Does Financial Advice add value?

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Introduction

I am a Chartered Financial Planner and Head of Industry Development at AEGON UK.

For the final project of my doctoral programme, I have investigated the role played by financial advisers and written guides in the provision of pensions in the UK. I have also specifically addressed the question "Does advice add value?"

The UK Government is currently embarking on the biggest change to UK pensions seen since the introduction of State Earnings Related Pensions (SERPs) in 1978.

Currently all UK citizens that are employed are covered by both entitlement to a Basic State Pension and to a State Second Pension (S2P). S2P was previously called SERPs. Both SERPs and S2P are contributory benefits funded by National Insurance payments (taxes) from both employers and employees. It is possible for an occupational pension scheme or an individual to "contract out" of S2P and instead have a proportion of their National Insurance invested into their occupational pension or personal pension scheme.

The self-employed pay lower rates of National Insurance and they are not eligible for the Second State Pension (S2P). This paper focuses on the employed.

The Basic State Pension (BSP) is not large. The current rate of BSP is £87.30 (129 euros) per week and £139.60 (260.60 euros) for a couple. The Government also provide additional financial support for those that are near the poverty line, but this is 'means tested' and is not a universal benefit.

Whilst state pension benefits have never been generous, the UK has benefited from a robust private pension sector. Traditionally many employees have been provided with membership of good occupational pension schemes. These were usually provided on a defined benefit basis. Defined Benefit (also known as 'final salary') schemes give the employee a pension that is calculated as a percentage of their (final) salary at retirement. The scheme (and ultimately the employer) bears the investment and longevity risk of this type of scheme.

In recent years, defined benefit schemes have gone into decline. There are a number of reasons for this including.

1. A change to the UK taxation of equities (shares)

2. When equities markets fell in 2001 the average UK pension scheme was invested 70% in equities and was obliged to switch into fixed interest and government bonds. They therefore missed the subsequent ‘bounce’ in share prices thus permanently weakening their solvency
3. Increased longevity, causing an increase in the cost of annuities/pension payments
4. A desire by finance directors and shareholders to have 'cost certainty' on the balance sheet.

In the UK, there has been a steady switch out of defined benefit schemes and into defined contribution. For a number of technical reasons and simpler administration, the new defined benefit schemes are increasingly being set up on Group Personal Pension (GPP) basis.

Defined Contribution schemes are ‘money purchase’ based where the eventually size of the employee’s pension is determined by

- the amount contributed (by employer and employee)
- the investment performance of the assets
- the annuity rate (the rate by which the accumulated funds are converted to an income)

In effect, the employee is bearing both the investment and longevity risk.

Although the majority of employers in the UK provide access to a pension scheme, not all do and there are estimated to be over 7m individual employees that have no private pension (DWP 2004) and even those who do offer a pension scheme rarely have 100% of employees joining. (Membership of an employer sponsored pension scheme is not compulsory in the UK).

The UK Government has recently announced a series of major changes to pension policy. Apart from a major simplification of the pension tax regime the Government is embarking on significant changes to the state pension arrangement. The Basic State Pension is being amended, the Second State Pension (S2P) is being down graded to a flat rate scheme and new "Personal Accounts" are being introduced.

The relatively poor position of UK pension provision can be seen from following table from the recent OECD report (OECD 2007).

