caceis
INVESTOR SERVICES

Ideal Advice

A step-change in the industry's relationship with the individual investor

June 2010

Message from the authors

PricewaterhouseCoopers

The provision of financial advice to investors has, and will continue to be a critical aspect of the financial services industry. The role played by advisors should not be underestimated as it encompasses not only investment advice but also comprehensive financial planning, educating consumers, and encouraging savings. This responsibility is becoming all the more important as the pressure on individuals to independently save for retirement in an environment of ever growing financial complexity continues to rise. In this respect, the quality of advice to individual investors is crucial. However, it is also important for the financial services industry because the strengthening of investor confidence will ensure a sustainable long-term growth for investment product manufacturers and distributors alike.

Within this report we examine the state of play of financial advice within Europe and provide a set of key recommendations which we believe are critical to enhance the overall quality of investment advice. In our view, now is the time for our industry to take bold and convincing steps and an active role in achieving a business model that is both sustainable and investor centric. If not, the industry will be swept along by a flood of new regulations and controls that make future financial innovation, distribution and growth more challenging than it otherwise could be. We hope this report will add to the necessary discussions on the future of the financial advice industry in Europe.

Mark Evans

Partner - PricewaterhouseCoopers

Global Fund Distribution

CACEIS Investor Services

The 2007-2009 crisis was a crisis of confidence, and much has been written about the loss of investors' confidence following numerous cases of product misselling and massive institutional fraud. Newspapers and the financial press deplored the fact that highly toxic assets had been hidden in certificates and distributed to retail clients, and that aggressive sales practices had sold dud funds to retail investors, and how, as a direct consequence, the levels of investor confidence had been heavily impacted.

At CACEIS, we decided to embark upon an extensive research project, looking into the current state of investment product distribution, in order to propose a new distribution model that would give investors the fair deal they deserve, restore confidence and drive further growth in collective investment product market. The "Ideal Advice" report examines how, today, financial advisors have to deal with clients who have lost both savings and confidence, are sceptical about accepting advice and even about revealing their financial status. In this report we propose that financial advisors sign a pledge always to act in the best interest of the client; that industry enhances transparency in both investment products, nature of advice and fees; and last but not least, that levels of financial literacy for advisors and investors are raised. The principal drivers of change are regulation, self-regulation and education, and we believe that the recommendations this report makes could have a very positive and wide-reaching impact on the collective investment product industry.

José-Benjamin Longrée

Deputy CEO, CACEIS Group

Executive Summary

Although the European financial services industry is a mature, diverse and highly regulated market, the events of the last two years have served to highlight certain industry weaknesses and accelerate the need to re-evaluate the current model of providing advice on investment products to clients, especially individual investors.

This paper examines the current method and process by which advice on investment products is provided and outlines various recommendations for the industry to improve the quality of advice in order to give investors the right financial solutions for their needs. Improving the quality of advice is a multi-dimensional endeavour that needs to be addressed through a balanced approach between regulation, education, and self-regulation. We propose an approach whereby three key foundations to improve outcomes are phased in. These foundations for improvement are: to strengthen the duty to act in the best interest of clients, to increase transparency, and to improve financial capability of advisors and investors.

In our view, these steps will benefit both investors and the industry alike. A sustainable increase in the quality of advice and confidence of investors will drive new assets and customer segments to the industry and more than compensate for any concerns about the potential dilution of profitability caused by increased investor centricity and transparency. We also believe not only advisors but also product manufacturers should play a vital role in this transformation to increase their investor proximity.

Foundation I
Strengthen the duty to act in the best interest of the client

State of play

There are substantial impediments to advisors being able to fully understand the needs of investors. We believe this to be so because not only is the current regulatory framework not consistently applied across all financial products but, there is also a lack of industry-wide self-regulation through comprehensive and binding codes of conduct. These "gaps" have, over the years, created barriers to many advisors being able to achieve a consistently deep understanding of their clients' needs and therefore produce best investment advice.

Despite MiFID and the different national laws, conflicts of interest remain one of the most debated industry themes. Firms providing investment advice have adopted a "compliant" conduct rather than taking a business approach or opportunity to do away with conflicts of interest and act as trustees to their clients.

Recommendations

- Harmonised regulatory regime: a level playing field in the delivery of advice across all types of investment products (packaged or unpackaged), and all services.

- Creation of a comprehensive and binding code of conduct: the industry should sign a pledge outlining a set of principles and detailed rules of behaviour to ensure that advisors always act in the best interest of clients. The industry should also establish controls through an independent body, define a series of consequences in case of a breach by its members, and identify and isolate covenant breakers before they can harm the reputation of the financial industry.

Foundation II
Greater levels of transparency

State of play

The financial services industry is characterised by complex agency relationships and asymmetry of information. Investors often do not have access to and/or understand the key messages about conflicts of interest, cost, risks and features based on current disclosure regimes. In addition, it is almost impossible for investors to compare all offers presented in the market in order to identify the best one. Greater levels of transparency are critical for the industry to improve the quality of service and deepen its credibility with investors.

Recommendations

- Improved transparency related to the nature of advice: financial intermediaries should clearly state the kind of products with which they are familiar and are able to access. They should also describe and disclose the nature of advice services to consumers as well as the relationship between the advisors and the manufacturers of the financial products.

- Improved transparency about what the product entails: product information should focus on the main or principle features of the investment products, be easily accessible, easy to understand, and disclosed in a timely fashion to investors. While the KID (see Appendix 1) will drastically improve the transparency of UCITS funds, it is critical that all retail investment products have equivalent reporting objectives.

- Improved transparency concerning services and prices: in a single European financial market where a large range of similar financial products are distributed on a cross-border basis there should be clear and harmonised industry-wide definitions used for calculating and disclosing fees and expenses.

Foundation III
Improving the financial capability of advisors and investors

Financial capability of both the advisor and the investor builds the basis for delivering and receiving ideal financial advice.

INCREASING FINANCIAL LITERACY OF INVESTORS

State of play

Although the effectiveness of efforts to increase financial literacy may be in question, results of a PwC/CACEIS Financial Advisor/Distributor survey conducted in 2010 show that advisors view an investor's low level of financial literacy as one of the main hurdles to providing high-quality advice.

Recommendations

- An integrated financial education program: as detailed in our last report, "Ideal Fund"[1] , we recommend an integrated and harmonised financial education program across Europe to be delivered to students during school and university and optional and need-based during the rest of an investor's life.

- Provision of financial educational materials by product manufacturers and industry associations: we recommend that product manufacturers and associations provide general and specific education materials and training to investors.

- Responsibility of investors to use educational opportunities: efforts should be made by governments and the industry, but investors also have a responsibility to use the available offers and opportunities to enhance their ability to handle financial matters.

[1]Ideal Fund - Reengineering the fund value proposition, PwC/CACEIS - June 2009

State of play

The barriers to entry for operating as a financial advisor are surprisingly low in a number of European countries such that in these jurisdictions necessary qualifications can be obtained with little study and no practical experience, and often ongoing education is not compulsory.

Recommendations

- Minimum level of pre-education: we recommend that individuals must successfully complete a mandatory minimum level of pre-education (not number of study hours), equal in all European member states prior to their acceptance for financial advisor professional training.

- In-depth theoretical and practical training: individuals satisfying this pre-condition should complete a European-wide standardised, rigorous, and in-depth theoretical training program consisting of cognitive and behavioural skills and ethical conduct modules. They should also complete a two-year job training program with a registered financial advisor or institution.

- Certification matrix linked to sophistication of advised products: upon completion of this minimum training and certification, an additional certification matrix linking advice on more complicated products to a higher level of education and examination should be introduced.

- Continuing education: advisors should be required to spend a specified number of hours of training every year to retain their license.

We believe that the industry should further commit in improving the quality of advice as otherwise it will find itself confronted with increasing regulation and scrutiny as regulators move to ensure a higher customer protection.

Introduction

Introduction

The European financial services industry is a mature, diverse and highly regulated market. However, the global financial crisis and recent scandals have done much to weaken investor confidence. The industry has become one of the scapegoats for the crisis due to the actions of a few unscrupulous players.

