Discussion Paper

07/1

Financial Services Authority

A Review of Retail Distribution

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Contents

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Overview

Purpose

1 In this Overview we summarise the issues we are seeking to resolve through this review of retail distribution, the ideas that have already been put forward, and how far we think these ideas could make a real difference to the retail investment market. We provide more detail later in the document, together with the questions we want to answer and the further work we need to do before we decide how to go forward.

Our aims for the retail market

2 We aim to help consumers to achieve a fair deal from the financial services industry and have confidence in the products they buy and in the advice they take. We are tackling these issues in several ways, including our work to improve the UK population's understanding of financial matters; through our work with the firms that we regulate to ensure they treat their customers fairly; and by setting expectations through our rules and guidance. So we want a retail market where:

- consumers are capable and confident;
- information for consumers is clear, simple and understandable;
- firms are soundly managed, adequately capitalised and treat their customers fairly; and
- regulation is risk based and principles based.

Problems with the distribution of retail investment products

3 However, there are features of the retail investment market and the way products are designed and distributed that make these aims difficult to achieve. It is these features, and where they give rise to problems, that we want to address through this Retail Distribution Review (RDR). In particular:

- Many retail investment products have complex charging structures and it is often not clear how benefits accrue to consumers. Consumers purchase them relatively infrequently, so have little experience to draw on. They tend to find the risks and commitment involved hard to understand and the 'price' of the product hard to determine. The low level of financial capability among many consumers, together with a lack of interest and engagement, mean that consumers do not act as a strong force in this industry.

- Consequently, many consumers rely heavily on advisers through whom retail investment products are sold. Product providers often remunerate advisers, and there can be a mis-alignment of advisers' interests with those of consumers, adding to the risks of consumer detriment. But such problems are not limited to commission-based sales. For instance, when products and services are sold directly, incentives for staff to achieve target sales levels, or penalties for not doing so, can lead to poor outcomes for consumers if the risks are badly managed. Remuneration-driven sales can also lead to inappropriate advice to switch between different products in order to generate income for advisers, often resulting in high levels of early termination of these long term products. The costs of this low product 'persistency' are borne mainly by providers but may ultimately be passed back to consumers.
- It may be many years before poor quality advice, or problems with the performance of a product relative to what the consumer was led to believe, become apparent. The result of this can be uncertainty for consumers, and mean potential claims against those who supplied the product or gave advice, many years after the original purchase. And by the time these claims come to light, those that gave the advice may no longer be in business, leaving others in the industry to meet the costs of compensation.
- Many consumers who have the means to save are simply unable to afford advice relating to their financial situation. Moreover, some consumers may not be able to access advice because the costs of regulatory requirements, and the ways in which many firms apply these requirements, limit the number of firms willing to serve certain types of consumer.
- Those providing advice can do so with relatively little training and testing when compared to other professions. So one reason why the problems of consumer understanding set out above may be occurring is because the provider of the services cannot explain the benefits, risks and costs of the services sufficiently clearly. And consumers have low levels of trust in those selling and advising on investment products, not least because of past cases of widespread mis-selling.

4 Taken together, these features suggest that the market for retail investments does not work efficiently – and certainly not as well as it could – serving neither the interests of consumers or firms, whether providers or distributors of retail financial services[1]. We have been encouraged by the wide degree of consensus amongst market participants that the time is right for significant changes to be made. This has allowed the RDR to focus on exploring ways to deliver better outcomes for consumers without spending too much time analysing the past.

1 This point was also made in a speech in September 2006 by Callum McCarthy entitled '*Is the present business model bust?*' (http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0916_cm.shtml)

Market developments

5 The market is also developing and changing. The forthcoming introduction of government-led initiatives such as a Generic Advice service and Personal Accounts, at a time when more and more people need to make their own provision for their future, is likely to lead to a growing number of people that need and want advice on their financial affairs. The rising income and wealth of some consumers will also increase the number of people needing and wanting financial advice and help.

6 At the same time, there are continuing advances in technology and new ways of managing portfolios through, for example, platforms and wraps[2]. Many firms, both here and in other countries[3], are changing the way they operate and how they design, deliver, and charge for their products and services.

Regulation

7 The retail investment market has been regulated for almost two decades and, over this time, regulation has been targeted at many of the specific features described in paragraph 3. Although much has been achieved, our regulatory requirements and supervision of this sector have tended to focus on the symptoms arising from the problems rather than solving the root causes of the problems. While various reviews have led to changes in the way products are designed and sold[4], these have not resulted in sufficient progress towards a more efficient market which delivers services to meet the range of consumer needs. And other regulatory developments, for example the European Commission's review of Retail Financial Services in the Single Market[5] and the implementation of European Directives have the potential to influence the way the market works.

8 Regulation needs to be responsive to these changes and the market needs to be ready and able to deliver the right services to consumers, whatever their needs, both now and into the future.

The Retail Distribution Review

9 We could, of course, continue to attempt to tackle the individual problems and developments through ever more detailed rules. But, to make a real difference to this market, and for any change to meet our aims for this market, we believe that the industry needs to identify the best ways to serve its customers and address the problems itself and take advantage of the significant appetite for change that we see and hear. We also need consumers to be able to act as a stronger force, demanding services appropriate to their needs.

