

Business Ethics - what is it and how might you measure it? (An IFA's perspective)

Robin Keyte ASFA, MSc, PhD

Towers of Taunton (Financial Services) Ltd, The Post House, Church Square, Taunton, TA1 1SA

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Introduction

The author has taken part in each of the two meetings of the Business Ethics Forum and believes the application of good business ethics is essential to the long-term future of financial services. However, in the brief 'breakout sessions' the lack of a common understanding of what makes good business ethics was a source of significant frustration.

In this paper the author seeks to establish his understanding of some of the issues raised to date by the Business Ethics Forum, and has used examples to help readers understand his thinking.

He has then looked at the very difficult issue of measuring the application of good business ethics and made a proposal for a potential solution. We hope this will generate debate and bring out other ideas.

Finally, some wider observations and comments and have been made which will hopefully stimulate further debate.

Present Understanding

If we look at each individual financial services transaction, we can identify a number of stakeholder groups that potentially might be involved, which can include the following:

1. Customer
2. Financial Intermediary Firm / Company
 - a) financial adviser / employees of the financial intermediary firm / company
 - b) management / executives of the financial intermediary firm / company
 - c) partners in the firm / shareholders in the company
3. Product Provider Firm / Company
 - a) employees of the product provider firm / company
 - b) management / executives of the product provider firm / company
 - c) shareholders / owners of the product provider firm / company

In principal, good business ethics should see all categories of stakeholder benefit to a reasonable degree through a relationship of genuine mutual benefit.

However, the potential exists for the benefit arising from this relationship to be excessively weighted in favour of one or more stakeholder groups, and away from other stakeholders groups.

Examples that illustrate this point might include:

- i) A financial adviser selling a stakeholder pension plan to a 40 year-old individual client wishing to make regular pension contributions of £20 per month. The relationship of mutual benefit can be viewed as being:

- strongly against the product provider stakeholder groups
 - against the financial intermediary stakeholder groups (but less strongly than for product provider stakeholder groups)
 - in favour of the customer
- ii) A financial adviser selling an investment bond to a 50 year old basic rate taxpayer with £25,000 to invest. The relationship of mutual benefit can be viewed as being:
- in favour of the product provider stakeholder groups
 - strongly in favour of the financial intermediary stakeholder groups
 - against the customer
- iii) A financial adviser selling an equity release product to a 70 year old client with a 6 bedroom house. The relationship of mutual benefit can be viewed as being:
- strongly in favour of the product provider stakeholder groups
 - in favour of the financial intermediary stakeholder groups
 - against the customer

It seems our aim is to ensure that all categories of stakeholder group consistently benefit to a fair and reasonable degree from the relationship of mutual benefit. Our incentives to achieve this might include:

- lighter touch regulation from FSA
- gaining the trust of our customers
- building longer term relationships with our customers
- reductions in incidences of misselling
- fewer complaints or cases requiring compensation
- lower Professional Indemnity Insurance premiums

A difficult issue to approach is that of measuring the relationship of mutual benefit.

Proposal for Measuring the Application of Business Ethics

Focusing on the customer stakeholder group, in very general terms, the relationship of mutual benefit goes against customers when they have been sold / advised to take out expensive products, that have high charges (i.e. initial charges, annual charges, surrender charges etc) and often pay high commissions.

One proposal could be to extend the existing CAT marking principal, and categorise all existing financial services products into one of three categories. For investment business, these categories could be:

- CAT 1 = lowest charging products (i.e. charges limited to 1% per annum)
- CAT 2 = intermediate charging products
- CAT 3 = higher charging products

The specific basis of defining the different categories is detail we need not get into now, but factors might include:

- level of initial charge
- level of annual charge
- level of other charges (such as policy fee or establishment charge etc)
- surrender penalties over say 3, 5 and 10 years
- reduction in yield figures over say 3, 5 and 10 years

A different approach may be required for categorising protection policies and other types of business, but it would also depend upon the analysis of several key factors.

Product providers would then be able to include the appropriate CAT category in their Illustrations &/or Key Features Literature, which would help intermediary firms to record the correct CAT category for each transaction and might help customers to recognise when an expensive (high charging) product was being sold to them.

Thereafter, using the FSA Annual Questionnaire, intermediary firms could report to FSA the number of transactions arranged in the last year, and which CAT categories those transactions fell into. This would allow FSA to use desk based monitoring to give some indication as to the degree to which good business ethics was being practised.

Comments

Our practical interpretation of good business ethics is to avoid selling expensive products to customers, that have high charges (i.e. initial charges, annual charges, surrender charges etc) and pay high commissions.

This will be very unattractive to several stakeholder groups for a variety of reasons, the following of which are just a few:

- short-termist views often prevail
- adviser remuneration packages often include an annual commission related bonus
- if the average adviser age is mid 50s then many will be planning to retire soon
- management / executives and business owners all want turnover and profit now

These and other issues could become significant barriers to the practice of good business ethics. We believe good business ethics is linked to longer-term views, and more sustainable business models.

Whilst we have focused on the customer stakeholder group, we recognise other stakeholder groups may be equalising deserving of attention, we simply have not had the time to look into them.

Looking again at the various potential stakeholder groups, it is interesting to note one of the simplest formats could be where a mutual product provider has tied agents:

- Customer / owner of the mutual product provider
- Adviser / employees of a mutual product provider
- Management / executives of the mutual product provider

With only three stakeholder groups, there should be a better chance that a true relationship of mutual benefit will exist between the stakeholder groups. Conversely, any abuse of the relationship of mutual benefit could have a bigger impact on the other stakeholder groups (e.g. a recently failed insurer).

We believe the pursuit of good business ethics may require the owners and management / executives of product providers and financial intermediaries to adopt a significantly longer-term view than at present, and perhaps to embrace the values held by existing mutual organisations.

In this respect, the move of several With Profit funds to allocate 100% of fund returns to policyholders (instead of 90% policyholders, 10% share holders) is a source of encouragement.