Panel 5

"What relation between banks & independent financial advisors: Partners or competitors?"

Moderator:

Carlos Orduña, *President of Official Council for the Financial Advisors of the Economists Spanish Association, Madrid*

Speakers:

Chris Cummings, *Director General, Association of Independent Financial Advisers (AIFA), London*

Georges Ugeux, *Former EVP of International & Research for NYSE, Chairman & CEO, Galileo Global Advisors, New York*

As an introduction to this panel, the moderator **Carlos Orduña** gave a quick presentation of financial advisory in Spain, and in particular the relationship between banks and independent financial advisors. The IFA is a relatively recent figure in Spain, he said, introduced through the national transposition of the MiFiD European Directive. The legal figure created in Spain that financial advisors can adopt is the EAFI, Empresas de Asesoramiento Financiero Independiente. "Since March 2009, no one that is not inscribed in the Spanish register of the CNMV (Comisión Nacional del Mercado de Valores, SEC equivalent) as an EAFI can do any financial advisory in Spain anymore. So far, said the speaker, only 25 members are officially registered as independent financial advisors, which is a small number considering the size of the market, as there are an estimated 300 000 financial advisors in Spain. The process of adapting to the new situation has been slow for various reasons. Financial advisory is defined by the Spanish law as an advisory for individuals resulting in concrete investment recommendations. The only thing they can do is advise clients and earn a fee for their recommendations.

The new law allows for the first time IFAs to be physical persons, and not only companies. Special requirements apply to individual IFAs in terms of proven experience: the law requires at least three years of demonstrated experience as a financial advisor. Many practitioners who were not working for financial institutions or were self-employed find it hard to fulfill this requirement in Spain, said the panelist. This is a key role of the organization headed by Mr Orduña, which helps its independent members prove their experience and convince the authorities of its validity. Of the 25 registered members, five are individuals, and the rest are financial advisory firms. "We hope that in the coming years the number of individual IFAs will rise significantly", said the speaker.

Next to the IFA, another new figure has been created, which is the broker agency. Contrary to the financial advisor, the broker can execute orders. The IFA cannot manage funds nor execute orders. So what is the relationship of IFA with banks in Spain? This relationship is relatively new, and marked by the very wide and deep banking network of Spain. Up to 98% of clients are related to banks in Spain, and around 2-3% of the individual investments in Spain are channeled trough IFAs. The banks see IFAs in two ways: either as competitors, who can take up the advisory activity they were used to providing clients with. "We are currently undergoing some problems of relation between the recommendation of the IFA and the way the order is executed by the bank", said Mr Orduña: The banks sometimes tries to reorient the client to some different investment. But the IFA can sometimes also bring clients to the bank for execution, and then it is perceived more like a partner than a competitor. So the road is still long for IFAs to gain a significant share of the financial advisory market in Spain.

What are the challenges ahead? "I think the financial crisis has really helped the clients see the reality, which is that the banks recommended some products without being able to explain the impact and risk to the client. So we clearly see a demand for independent financial advisory in Spain", said the panelist. But how to materialize this opportunity? The creation of an official register is very important, as it gives clients a quality criteria. "This is important because up to now you had unregistered financial advisors who were not adequately qualified", said Mr Orduña.

Chris Cummings presented the UK experience of the relationship between IFAs and banks and its contrast with the experience of other European member states. The challenge between IFAs and banks is whether they can cooperate, as they have always been pitted as enemies against each other, said the speaker. Is there perhaps a different position to pursue?

As a matter of context, the panelist first presented the position of IFAs in the UK and the role of his trade association. "We look after around 86% of all IFAs in the UK and the independent financial advise profession in the country accounts for 76% of all retail financial services transactions measured by value. My membership is around 27 000 firms, in an industry of 128 000 people".

