Your best defence

Tony Vidler | Strictly Business | 5 June 2012

One of the most worrying aspects of the best practice advice process for many advisers is trying to determine what constitutes "good" advice – and therefore (the worrying part), what might be considered less than good? How do you identify why a particular piece of advice is appropriate for a consumer? How can you do so in a defensible manner? These questions run to the heart of the problem facing advisers trying to work out whether their advice, their methodology, their research, their everything, is good enough.

Fortunately, we have been given some guidance courtesy of the Code of Professional Conduct. And, we are also able to inspect how regulators consider these questions, courtesy of our Australian cousins. A recent Shadow Shopping exercise conducted in Australia by regulator ASIC is of some use for New Zealand financial advisers grappling with understanding how a regulator may view the "suitability" of advice. In addition, the study was extremely useful in identifying key areas where advisers found themselves open to criticism.

In NZ we have a requirement to ensure "suitability". Code Standard 8 states:

> When providing a personalised service to a retail client an Authorised Financial Adviser must take reasonable steps to ensure that the personalised service is suitable for the client.

There are some tough standards created in this sentence. Key words such as "ensure" and "suitable" create a clear obligation upon AFAs to have created a defensible position through analysis and research prior to finalising a recommendation.

Before going on to consider how an adviser might do that, it's worth reviewing (very briefly) some of the key findings from the ASIC shadow shopping exercise. The report was released in late March 2012 and identified a series of common problems by many of the financial advisers (or advice given). They included:
- Conflicted remuneration issues;
- Inaccurate or incomplete investigation of client circumstances;
- Inappropriate recommendations for the client circumstances;
- Poor scoping of advice;
- Failure to address client concerns or areas where there was not a financial product solution;
- Poor communication (especially in the SOA); and,
- Failing to provide justification for switching recommendations*.

The last point is to my mind the most significant in light of the standards to which NZ advisers are being held.

The very essence of testing suitability must surely be that of providing justification for the advice recommendation. In the ordinary course of business, the concept of financial justification would involve some form of financial analysis to determine whether the advice on a particular course of action represents a good business decision. As you begin to think through how other professions have managed this requirement – and they have – you can actually come up with a reasonably simple set of questions to apply to your recommendations that would answer the question of suitability. Perhaps:
- Does this present the best use of available funds?
- What risks might prevent the client goal being attained?
- What benefits will the client derive from following this advice?
- Does the advice improve the client's financial position, or protect them better?
- Will the client feel more confident of, and be more likely to achieve, their goals by doing this?

Answering these questions in the affirmative may go some way towards determining whether the advice is indeed suitable.

But this does not of course create a defensible position for the adviser. Even if you sincerely and honestly believe that you have answered these questions satisfactorily in your own mind (and client file notes!), how do you prove it? That is, how do you justify the conclusion you came to? In fact, you can't – unless you were very sure of what the underlying needs and priorities were that required your expertise. So, what is your methodology for determining if there is a sound rationale to support your affirmative answer to the questions outlined above?

Some examples of methods that may add support the suitability testing:

- Net cash flow modeling;
- Determining internal rate of return;
- Payback period;
- Total cost of holding/action, versus cost of not acting;
- Determining what is at risk, and identifying less preferential methods & costs; and,
- Calculating future financial requirements for the client.

This may sound onerous to many advisers, but we have to be mindful that the people questioning the suitability of your advice will more often than not be done so after the fact. If, as was found in Australia, there is serious product or supplier concentration in your business AND you have not had a robust process of determining suitability, then your position may be precarious.

Endnotes

* Percentage of business (in 2009) placed with advisers' top three products/providers: 94% of platform/wrap business; 83% of Master Trusts; and, 75% of personal insurance products. "Review of financial advice Industry practice" (Sep 2011; ASIC).

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