10 We envisage a market which allows more consumers to have their needs and wants met and to be able to understand the products and services provided to them, bearing in mind that many consumers lack the knowledge to grasp many of the

2 See also DP 07/2 – Platforms: the role of wraps and fund supermarkets

3 See Annex 3: International comparisons

4 For example, the Sandler Review and Depolarisation

5 Green Paper published 30 April 2007 (COM(2007) 226 final)

complexities. We want standards of professionalism that inspire consumer confidence, and remuneration arrangements that allow competitive forces to work in favour of consumers. We want an industry where firms are sufficiently viable to deliver on their longer-term commitments and where, in doing so, they treat their customers fairly. And we need a regulatory framework that can support these outcomes and which does not inhibit future innovation.

11 As we move towards a principles-based approach to regulation, we would rather achieve this by tackling the root causes of the problems and removing unnecessary barriers that prevent firms from operating in a way that is both commercially viable and results in the fair treatment of their customers. Regulation needs to support market moves to create greater consumer trust, understanding of the benefits of good quality financial advice and deliver services that meet the very wide range of consumer needs.

12 To deliver this, and in light of the wider developments, we are undertaking this review. So far, we have considered the views of a great many people in the market, including consumer representatives and firms – from banks, building societies, life and pensions companies, financial advisers and investment managers. Specifically, we have used five formal groups of senior market individuals[6] to come up with ideas and to try to reach consensus on the possible solutions to the problems with retail distribution.

13 These groups have reached an encouraging degree of consensus on the issues they have each discussed, and very similar ideas have been put forward by others who have shared their thoughts with us. This paper sets out our views on the possible future shape of the retail market that might emerge if the ideas that have been discussed were to be implemented and were to deliver their intended outcomes.

High-level ideas emerging

14 There is general agreement that the quality of advice and clarity of services offered to many consumers need to improve to enhance the industry's reputation and build consumer trust. This could be achieved by improved standards of professionalism and a clearer distinction between the different services being offered to consumers.

15 There is also agreement that more cost-effective ways of delivering investment products and services, and of making advice available to a wider range of consumers need to be found. And there is considerable scope to improve consumers' understanding of the services they receive and what they are getting in return for their money.

16 The groups and others have put forward some specific, and in some cases quite radical, proposals on how these changes might be achieved. Some of the proposals require the industry to lead the way, but we recognise that regulation would have to play a strong role to bring some of them about, at least in the short term. In this Discussion Paper (DP) we have set out in detail the ideas that have been put forward and their implications. These are summarised below.

6 The five groups covered: Consumer Access; Sustainability; Professionalism and Reputation; Impact of Incentives; and Regulatory Barriers & Enablers (see Annex 4 for members and observers at these groups)

Different forms of advice

17 The logical conclusion from the groups' and others' proposals is we should strengthen substantially our existing regulatory requirements for those firms and advisers who offer a full range of financial planning and specialist advice services. In parallel, we would expect the industry itself to raise the standards of professionalism in this market using the ideas the groups have put forward.

18 Increased regulatory and professional requirements could well lead to an increase in costs to these firms so that only those consumers with the financial means to address their needs are likely to be able to get full financial advice. The consequence of this may be fewer firms and advisers offering services to the many other consumers who need to save and have the means to do so, most likely those on middle incomes[7]. To fill this potential gap the groups have put forward a number of ideas for how this consumer segment could be better accessed and how regulation could help. We expect regulated advisory services for this segment to dovetail with the unregulated Generic Advice service that might result from the Thoresen Review[8].

19 If such a market is seen as a desirable outcome from the RDR, then we would need to put in place a regulatory framework that reflects both the nature of the services supplied as well as how well firms manage the risks of giving advice to consumers. There would need to be clear, market-standard labelling of different services available to consumers to avoid confusion.

20 This might suggest that the market for regulated investment advice could then be divided into two parts, which, for the sake of clarity, could be termed:

- **professional financial planning[9] and advisory services**; and
- **'Primary Advice'** providing more straightforward advice and help on more straightforward needs using simple products.

Professional financial planning and advisory services

21 In such a market, full and detailed financial planning might be the predominant offering to more affluent consumers:

- To improve the quality of advice, the industry is suggesting that higher professional standards are needed.
- Financial planning firms might be expected to apply remuneration practices that remove the potential for conflicts of interest and which give customers clarity about the services provided by all parties, and their corresponding costs. To achieve this, the form and derivation of the remuneration might be best determined on a 'fee' basis. For this purpose, we might re-define the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer and not influenced by the product provider. This definition could

7 These could be consumers with, for example, incomes of between £25,000 and £50,000 a year

8 The Thoresen Review of Generic Financial Advice was announced in '*Financial Capability: the Government's long term approach*' (15 January 2007)

9 This term is used for the purposes of this paper and we recognise that it is already in use and may have other meanings in various sectors of the financial services industry

then encompass arrangements currently categorised as fees, as well as some payments that are currently treated as commissions, but only where these payments have been determined with customer agreement. We would want to understand how the fee concept could also apply to different sectors of the industry, including direct-selling businesses and banks, without giving competitive advantages to any sector.

