The Best Way to Pay your IFA? Commission or Fees?

What is Commission?

What is commission or rather whose money is it really?

Strictly it is the payment by a principal to an agent for business he places with the principal or products he sells for the principal. For the traditional product based IFA this leads to confusion as to whom he is exactly acting for.

As fee charging advisers by default we arrange all products on nil commission terms and invariably this reduces the premium or enhances the terms; often substantially so. In other words your money is passing through the manager/insurer to the product seller.

To take this to its logical conclusion it could be said that the insurance company or investment group that pays commission is really just acting as your agent in the matter of paying your adviser. This would not be so bad if the commission system was not so horribly complicated and obscure that clients do not know really know how much they are paying. You are excluded from knowing the price by ignorance of the system and how it affects your investments. This leads to distrust. You know that you are paying somehow, but you do not know how much, or its affect on your investments. You would not buy baked beans on this basis why should you buy financial services and financial products in the same way?

What are you paying us for?

Let us assume you ask us to sort out an ISA for you. What we actually do is discuss with you how you feel about the different types of asset class, decide an asset allocation to suit your risk profile and aims, research the market and select suitable funds, match all these to any existing holdings you may have and then write to you with this analysis and the application forms which you then return. We then process the application. As this processing is frequently electronic it takes very little time and can be carried out by lower cost staff.

As you can see most of the work is in the advice. Very little is in actually transacting the deal. In actual fact the transaction of purchasing the ISA investments takes about 10 minutes. So at the standard commission rate of 3%, or in cash terms £210 for a full £7,000 maxi ISA, your money is actually mostly spent on the advice. (And do not kid yourself that you would not pay this commission if you bought you product direct from the investment group, bank, building society or whatever. You would. And their overall charges are often higher than those on products we supply. (This includes so-called low cost funds like trackers).

Once we have established an asset allocation model for your portfolio we can fit new money into it relatively easily. This means that we do not have to repeat the analysis. So for your next ISA, say, the cost would be much less than the notional 3% commission - a saving to you.

Using the commission system has other problems. In the past 'advisers' would have, on average, only successfully completed one in every three deals they proposed. The work they had done would have been abortive. They would have swallowed this loss knowing that they could make it up on the next successful deal. In other words very large commissions on the successful product sales subsidised the advice given for 'free' to the unsuccessful ones. That is successful clients were overcharged to compensate for unsuccessful ones. This is daft as it penalises the very clients who want us and whom we want.

The second, and very important, part of our work for you is to accurately maintain the details of your plans and investments. This makes sure that we are able to monitor the progress of the investments you have made and to make sure that you are made aware as soon as possible if any changes are required. We also strongly recommend at least one review meeting a year when we can properly discuss the progress of your investments and make sure that any plans you hold are still appropriate. Generally we have used the renewal commission (or service fees as we term it) to pay for this work.

Fees

We have always been very aware of these distortions and inequities. By removing the distortions caused by the commission system we can both reduce the overall costs of our advice to each client and secure better terms on any investments or plans we recommend for you.

We are financial advisers. We believe that this means that we should do all we can to give you the best advice at the least cost and where products are supplied as part of our advice then these should be as cheap as possible compatible with being the best value.

Can We Save You Any More Money?

Commission is an exempt supply with respect to VAT. We are here to save you money and if that means legitimately avoiding VAT we are all for it. Similarly, commission paid from pension business is collected after you have had income tax relief. So not only do you not pay VAT you get tax relief on our remuneration. So if required, and using an insurer properly organised to exploit this opportunity, we can manipulate – in a completely transparent way – some elements of the commission system to your advantage.

Summary

We operate on a fee based remuneration structure. The purpose of which is to give the best value for money. This will result in savings to you. The fee system is transparent. You will be then able to judge whether we give you value – or not!

On the next pages are some notes on the commission system. A word of caution. Before embarking on a study of these you should be aware that attempting understanding can be a hazard to mental health.

Initial Indemnity Commission.

I am not going to get too involved in all the arcane detail of this atrocious system but broadly what happens is that the insurance company pays a large up front payment on the theory that you will keep paying the premiums for up to four years. If you stop paying the premiums they ask the agent (us) for their money back. It is our general principle to avoid indemnity commission like the plague. However we have used it as fee compensation when asked but the client has remained responsible for the fee until the indemnity period is ended. This has caused some problems and can compromise our relationship with you. You might also like to know that these indemnity payments can be huge and out of all proportion to work done for you. For example for a typical term life insurance policy of £50 per month the payment to us could be as much as £1000. This encourages bad selling of products and absolutely reinforces the cross subsidy between clients problem. You would not believe the complication of the vast

table of calculation factors and discount rates that are required to calculate the appropriate commission payment from any type of plan.

Nowadays most sensible insurers offer flexible commission systems that allow us to adjust the commission to be the same as the fee we would have charged.

Initial Commission

This is initial commission paid on a level – rather than indemnity (up-front) – basis. It is paid for a period of up to four years depending on the type of plan and its term.

Level Commission

This is a usually enhanced level of commission paid on the same amount basis throughout the term of the plan. In our opinion it can have a hugely deleterious effect on investment performance.

Renewal Commission

This is commission paid after the initial period until the maturity of the plan. On regular premium policies this is usually 2.5% of the premium payable.

Single Premium Commission

This is commission paid as a percentage of the investment. It is only paid on single premium business, but just to confuse you can have regular single premiums. It varies from about 1% to perhaps 10%.

The calculation of the effect of single premium commission can be complicated by the allocation rate (don't ask) applied by the insurer.

Fund Based Commission

This is commission paid as a percentage of the value of the investment, usually on an annual basis. The rate is between 0.1% and 0.5% of the value of the investment. It can be higher.

This is actually quite a good idea – AS LONG AS IT USED PROPERLY. Please refer to our service schedules and terms of business for details of our open and accountable approach to this form of remuneration.

Soft Commission

These are usually non-cash payments. Things like offices and computers can be supplied free of charge to the tied 'adviser' by an insurer or bank. These have to be paid for and if their free supply reduces the 'advisers' costs they must be a form of income. Bigger IFA's can get other subsidies, like help with printing mail shots and the like. We also get soft commissions. Actually so far this year – 2007 – we have had nothing.

Commission Uplifts

We get enhanced commission rates from some groups because we are members of several voluntary marketing groups (rather like Spa shops). Again these can distort the market for products by encouraging the sale of inappropriate products because of the revenue they earn the seller. In our case, as we are on fee terms, this is irrelevant. We just use any enhancements for your benefit.

Other Remuneration

Little jollies to far away places with ones wife/mistress/girlfriend/boyfriend paid for by the insurer or bank etc. (We confess – Farrall once had a jolly to the Isle of Man TT courtesy of Flemings Bank. Flemings Bank was soon after sold to Abbey National who merged it into their Cater Allen brand. We do not believe there was any connection). Thankfully most of the past poor practises have been stopped by a combination of regulation and market forces, although we have anecdotal evidence of churning and product selection distortion still going on. Another example would be the technical help desks and technical briefings offered by most good managers. We often avail ourselves of these. Nowadays most of this is delivered through the interweb. Nevertheless as it saves us time is saves us money.