
Off the Grid

By Kerry Pechter Wed, Jul 13, 2016

As the DOL rule changes the role of the employee-advisor, the mode of compensating and incentivizing advisors may need to evolve. And that may spell changes in the almighty "grid."

Incentives matter. Compensation shapes behavior and vice-versa. And, where retirement accounts are involved, the compensation system that banks and brokerages have used for decades to pay advisors could change dramatically because of the DOL fiduciary rule, which begins to kick in next year.

Indeed, some believe that the DOL rule could have the biggest impact on the economics of the brokerage business since May Day 1975, when the SEC banned fixed commissions and opened the gates to disruptors like Charles Schwab and The Vanguard Group.

"This is a once-in-a-business-generation change," said Peter Bielan, a principal at Kehrer Bielan consulting in Chapel Hill. "The degree of difficulty just went up for the advisor job and the pay went down."

Last spring, not long after the DOL issued its controversial rule—which in essence requires the financial industry to treat rollover-IRA accounts more like 401(k) accounts and less like after-tax retail accounts—Kehrer Bielan sponsored a webcast for its banking clients. The firm expects that:

- The traditional compensation "grid" for new or low-producing advisors could be modified to include a salary-plus-bonus compensation option, especially for new or low-producing employee-advisors;
- Banks and brokerages will begin to look for future advisors who are more consultative and less sales-driven than the current cohort;
- Sales of commissioned insurance products to retirement clients will decline but not disappear. Up-front commissions will be smaller and trail commissions will become more common, to reduce the incentive to favor, and the appearance of favoring, higher-compensation products.
- Top-producers who have flourished in the advisory side of the business—as opposed to selling lots of commissioned products—will be increasingly valuable, especially if the overall advisor population continues to shrink.
- To reduce costs, firms may consider paying advisors less for servicing existing assets-under-management than for bringing in new assets.

The DOL rule, in effect, pressures advisory firms to emphasize service over sales and to

charge less for their services. With compensation still based on the grid system, which appears to favor quantity of sales over quality of advice, it's clear that something has to give. (A sample grid from a large brokerage firm is shown below.)

TRAILING 12 GROSS COMMISSION		PAYOUT PERCENTAGE
-	200,000	20.0%
200,000	225,000	25.0%
225,000	250,000	27.0%
250,000	300,000	32.0%
300,000	350,000	40.0%
350,000	400,000	41.0%
400,000	500,000	42.5%
500,000	600,000	44.0%
600,000	800,000	44.5%
800,000	1,000,000	45.0%
1,000,000	1,500,000	45.5%
1,500,000	2,500,000	46.0%
2,500,000	3,500,000	47.0%
3,500,000	5,000,000	48.0%
5,000,000	100,000,000	50.0%

Compensation disruption

The Kehrer Bielan webcast was aimed primarily at banks and their advisory businesses. A bank or brokerage firm earns fees on assets under management and commissions on product sales. Advisors receive 20% to 50% of the fee and commission revenue they produce, as determined by the grid. The more revenue, the greater the advisor's percentage. Here are some of the takeaways from the webinar. (The quotes are mainly attributable to Bielan, below right):

The grid is in question

"Traditional grids will not meet the needs of all advisors going forward. If you think about the mix of business today, you have some advisory, some commission. A one-size-fits-all grid that just looks at production will be difficult to sustain. You'll be paying some of your advisors what you paid them last year, but not the ones who do a high level of commission business. And think about the ramp-up time for new advisors. If they can't get the revenue they did in the past, you can't put them on 12-to-18 month ramp-up and expect them to

cover their compensation and commission costs and be profitable.”



Salary-plus-bonuses for new or lower-producing advisors

“We need new methods of compensation. Let’s start with a base salary and a bonus or profit-sharing. Lower-producing or new advisors would get paid this way until they achieve a certain production threshold. Then they might move to a different plan. This is an opportunity to get the modestly producing advisor off the grid. It also means that advisors would be paid more like other individuals in the institution.”

The DOL’s Best Interest Contract Exemption has limited usefulness

The BICE allows commissioned sales to retirement clients if the advisor pledges that the sales will be solely in the clients’ best interest. But advisors shouldn’t make a habit of using it, Bielan said:

“A business model based mainly on getting exemptions from prohibited transactions wouldn’t pass regulatory muster. Some firms will decide to operate with the BICE, but it’s very difficult to implement, it involves transactions that are prohibited to begin with, and it opens you to class action litigation. The DOL has no enforcement power so it will rely on class action litigation to solve problems. That’s very troubling. Some firms will abandon business that requires a BICE.

“The cost of that business—driven by implementation and defense costs—will go up. Profitability will go down. Revenue in that area won’t be as valuable. There will be little impact on purely advisory business. The biggest impact will be on packaged insurance products. That are will see the most change.”

A different personality may be needed

“As for bringing new advisors into the business, you may have to look at a different type of individual. When we examine what makes advisors succeed, we foresee a different profile,

especially in terms of organizational and technical skills. Among the best sales people of today, that may not be their strong suit. It will be require listening better and communicating better with high-net-worth clients, who will be even more in demand than they are today. It may be a different kind of person, someone not as financially motivated.”

Top producers will be in higher demand

“The demand for higher-producing advisors will increase. You’ll be at higher risk for losing them and it will be harder to get those individuals in the future. They’re in an envious position, especially if their book is advisory-based production. Those that can operate in the new environment will be the most valuable.

‘A one-size-fits-all grid that just looks at production will be difficult to sustain.’
— Peter Bielan

“At the same time, the net new number of advisors is very flat. We are stagnant in the last five years. I worry that, with the new headwinds, we’ll go backward in number of advisors. We don’t have enough advisors, and that’s one of the best revenue growth opportunities around.”

RIA firms will poach top producers

“RIA firms are saying that the DOL rule is great news for them. They believe there will be a two-year window while advisors from brokerage firms become accustomed to the new changes, and there will be disarray. It will be an ideal time to poach some of your best advisors, and an even better time to tell clients that they’ve done business this way all along.”

‘Robo’ capability will be essential

“That’s what the industry is being priced towards. Besides, letting advisors pick the clients’ investments—you can’t afford the risk of letting that happen,” Bielan said, noting that Labor Secretary Tom Perez implicitly blessed robo-advice by putting a Financial Engines executive on the dais with him at the press conference to announce the fiduciary rule last April.

“After the announcement, the DOL did a roundtable with four government officials and someone from Financial Engines. That’s four officials and someone offering a robo-solution. If Secretary Tom Perez chose that moment to interview the guy from Financial Engines, I have to believe the intention is to move people toward automated advice. It sounds like a hint. And with the promotion of robo-advice I think in time it will be difficult to justify 125

basis points on investment management only. You can't earn the same revenue off the same assets."

'We have to embrace it'

"The message is that we charge too much. We have to address that," Bielan said. "If there's a product that can do the job at a lower cost, that's what we have to provide. The financial metrics behind that are difficult: \$17 billion [the DOL's estimate of excessive annual fees on retail retirement accounts] will come from advisory firms and go to consumers. As a consumer, you can't fault that. That's why we have to embrace it."

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