- We could restrict the use of the term 'independent' to those firms which offer these services, are fee-based according to the above definition, and have a high proportion of their advisers maintaining the highest level of professional standards.
- Firms and advisers offering full financial advice, but who did not meet the professional financial planner requirements (general financial advisers), would be able to continue using the full range of commission-based remuneration arrangements. They would not, however, be able to hold themselves out as independent, even where they currently do.
- For both professional financial planners and general financial advisers, there could be adjustments to prudential requirements up or down to reflect the nature of their businesses and the quality of their risk management. For general financial advisers we might expect the effect of these changes, on average, to be a marked increase in prudential requirements. We will publish a separate DP[10] in early July to open up the debate about prudential requirements for personal investment firms as a means of reducing consumer detriment.
- A transitional period would be appropriate before higher professional or prudential requirements were brought in, to limit the risk of disruption to the market. We would also need to consider whether there might be conditions for advisers to carry over their existing qualifications even if not of a similar standard to new qualifications (this is commonly referred to as 'grandfathering') and if so, whether these advisers would still need to acquire the higher qualifications within a particular time period.

Primary Advice

22 A new form of advice, 'Primary Advice', may be needed to serve the needs of those consumers who may not be able to access full financial advice:

- To enable firms to offer this service, and help them to manage the risks and costs to their business, we may need to reduce significantly some of our existing suitability requirements – so far as the standards laid down by the general law allow – and work with the Financial Ombudsman Service (FOS) to ensure firms understand the level of their obligations. We are willing to do whatever is in our powers to help this happen, but only if we believe firms will respond. And we would not do this unless we could mitigate the risks of widespread inappropriate advice for consumers.
- There are many ways in which the giving of Primary Advice could be made less costly and in which the potential risks to consumers can be contained, for example by limiting product ranges according to some form of product

10 DP07/4: *Review of the Prudential Rules for Personal Investment Firms*, in early July 2007

selection. We refer to products meeting such criteria as 'simple'. This is intended to imply that the potential benefits, risks and other limitations can be easily explained to consumers, even though some of these products may have complex constructions. Consideration would also be given to regulating the sales process, for instance by using standardised fact finds and decision processes, again to limit the potential risks to consumers.

- Primary Advice could be aimed at a wider consumer segment than the existing Basic Advice regime and the range of products could be wider than the Stakeholder products and would not include charge caps.

23 Firms and advisers offering Primary Advice would need skills and qualifications appropriate to the services they provide. We would expect a wide variety of firms to be interested in offering Primary Advice:

- Some would have access to a broad range and number of consumers, for example banks, building societies and insurers, and so have the scale to make this economically viable. These firms might choose to offer this service through their branches, by telephone or over the internet, possibly alongside non-advised offerings.
- Some financial advisory firms currently providing services to the consumer segments that may most need Primary Advice might find that by becoming a Primary Advice firm, the potential for reduced operating costs could improve their economic viability.
- There may be potential for different types of firm to offer these advice services through employers at consumers' places of work (this is often referred to as 'worksite marketing').
- For some firms a Primary Advice service could be ancillary but compatible with their core business, for instance mortgage or general insurance brokers. Some could be predominantly professional financial planning firms, but who also offer these services, in some cases providing a 'staging post' in the career development of their trainee professional financial planners.

The Discussion Paper

24 In this DP, we set out in more detail the thinking behind the ideas of the groups and the many others who have contributed thoughts and views. We are seeking feedback on these ideas and their implications, including the costs and benefits of any regulatory changes that might be necessary to deliver these potential market solutions. We are also seeking feedback on some specific areas where the UK system of benefits and taxation, both for individuals and firms, might restrict the extent to which the ideas put forward could be made to work.

25 There is an emerging consensus on both the need for change and how that might happen, but given the importance of the issues we think that a six month period for receiving feedback is appropriate. During this time, we will undertake further research with both consumers and firms to enable detailed consideration of the practical effects that these ideas could have on all players in the market. We will also be engaging very actively with those affected.

26 We look forward to receiving feedback on the ideas put forward in this paper. In particular, we want to know if the proposed solutions and the way that they might be delivered will provide the basis for a more efficient market for retail distribution and one that more often ensures the fair treatment of customers. And we particularly want to know if there is real demand for Primary Advice – both by firms for providing it and by consumers to take it – and, if there is, how regulation could best be changed to accommodate it.

Conclusion

27 We welcome further steps by firms, ahead of regulatory changes, to adopt the practices and to operate to the standards envisaged by this DP, as indeed some firms are already doing. We recognise that we will have a role to play in working with the industry to provide tangible assistance to those that are able, but need most help, to transition. Of course, if we find sufficiently strong evidence from our further work of the need for change, and if the market does not respond by itself, we may need to press ahead with regulatory changes to make it happen.

28 Depending on how firms respond, we think the package of ideas put forward could reduce significantly the incidence of poor treatment of consumers in this sector, could improve the reputation of the industry, and could provide firms who adopt good practices in supplying the services with a more sustainable outlook. It will take several years for the full effects to come through, will require commitment to change from right across the industry, and may need tangible progress in other areas such as financial capability. We recognise that some of the ideas put forward, if implemented, will require regulatory intervention, the details of which would need to be based on a proper understanding of the costs and benefits to both firms and consumers. We intend using the feedback we receive on this DP, together with further market research, to inform these cost and benefit analyses. This will help us proceed swiftly to consulting on changes to our rules if that is where this DP leads us.

