POWER FINANCIAL
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Why Banning Embedded Sales Commissions Is a Public Policy Issue

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HENRI-PAUL ROUSSEAU

Why Banning Embedded Sales Commissions Is a Public Policy Issue

Financial advice is a multi-faceted service offered in a wide variety of types and paid for in numerous ways by a very heterogeneous population of households having very different needs and risk appetites over their lifetime.

This is the complex reality that regulators and policy makers face as they try to "guarantee" a transparent, fair, innovative and competitive marketplace to retail investors. Retail investors are rightly expecting to receive value for services from "their" advisors, but generally have less understanding of financial matters than those advising them, who, in addition, are more knowledgeable about financial investment products and services.

To this asymmetry of information between the advisor and client we must add the inherent conflict of interest that arises from the fact that the advice will frequently come with a recommendation to buy or sell a financial product, in many cases manufactured by a third party who may be compensating the advisor for distributing its products.

In this context – a classical “agency problem” in the jargon of economists – the tempting regulatory response might be to forbid advisors to receive sales commissions from product manufacturers and to mandate that any compensation be paid directly by the retail investor.

The conflict of interest would disappear. And the client would have better control over the value for services received from the advisor. Simple, clean and transparent.

But is it?

I’m not so sure. Let’s have a look.

THE THREE FUNDAMENTAL COMPONENTS OF THE VALUE OF ADVICE

At the root of the debate on how to regulate advisory services, there is confusion between three fundamental components of the value of advice. They are:

1. The role of the financial advisor as an *asset (or portfolio) manager*. I would like to call this the "alpha factor”: it compares the performance of a given asset with a specific market benchmark during a specific time period.

2. The role of the financial advisor as an *asset allocator*. This I call the "beta factor": it manifests itself through the investment portfolio policy recommended by the advisor, which should take into account the liquidity needs, the long-term financial goals and the risk appetite of the investor. The "beta factor" ultimately embodies the value of constructing a portfolio that optimizes the prospective return for a given level of risk.
3. The role of the financial advisor as a *coach* with respect to savings, financial planning habits, and discipline. This, for me, is the “gamma factor”: it stands for the impact of having a financial plan (and sticking to it) over many years. The “gamma factor” also stands for the disciplined response of the retail investor to market volatility, for adjustments to the investment portfolio policy over the life cycle of the investor’s household, and for the better use of fiscal planning.

Most studies on the value of advice focus solely on the alpha factor. The empirical evidence on the impact of the alpha contribution from active asset management indicates that it is very small.

Moreover, in cases where the empirical evidence favours active management, critics are quick to point to a large survivor bias in the sample.

Certainly, in the last fifteen years or so, the case for active management has weakened. Retail investors, most likely on the basis of advice from their financial advisors, have transferred billions of dollars in assets from active to passive products and strategies, offering additional evidence that if the value of advice is contingent only on the alpha factor, it can indeed be very small. But if one takes into account the advice to reallocate assets (the beta factor) from high-cost active products to lower-cost passive products, then the value of advice is actually much higher!

A good example of measuring the value of advice only on the basis of alpha is the study by the Council of Economic Advisers to the U.S. President on "The Effects of Conflicted Investment Advice on Retirement Savings," published in February 2015. In this study, the value of advice is defined and measured purely by the size of the net performance of the assets selected.

For another example of confusion about the value of advice, think about the role of the advisor in rebalancing the client's portfolio (again, the beta factor) after a major change in relative asset values. In such a scenario, the financial advisor will often recommend that the client sell funds that have performed relatively better (“sell high”) to buy funds that have performed less well (“buy low”). This makes sense, of course, in the context of portfolio rebalancing, and is of great value to the investor given the objectives of his or her investment portfolio policy; however, flow-of-funds studies would show a bad asset selection and possibly blame a conflict of interest.