How is the position of IFAs different in the UK as in other European markets? First, the IFAs are in a dominant position, as indicated by the figures just mentioned. Second, in terms of remuneration, while there is still an element of commission payable, that system will come to an end in 2012, and already today most UK IFAs' remuneration model is based around fees. "To us the future of financial advice, certainly in the UK, is in the word 'advice', not 'sales'", said the panelist. "The difference between sales and advice is that advice is about the client's needs over the long term, it is about being on the same side of the desk as the client. Sales, on the other hand, is about selling products, and that is a fundamental difference", said Mr Cummings.

Describing how big the IFA community was in the UK, he said that banks and insurances have struggled to serve between 15% and 20% of the market over the last 20 years. The strong position of the IFA emerged historically out of two main developments. In the 1980s, there were about 250 000 tied insurance salesmen in the UK. The life insurance companies, said the panelist, convinced the government that private companies could offer better pension deals than the government, so the market was widely liberalized. Life insurance companies went around misselling pension products to anybody, and when the scandals hit, all their direct sales force came under scrutiny. So life insurance companies fired their direct sales force, liberating about 200 000 people, many of whom became IFAs. Just about the same time, banks discovered efficiency, said the speaker, and started pulling out of local communities and centralize their operations. This created a vacuum in which the IFA profession bloomed.

What has been the response of banks? They employed three strategies: build, buy or borrow. First they tried to build up their own sales force again, a strategy that never really worked, partly because of internal political strife within the banking organizations, partly because of the short term culture of banks. The second strategy was to buy successful IFA firms. But then banks tried to stamp their own culture on these firms, resulting in all the good people leaving the bank to set up an IFA firm again. The third strategy has been to borrow the IFA model, the recent trend in banks being to set up what is called "high net worth services". But this emulation is not very successful, said Mr Cummings.

A third player in the financial services are the private banks and private client managers. So the UK market was divided in three layers: the mass market would use tied sales force from banks, the middle market would use IFAs and the top of the market would use private banks. "Yet all that is changing as people move away from the mass market", said the speaker. "We have a major issue of trust in financial services in the UK. Nobody trusts banks, insurances or any part of the retail financial services apart from independent financial advisors", said Mr Cummings.

The recent financial crisis has only made this trend stronger, the consumer confidence in IFAs has been skyrocketing. "We have not only weathered the financial crisis – which I actually call a banking crisis –, in many ways it has been very good for us, because it has driven a clear separation between the people who sit on the same side of the desk as the client and those who want to sell them another product". In terms of complaints, IFAs generate 3% of all complaints in financial services in the UK, while the banks generate over 80%. The regulator immediately responded to the banking crisis by launching a retail distribution review program. For the IFA community to implement this new regulatory initiative will cost 1.7 billion pounds, and will only make the provision of financial advice more expensive, described the panelist.

How does the future look like? "I think the market is big enough for banks and IFAs, if we are allowed to have a market", said Mr Cummings. His greatest concern is the plan by the government to launch in 2012 a nationalized pension products under the title NEST, providing a state guaranteed pension for every individual if they pay into it. "I think we run a risk in the UK financial services of the government just coming in and taking the market", said the speaker. "So our answer is to create a social norm, we need to reconvince the politicians that financial services can again be trusted with looking after individuals' long term financial good". The future, said Mr Cummings, is about helping people re-engage with savings again, because in the UK savings has become a dirty word, while spending is seen as a social good. Concluding: "We need to separate advice from selling, recognizing that both are honorable professions but both are different". That would reconcile then banking activity with the independent financial advisory activity.

Georges Ugeux endorsed the trust issue raised by Mr Cummings and said: "If you were on the streets of New York asking questions to the average person about what does he or she know about independent financial advisors, the person will certainly tell you 'does that exist'? If you ask the person if he or she has heard about honest bankers, everybody will tell you for sure 'that definitely doesn't exist'!". At the last Davos conference, a veteran investment banker from Morgan Stanley publicly said that, having been in Davos for 25 years, he believed that bankers in public opinion ranked now just before terrorists.