29 Although we cannot be sure now that the ideas put forward will address all the problems in this market sufficiently we think they do have the potential, taken together, to achieve substantial progress. In doing so, these proposals could result in a much more efficient market for retail distribution than that which exists today, and therefore make a real difference to consumers.

Next steps

30 The consultation period on this DP will end on 31 December 2007. We expect to issue a feedback statement in the second quarter of 2008 and, depending on its content, to issue Consultation Paper(s), containing more detailed cost-benefit analyses during 2008. Where possible, these Consultation Papers would consolidate the regulatory measures that address related FSA workstreams as well as the RDR itself.

31 We also intend to set up and participate in several events during the discussion period to give opportunities, particularly for smaller firms and consumer groups, to discuss the main issues and to share their views.

1 Introduction

Purpose of this Discussion Paper

1.1 This Discussion Paper (DP) seeks to trigger widespread debate and action by the industry on ways to improve the efficiency of the market for the distribution of retail investment products as part of our Retail Distribution Review (RDR). It is aimed at firms involved in the distribution of retail investment products, trade bodies and professional bodies whose members are involved in the sector, consumers and consumer groups. We welcome the views of all these stakeholders.

1.2 The DP is structured around an emerging view of the future for retail distribution based on the main proposals from the groups that we have used to inform the RDR and from other contributors. Chapter 2 provides a more detailed description of this view whilst Chapters 3 and 4 are fuller descriptions of the groups' ideas. Chapter 5 explains how other FSA workstreams (including our work on capital for personal investment firms[1]) fit with the RDR, and sets out the main legal and regulatory issues that we will need to recognise in making any changes. The preliminary analysis in Chapter 5 suggests that there are issues to overcome, but depending on the particular solution advanced, these should not be insurmountable. The proposals must also be considered in the light of, and be relevant to, wider market developments and reviews.

1.3 Throughout this DP we pose questions where we would welcome responses from all parties. All the questions are listed in Annex 1. We set out in Annex 2 our initial high-level thoughts on the costs and benefits of proposals in this DP. Some firms are already doing what is proposed; others may be planning change but can see material barriers that either we or the industry need to address. We need feedback to help us to understand better the possible consequences of the industry proposals, to help us to refine the ideas, to reach a view on our regulatory responses and thereby allow us to help the industry to implement workable solutions to benefit both consumers and industry participants.

1 DP07/4: *Review of the Prudential Rules for Personal Investment Firms* will be published in early July 2007

Why a review of retail distribution?

1.4 As we explain in Chapter 2, there are features associated with the distribution of retail investment products that result in inefficiencies for the market and poor outcomes for consumers. This is despite intensive regulation in this area for nearly two decades. Such problems appear to have a number of root causes, many of which the Review seeks to address. These issues are not unique to the UK and, in parallel with the RDR, we have undertaken some work to consider distribution issues in other countries. Our key findings are included in Annex 3 as they provide some areas for comparison and others where lessons could be learned.

1.5 Our regulatory regime needs to keep abreast of change, and anticipate future developments and trends, for example the emergence of technology-enabled services, such as wrap platforms[2] on which we are also conducting a review[3].

Scope

1.6 The RDR covers the distribution of retail investment products and services by any regulated entity, including banks, building societies, insurers, fund managers and financial advisers. It covers the sales and distribution of investment products both where advice is given and where there is no advice.

1.7 We do not currently intend any read-across of regulatory changes that might emerge from this review of the retail investment sector to the mortgage and general insurance regulatory regimes. We recognise that these markets have different features. However, we know that the provision of investment advice or services will often include or arise from advice on other products, as is particularly the case with mortgages and protection products. As such, the market may choose to apply the ideas put forward in this paper to other types of business and we would be interested in feedback on the implications of this. Of course, depending on the nature of that feedback, if we were to consider wider application, then we would need to undertake cost and benefit analyses. We would then ensure that we had a proper debate with the relevant parts of the financial services industry.

Approach

1.8 Our preference is for market- not regulatory-led ideas. We recognise that we may need to take action to make the industry ideas happen but our role so far has been to act as a catalyst for change. We are committed to moving at a pace, by publishing this DP now, to open the debate to the whole industry and maintain the momentum which was evident from the moment the RDR was announced.

1.9 To facilitate industry ideas, at the end of 2006 we set up five groups to consider the issues and identify potential solutions. The names of the chairs[4] and members of the

2 Wrap platforms are web-based portfolio administration services that allow intermediaries, and sometimes their clients, to view and administer investment portfolios. Several different wrap platforms are available – provided by life companies, fund managers and other types of firms – offering access to a variety of tools, products and services

3 DP07/2: *Platforms: the role of wraps and fund supermarkets*

4 The five groups were chaired by four key industry figures and our Director of Retail Policy. Each group comprised individuals from across the distribution sector including consumer representatives

groups, as well as observers, are given in Annex 4. These groups have met regularly since the beginning of 2007 to consider the following themes:

- **sustainability** of the distribution sector;
- **impact of incentives** on advice processes;
- **professionalism and reputation** of the sector;
- **consumer access** to financial products and services; and
- **regulatory barriers and enablers** for the market solutions.

1.10 We are very grateful to all those who have contributed to this review, whether as part of the groups or otherwise. We would like to thank in particular the groups' chairs, who gave up a significant amount of their valuable time to deliver thought provoking and constructive ideas through their group members.