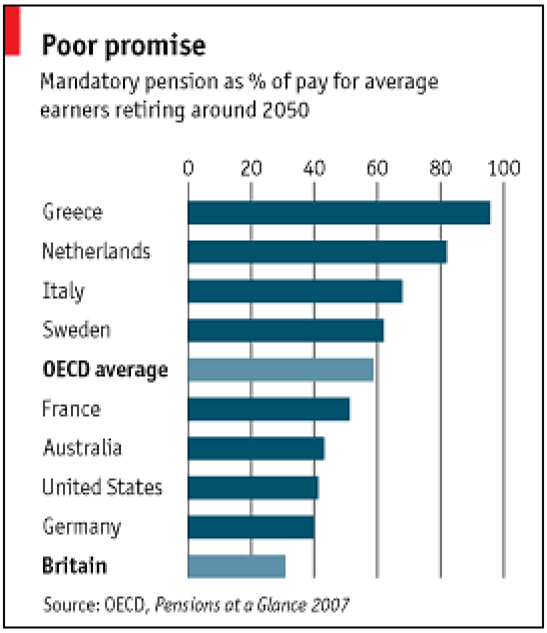

Figure 1. Pensions at a glance – OECD Report

Last year the Economist magazine (Economist 2007) reported that by 2050 the average British citizens would retire on a state/compulsory pension of only 31% of their earnings at retirement. This compares with an OECD average of 41% and a staggering (and probably unsustainable) 96% in Greece. However if contributions are paid into Personal Accounts for the full potential term of 45 years then the UK average would go up to 59%. The by-line to the report is “Young workers will be poor when they retire unless they save”.

The new "Personal Accounts (PAs)" will be defined contribution (Money Purchase) arrangements overseen by a new Personal Account Delivery Authority. All employers who do not offer their staff an ‘appropriate’ pension will be obliged to automatically (auto) enrol their staff into the new PAs. Employers and employees will both have to contribute, although employees can elect to opt out, in which case no contributions are payable by either the employee or the employer.

The Government has been keen to keep the cost of PAs low and thus PAs will have no regulated advice built into the terms.

The Project

My doctoral studies have been centred on financial planning and the value (or not) of advice.

For my final project, I have been examining a Group Pension Scheme where the employer is offering membership to all staff, on a basis that is at least comparable with

PAs and significantly better for senior staff. The employer also promotes the scheme and is genuinely keen that their staff joins the pension scheme and takes up the other benefits on offer, yet less than 30% of staff has joined the pension.

My research project title was: **What value advice? An investigation into the role played by Financial Advisers and written guides in the provision of pensions in the UK**

Through the research, I have been able to consider

- What role can financial education play?
- Does advice add value?
- Why are staff so disengaged?
- What lessons can be learnt from this scheme?
- What will the Government need to do to ensure that PAs succeed?
- I was also able to consider a number of other topical issues such generic advice and the FSA (financial regulator) Retail Distribution Review

Methodology

Following a comprehensive literature review, I conducted a case study exercise at the London offices of a large international Human Resource and recruitment firm. The company, Alexander Mann Solutions (AMS) offers all UK staff membership of a Group Personal Pension Scheme. Membership is subject to the employee contributing, but the employer (AMS) matches contributions up to certain levels.

As explained in the introduction, the take-up rate (percentage of employees joining the scheme) is extremely low and the employer was keen to understand why so that remedial action could be taken. In addition, whilst AMS's independent financial adviser (IFA) was available to support the scheme it was uncertain what effect this facility was having.

For the case study, I took two groups of employees, one group that had joined the scheme and one group that had not. The groups were selected on a stratified sample basis (semi random sample basis (Baines and Chansarkar 2002)). This was to ensure that the correct balance of age, gender, salary grade, etc, was represented.

Following analysis of the scheme and membership data, I interviewed the individuals from both sample sets. These individual interviews were in depth and sought to understand a range of issues including the list above. In total, there were 18 interviews in the first round. This was a descriptive case study (Yin 2003).

Based on the outcomes of these first round interviews I wrote a simple guide to financial matters and this was distributed to all the non-joiners[1] whom I had interviewed. In developing the guide, I had followed the 6-stage action research cycle (McNiff et al 2003). This group was subsequently re interviewed to see what effect (if any) the guide had had. This action research completed the project.

For the interviews, I adopted a semi-structured approach (Denscombe 2003).

