance as it will compensate an advisor ***only*** for the intermediary services provided. It is proposed that 50% be paid upfront and 50% ongoing although the level of commission has not been decided upon and it is therefore difficult to understand the impact of this on the business of an advisor. As an initial step, we suggest that advisors analyse their own income streams – start with a view of how much is earned from long-term insurance business (through upfront commission plus renewal commission) and how much is earned from short-term insurance (through ongoing commission plus service/policy fees). From here one can see what the possible impacts would be under various scenarios.

The current as-and-when commission in respect of Short Term Insurance will continue to be subject to regulated commission caps and as mentioned previously the fee in respect of Section 8(5) will be replaced with an advice fee.

It is proposed that commission be prohibited in respect of replacements of life insurance policies. However, a product advice fee could still be charged. Together with the suggestion above, in order to understand the impact of this change, it is important for advisors to look at how much of their new business in a year comes from replacements – that way, they can assess the impact and plan ways to deal with the change.

Because most financial advisors have not charged their customers directly for any activities relating to financial planning or product advice, these proposals will require advisors to take a hard look at their business and the services which they offer to their customers.

Lessons from the UK show that those advisors who start early in preparing their business for the changes, will be most likely to survive and grow. With any change, while there are certainly challenges there are also opportunities. It is those advisors who are proactive in their approach, are willing to assess where they are, understand the challenges and search out the opportunities who will have the greatest chance of building value and sustainability in their business.

What must an advisor consider?

1. Understand where you are. This is a about analysing the source of income streams so that you can understand the impact of changes to these.
2. Understand what you do. Are you able to articulate what financial planning service/s and advice you currently offer to your customers. It may differ according to customer type or segment or product type but are you able to ***list the activities*** which you do and which can be charged for?
3. Decide what you want to do. Advisors who decide that they are committed to their businesses will need to define what they want their business to look like.

4. Be certain of the value which you offer to customers. If you can identify the value that you are or can provide to customers this can translate into a fee. A clear and understandable value proposition will enable you to motivate a fee and provide your customer with a clearly defined service agreement.
5. Communicate: Customers have indirectly been paying for financial planning and advice on some level. More than ever it will be important that you communicate with your customers the value of your services.
6. Identify the Risks and the Opportunities. How will the changes in the regulatory landscape impact on the behavior of your customers? Customers will also need to adjust to the change in approach. Advisors must be able to identify the risks to their business, their income stream and appropriate actions to deal with the risks. There may be increased management responsibilities and expenses to manage fee agreements and service level delivery. Find the opportunities and identify the value which can be built on a new model.