1.11 We would also like to thank all those other organisations who have shared relevant thoughts and research with us, providing insights on many of the issues. We are confident that if a similar amount of commitment is shown by the industry in implementing the eventual conclusions of the Review as has gone into designing the ideas, then there is every prospect that the intended outcomes will be delivered.

Output

1.12 The Review has led to several proposals from the groups. We have put these proposals together to consider what this could mean for the future of retail distribution. We have also taken into account the views of the other contributors mentioned above, who in many cases put forward similar ideas to those of the groups.

1.13 We have been encouraged by the wide degree of consensus amongst market participants that the time is right for significant changes to be made. This has allowed the RDR to focus on exploring ways to deliver better outcomes for consumers without spending too much time analysing the past.

1.14 Of course, views on the changes needed are bound to differ, and we anticipate receiving a wide range of opinions in the feedback on this paper. This emphasises the point that a 'one size fits all' approach is unlikely to succeed. We will be actively seeking views of all players in the market over the next few months to ensure that the conclusions from the Review are relevant and appropriate for the variety of business models that exist.

1.15 This also reinforces our view that in some areas we should take a predominantly principles-based approach to enabling the solutions. This would give firms more discretion, together with appropriate regulatory incentives, to choose approaches that best deliver the intended outcomes according to the particular needs of their customers and their own business circumstances. However, if we are to give the industry the certainty it needs to make this market work, in some places we may have to go beyond a pure principles-based approach. This is of relevance in particular to the ideas put forward in Chapter 4.

1.16 We recognise that if some of the regulatory measures outlined in this paper are to be converted into changes to our Handbook, then considerably more work is needed to develop the detail of those changes and to understand the full consequences. It is possible that such analysis will lead us to different conclusions, but we hope it is nonetheless helpful to set out some defined ideas for wider industry debate at this stage and ask for more information about the costs, benefits and implications of any changes. This will then allow us to examine in more detail whether the proposed approaches go far enough towards meeting our intended market outcomes.

1.17 We acknowledge that regulation is not the only external factor in this market. We recognise that other matters, such as tax, shifting employment patterns, benefits systems and means testing, evolving technologies that enable product enhancement and extend communication channels, as well as changing consumer behaviours are also major influencers of supply and demand. Such factors may encourage or dissuade firms from operating with certain types of consumer or in certain product areas.

1.18 The main focus of this paper is to improve retail distribution through market-led solutions supported by regulation where necessary. Any comments received on other factors, such as tax, that might prevent or restrict certain proposals from achieving their aim will be put to the relevant central government department which will consider the wider impact of any proposed changes within its own framework.

Next steps

1.19 The consultation period on this DP will end on 31 December 2007. During this period we will run and participate in events across the UK aimed at seeking feedback and thoughts from in particular smaller firms, who do not tend to engage with us on a regular basis, and consumer groups.

1.20 We expect to issue a feedback statement in the second quarter of 2008 and, depending on its content, to issue Consultation Paper(s), containing more detailed cost and benefit analyses and proposed calibrations during 2008. Where possible and appropriate, these Consultation Papers will consolidate the regulatory measures that address related FSA workstreams.

1.21 We would also welcome moves by different parties in the industry, to develop their own guidance on new market practices and/or to establish the appropriate frameworks for enhancing professional standards. Clearly, we cannot commit to standing behind such guidance and standards at this early stage, but its development would be an important step in that direction.

Who should read this paper?

This paper is aimed at regulated and appointed representative firms involved in the manufacturre and distribution of retail investment products, their trade bodies, professional bodies whose members are involved in the sector, analysts, professional indemnity insurers and consumer groups. The paper is relevant to firms of all sizes, but we are also publishing on our website today a guide for smaller investment firms[5] to help them navigate this paper. The paper will be relevant to consumers, but we recognise that their views might be expressed through consumer groups.

5 This can be found at http://www.fsa.gov.uk/Pages/Doing/small_firms/advisers/index.shtml

2 The future of retail distribution

Introduction

2.1 In this chapter, we draw together the ideas the groups proposed and describe what these might add up to for consumers and for the future of the industry. We give more detail on the conclusions of the groups, and on some of the other ideas put forward, in Chapters 3 and 4.

2.2 We are determined to find ways to enable, and not to inhibit, the implementation of a better future for the retail distribution of investment products in the UK. Our aim is to develop a regulatory framework that facilitates industry ideas, is proportionate to the risks presented, and which enables future innovation and competition where these deliver clear consumer benefits. Although we would prefer the 'market' – which comprises consumers, firms and other stakeholders – to lead the way on change, we know that there is a role for regulation to act as a trigger when necessary.

The problems the RDR is seeking to address

2.3 A principal aim of regulation is to deal with market failures. These have manifested themselves in various ways in the distribution of retail investment products. We are using this review to address these issues with a view to improving the working of the market and thereby reduce the need for regulation. It is difficult to address all of the market failures directly. We are, of course, also addressing them through our work in other areas, for instance on financial capability and Treating Customers Fairly (TCF), but the effects may take some time to feed through and other measures may be necessary.

2.4 The market for the distribution of retail investment products is characterised by a number of market failures, in particular:

- Many retail investment products have complex charging structures and it is often not clear how benefits accrue to consumers. Consumers purchase them relatively infrequently, so have little experience to draw on. They tend to find the risks and commitment involved hard to understand and the 'price' of the product hard to determine. Retail investors do not have the same information as the sellers of these products. As a consequence of this failure, the low level of financial capability among many consumers, together with a lack of interest and engagement, consumers do not act as a strong force in this industry[1].