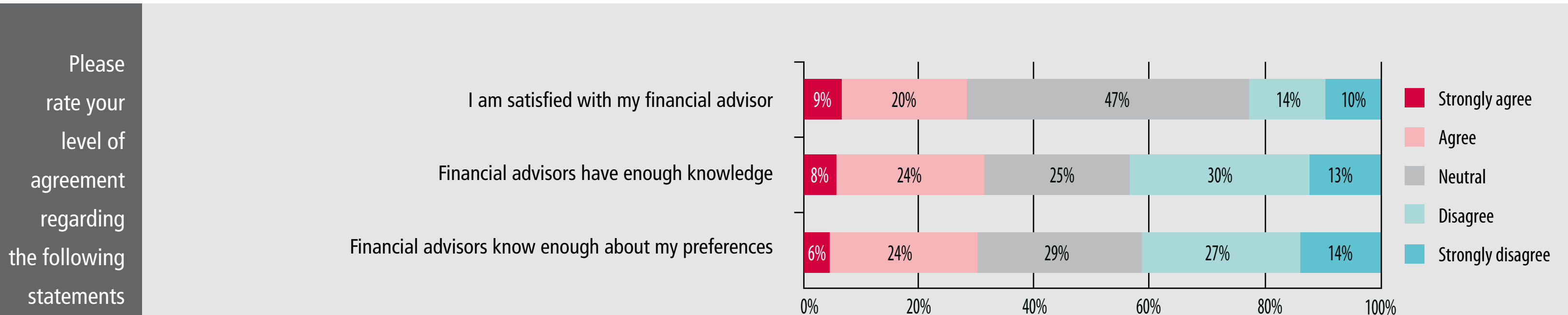
These events over the last two years have served to both highlight certain industry weaknesses and especially accelerate the need to re-evaluate the current model of providing advice on investment products to individual clients, thereby allowing financial advisors to rebuild their status as trusted advisors. According to the PwC/UCL Investor survey in 2009, only 29% of investors were satisfied with their financial advisor (see figure 1).

Poor advice often occurs for a variety of reasons, including insufficient and/or inefficient client segmentation, insufficient client knowledge or understanding, a lack of product transparency, conflicts of interest, and, last but not least, insufficient qualification and/or experience of advisors. These criteria are among the most important issues that the European financial industry needs to urgently address in order to recover from the present crisis of confidence.

In Europe, the financial industry has to date reacted with a few proposals, mainly from the European Fund and Asset Management Association (EFAMA), as well as from other national professional associations. European regulators have also felt the urge to improve financial advice and distribution of financial products by trying to enforce new and enhanced legislation. The majority of these regulations have targeted the mainstream investment fund industry making funds one of the most regulated and transparent investment products distributed in Europe. The recommendations of CESR on MiFID, the adoption of a framework for PRIPs in April 2009, the KID to be enforced within UCITS IV, and the RDR proposal for the UK are examples of legislation aimed at improving distribution practices of financial products in Europe.

This paper examines the current state of the provision of advice on investment products and outlines recommendations for the industry

Figure 1



Source: PwC/UCL Investor survey 2009

to improve the quality of advice in order to give investors the right financial solutions for their needs. Our analysis is based on extensive desktop research, discussions with numerous experts, product advisors and detailed findings from two surveys: the PwC/CACEIS Financial Advisor/Distributor Survey 2010 and the PwC/UCL Investor Survey 2009 (see Appendices for further details on the two surveys).

The focus of this paper is on the advice demanded by and offered to individual investors in Europe. Advice to institutional investors is not included in the scope of this report on the basis that most institutional investors have internal buy-side analysts and usually deal directly with the asset managers. We analyse the advice on and the distribution of collective investment products in Europe as a proxy for the distribution of other financial products: e.g. certificates, whose distribution patterns and characteristics are more opaque. For the scope of our study and the Financial Advisor/Distributor survey we have included universal banks, private banks, insurance companies and IFAs. We define investment products as insurance and pension reserves, investment funds, quoted shares and debt securities, specifically excluding real estate, currency and deposits.

Forces of change

Our recommendations focus on three main forces of change to increase the quality of financial advice: industry self-regulation, prudential regulation, and education. Improving the quality of advice is a multi-dimensional endeavour that needs to be addressed through a balanced approach between these three forces of change.

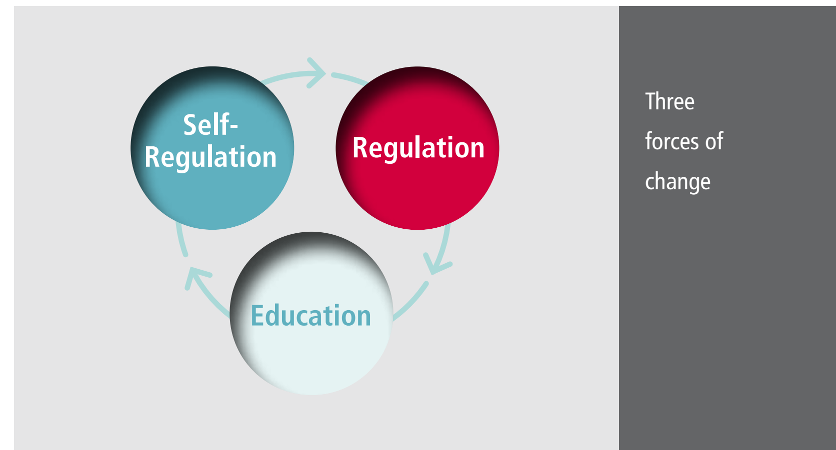


Figure 2

Greater levels of industry self-regulation are absolutely critical in order for financial organisations to ensure that their advisors deliver the best advice possible for each investor. Clear commitments from market players to act in their clients' best interest as well as to abide by effective controls would benefit investors and boost the reputation of the industry as a whole. Initiatives to set up internal codes of ethics, clearly label products, and improve the transparency of services offered and related pricing have already contributed to improving the quality of advice delivered.

However, the limits of self-regulation are well known, especially so in the current environment where today stong political will exists to greatly expand the overall level of prudential supervision. The lack of oversight and enforcement and the absence of legal redress contribute to this limitation. Self-regulation will ultimately fail without a strong commitment to ensuring adherence to policies from all market players and without meaningful opportunities for harmed individuals to be compensated for breaches of policy.

Secondly, regulators have a role to play when it comes to improving investor protection and ensuring that quality advice is delivered. As shown in Appendix 1, with MiFID, PRIP, UCITS, and RDR in the UK, significant regulatory developments are firmly under way in Europe. Increased regulation aims at ensuring investors receive suitable products and information relevant to their needs and that the interests of financial advisors and clients are aligned. However, increased regulation also has limitations when considering the level of uncertainty and cost financial organisations have to comply with.

Bankers consider "too much regulation" as one of the top risks they face[2]. Further, regulations tend to be reactive to specific historical problems and thus focus on protection from harm. Anticipating future developments and proactively introducing regulations to foster them could enhance the services and products received by the investors and guide the industry in the right direction.

Finally, it is critical to educate financial advisors and investors so that they clearly understand that advice should encompass investors' situations, objectives, and constraints and that those needs are satisfied with appropriate products. Financial advisors should be well-equipped to understand and then offer the most suitable products to their clients. According to the PwC/CACEIS Financial Advisor/Distributor survey, 94% of distributors plan to increase the level of qualification of individuals within their organisation providing advise to clients.

In a well functioning financial services market it is essential that investors are able to understand the product in which they are advised to invest and what associated risks and returns they should expect to receive. Over the last few decades little seems to have been done to increase the overall level of financial literacy of the retail investor population and we believe that there is now an even greater urgency for the industry to take major initiatives in this respect. However, what is also clear is that increasing the financial literacy of the investor population is a long-term objective given the existing low levels of financial education and engagement of retail investors. Therefore, in the short-term emphasis should be placed on increasing the financial capability of financial advisors.

It is clear that the three forces of change highlighted above each have their respective advantages and limitations but, when combined, we believe that they can make a material and even significant impact, especially over the medium to long term.

In order to improve the quality of advice to individual investors, we propose a phased approach based on three key foundations: to further strengthen the duty to act in the best interest of clients, greater product and relationship transparency, and improved financial understanding and capability of both advisors and investors. The first foundation (section I of the report) further engages advisors in acting in the best interest of their clients. The second foundation (section II) examines transparency issues and how to ensure that investors understand what they invest in and pay for and what advice bias they may face. The final foundation (section III) considers the long-term goal of ensuring a minimum level of education among both investors and advisors.

[2]CSFI/PwC Banking Banana Skins Survey, 2010.

We believe these steps will help to make the industry more investor-centric and benefit investors and the industry alike. Although the advantages of this model for the investor are evident, the advantages for the industry may not at first sight, seem self-evident but, we believe that they exist.

The analysis between 2000 and 2008 demonstrates that there has been an overall slow decline in assets held in investment products[3] by European households (from 64% down to 58%) especially within investment funds, quoted shares and debt securities (see figure 3). Although a portion of this decrease can be attributed to the decline in asset values and withdrawals due to the burst of the internet bubble in 2000 and the 2008 financial crisis, the weakening confidence in the industry could be another factor in this decrease.

In our view, a sustainable increase in the quality of advice and confidence of investors in the industry through the steps laid out within this report should inevitably drive new assets from deposits and money accounts into investment products, thus encouraging new customer segments to invest their assets in investment products. This in turn will increase the percentage of total household financial assets held within investment products and will more than compensate for any dilution in profitability stemming from increased investor centricity and transparency.