Background to the employer and the employee benefit package

AMS aims to provide its staff with a high-quality benefit package – life insurance, private medical insurance and the contributory GPP scheme. Apart from a desire to 'do the right thing', it recognises that this should help with staff recruitment and retention. Staff turnover was less than the sector average, and every employee interviewed regarded the firm as a good employer. 70% of the employees were female and the average age was 31.

The scheme was recommended and set up by a firm of Independent Financial Advisers (IFA) that operates on a fee basis. Because of the lack of a commission charge within the pension, the annual management charge (AMC) on the GPP is very competitive at 0.65%.

The IFA firm was available to support the scheme, but it was unclear what, if any, affect this facility was having. The firm had agreed to run induction events for new staff and provide phone support to the individual employees and the HR department. When the scheme was originally established, these group presentations saw higher initial take-up levels but as staff left and were replaced in ones and twos, worksite presentations didn't always take place.

Most new employees were given brief details of the benefit package at the recruitment stage and were later sent a pack with comprehensive details of the pension scheme, including fund choices and so on.

What has been learnt from the study

[1] Following the second round of interviews all participants in the research were given copies of the guide "How to make your dreams come true"

Firstly, it is worth restating that the participants regarded AMS as a good employer that was "client focused and lived its values". AMS also seemed genuinely keen on providing staff benefits. We are therefore not talking about an employer who is 'disengaged' from pensions and this makes it even more surprising that the pension scheme take up rates is so low.

Secondly, the lack of face-to-face contact with AMS's IFA meant that no relationship was established between the IFA and the employees. Thus, the employees didn't think of, or turn to, the IFA for advice and not surprisingly, the bulk of financial advice taken was from advisers who 'prospected' the employees outside of work. This is interesting as in my experience, where an adviser is endorsed by a well-respected employer, it is easier for the adviser to build trust and empathy with the individual employees. However, in this case, the relationship between AMS and the IFA was not fully exploited and thus the employees were left to establish their own sources of advice. Due to the general mistrust of advisers and financial services in general, many of the employees chose to do nothing and it was only when confronted with immediate financial needs (mortgage etc) or when approached by advisers (often 'tied' advisers) any action was taken. Even then, there often remained a deep suspicion of the motives of the advisers and a lack of trust.

The above said, there were a number of examples of a strong adviser/client relationship and a strong sense of trust but these relationships were on a 'personal' basis and not via the IFA appointed by AMS.

I have grouped the lessons from this study under headings that are relevant to a number of market developments and where appropriate I have recommended courses of action. I have also added comments where overseas research (as identified in the literature review) or my own market experience can add some light to the issue.

Reasons for the poor pension scheme participation rate

- For this scheme, the pension scheme participation rate was driven by age and not gender. This is partly a reflection of experience ('I was in a pension scheme in my last job so I will join') and behaviour. For the Government and the wider community this raises an important question. If this finding is representative of the entire population and the young do not have such experiences or if they do not have a savings behaviour, what will the position be in 10 years?
- The lowest participation rate was at the lowest staff grade. This is likely to be part of the core target group for Personal Accounts, so this could be of

- Participants were attracted to AMS by the job and salary. Even in the context of an employer who is viewed as "good", with senior management keen to see their staff join the pension scheme, the participation rate is poor because this senior management commitment was not carried through by the staff who dealt with recruitment and induction.
- In the fast paced environment in which AMS operates, the pension was treated (by many) as almost an afterthought.
- Without face-to-face support (answering questions, filling in forms, etc) the scheme participation rate suffered. Such a role could be filled by the HR department, or a junior staff member from the IFA (possibly focused or generic adviser?)
- There is a clear a benefit in, and demand for, 'face to face' contact with the opportunities to ask questions.
- The information provided by the GPP provider was comprehensive, but there was too much information ("information overload") and it was difficult to understand. However, from experience I know that it is probable that this comment would have been made whoever the insurer was, as all insurers are tightly regulated and the volume of information is often a symptom of regulation. This said, the positive response to the guide 'How to make your dream come true' shows that improvements can be made.