- Consequently, many consumers rely heavily on advisers through whom retail investment products are sold. Product providers often remunerate advisers, and there can be a mis-alignment of advisers' interests with those of consumers. This, in addition to the above market failure and the importance of these products to consumers, creates the risk that substantial consumer detriment will occur. But such problems are not limited to commission-based sales. For instance, when products and services are sold directly, incentives for staff to achieve target sales levels, or penalties for not doing so, can lead to poor outcomes for consumers if the risks are poorly managed. Remuneration-driven sales can also lead to inappropriate advice to switch between different products in order to generate income for advisers, often resulting in high levels of early termination of these long term products. The costs of this low product 'persistency' are borne mainly by providers but may ultimately be passed back to consumers.

- The costs of poor quality advice may not be fully faced (or perceived to be faced) by advisers as unsuitable sales may be identified only years after the sale, if at all. There are limitations in the way that capital resources requirements and Professional Indemnity Insurance (PII) requirements for firms currently remedy this. Product providers also have responsibilities for treating customers fairly – again, it may be many years before problems become apparent, for instance with the performance of a product relative to what the consumer was led to believe. The result of this can be uncertainty for consumers, and mean potential claims against those who supplied the product or gave advice, many years after the original purchase. And by the time these claims come to light, those that gave the advice may no longer be in business, leaving others in the industry to meet the costs of compensation.

2.5 There are two further problems that are linked to the market failures that we would like the Review to address:

- Many consumers who have the means to save are simply unable to afford full advice relating to their financial situation. Moreover, some consumers may not be able to access advice because the costs of regulatory requirements and the ways in which many firms apply these requirements limit the number of firms willing to serve certain types of consumer.

- Those providing advice can do so with relatively little training[2] and testing when compared to other professions. So one reason why the problems of consumer understanding set out above may be occurring is because the provider of the services cannot explain the benefits, risks and costs of the services sufficiently clearly. And consumers have low levels of trust in those selling and advising on investment products, not least because of past cases of widespread mis-selling.

1 This is also the case in most other developed economies. Some examples are discussed in Annex 3

2 We estimate that only around 10% of financial advisers who gain the entry-level 'appropriate examination' for providing retail investment advice go on to achieve higher qualifications

2.6 Historically, the market failures and associated problems in 2.4 and 2.5 have led to significant market issues, including:

- widespread cases of mis-selling – for example: pensions, mortgage endowments, 'Splits'[3] and 'SCARPs'[4]; and
- low levels of profitability, particularly amongst distribution businesses[5] (which includes the distribution business units of firms with other lines of business, such as the direct salesforce operations of insurers).

2.7 These issues must be seen within the overall picture of a changing marketplace. Consumers' needs and wants are constantly evolving – reflecting, amongst many factors, an increasing need for consumers to take on more responsibility for their own pension provision, changes in the UK benefits and tax frameworks, shifting employment patterns, the growing power of technology and its increasing use by consumers, and changes in consumers' spending and savings behaviours. Forthcoming changes, such as the introduction of Personal Accounts[6], may also have implications for the provision of advice even ahead of implementation. So it is an appropriate time to consider whether the industry can deliver its products and services in a more efficient way.

The outcomes from the RDR

2.8 The RDR needs to deliver market practices that, in conjunction with other initiatives such as our work on financial capability and TCF, address the five key problems set out in 2.4 and 2.5. In paragraphs 2.73 to 2.75, we outline how far we think the groups' and others' proposals go towards tackling these problems.

2.9 We want the RDR to stimulate delivery of a number of specific outcomes. These include:

- an industry that engages with consumers in a way that delivers more clarity for them on products and services;
- a market which allows more consumers to have their needs and wants addressed;
- standards of professionalism that inspire consumer confidence and build trust;
- remuneration arrangements that allow competitive forces to work in favour of consumers;
- an industry where firms are sufficiently viable to deliver on their longer term commitments and where they treat their customers fairly; and
- a regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.

3 Split capital investment trusts, or 'Splits', are investment companies which issue different classes of shares

4 Structured capital-at-risk products

5 Analysis provided by Towers Perrin-Tillinghast, based on 2005/6 data, indicates that although a range of profitability outcomes is observed, typical distributor profit margins are less than 5% of commission income received for a range of products. The majority of commission income is typically paid as adviser remuneration

6 Personal Accounts will be introduced from 2012, offering employees automatic enrolment into a low-cost pension arrangement with minimum employee and employer contribution levels

The groups' proposals

2.10 The five groups[7] that we set up at the end of 2006 were asked to consider these issues and identify potential solutions to the problems. We asked the groups to assess whether their proposed solutions had sufficient potential to work in both current and future market structures. Alongside the work of the groups, we have also sought input from a very wide variety of stakeholders representing most parts of the market.

2.11 Consequently, the groups' ideas and thinking form the bedrock of this DP. We recognise the role of regulation in helping these ideas to take effect but we are not seeking to use regulation to prescribe firms' business models. Rather, we want to offer choice and to incentivise good practices and behaviours, consistent with our move towards principles-based regulation.