A major contribution to the measurement of the value of advice has been made by the econometric studies conducted by Montmarquette and Viennot-Briot from CIRANO in Montreal. These studies indicate that, when all three components of advice are considered, the value of advice is significant and, at any rate, higher than the cost of the advice paid by the investor.[1] Over the years, substantial financial wealth is created. In addition, in their most recent study, Montmarquette and Viennot-Briot show that discontinuing the use of a financial advisor has seriously negative impacts on the level of household wealth.

WHY BANNING EMBEDDED SALES COMMISSIONS CREATES AN ADVICE GAP

If the value of advice is that important, and is proven to be much higher than its cost, and if banning embedded sales commissions is required to eliminate the inherent conflict of interests, then what could possibly be wrong with mandating that retail investors pay their advisor directly, like they would do for any other service?

Today, a very large proportion of household assets is managed with the help of an advisor (in Canada it is 66% and in the USA 75%), and a "fee for services" arrangement is widely used. The fee is generally expressed as a percentage of the value of assets under management; it tends to fall in proportion as the size of the asset pool increases. It is well known and observed around the world that households with considerable assets are ready to *pay directly for advice* through a fee expressed as a percentage of the value of their assets under management, such fee to be negotiated directly with their advisor.

Affluent households have either received their wealth in inheritance or they have built it over time – or both. In every case, such households would have learned about the value of advice through education, the influence of peers or, more likely, through experience.[2]

Indeed, the value of advice is normally learned or discovered through experience and through a relationship built over time.

This is a key characteristic of advice: its value must be learned, tested or experienced by the retail investor before he or she becomes ready to pay directly and explicitly for the service.

It is this characteristic that makes it tricky to regulate!

In fact, financial advice is what economists call an “experience good.”[3] Consumers cannot know in advance how good it is until they actually consume it. In the case of experience goods, the price the consumer is prepared to pay up front has to be very low relative to his or her income, otherwise he or she will not buy (or even sample) the good.

1. Separately, Morningstar has estimated the value of the gamma factor alone at 159 bps and more.
2. Financial literacy has been shown to be a complement, rather than a substitute, to financial advice (except for a small percentage of self-advised retail investors).
3. As opposed to a “search good” or a “credence good” (Phillip Nelson). Pierre Lortie argues that financial advice is a credence good but the characterization as experience good changes nothing in the argument here.

There exist many experience goods: when you buy a new set of tires for your car, you probably receive advice from the distributor, but you are not asked to pay for this advice separately! (By the way, the garage may very well get an embedded sales commission from the tire manufacturer; this will not stop you having your car repaired at the same garage over time as you develop a trusted relationship with this supplier.)

Another example of an experience good is a bottle of wine. In this particular case, you may be prepared as a consumer to pay a high price up front – but only because you have the guarantee that if, once the bottle is opened and the wine tasted, the product is not good, you will get your full money back.

In the case of financial advice, there is no way to offer a guarantee. The client has no choice but to experience the service over many years, in order to make his or her own judgement about the quality and value of the advice he or she is receiving. Thus, the explicit and upfront demand for advice (the price the client is ready to pay) by a retail investor with a modest income will normally be very low, if not non-existent.

This explains why, in markets such as the U.K. and Australia, where regulators have banned embedded sales commissions and required retail investors to pay directly for advice, a large proportion of low-income and low-wealth retail investors have chosen not to buy any advice. Moreover, on the supply side, in countries where embedded sales commissions have been abolished, the number of financial advisors has also fallen. In those countries, new clients at the lower end of the income and wealth spectrum who might have developed higher wealth over time in a commission model refused to engage into a long-term advisory relationship in the mandated fee-based model.

This phenomenon has been called the "advice gap."

The size of the advice gap is not easy to measure, but in the U.K., Her Majesty's Government was concerned enough to consult on a Pensions Advice Allowance of £500 for pre-retirees to obtain financial advice on retirement matters. The Allowance is now in the process of being implemented.

In Canada, the CSA acknowledge that an advice gap may develop as a consequence of a ban on embedded sales commissions. However, they assume that such a gap, should it appear, would be small and that in any case robo-advisors and Canadian banks would step in to supply any required advisory services.