Financial capability

- Participants' financial capability was not good even though we are dealing with highly educated and remunerated individuals.
- Whilst there is a great volume of useful material available (both written and via the internet) there is little awareness of its existence and even less interest in searching it out. The participants wanted information that was relevant, short and easy to digest. They also wanted to be able to deal with the issue, then and there, with the minimum of fuss. With this background, it is easy to see why consumers are drawn to store cards that can be opened in minutes and which can provide immediate gratification (the ability to purchase – often with an introductory discount). Compare this with most medium and long term saving products that come with an immediate cost, are intangible, providing little or no immediate gratification and which can take hours (or days) to set up.

- The internet was popular for searching for information and occasionally for purchasing simple commoditised products such as car insurance and life insurance. A lack of confidence prevented more complex purchases and a distrust of 'advisers' meant there was little engagement with an adviser unless a specific financial need (e.g. a mortgage) arose or they were actively approached and persuaded.

Wider savings and retirement views and expectations

- Nearly everyone wanted to retire early on a huge pension but they failed to recognise (accept) that this would require action (saving now) on their part. Comments received included

  "Haven't thought about it. It would be nice (to retire) at 50" (mid 30s)

  "Not thinking about it, too far ahead" (mid 40s)

  "I need to be financially secure in retirement" (mid 30s, not in the GPP)

  "When I retire I want to travel and do things without financial pressure and to fund long term care"(a member of the GPP and one of the few with a 'plan')
- This attitude of 'Live for today and worry about tomorrow later' applied across most ages although it was particularly prevalent amongst the young. There is acute denial of the problem. When asked what income they would need in retirement most of the participants were unrealistic in their goals. The most extreme was one participant, who was not a member of the GPP and had no other savings, who estimated that she would need 94% of her current salary when she retired.
- There were surprisingly low levels of investments and savings. Those held were 'run of the mill'. There was little property investment outside the main home
- There was clear evidence of an over reliance on credit cards and individuals were continually living up to their means (and occasionally beyond their means). This was not restricted to those on low(er) incomes

Attitudes to financial advice and advisers

- The participants' main financial service contact was through their Bank
- Tied Advisers (or possibly multi tied) were the most common advisers used, outside of mortgage advice.
- There was a mixed view on the quality of advisers and advice. This ranged from excellent to very poor.

- The first choice for financial advice was ‘a member of the family’, typically “Dad”. Advisers were second, followed by “the Bank”.
- 77% knew about ‘polarisation[2]’ and could describe what an IFA was. However, there was little recognition of the revised categories (Tied, Multi tied, Whole of Market and Independent).
- Participants expected advisers to hold a degree equivalent qualification.
- When presented with a ‘fee’ they were shocked by the amount but they were willing to accept charges taken from the plan to pay for advice. However, they do want to be reassured that the charge (or fee) is fair and therefore some form of benchmarking is necessary.
- The concept of Factory Gate Pricing (Customer Agreed Remuneration[3]) was welcomed but some form of benchmarking will be required if confidence is to be established.
- TRUST is essential.

The Key questions

Does advice add value?

It is possible to define the ‘value of advice’ by modifying the Institute of Value Management’s standard definition of value, by replacing ‘customer’ with ‘contact’ and ‘organisation’ with ‘consumer’ . The revised definition would thus read:

“The concept of value relies on the relationship between satisfaction of many differing needs and the resources used in doing so. The fewer the resources used or the greater the satisfaction of needs, the greater the value. Stakeholders, internal and external contacts may all hold differing views of what represents value. The aim of Value Management is to reconcile these differences and enable a consumer to achieve the greatest progress towards his/her stated goals with the use of minimum resources. It is important to realise that Value may be improved by increasing the satisfaction of need even if the resources used in doing so increase, provided that the satisfaction of need increases more than the increase in the use of resources” (IVM 2005 – modified by the author, customer/contact and organisation/consumer).