2.12 We have summarised the groups' main proposals in Box 1. These ideas are covered in more detail in Chapters 3 and 4 of this DP, where we also ask some further important questions. We want to analyse these ideas in more detail, using feedback on this DP together with other research, to assess whether and how we would support their implementation.

Box 1 – Main proposals from the groups

The **Professionalism and Reputation Group** reached consensus on two principal objectives – first, that there should be better segmentation and labelling of advisory services to consumers and second, that there must be higher standards of behaviour and competence appropriate to the services supplied. To make this happen, the group proposed greater collaboration between firms, professional bodies, trade bodies, consumer bodies and the FSA.

The **Sustainability Group** concluded that there are three inter-dependent routes to realising a more sustainable sector. First, there needs to be a more risk-based approach to prudential requirements with incentives for good risk management for personal investment firms[8]. Second, it saw effective supervision of small firms, and oversight of compliance service providers, as necessary, together with a risk-based supervisory approach, including assigning risk ratings to firms. Third, there should be limitation periods for complaints and claims relating to past advice, to provide greater balance sheet certainty for all firms and so encourage the inflow of new capital to the sector.

The **Impact of Incentives Group** concluded that intermediary or adviser remuneration should be regarded as the customer's money, and that consumers should have clarity on the services being provided and their costs. It then considered in more detail the benefits and limitations of wider adoption of a more transparent

7 The groups were chaired by key industry figures and the Regulatory Barriers and Enablers Group was chaired by the FSA's Director of Retail Policy. Each group comprised individuals from across the distribution sector. Trade and professional associations were given observer status, as were the Financial Services Consumer Panel (see Annex 4 for members and observers at these groups)

8 For the purpose of this paper 'personal investment firms' are financial adviser firms not caught by the Markets in Financial Instruments Directive (MiFID), the most substantial part of whose gross income is derived from advising on investments, or arranging deals in investments, in relation to packaged products for retail customers. They are subject to Chapter 13 of the FSA's Interim Prudential Sourcebook: Investment Businesses. Such firms were regulated by the Personal Investment Authority prior to the commencement of the FSA in 2001

remuneration model (known in the industry as 'Factory Gate Pricing' but renamed by the group as 'Customer Agreed Remuneration') where the costs of intermediary services are separated from the costs of the product. This would allow customers to see, and where possible to agree, the amount of remuneration and the additional product charges paid by the customer to finance that remuneration.

The **Consumer Access Group** developed ideas around simple models of advice that could reduce costs and improve the clarity of the offering. For a simple advice service, it considered product ranges that were limited by criteria so that they are more likely to be fit for purpose for consumers. It also looked at the potential for consumer-owned standardised portable 'fact finds', as well as other changes to overcome real and perceived barriers to the industry-led development of such approaches.

The **Regulatory Barriers and Enablers Group** met to consider some of the ideas emerging from the other groups. The group also commissioned analysis by the FSA of potential legal constraints, including those from European directives, which may apply to key elements arising from the work of other groups. We summarise this analysis in Chapter 5 of this DP: whilst there are issues to overcome, depending on the particular solution advanced, these should not be insurmountable.

What might the proposals add up to?

2.13 We are interested in views on whether the combination of proposals emerging from the groups would, if implemented, go far enough to address the historic problems in this sector, and be sufficiently flexible and durable to accommodate future market developments. In drawing them together in this DP we can see the emergence of one possible coherent picture which we describe below. We know that the ideas need further elaboration and analysis to assess the extent to which the key market problems are addressed. However we think that the ideas provide the basis for making a real difference to the quality and accessibility of investment products and advice, but whether this happens will depend largely on how firms and others respond.

2.14 The proposals from the groups, and wider market developments (such as the Thoresen Review[9]) suggest to us two features of an industry that delivers products and services that are appropriate to the needs of the consumers it serves:

- The high standards that must attach to services to give consumers the confidence and trust to buy.
- All consumers who would benefit from accessing the industry's products and services, and who can afford to do so, should be able to do this cost-effectively.

Higher standards

2.15 The groups have told us that to achieve the first of the above features we may have to raise minimum professional and regulatory (including prudential) requirements for those firms and advisers supplying full range or specialist

9 The Thoresen Review of Generic Financial Advice was announced in 'Financial Capability: the Government's long term approach' (15 January 2007)

financial advice. This could lead to increased costs for those firms, making this type of financial advice more expensive and therefore limiting its availability.

2.16 The effect of this could be to increase the number of people who are not pro-actively served by the market because they fall short of the earnings and net wealth thresholds operated by some firms. But these consumers may have less complex needs than those who are more affluent, and therefore may not require such a comprehensive and expensive full financial advice service.

Wider access

2.17 To achieve the second feature in 2.14 above, and in response to other requests from firms, we might need to allow the development of other types of services, less comprehensive in scope and less costly to supply. For potential suppliers to see these services as economically attractive, and for the market to operate efficiently, we might need to reduce, or add greater clarity to, our regulatory requirements. We cannot, of course, reduce standards laid down by the general law, for example the duty of care. It is also vital that the consumer understands the nature and limitations of any services supplied.

2.18 We are not suggesting that these less comprehensive services should be targeted at those consumers who have no means or need to save. But we do see the prospect that an important consumer segment[10] may benefit from such services even though Personal Accounts may address part of their pensions needs. And from time to time, other consumers may want and need to access these services, as indeed there will be circumstances when those in this segment need to access full financial advice. For this DP we have called these less complex services 'Primary Advice'.