It is our strong belief that not only advisors but also product manufacturers, such as asset managers, can play a vital role in the transformation of the industry by increased proximity towards the end investor through transparent product information, and educational programs to increase financial literacy and understanding. This will also benefit product manufacturers through increased brand awareness and lower distribution costs. We believe that a win-win outcome is possible and, indeed probable.

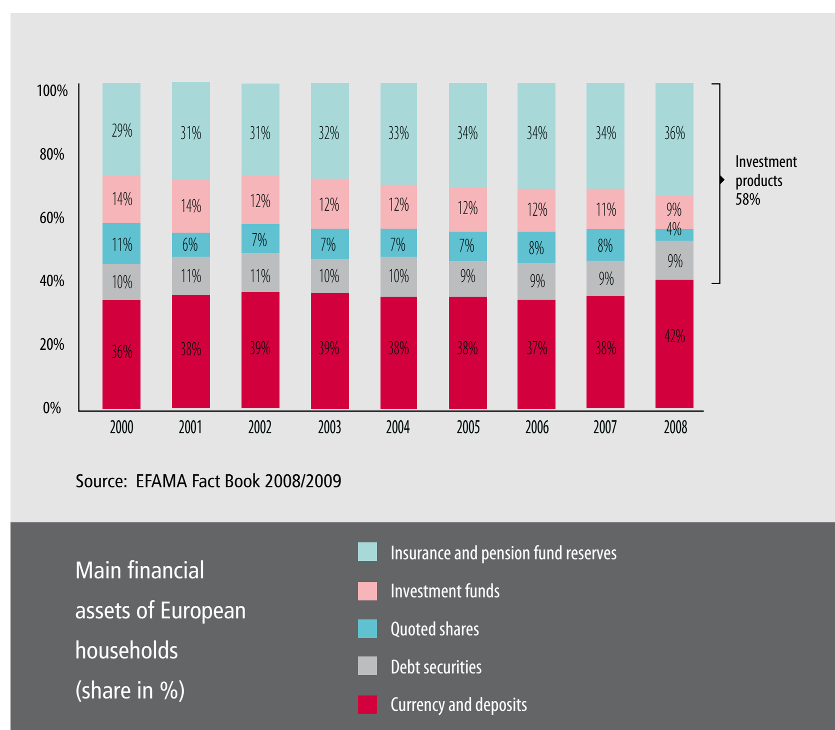


Figure 3

[3]In 2008, the main financial assets of European households, (excluding real estate), amounted to EUR 14.46 trillion. Only 58% of these financial assets were held in investment products (insurance and pension reserves, investment funds, quoted shares and debt securities). Insurance and pension reserves made up the majority of investments (36%) after currency and deposits (42%) given the aging population and tax benefits of such products in countries such as Germany and France. Investment funds accounted for only 9%. Quoted shares and debt securities made up 13%.

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Foundation I

Strengthen the duty to act in the best interest of the client

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State of play

UNDERSTANDING INVESTOR NEEDS

It is both logical and essential that a client's characteristics, specific circumstances, requirements, needs and objectives be fully understood before an advisor determines and finally recommends a series of financial solutions. However, today we see substantial weaknesses in or barriers to advisors being able to achieve the level of client understanding needed to provide good and effective advice on a consistent basis. Whilst there are probably a multitude of different reasons why this is the case, especially on an individual basis, we believe that the impact of the existing regulatory framework not being consistently applied across all financial products and a lack of self-regulation through a comprehensive and binding code of conduct, are acting as significant barriers.

Regulatory oversight provided by the MiFID Directive has for a number of years now imposed EU-wide harmonised rules requiring advisors and distributors of financial products to collect information about their client's knowledge and experience and to then match the recommended products to their risk profile. This has resulted in many advisors collecting and documenting at least a minimum level of client information.

However, this directive is not being consistently applied across all products and in all countries. MiFID only applies to certain financial instruments and services, such as buying or selling shares, bonds, or warrants, or subscribing to or redeeming investment funds. Arguably it does not apply broadly and deeply enough such that other products, e.g. unit-linked life insurance policies, which are governed by the Insurance Mediation Directive (IMD), are not included but rather have different rules about selling practices.

In addition, MiFID is currently perceived by a number of financial institutions as a regulatory constraint that only increases administrative costs. It has not fundamentally modified the way financial products are distributed through these institutions. MiFID also demonstrates that even when well-intended regulations are established, they do not always achieve the original desired effect if industry participants do not apply these rules to enhancing their long-term fundamental business model.

Profiling a client should be a process of ensuring that his or her needs, interests and objectives are well understood, rather than often seen as an administrative burden by the advisor. A perceived failure to understand the needs and objectives of investors is reflected in the results of the PwC/UCL Investor survey, in which 41% of individual investors stated that financial advisors did not learn enough about the investor's personal preferences and goals before making product recommendations (see figure 1).

These results demonstrate that the quality of client profiling may not be sufficient to reflect investors' needs, resulting in a greater chance of inappropriate investment strategies and product advice. We believe that it is reasonable to suggest that on balance, (with other factors being equal), greater client profiling leads to reduced levels of mis-selling or non-suitable selling by advisors.

As mentioned, multiple factors may prevent financial advisors from more extensively profiling their clients and thus better understanding their needs. Firstly, not all clients want to fully disclose information on their personal circumstances/wealth to their advisors. Further, market volatility and change in the level of wealth of investors can impact the clients' profile. Another factor may be the limited time available to advisors to perform such activities. According to the PwC/CACEIS Financial Advisor/Distributor survey 2010, the average number of clients per advisor is 218, and one of the most important barriers advisors mentioned to delivering quality advice was the limited time they had available (see figure 13). On the other hand, advisors clearly recognised that the accuracy of client profiling is the main driver for delivering high-quality financial advice (see figure 4).

CONFLICTS OF INTEREST

Currently, one of the most heavily debated themes within the financial advice industry are conflicts of interest between the person or entity giving advice or guidance concerning financial products and the person acquiring such products for either short or long term investment. Conflicts of interest are many and varied and they may arise in different circumstances from or during the provision of financial advice. These include:

- Product distribution – Financial advisors part of or linked to, retail banking organisations, have traditionally been dedicated to distributing their proprietary financial products, which in theory may, (unless certain processes are followed), result in an inherent conflict of interest or deficiencies in offering independent and objective advice.

Could you please rank the five most important drivers for delivering high quality advice?

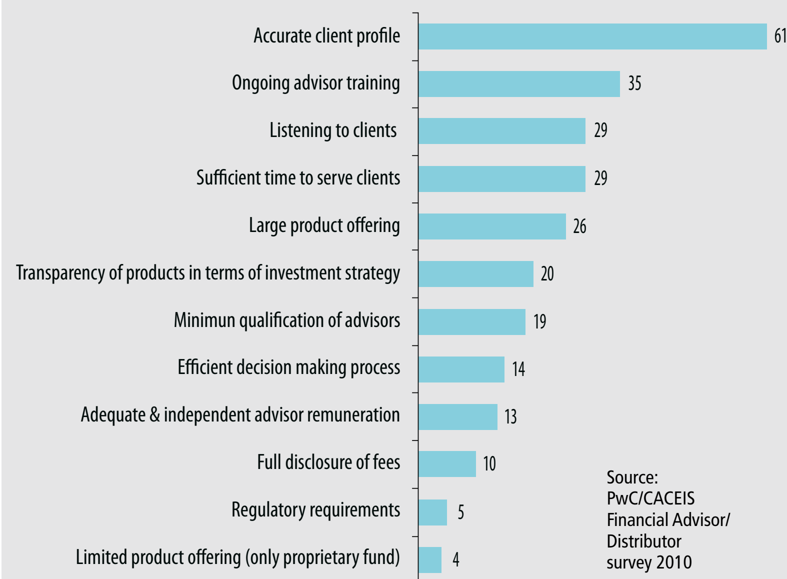


Figure 4

- Remuneration –The most common way in which financial advisors are remunerated is via certain fees received from the product manufacturer, essentially out of the management fee, especially those of packaged products. Usually, (and some would say unusually), the client pays no direct fee to the advisor for the "advice" he or she receives. This relationship between the three parties can be one of the most significant sources of conflict of interest.

The two above mentioned conflicts of interest (product distribution and remuneration) are systemic to the industry and it will require more comprehensive efforts by the industry to address these issues.

- Product selection – Selecting products for a portfolio and advising clients on strategies and investment vehicles require in-depth knowledge, research, and product access that can be costly, prove difficult to implement, and may be subject to biased influences.

- Oversimplification of advice – Many advisors have simplified their advisory processes to such a degree that they classify clients into broad categories and provide them with a predefined portfolio without taking appropriate financial planning and other investment factors into consideration.