[2] Until 2005, the UK advice market was ‘Polarisation’ into Independent Advisers (IFAs) and Tied Advisers. Tied Advisers were restricted to recommending the products of one Insurance Company

[3] Factory Gate Pricing is where the advice costs are separately calculated and explained to the client. These are then add to the manufacturers costs to give the overall costs

From this, it can be said that an IFA adds value by either increasing the monetary worth of the consumer, by limiting the loss that the consumer would otherwise suffer and/or by giving the consumer satisfaction and peace of mind.

In the case of the project, contact that participants had with advisers was either relating to the employee benefit package offered by AMS , and (in this case the adviser was an IFA), or it was an external contact with another adviser that was related to other financial needs and matters.

Looking firstly at the relationship with the IFA, where this existed, the participants were able to have their questions answered and it appears that all those who saw an adviser subsequently joined the pension scheme (and signed up for the other benefits). However, we know from the research that some were already conditioned to join the scheme but the involvement of the adviser appears to have re-enforced the commitment by assisting with the details (fund selection etc).

Clearly, those participants who saw the IFA have gained financially by the pension fund that has been built up. Whilst this has been at a cost to the participants (their personal contributions – net of tax relief) the benefits have fair out-weighed the costs as the participants have benefited from the employer's contributions and the growth in the fund value.

This monetary gain satisfies the IVM definition.

The majority of participants have had contact with advisers outside AMS. These contacts can also be assessed against the IVM definition and again value can be seen to be added in many instances.

Peace of mind also features here, but what is also apparent is that negative value can also apply. Those participants who were mis-sold endowments or pensions fall into this category.

More positively some participants successfully dealt with advisers and were 'relieved' that the adviser had done all the chasing around for them and put their finances on the right footing.

Therefore, it can be said that advice CAN add value, but a positive value is by no means certain.

What are the core requirements for advice to work?

From the analysis and evaluation, it is possible to identify that a number of factors must be present for the advice to have value. Top of this list is Trust. According to research by Wharton for State Street in the USA (State Street 2007), there are 3 levels of trust that an adviser must fulfil (a) trust in technical competence, (b) trust in ethical conduct and (c) trust in empathic skills.

In the UK environment, we can also highlight the need for openness within ethical conduct, especially with regard to remuneration. Clients are suspicious that (all) advisers are ‘in it for themselves’. The bad experience that some have had, or the experience of others that they know, has created an environment of suspicion.

Advice must also be accessible. Only a few of the participants in this research would have required the services of a highly qualified Chartered Financial Planner, but they all could have benefited from advice. Advisory firms should therefore look to see how they can provide wide coverage at the basic level together with an adequate internal (or external) referral mechanism.

Lessons for the FSA Retail Distribution Review.

Firstly, for the market to be successful, we need to build confidence and trust and this can only be achieved by ensuring high standards. The FSA has done much to improve the market in this respect, but if a new advisory category of primary advice is introduced it is important that high levels of integrity, honesty and trust are attained.

The participants in this research expected their advisers to be higher qualified than they are today. Currently advisers in the UK are required to have passed the Chartered Insurance Institute’s (CII) Financial Planning Certificate (FPC) or its equivalent. In the UK’s National Qualification Framework the FPC sits at Level 3 alongside A Levels and (High School) Diplomas. However, most of the participants expected advisers to be qualified at ‘bachelor degree level’. A bachelor degree is level 5 or 6 of the National Qualification Framework and this is the level of the Chartered Insurance Institute’s Chartered Financial Planner . This would therefore point to this being the minimum qualification for the suggested, ‘Professional Financial Planner’.

The second most popular qualification was ‘between A Level and a bachelor degree’. This is where the CII’s Diploma sits and this is where the suggested General Financial Adviser category is set.