As a result of this major trust issue towards banks, Mr Ugeux proposed a set of advices and perspective to the audience of independent financial advisors. "I think the approach and the business model on which the IFA has been built has to change. Because you now have a unique opportunity to gain a more important position, just like in the UK", said the panelist. Banks, as financial advisors, will not be considered independent and trustworthy for at least the next five years, predicted Mr Ugeux. Large banks behave like hedge funds, managing their positions. "Clients are not the first preoccupation of financial institutions today. Their own profit, and above all their own remuneration is what counts to them", said the panelist. It is time for the independent financial advisor community to stand up and say that the banking model has failed and build a new model for which it exists, i.e. independent financial advice for the benefit of clients. "There is no way the banks will be able to compete with you on that field for a while. Even if they tried, they will not be believed", commented the speaker. Further, large financial institutions are like cruise liners, while IFAs are like speedboats. "Large banks just do not have the speed, the independence and the freedom to take the move that needs to be taken in the turmoil we are in today", he added.

Aside from this need to clearly differentiate themselves from the banks, independent financial advisors need to ride the wave of requirements from clients to go back to fundamentals, to sound and understandable investments. So research becomes a central resource for IFAs, said the speaker. "But most of you cannot afford research. So you have to build a model and start considering how much you can actually pool your forces and resources in the direction of research, so that you can form better judgments about products and opportunities for your clients, but also answer new types of questions clients are going to ask you". Such as currencies, which were not talked about as investment vehicles just a couple of years ago and now make the front page of financial newspapers. Or plain and straightforward investments like government bonds, which used to be a basic asset sold to clients, now have to be questioned. "Because as we are getting out of a banking crisis, we are now entering a public finance crisis. And the problem is that there are governments to save the banks, but no one to save the governments", said Mr Ugeux. As an example, the speaker cited the spread of CDS (Credit Default Swaps) on US Treasury Bills, so the price of protection against a bankruptcy of the United States of America: in December 2009, it was at 10 bps. Three months later in March it doubled to 20 bps. And it is at 90 bps for the UK, which is in a much worse position than Greece at the moment. "So going back to fundamentals requires a much more sophisticated model than what you have now. You have to have a more complex toolkit", noted the panelist.

Third point, the IFA profession has to learn to demonstrate its independence. "You are not the bankers' best friends! You are their best distribution channel", said Mr Ugeux. The issue is that IFAs cannot sell the fact that they are independent if the public doesn't perceive that you are not any different than banks and you do the same thing. "You are not going to live without the banks, but you have to change your relationship with them to a customer relationship. That doesn't make you a party to what they do in that business, you are just a customer". IFAs will continue to need to sell bank products, but have to beware of two points: don't trust a product just because it comes from a major bank. "At least do your homework and due diligence, as to a large extent it hasn't been done", said the panelist. Second, the premium for simplicity has never been higher. "Stay away from sophisticated products", advised the speaker. Finally, he added that the governance of international financial advice had to be revisited, especially at the level of the board. "You have to start thinking about bringing people from outside who will be able to reassure your clients about your business. People are now looking for independent directors". To conclude, he said: "We are at a moment for your industry where you have to elevate the discussion to another level and start thinking that you could be, on the Continent, like in the UK a much more substantial independent and respected industry. This is all I wish you".

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Questions & Answers

Question
A question to Mr Orduña: you said that advisors in Spain are not able to manage the funds of their clients. what happens if the client gives you an investment mandate or a management mandate to manage his funds? Can the registered independent advisors in Spain then operate with the bank, does the bank accept it, and if not why?

Carlos Orduña
The bank doesn't accept any order that doesn't come directly from the client. So the IFAs can only advise, put their recommendation in written to the client, who will address them to his bank. So in fact they are advising but they are not getting responsibility from the results of the advice. IFAs cannot accept mandates form clients.

Chris Cummings
In the UK, IFAs have discretionary investment management, and indeed even went out setting up their own funds. A lot of IFA firms have their own funds that they can advise clients on as well. So actually the difference between IFAs and fund managers has practically gone as well.