- Affiliations – Most advisors need product information as well as back and middle office support from custodians, broker dealers, asset managers, and research/market data providers. These relationships require careful management to avoid the possibility of conflict of interests.

- Lack of resources – In an increasingly competitive world of complex financial products, smaller independent investment advisors may not always have at their disposal the appropriate tools needed to understand and assess the universe of appropriate products for differing investor groups. Moreover, it may also be difficult to have access to sufficient products necessary to develop and implement a client's investment strategy. They are usually limited with regard to their own capabilities and that of their associated service providers.

Whereas all these potential conflicts of interest hold for discretionary mandates, for advisory mandates (where investors take the final decision), the advice provided can also have the potential for bias through the lack of information and distrust of the investor towards the advisor.

From a regulatory perspective, Article 19(1) of MiFID requires an investment firm to act in accordance with its clients' best interests. Furthermore, it is often the case in many countries that legal provisions create a duty of care within the contractual framework between the investor and the advisor. Moreover, national laws usually offer some form of remedy where a breach of this duty occurs.

However, in general we believe that many of these regulations, especially MiFID, have not had the expected nor intended overall effect. One reason for this probably lies in the principle-based regulation of MiFID and lack of detailed definition and implementing measures as well as the extreme difficulty for investors to prove wrongdoing on the part of the advisor.

Broadly speaking, the practical impact of these regulations has been to drive a number of firms providing investment advice to create their contracts and supporting documentation in order to strictly comply with the letter of the law, rather than taking a more commercial or business approach or opportunity to do away with conflicts of interest and act as trustees to their clients. "Compliant" conduct towards clients does not automatically mean "ethical" conduct. An advisor who has ticked the boxes, given the warnings, and complied with everything the law requires may nonetheless still have room to act in his or her own interest, rather than the client's.

Recommendations

HARMONISED REGULATORY REGIME

Our first recommendation calls for a European level playing field in the delivery of advice across all types of investment products (packaged or unpackaged), and all services. This means that such advice should encompass all financial advisors (independent or belonging to an institution).

Creating a level playing field within the single market for financial services is a necessary goal so as to avoid arbitrage or the creation of loopholes, which would inevitably damage the quality of advice and the confidence of investors in such products. Our recommendation is in line with those of the European Commission which has committed itself to create a level playing field for product disclosure and sales processes for all packaged retail investment products.

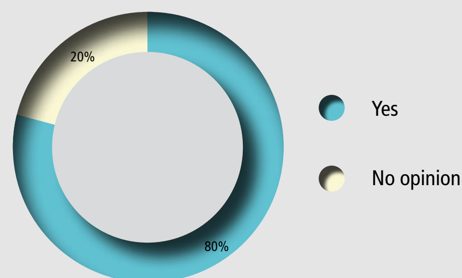
CREATING A COMPREHENSIVE AND BINDING CODE OF CONDUCT

Our next recommendation focuses on the obligation of financial advisors to always act in the best interest of their clients. That is, acting in the best interest of the person investing their savings into a financial product and not the person or entity that has created the product, as is already the norm for lawyers, doctors and other professionals. Financial advisors need to act towards their clients similar as would a trustee towards a beneficiary, such that their actions are only for the benefit of their client. This includes avoiding conflicts of interest, should such conflicts arise, financial advisors must put their client's interest ahead of their own.

In the spirit of self-regulation, we would recommend that the industry, at a European or national level, draft and sign a pledge outlining a set of principles and detailed rules of behaviour to ensure that advisors always act in the best interest of clients. The industry should also establish controls through an independent body and define a series of consequences in case of a breach by its members and identify and isolate covenant breakers before they can harm the reputation of the financial industry.

The voluntary adoption of and precise adherence to ethical behaviour by the industry itself rather than because of regulatory enforcement would be a significant step towards restoring the confidence of investors and enhance the image of the profession amongst the investing general public. Our survey highlighted that 80% of financial advisors agreed that a single set of code of ethics should apply to their profession (see figure 5).

However, if the industry is unsuccessful in implementing a self-regulatory based approach, we believe that national or EU based regulators will increasingly adopt and impose even stricter rules to protect the interests of indivudual investors, thereby increasing the organisational and capital burden on the industry participants.



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Do you think a single set of professional standards and code of ethics should apply to all advisors?

Figure 5

Regulators have started going so far as to break the current prevalent structures within the industry such as through the RDR in the UK.

From a regulatory perspective, the introduction of a "no conflict rule" and "no profit rule" (which is under the general rule of fiduciary duty in common-law countries) would be one of the most effective instruments to ensure that advisors do not engage in any practices that would harm the interests of the investor. Within a "no conflict rule", the advisor would not be permitted to enter into engagements in which he or she has or can have a personal interest that conflicts with the interests of the investor.

The "no profit rule" would require the advisor to account for any benefit or gain obtained or received by reason of or use of his position toward the investor or of any opportunity or knowledge resulting from it. The goal would be to prevent the advisor from actually using or misusing his or her position for his or her personal advantage or profit.

If the advisor makes a profit by virtue of his or her role toward, the investor, then the advisor must transparently disclose the profit to the investor. If the investor consents, then the advisor may keep the benefit. In case of breach of these rules, the burden of proof should be on the advisor rather than the investor, and consistent rules of evidence and imposed penalties should apply. In introducing such regulations, the objective would be to ensure that these rules and responsibilities are applied not only at an individual advisor level, but also on an institutional level, i.e. to firms that offer such products and services and engage or employ financial advisors in this respect.

For example, such regulatory actions are currently being taken in Australia. From 1 July 2012 Australian-based financial advisors will have a statutory fiduciary duty to act in the best interests of their clients. In the U.S., members of the Senate have introduced a provision that would require the Securities and Exchange Commission (SEC) to adopt rules that would impose a fiduciary duty on brokers when they advise individual investors. In Italy, the regulator has ordered some banks to hold board meetings to resolve how they deal with small investors, since sales strategies had been determined by products rather than by client best interests.

A radical change expected in Europe is the entry into force of a full ban on the payment of commissions by product manufacturers to distributors of financial products to retail investors. Stemming from the FSA's Retail Distribution Review (RDR), such rules would operate from 2013 in the UK. The new provisions would introduce an advice-based fee model for independent advisors. The customer (investor) would pay a fee for independent advice, and the advisor will be totally banned from receiving any commission from the product manufacturer.

For the moment, this measure is restricted to the UK only but discussions about potential implementations at the European level have been led by CESR. CESR has highlighted that specificities of each European country in terms of distribution channels need to be considered. The UK is unusual by European standards insofar as retail product distribution is heavily dominated by independent financial advisors, including both a number of large IFA networks and thousands of single or small operators. By contrast, in continental Europe, whilst IFAs exist, retail banking networks dominate the market of investment product distribution.

Nevertheless, in continental Europe, some players, especially in Germany, are currently testing the advice-based fee model. Commerzbank, the first major German bank to do so, carried out an advisor fee test via its online broker, Comdirect. Quirin, a German private bank, introduced a new advisor fee system that allows clients to select a financial advisor and choose between paying a yearly all-

inclusive fee of 1.65% of their invested assets (minimum of €900), €150 per hour of advice, or €75 per month and 20% of the profit. However, the bank, which was founded in 2006, has not yet reached profitability.

Independent of these German initiatives, we believe that the RDR in its current form would be very difficult to introduce into continental Europe without severely affecting the current banking networks and their distribution structures. Furthermore, many argue that investors should be given the freedom of choice, the possibility of choosing between a commission-based or advice-based fee model as long as they are aware of the remuneration source and the amount the financial advisor will receive.

Hence, as a first step we would recommend ensuring much greater levels of transparency as well as understandability of fees received by distributors for the investor. We will elaborate on this concept in the rest of the report.

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Foundation II

Greater levels of transparency

Foundation II
Greater levels of transparency

Acting in the best interest of the client is clearly necessary and a vital step in delivering sound financial advice. The next key principle for improvement in the quality of advice is increasing the current levels of transparency.