Based on this project the FSA would do well to keep the definition of ‘Personal Financial Planner’ at the level of a (full) bachelor degree.

However, it is also the case that the participants did not realise that advisers could hold qualifications above the regulatory minimum. Thus for any change in the levels of adviser to work, it is vital that there is clear labelling and a communications programme established to explain to the consumer what the different levels mean. If adopted, the success of these new categories of adviser will depend on the consumer understanding the difference between the levels on offer.

The participants in the project welcomed the ‘factory gate price’ proposals (now called CAR – customer agreed remuneration) but they also need to be able to compare an advisers CAR charge against a market average or benchmark. It would therefore be desirable for CAR to have such a benchmark.

Finally, the participants that I saw were quite clear that ‘independent’ meant that the adviser was not restricted in the products that they could recommend. The Retail Distribution Review suggests that the term ‘independent’ should in future refer to remuneration and not product choice. From this research, it would seem that removing product choice would be against the consumer’s wishes. As the term ‘IFA’ is widely recognised by the participants in this study, it would seem sensible to require IFA’s to remain ‘whole of market’.

Even if ‘independent’ remains on a whole of market basis it would still be desirable to offer CAR to reduce the suspicion that the advice was driven by the commission and not by the clients needs.

What does this research tell us about financial capability ?

As shown by the research the level of financial capability of the participants was not high. Action is therefore needed to assist individuals understanding and knowledge. The FSA already has a financial capability strategy in place and the Government is making concerted efforts. Many not for profit organisations are also involved. Whilst all the parties produce some useful material there does appear to be a fair amount of overlap and some material is over complicated. For example, the GPP information provided to the participants was seen as being too extensive. The use of an introductory guide and access to more detailed information ‘on line’ appeared to work for the participants in this research. However, the mass of material already available and the wide range of activities from Government, regulator, industry and other bodies, may mean that better co-ordination is required. Perhaps the FSA, or a new independent body, should be tasked with fulfilling the role played so well by the New Zealand Retirement Commission (PPI 2006) . Such a body could be responsible for a comprehensive public awareness campaign, on the lines of the ‘drink driving’ campaign, which has been successful in tackling anti social behaviour.

How might Personal Accounts affect retirement savings?

If an engaged employer, who is keen to see his employees in the pension scheme, can only attract a 29% take up rates, this raises serious questions for Personal Accounts. However, the research does point to the potential success of a number of initiatives.

Auto enrolment (or streamline joining in the case of GPPs) could have a major impact on pension take-up. Auto increase might also work for those wishing to increase their pension savings but who lack the will to carry out the necessary review and changes

However, action beyond this is needed if we are to break the culture of living for today and ignoring tomorrow. This will require some enforcement (auto enrolment) and a great deal of trust which the industry and Government must be jointly responsible for creating. The scale of this task should not be underestimated as arguably this intent in counter to the consumerist mentality that now prevails in the UK and most of the world, including China and Russia.

Consumerism is often described as providing personal happiness through the purchase of material possessions and consumption and we are now seeing the pace of repurchase and fresh consumption accelerating Since the 1970s, it as become “essential” to possess a telephone, washing machine, and car and as the decades have progressed the list as grown longer. The trend towards dual income families as been driven by this need to consumer and this acceptance of consumption as passed down to the children. Mobile phones are a case in point. My daughters regularly change their phone, not because the old mobile is broken but because it is no longer the right colour or the most fashionable.

The increased debt mountain (probably better described as a pit that consumers need to climb out of) is funding this consumerism and any attempt to restrict consumption so that savings (including pension savings) can be increased is likely to be resisted. In essence, consumers are addicted to spending and we now need to change this to a savings orientation (although a balance must be drawn as over saving and a lack of consumption is also not in the national interest).

The following table from the Economic and Social Research Council shows how consumption as increased from the 1970s to 2004.