THE PUBLIC POLICY ISSUES BEYOND THE ADVICE GAP

The issue is not only the size of the advice gap as measured by the number of Canadian households, especially at the lower end of the income and wealth spectrum, which may be averse to paying a fee for advice. At stake is also the breadth of choices that the heterogeneous population of Canadian households, as I said at the outset, have in terms of financial advisory services. Clients' circumstances, needs, risk appetites and, indeed, digital literacy vary enormously; they are well served by a competitive and innovative market for the distribution of financial products and financial advice. I would note that this distribution market is currently composed, in Canada, of numerous independent advisors competing with each other and with the banks (and their investment dealers) to serve the households using financial advice.

A further public policy issue, also linked with consumer choice, arises in connection with the proposed ban on embedded sales commissions.

Banning embedded sales commissions is likely to have a profound impact on the structure of the market for the distribution of financial products in Canada beyond the demand and supply of financial advice. It will precipitate a vertical integration of the distribution of financial products and services, and also a concentration in the market. The short explanation for this is that banning embedded sales commissions will transfer market power from manufacturing to distribution, endangering in the process smaller and independent *product manufacturers*. In addition, smaller and independent *distributors* will find it hard to survive in an environment where their income depends on arrangements with retail investors, as opposed to compensation from product manufacturers. This will favour well-capitalized distributors, putting a premium on scale.

The consequences for consumer choice in the event of vertical integration and concentration are obvious. The impacts on the price of financial advice cannot be ascertained yet, but it would seem heroic to assume that consumers will get a much better deal with fewer (and bigger) players in the market.

Other policy issues emerge as a consequence of banning embedded sales commissions. To name only two at this point:

- Mandating a fee-based model will obscure the transparency of pricing for clients and lead to increasing price disparity for the same, or similar, services;
- The growing shift to passive investment products may increase systemic risk in our financial system.

It is because concerns of this nature prevailed that the governments of New Zealand and Sweden, while supporting regulatory reforms aiming at improving advisor conduct, opted not to ban embedded sales commissions.

CONCLUSION

Following the global financial crisis of 2008, policy makers and regulators around the world developed and implemented, first, enhanced macro-prudential policies and regulations, and second, policies and regulations aiming at improving market conduct. There is a broad consensus on the main objectives and principles underlying these reforms.

The third wave of regulatory reforms is concerned with professional conduct and, more specifically in our case, advisor conduct. The debate on embedded sales compensation models for financial advisors is part of this third wave.

My message is that this question is more than a regulatory issue; it is also a public policy issue:

1. Banning embedded sales commissions is likely to create an advice gap in Canada, due to households being averse to paying up front for a service they haven't experienced. (I will not dwell on the fact here that only one third of Canadian households are using financial advice, which should also be cause for concern given our retirement system's reliance on individual savings.)
2. It is, at any rate, likely to cause a loss of choice for Canadians who have varying circumstances, needs and preferences.
3. It is also likely to cause a change in the market structure for the distribution of financial products and services by increasing the vertical integration and concentration of the market. This raises questions of consumer choice and empowerment.
4. A loss in pricing transparency for clients, as well as an increase in systemic risk, may also follow from such a ban.

In conclusion, while it may not be part of the remit of the CSA to implement policies aiming at increasing access to financial advice, it certainly is the job of policy makers to do so.

We need policies that both increase financial literacy and ensure, and improve, wide access to financial advice.

In this context, we also strongly support the current policy efforts by provincial governments to require higher proficiency standards for financial advisors. This will improve both the quality and the consistency of financial advice throughout Canada. Higher proficiency standards will also create the conditions for implementing principles-based, as opposed to cumbersomely prescriptive, rules-based regulations.

Lastly, policy makers should not lose sight of the need to ensure better access for all Canadians to a competitive and innovative market for the distribution of financial products.

This is a necessary condition for the long-term level of savings and for the retirement readiness of Canadian households.

Thank you.