State of play

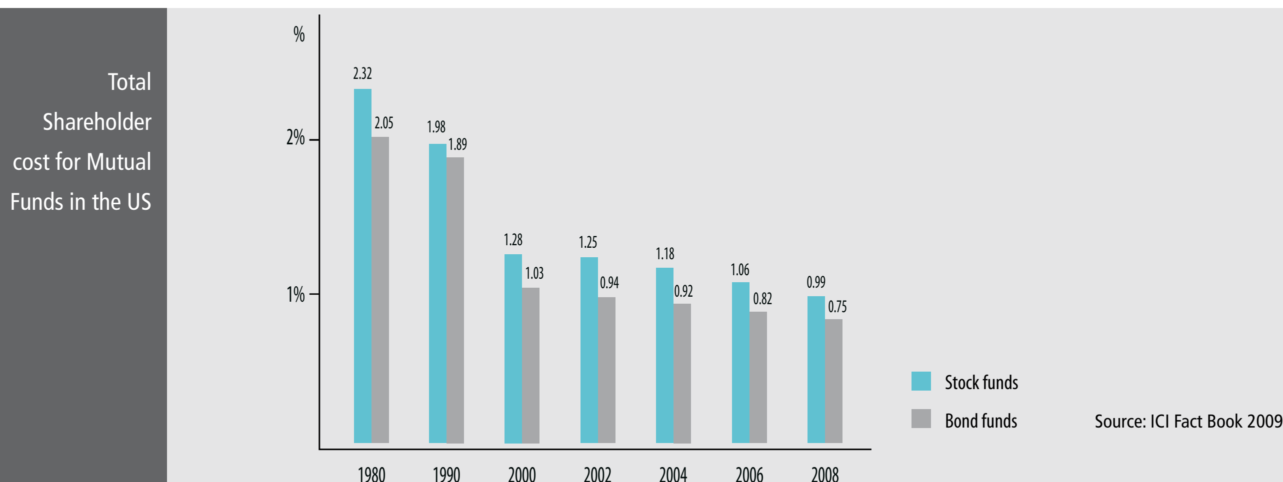
The investment fund industry is characterised by complex agency relationships and asymmetry of information. The assets are managed by institutions with considerable power to control the flow of information, on behalf of a dispersed group of investors with incomplete information. According to IOSCO[4], investors do not understand many key messages about charges, remuneration, conflicts of interest, and fund risks and features based on current disclosure regimes, and will commonly simply follow the advice of others. CESR chairman, Eddy Wymeersch, also pointed out last year[5] how difficult it is for investors to find information about products on promoters' websites and urged the industry to make sure their websites contain what the investor needs.

Hidden costs and lack of transparency in the financial intermediaries' information on their tariffs make it almost impossible for consumers to systematically compare all the offers presented in the market in order to identify the one that is best for them[6].

In contrast to the US, where the SEC has harmonised the definition of and communication about fund fees towards investors, no single definition of fees and expenses exists in Europe. This transparency towards investors, which was first introduced by the SEC in 1988, resulted in total shareholder costs to decrease (see figure 6) over the years with more and more funds with lower fees receiving the most assets (see figure 7).

Figure 6

Total Shareholder cost for Mutual Funds in the US



Source: ICI Fact Book 2009

In addition, in the US the so-called "12b-1" distribution fee is publicly disclosed, but this information is kept confidential in Europe. According to the PwC/UCL Investor survey 2009, many investors are not aware of the total amount of fees the fund is charging (34% of participants), the types of fees (31%), and who benefits from the fees (23%) (see figure 8).

A research by UFC-Que Choisir comparing fees charged by 12 major banks in France between 2004 and 2009 found that the fees were so complicated that consumers were unable to make any accurate comparisons. Already in March 2010, Christine Lagarde, French Finance Minister, announced that an investigation would be launched into the fees charged by banks.

The PwC/UCL Investor survey 2009 showed that some 73% of respondents saw a high level of transparency as an important feature when investing, meaning a critical factor in deciding whether to invest (see figure 9). Furthermore, according to the PwC/CACEIS Financial Advisor/Distributor survey, a lack of information available to clients is one of the key barriers to delivering high-quality advice (see figure 13).

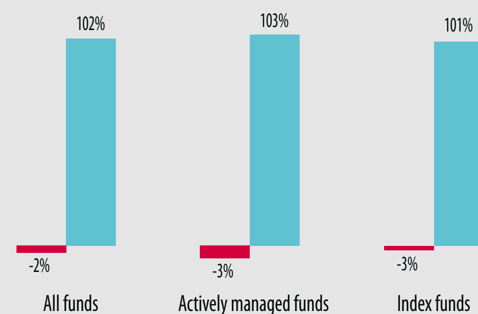
Greater levels of transparency can assist financial intermediaries to strengthen their credibility with both investors and national regulators, but the value of transparency reaches well beyond its impact on public trust; it affects the bottom line.

[4]IOSCO - Principles on point of sale disclosure - November 2008

[5]EFAMA's annual conference, Brussels - October 2009

[6]Commission of The European Communities - Commission staff working document on the follow up in retail financial services to the markets scoreboards - September 2009

Figure 7

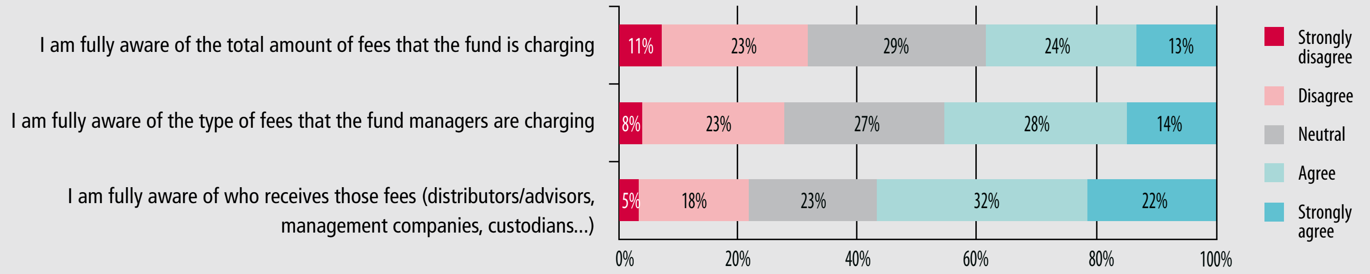


Least costly stock funds in the US attracted most of the net new cash (1999-2008)

Source:
ICI Fact Book 2009

Figure 8

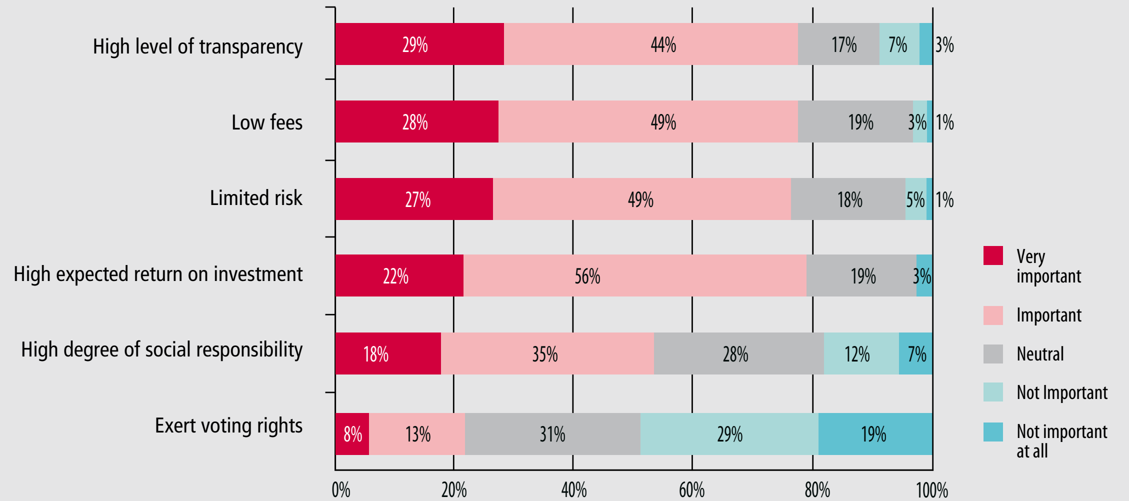
Please rate your level of agreement regarding the following statements



Source: PwC/UCL Investor survey 2009

Figure 9

Rank the following features of investment in terms of importance in your investment decision



Source: PwC/UCL Investor survey 2009

Recommendations

Increasing the level of product transparency does not necessary mean simply giving more information to investors. Greater transparency also means more understandable information, free from the jargon, marketing speak and overly technical facts, often used to convey importance or product complexity, and hence raise the price. What is at stake is to give investors the most appropriate information using the right language at the right moment and the right place.

The objective of transparency is to ensure that investors know:

- What advice bias they may face, i.e. transparency related to the nature of advice;
- What they invest in, i.e. transparency about the product;
- What they pay for, i.e. transparency concerning services and prices.

Product manufacturers and advisors can utilise enhanced product, service and fee transparency as well as the adoption of an ethical charter to their advantage as valuable marketing tools. In times when investor confidence is low, companies able to demonstrate a high level of transparency in their products and services are more likely to attract new capital inflows and therefore stand a better chance of achieving sustainable growth in the long-run.

TRANSPARENCY RELATED TO THE NATURE OF ADVICE

Investors need to understand the nature of the advice they receive and any bias that may exist. Financial intermediaries should clearly state the kinds of products with which they are familiar and are able to access. They should also disclose the nature of advice services to consumers as well as the relationship between the advisors and the providers of the financial products.