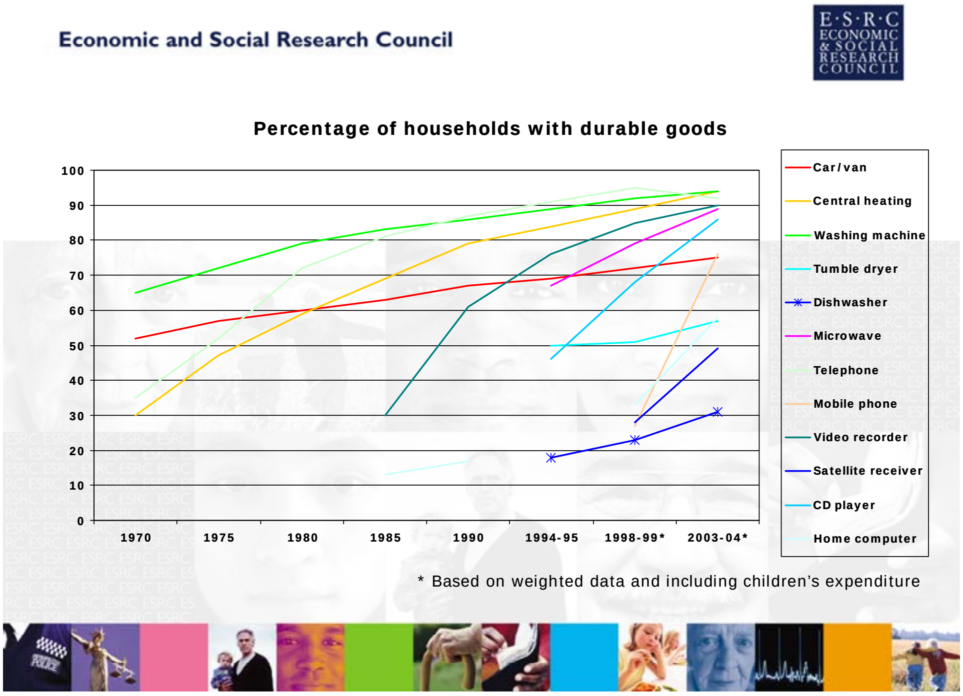

Figure 2. ESCR. Percentage of households with durable goods

This research project is not designed to investigate consumerism, but it's impact on the lack of a savings culture, is important to record.

Can Written information such as the Guide, 'How to make your dreams come true' , make a difference?

The guide used in this project was written to provide generic 'guidance' and not regulated advice. It dealt with the main financial planning subjects identified in the first set of interviews and was designed to answer simple questions and stimulate interest and further action by the reader.

The guide also provided 10 financial planning tips. These proofed to be particularly popular and are reproduced below


Here are “10 quick ways” to improve your financial well-being.

1. Protect your family with Life Insurance and/or other protection products
2. Shop around for the cheapest interest rate for your credit cards, store cards and mortgage
3. At the end of each month pay off your credit card bills
4. Look at switching your utility bills (gas, electricity, phone)
5. shop around for your annual insurances (House, car , etc)
6. If you regularly holiday, buy annual travel insurance
7. Make maximum use of the ISA limits (especially for cash deposits)
8. Make a Will. A local solicitor is usually best and the cost is modest (typically £100-300).
9. Use the internet to check out the prices on large purchases such as TVs etc
10. See Origen (or another IFA) and get your pension (and other finance needs) sorted out.


Finally, remember if you don’t save for your retirement, who will?

Don’t delay, act today

I would not attempt to claim that the guide was perfect, but it was well received by the participants. It is clear that to be most effective, guides must be focused, written in plain English and easy to read. In addition the more direct the guides can be in answering or dealing with individual’s questions and concerns then the more likely they are to be used. To achieve maximum success such guides need to be short and targeted to the consumer’s wants or needs. There also needs to be a clear referral mechanism.

In summary, advice <u>can</u> have a value, but we all have to work hard to ensure that it is a positive value.

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