Georges Ugeux
In the US, to be called a financial advisor, you have to become a broker dealer. And to be a broker dealer – of course your firm has to be a broker dealer – but every single person who handles client orders has to be a registered rep and pass exams. There are practically no what I would call "naked" financial advisors who just give advice. But at the end of the day I think one of the issues that the model in Spain raises, is that you have a conversation with the client and the client agrees with your advice, by the time the client executes the order independently from the financial advisor, who knows whether the opportunity is still there?

Question
Talking about the future of IFAs, there is a political problem that nobody is talking about, that in independent financial advisor there is the word "independent", obviously, and it is difficult for them, as a group, to make some lobbying with the government. So how come the future could be bright for IFAs if they cannot be together and do some lobbying at a high political levels, how could we be known and what could be our power if nobody could do that?

Chris Cummings
In the UK, I spend a lot of my time endeavoring to lobby the European Commission, I mentioned that I am an advisor to the Treasury, and we have very good relationships with all the major political parties in the UK. So we have a seat at the highest table these days, by right. There is always a question about are we as influential as banks, the only think I can say is that we win a lot more than our size would suggest that we could. So we do try and outsmart the banks, we can never outspend the banks, they have far more money than we do. So it is a case of always wanting to stress, time and again, that the IFA profession looks after the client. That we are the agent of the client, that we are the voice and representative of the client, and indeed, when I talk to a minister or any politician, I always talk about what is in the best interest of the client. And then the industry perspective is almost out of it, because we know well that the banking community will be outspoken about what's good for the banks. But all I can say, you have to come together and have a single lobbying voice. The only way to influence government is to speak under a single campaigning organization. Otherwise the banks will throw you over every single time. It is impossible to represent an industry with more than one lobbying voice.

Question
You just said that in the UK the investment advisors can create their own funds for discretionary mandates. How does the panel perceive the risk, in a couple of years time, that the term "independent" in the advice is tainted, based on the product creation and potential conflict of interest on such products?

Georges Ugeux

I would like to give just one small comment. Independent is an abstract notion. The question you have to define is independent from what? Going back to the lobbying question, forget about independent financial advisors! All the major brokerage houses have been bought by banks. There is very little left except very high net worth individual institutions, and private banking. So I don't think independent will ever be a dirty word. But everybody who is not independent would like it to be.

Chris Cummings

I agree with that. We have seen in the UK IFAs bought by insurance companies or banks and there is a constant debate about what does actually independent means. Is it independent in terms of ownership? And actually I always struggle with this as a concept, because organization, to grow, need to attract investment, and that can only come from a number of sources. So I think independent is about what happens in front of the client. Because every organization has conflicts of interest. Every organization. And it is how those are managed and disclosed. Independent for me is all about being on the side of the client. And I think if we had one value to cling on to, it would be that.

Georges Ugeux

The difficulty is that you have to watch the compensation issue. Because the way you structure the compensation, if you are in the model we describe which is purely independent, you get a commission straight from your customer, that is fine. But if, when you sell a fund, you get a commission from the banks, even if you take the independent judgment that this is a good fund for your client, you start being in a situation where your revenue becomes hugely dependent from other sources. So that is exactly the question, it is extremely complex. And let me be candid with you: I don't believe in independence. I am independent, I created my own firm, I am no longer in an institution, but I have never been so dependent from my clients than I am today! But at the end of the day I'd rather do something where I get paid, if I can. And we have this difficulty that even if I own my own firm, even if I think about the best interest of the clients, they are the ones who pay. That was the problem with the rating agencies. And I actually believe that whoever pays a rating agency will not resolve the problem with the independence, because I believe that the issue there is the business model and the ownership. When Robert Murdoch is your largest shareholder, you're in for money, and you have to make money. That's what is expected from you. That doesn't create the quality of the product. So maybe we need a public agency. You have that in all elements of finance. And it is extremely complex. I would say something, the only person who is independent is the person who has a client who believes he is independent. It is the client who declares that you are independent.

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