In the UK, the FSA (through the RDR) will require that firms describe their advice services as either "independent" or "restricted." Firms describing themselves as "independent" would, in each transaction, need to demonstrate that they have conducted a comprehensive and fair analysis of the market, selected products in accordance with the client's best interest, and satisfied unbiased and unrestricted analysis requirements, especially when recommending their own products.

TRANSPARENCY ABOUT WHAT THE PRODUCT ENTAILS

Another important step toward achieving greater transparency is ensuring that clients are given all necessary information, so they are able to more easily evaluate and compare the content of advisors' offers. More specifically, the information should describe the main features of the investment product: security (level of risk, guarantees, etc.), flexibility (adaptation to market conditions or changing needs), return (past and expected return), and costs (type and level of fees).

Information should be relevant, accessible, easy to understand, and disclosed in a timely fashion to individual investors. The Key Information Document (KID) established by the UCITS IV Directive will, we believe, drastically improve the transparency of UCITS funds in order to enable investors to make better informed decisions about which investment product to select. The recent PwC/EFAMA survey conducted with European asset managers showed that 54% of respondents believe that the KID will provide the investor with a better understanding of a product's risk and reward (see figure 10).

According to the PwC/CACEIS Financial Advisor/Distributor survey, 35% of participants believe the KID will be an advantage to their business while only 5% of participants think that it will be a burden (see figure 11).

It is critical that other retail investment products have equivalent reporting objectives. Last year the German government called on the financial industry to agree on standardised fact sheets for all investment products. In December 2009, Deutsche Bank revealed that it would introduce a system of seven graphic labels for all funds and certificates offered by the bank. The symbols will give an overview of a product's key characteristics, e.g. asset class, geographic region, risk class, returns, and costs[7].

TRANSPARENCY CONCERNING SERVICES AND PRICES

Investors should also know what they are paying for and the purpose for the charging of particular fees. In a single European financial market where a large range of similar financial products are distributed on a cross-border basis there should be clear and harmonised definitions used for calculating and disclosing fees and expenses. When developing disclosure standards, one should consider the use of common terms and clearly describe the purpose of fees. Fee disclosure should be comprehensive and standardised and should highlight the fees that are most significant for the investors.

Whereas full disclosure is required in the US, other countries, such as Australia[8], have developed various practices for fee disclosure in order to improve access by and transparency for investors and to ensure clear, concise, and comprehensive information about the fees and costs they will incur for an investment product. Significant fees are disclosed in a single table which investors can read easily in order to help them to understand their fees, and to compare fees across different products. A second table enumerates ongoing fees, and is supplemented by a section for other important additional disclosure items such as information about advisor remuneration and information about fee changes.

Figure 10

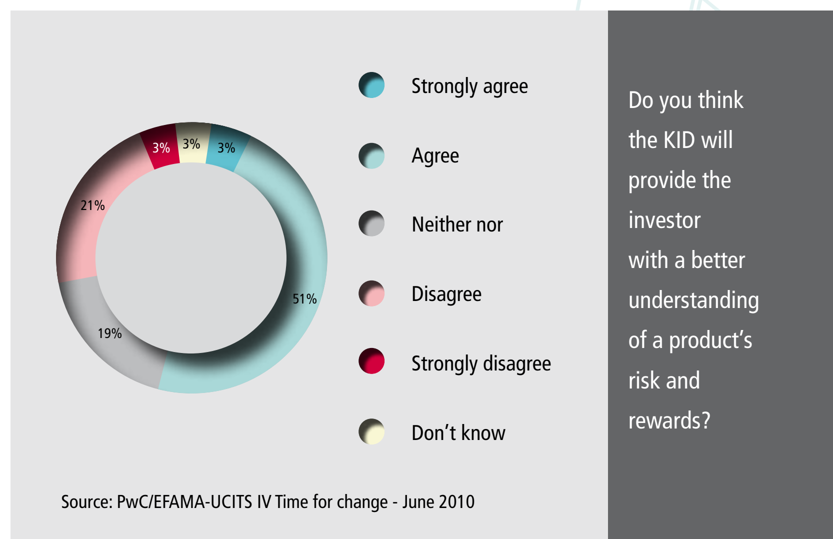
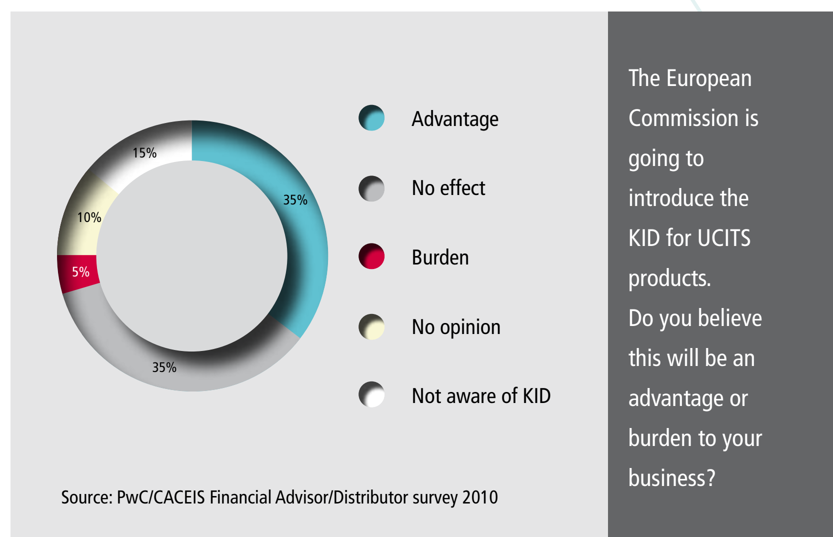


Figure 11



[7] A Deutsche Bank poll among 1,300 clients showed that three out of four customers welcome a clear labelling that gives an overview of a product's key characteristics at one glance. Ignites Europe - 22nd December 2009

[8] A model for fee disclosure in product disclosure statements for investment products, Australian Securities and Investment Commission (ASIC), 2003 and revised version in 2004.

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Foundation III

Improving the financial capability of advisors and investors

Foundation III
Improving the financial capability of advisors and investors

When discussing financial advice, it is critical to note that the financial capability of both the advisor and the investor builds the foundation for delivering and receiving ideal financial advice. In our 2009 Ideal Fund report, we identified and detailed possible medium and long-term solutions to improving the financial literacy of European investors. We will briefly address this theme before examining the qualification level of financial advisors.

FOUNDATION III - PART I

INCREASING FINANCIAL LITERACY OF INVESTORS

State of play

A proliferation in the number and complexity of financial products, providers, and transfer of risk to households has made investment decisions even more challenging in an environment where confidence is lower than in previous years. As a result, investors must now be better informed and literate on financial matters generally. According to the results of a PwC/UCL Investor survey conducted in 2009, 52% of individual investors claim to have little to no investment knowledge (see figure 12).

Financial literacy does not mean that all investors must become financial experts. However, in our view it should mean that they possess sufficient knowledge and understanding necessary to articulate their financial views, needs and objectives and deal with financial advisors in a manner such that they are able to ask appropriate questions.

Results of OECD research have highlighted the importance of financial literacy for a nation's economic growth. As the financial literacy of a population increases, so too does the quality of available financial services and this then enables individuals to use the products and services more effectively to increase their financial prosperity. Results of research conducted by Dr. Annamaria Lusardi and her colleagues at the National Bureau of Economic Research (NBER) demonstrates that individuals with low financial literacy tend not to plan for their retirement and do not choose products that will produce the best financial outcomes for their interests. Results of the EFAMA's latest report indicate that "one of the challenges facing the industry relates to investors' education and their ability to understand product descriptions, which can be very technical[9]."

Increasing financial literacy is not an easy objective to satisfy. Further, many red flags have been raised by experts as to the success and effectiveness of such efforts. The primary concerns involve the ability to awaken and retain the interest of investors in learning and accumulating the required knowledge and using this knowledge when working with financial advisors to make informed decisions.

Although the effectiveness of such efforts may be in question, results of the PwC/CACEIS Financial Advisor/Distributor survey 2010 show that advisors view an investor's low level of financial literacy as one of the main hurdles to high quality advice (see figure 13).

[9]EFAMA - Revisiting the landscape of long-term savings - March 2010

Recommendations

AN INTEGRATED FINANCIAL EDUCATION PROGRAM

As detailed in our last report, "Ideal Fund" , we recommend an integrated and harmonised financial education program across Europe that is required during school and university and optional and need-based during the rest of the investor's lifespan. The program should be funded by government and the industry.

The United States, United Kingdom, Australia, New Zealand, and other countries already have in place well-defined financial literacy programs funded and led by state governments often with support from the industry. In the United States, the National Financial Capability Challenge was put in place in December 2009 by the Treasury Secretary and the Education Secretary in order to promote financial education among high school students across the country.

