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## The FSA Sets World Leading Standards for Investment Advice

The fundamental message in the FSA's recent guidance paper on investment selection is that if you are involved in investment advising you should be sure you have a transparent, defensible and logical process to match investments to clients' needs or the FSA will make your life a misery.

The paper may not be the regulator's final words on the topic but only a fool would gamble on a significant change of heart before RDR bites. The paper sets a marker for the entire financial advice world. FinaMetrica talks with regulators, compliance professionals and others in many countries. We know that defining the process for the giving of investment advice is difficult. And here in less than 25 pages is the best exposition of what needs to be done that we have read. This is not wishy-washy consumerist sentimentality. This is a clear imperative to impose greater structure on the advice process. Its great strength is that it is not overly prescriptive. It concentrates on outcomes, leaving the adviser to determine how best to meet the regulator's expectations. Quite correctly, the FSA has left advisers and advisory groups to do their own research and reach their own conclusions as to best practice.

This is consistent with the overall thrust of the paper, which is enormously in favour of a reflective and critical approach where advisers sit at the epicentre of the advice process. Advisers are encouraged to balance up all the key, possibly contradictory points, and come up with a logical set of reasons for advice. This is a compliment to the quality of high-end IFA advice in the UK. The FSA's approach is not 'borrowed' from 'enlightened' colonies. It is derived from best practice in the UK. Advising is the key competency at the centre of an explicit and defensible process. Of course advice still has to pass the 'common sense' test. For instance, when a client's needs and circumstances suggest a high exposure to growth assets but their low financial risk tolerance suggests the opposite, make sure you work through the consequences with the client and record how you and they reached the decision that was made. Perhaps even better, both sign off in the notes when the decision is made. This is a polar opposite to the black-box functionality of many of the profiling tools with which the FSA, quite correctly, finds fault.

The major issue to note is the breadth of the project that FSA has taken on. In their words the task is to **"Assess suitability: Establish the risk a customer is willing and able to take and making a suitable investment selection."** This is, of course, much broader than a simple emphasis on the mechanics of risk tolerance and risk capacity assessment. It goes to the very heart of the advising process itself. While not prescriptive there is sufficient direction to enable both sensible advisers and prudent advisory groups to make appropriate decisions as to the adequacy of their advice process.

The paper can be seen as recognition (by the regulator) of the complexity and ongoing nature of the advising process. It supports the argument that an adviser's personal ongoing oversight and advice are worthy of reward. This should not be taken for granted. While it may seem self evident to those of you in the UK, in Australia there is a pernicious and ongoing denigration of the value of independent financial advice by the Industry Funds that make up one-third of the pension market place by value and over 90% by member numbers. Trade union dominated Industry Funds are the not-for-profit recipients of the mandated 9% of salary pension contributions paid by employers for the benefit of their employees. In Australia the financial regulator, the media and most of the public, it seems, have all been taken in by this argument.

This is to the detriment of both the value of financial advice as perceived by the community and, eventually, of confidence in the financial system.

The evidence tells us that financial risk tolerance is a stable trait. In fact it is likely to be one of the few permanencies in an individual's life. Other things are much more likely to vary - the value of assets, actual and expected earnings, actual and planned spending, the status of employment, state of health and so on. The regular review of the client's situation and aspirations taking into account these changes is the very essence of the professional process. A key part of this is the discussions and decisions around the trade-offs that most investors must make between three possible asset allocations: the portfolio consistent with their risk tolerance, the portfolio consistent with their risk capacity and portfolio most likely to give them the returns required to meet their goals and aspirations.

Let us return to the FSA guidance. As we read it this is not regulation for regulation's sake. No government can afford for consumers' trust in the financial system to fail. There is an obvious imperative to advance confidence in personal financial advice in all 13 of the countries where FinaMetrica provides services. This paper puts the UK at the forefront of such reform. Let the FSA's words tell the story:

*"The level of failure in this area is unacceptable. We have taken, and continue to take, tough action to address these failings with individual firms."*

*"As we apply our intrusive and intensive supervisory approach, we will be looking to see how firms have acted on this report. We will consider, for example, whether firms have robust procedures, tools and risk category descriptions (where used) to establish and check the level of risk a customer is willing and able to take, as well as assessing the suitability of investment selections."*

*"We expect to see improvements in the standards of advice and private client discretionary management, and will continue to take tough action where we identify poor practice .... Tools, where used, are fit for purpose and any limitations recognised and mitigated."*

*"We expect all types of firms to consider whether they need to improve the way they assess and check the risk a customer is willing and able to take and so ensure they make suitable investment selections. We encourage providers of risk-profiling and asset-allocation tools to take action to address any potential weaknesses in their tools."*

*"Firms [read advisers] remain responsible for assessing suitability, including assessing the risk a customer is willing and able to take even when using tools"*

Now a little background and some suggestions on the way forward:

- ❖ We presented to the review committee last year and followed up in some detail to a written request. We have been asked to respond to the FSA paper by end of January.
- ❖ The FSA says it reviewed 11 risk-profiling tools and found 9 had weaknesses. As we read it, the FSA's position is consistent with both the methodology that FinaMetrica promotes for the matching of investment products to investors' needs and the rigour of our approach to assessing risk tolerance.

- ❖ We will be talking with advisers and others over the coming few weeks while we prepare a more detailed analysis. In the meantime, if you are a FinaMetrica subscriber and use the system as we recommend, you should have no concerns.

The advising industry commenced as a product and sales driven engagement with the investing public. More recently the top end of the advisory community has engaged with the language of client-centric behaviour. However, for it to flourish beyond its current expression it must rapidly move to being both process-driven and client-centric. Consequently we are currently working on FinaMetrica's integration with other service providers in the supply chain. At this time we have completed integrations with Prestwood and Plan Plus and are in the process of doing so with Margetts, Morningstar and Voyant. Let us know if you are already working with someone we should link with.

If you are not currently a FinaMetrica user and are thinking of moving to this more comprehensive methodology for assessing risk tolerance and taking it into account in the planning process you might find it advisable to do so earlier rather than later. If you are unsure of how to judge the integrity of a risk-tolerance assessment tool you might choose to read **Some Guidelines For Financial Planners In Measuring And Advising Clients About Their Levels Of Risk Tolerance** by Victor Callan PhD FAIM FAICD and Malcolm Johnson PhD, CFP at [www.riskprofiling.com/Downloads/MeasuringRiskTolerance.pdf](http://www.riskprofiling.com/Downloads/MeasuringRiskTolerance.pdf). This will give you some idea of what needs to be done.

We have always believed that ethical processes will win out over commercial opportunism in the long run. It has taken a global financial crisis to encourage the UK government and its regulators to take the view that the market cannot generate equitable long-term outcomes unaided.

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