In the United Kingdom, the FSA is providing leadership through the National Strategy for Financial Capability. Since the launch of this program in 2006, hundreds of thousands of people have received assistance, education, and advice that was previously unavailable to them. The FSA's next step is to extend this program to reach millions of people across the UK.

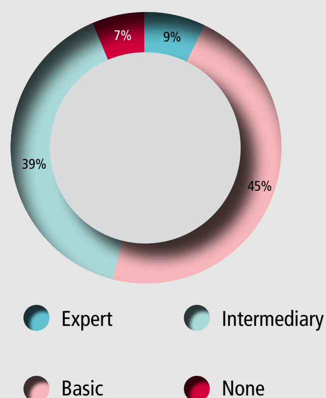
PROVISION OF FINANCIAL EDUCATIONAL MATERIALS BY PRODUCT MANUFACTURERS AND INDUSTRY ASSOCIATIONS

In addition, we recommend that product manufacturers and associations provide general and specific education materials and training to investors. Initiatives to increase the financial literacy also represent a huge opportunity for product manufacturers to get closer to and increase the awareness of their brand among investors. More than ever, now is the time for the industry to tackle the challenge of financial education.

As an example, T. Rowe Price has partnered with Walt Disney to establish a virtual board game on its website that educates children and adults on the importance of wise financial planning. In Italy, the theme of the most recent asset management convention was the improvement of financial education.

Figure 12

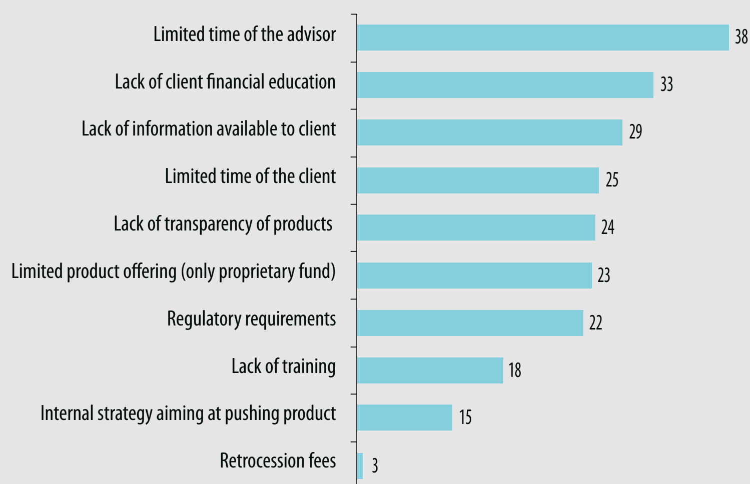
How would you assess your level of investment knowledge?



Source: PwC/UCL Investor survey 2009

Figure 13

Could you rank the five most important barriers for delivering high quality advice?



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

RESPONSIBILITY OF INVESTORS TO USE EDUCATIONAL OPPORTUNITIES

Although efforts should be made by governments and industry, investors also have a responsibility to use the available offers and opportunities to enhance their ability to handle financial matters. These recommendations are part of a long-term effort that will require several years to deliver the required results.

FOUNDATION III - PART II

INCREASING ADVISOR CAPABILITY

State of play

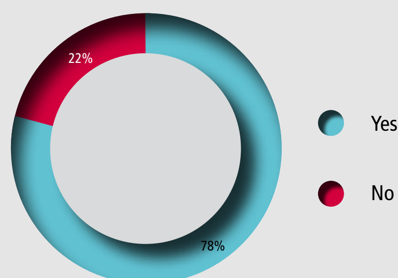
In most countries, many professionals, e.g. lawyers and doctors, must abide by stringent rules and possess high qualifications. However, this is not often the case in the financial advice industry. The barrier to entry for becoming a financial advisor is surprisingly low in a number of European countries, the certifications can be obtained with little study and no practical experience, and ongoing education is often not obligatory.

Regulators in a number of countries such as Spain, Belgium, etc. do not even require a qualification for practicing as a financial advisor especially within an institution. Hence it is a responsibility of the industry in such countries to require a set of minimum financial education for financial advisors and control that all players adhere to these. An absence of such standards leads to large differences in quality of advice as individual institutions define different priorities for their business. According to the results of the PwC/CACEIS Financial Advisor/Distributor survey, astoundingly some 22% of financial advisors themselves agree that the current level of qualification for advisors is inadequate in their country (see figure 14).

Further, according to the results of the PwC/UCL Investor survey conducted in 2009, 43% of investors stated that advisors do not have enough knowledge of the products on which they offer advice (see figure 1). Consequently, products are not always understood by both the client and the advisor, meaning that asset allocations are not always transparent. This results in a mismatch between the level of risk within the portfolio and the profile of the investor.

Figure 14

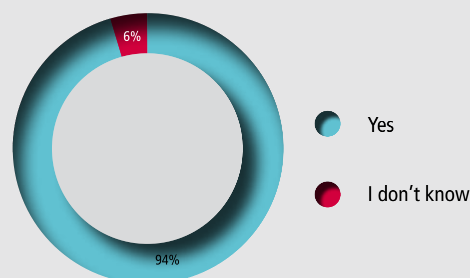
Do you think the current required level of qualification for advisors is adequate in your country?



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Figure 15

Do you plan to increase your own or your advisors' level of qualifications?



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Recommendations

As part of efforts to raise the level of investor confidence and improve the weakened reputation of financial advice among the investing public, we strongly recommend that far greater focus be laid on establishing a minimum standard of training and education to be completed before a person can achieve the status of financial advisor. No one can become a doctor or lawyer without having completed sufficient training and we believe that financial advisors should be subject to the same minimum educational criteria as those who give medical or legal advice. According to the results of the PwC/CACEIS Financial Advisor/Distributor survey, 94% of financial advisors plan to increase their level of qualification (see figure 15).

MINIMUM LEVEL OF PRE-EDUCATION

We recommend that individuals must successfully complete a mandatory minimum level of pre-education (not number of study hours) prior to their acceptance for financial advisor professional training. This pre-education should be at the bachelor's level to ensure that the future financial advisor has the intellectual capability and the basic academic fundamentals to complete the financial advisor training.

IN-DEPTH THEORETICAL AND PRACTICAL TRAINING

Individuals satisfying this pre-condition should complete a standardised, rigorous, and in-depth theoretical training program consisting of cognitive and behavioural skills and ethical conduct modules. They should also complete a two-year job training program with a registered financial advisor or institution. It goes without saying that serious and in-depth theoretical training cannot be completed within a few weeks or even months.

Further, professional training should not conclude without an examination from an independent board. Whereas the cognitive skills module would involve the acquisition of knowledge of investments, taxation, retirement, income, and debt planning, the behavioural skills module would include the fundamentals and theory of personal and interpersonal skills, which would be further developed during the practical training. The ethical module would deal with ethical and professional conduct codes and case studies.

CERTIFICATION MATRIX LINKED TO SOPHISTICATION OF ADVISED PRODUCTS

Upon completion of this minimum training and certification, an additional certification matrix linking advice on more complicated products to a higher level of education and examination should be introduced. The level and nature of the certification would determine which products and services the advisor is permitted to provide.

CONTINUING EDUCATION

Finally, in order to ensure that financial advisors participate in continuing education, they should be required to obtain a specified number of hours of training every year to retain their license.

As with the other recommendations, an industry and European wide coordinated move toward higher qualification standards and ongoing education without exception would reduce the pressure on regulators to introduce such rules. However, regulators in the United Kingdom have already introduced higher minimum education standards to be enforced by 2013, as part of the RDR. Currently, there is a benchmark qualification for all investment advisors that will be equivalent to the first year of a bachelor's degree. By 2013, financial advisors will have to be qualified at a higher level.

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Conclusion

Conclusion

The financial advice industry has reached a critical phase where it must take serious and convincing steps to build and improve a weakened level of investor confidence and win back the status of trusted advisor. Although moves from individual players are praiseworthy, it is time for comprehensive collective action by the industry. The days of paying lip service to customer centricity are over.

This will not only benefit investors but also enhance the long-term sustainable growth and profitability of the industry because high quality advice is integral to a well functioning and vibrant industry. Moreover, high quality advice that is fair to all will help to attract more investors and thus new assets to the sector.

We believe that a series of industry-wide progressive moves towards ensuring a higher advice quality is required to achieve this goal. As illustrated in the following figure, the phased approach should start with the pledge to act in the best interest of the client under all circumstances, followed by greater levels of transparency in the nature of advice, product features and prices. Last but not least, a sound and consistent qualification of advisors as well as an improvement of financial literacy of investors is the ultimate way forward for this industry.

This is not an option but a necessity for the industry because the alternative of little action or a lack of combined actions will mean that the industry will find itself confronted with increasing regulation and scrutiny as regulators move to ensure a higher customer protection.

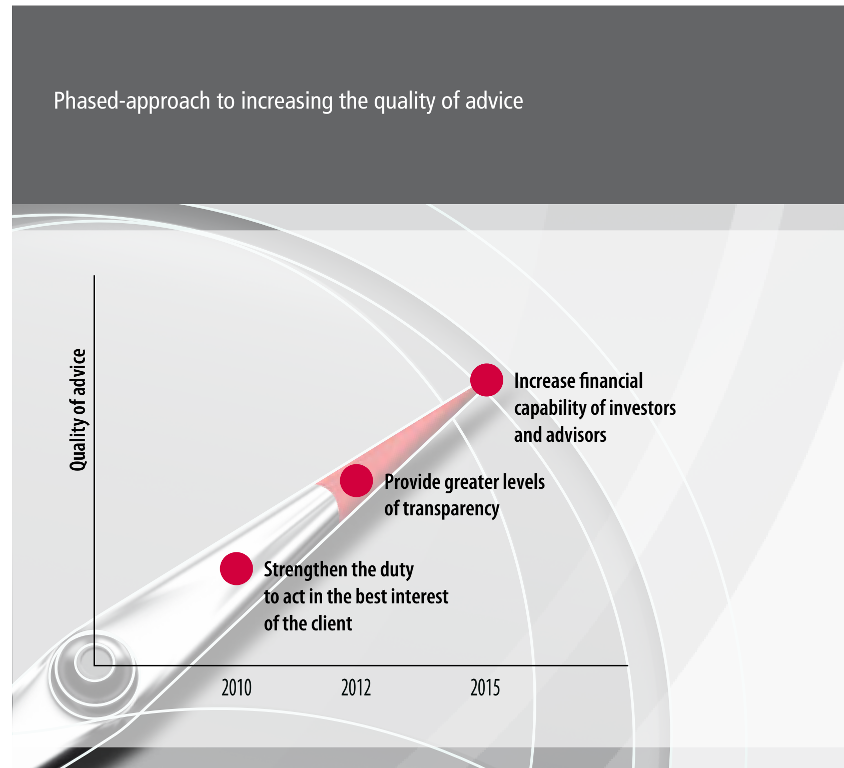


Figure 16

Appendix 1 Regulatory developments

MiFID November 2007

The Markets in Financial Instruments Directive (MiFID) came into effect on 1st November 2007, and replaced the existing Investment Services Directive (ISD). It aims to integrate the European Union's financial markets and to further increase the amount of cross border investment transactions.
MiFID provides measures to foster competition and transparency of the European trading markets and sets out rules of conduct in respect to knowing your customers, informing them properly and act in their best interest (e.g. "suitability", "appropriateness", "best execution", etc).

In 2009, a CESR consultation proposed to redefine the analysis and interpretation of MiFID's distinction between complex and non-complex financial instruments. Indeed, CESR considered that MiFID did not deal adequately with certain categories of financial instruments and that the Directive should deliver a more graduated risk-based approach. The risk-based approach should be particularly based on the nature of the client (i.e. whether retail or professional) and on the type of financial instrument involved in the transaction. The Directive is set to be reviewed in 2011.

PRIPs April 2009

In April 2009, the European Commission took the initiative to harmonize the selling practices and the rules on pre-contractual information applicable to packaged retail investment products (e.g. funds, unit linked insurance contracts, structured products, etc) which are subject to different sets of legislation today. The European Commission clearly pointed out that product information requirements and rules on product sales needed to be improved and made more coherent. MiFID is considered as the regulatory benchmark for all PRIPs.

UCITS IV – KID 2011

The entry in force of UCITS IV in 2011 plans to set-up a Key Information Document (KID) harmonized at the European level. The KID will replace the simplified prospectus and will present key fund information in plain language on a two-page long harmonized document to allow for comparisons between different offerings. The KID will also disclose risk and rewards profiles including appropriate guidance and warnings of the risks associated with investments in the relevant UCITS.

While the deadline for implementing UCITS IV is 1st July 2011, simplified prospectuses must be replaced by KIDs as soon as possible and at the latest by 1st July 2012.

RDR 2013

The FSA launched their Retail Distribution Review in June 2006 to address many of the persistent problems they had observed in the retail investment market. In their consultation paper CP09/18 the FSA cited insufficient consumer trust and confidence in the products and services supplied by the market. The RDR sets out three objectives:

- increase the professional standards of investment advisors;
- improve the clarity with which firms describe their services to consumers;
- address the potential for advisor remuneration to distort customer outcomes (no retrocession paid by the product manufacturer for the placement of his product).

The RDR will come into force in the UK at the end of 2012 and should fundamentally change the way the market for retail investments is structured and operated.

Appendix 2
PwC/CACEIS Financial Advisor/Distributor survey 2010

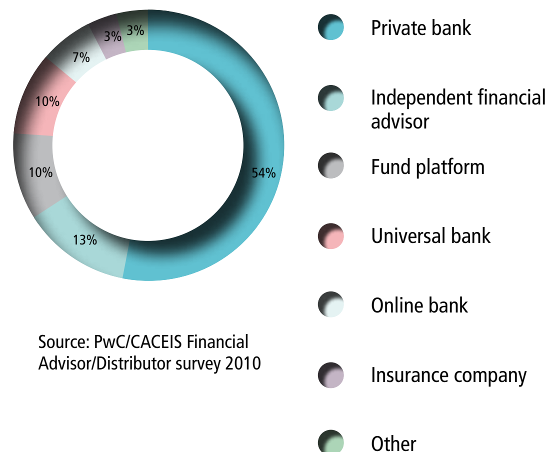
The survey was conducted by PwC and CACEIS between April and May 2010 across a representative sample of investment product distributors: private banks, IFAs, fund platforms, universal banks, online banks, and insurance companies.

Their businesses are based in major European markets, including Austria, Belgium, France, Germany, Italy, Luxembourg, Switzerland and UK. They serve a wide range of investors, from retail investors to ultra HNWI.

The survey covered several areas concerning distributors and advisors of investment products in Europe, namely current methodology to profile clients, product selection process, nature of advice offered to clients, channel and content of information delivered to clients and relation between distributors and product manufacturers.

Types of organisations

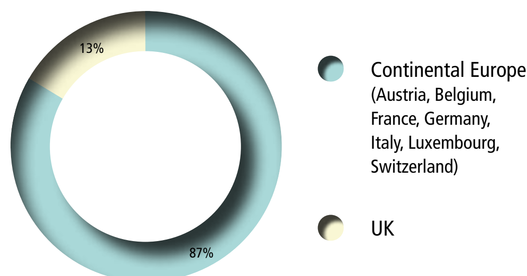
Figure 17



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Origin of participants

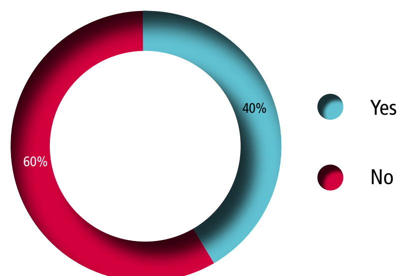
Figure 18



Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Participation of the Top 10 European banks

Figure 19



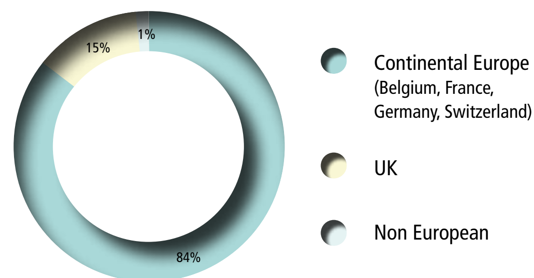
Source: PwC/CACEIS Financial Advisor/Distributor survey 2010

Appendix 3
PwC/UCL Investor survey 2009

The survey was performed in 2009 by PwC in conjunction with students from the Université Catholique de Louvain (UCL). Participants were retail investors and HNWIs based in Belgium, France, Germany, Switzerland, UK and non European countries. The goal of this survey was to understand and analyse the advice and information needs of investors. The survey covers several areas, such as demographics, investment profile, investment advice, financial education, reporting and fees.

Figure 20

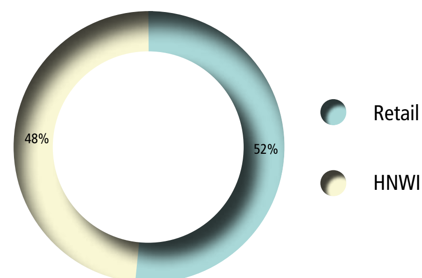
Origin of participants



Source: PwC/UCL Investor survey 2009

Figure 21

Breakdown of participants by wealth segment



Source: PwC/UCL Investor survey 2009

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