The proposed market for advice

2.19 All of this suggests the possibility of a distribution industry segmented more in terms of the services provided to consumers, rather than the current product-led or status-led (e.g. tied, independent, multi-tied) industry. To make this new market work most efficiently for consumers, there would need to be a greater emphasis than currently on helping them to identify the nature of their needs and establish their financial means at an early stage in the process. This would then help consumers to identify the most appropriate services (including non-advised) to meet those needs.

2.20 Based on the groups' ideas, the future of retail distribution of investment products could be illustrated as shown in the diagram below. We describe the ideas in more detail in the next section of this chapter. Each of the services could in some cases prompt other services to be sought either at that time or at a later time when a consumer's needs or circumstances have changed.

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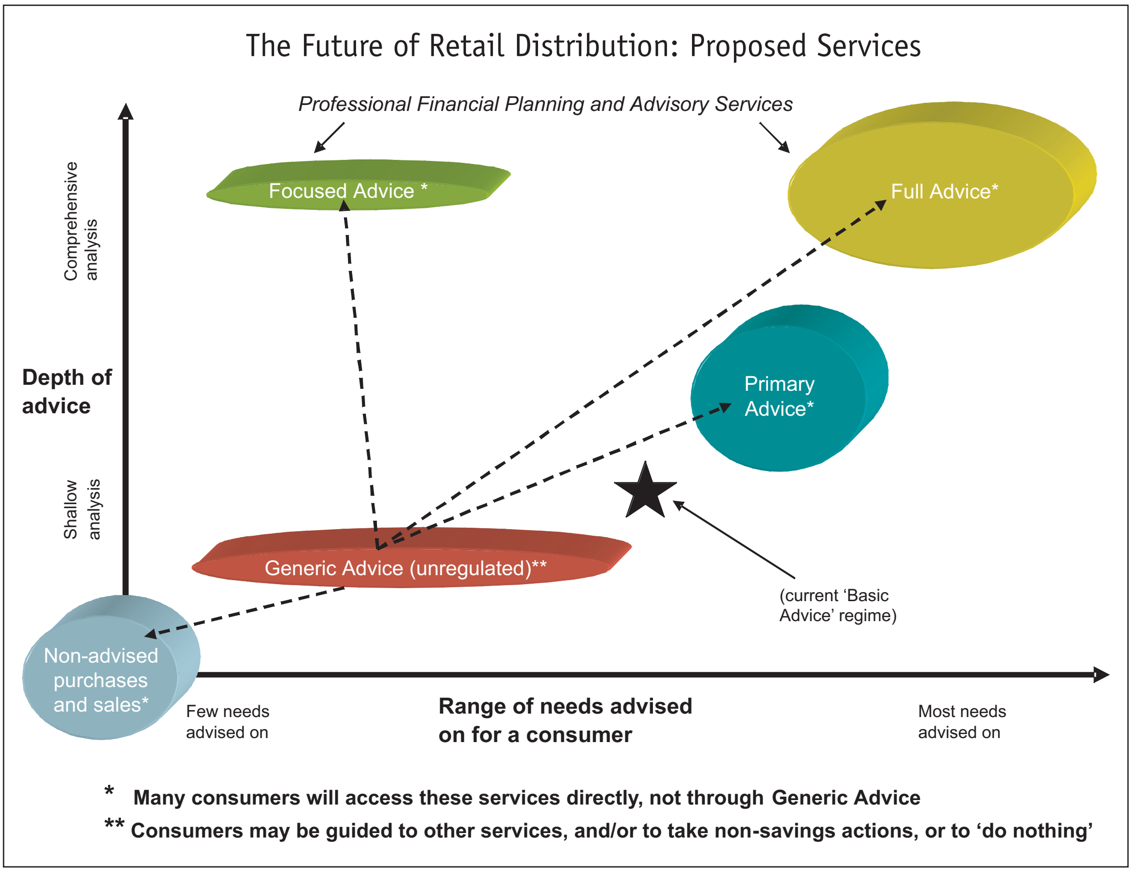
10 It may perhaps be most attractive to those consumers who earn or expect to earn, for example £25,000 to £50,000 a year, who need to save and have the means to do so. These are illustrative levels only, not based on any research. The comments we receive on this DP, in conjunction with the consumer research we now intend to undertake, will help us to refine the view of the characteristics and potential size of the likely target consumer segment



2.21 This diagram illustrates the differences between:

- full advice, which should cover the full range of needs in depth;
- focused advice, which is narrow in terms of the range of needs considered, but involves deep analysis of the needs within that range;
- Primary Advice, which is intended to cover a substantial range of savings (and possibly, protection) needs but with limited analysis of those needs in determining product recommendations;
- Generic Advice, which is likely to be personalised but unregulated in terms of the Financial Services and Markets Act 2000 (FSMA), giving help and guidance for consumers on their financial needs. The Thoresen Review will be working up ideas on the precise scope and degree of personalisation it will offer consumers, and on what sort of quality control or accreditation will be required for suppliers. It may be very limited in terms of the level of advice provided, and it may act as an important introduction to regulated services (although it would not be necessary for some consumers to start with Generic Advice before accessing other services); and
- non-advised purchases and sales, where consumers choose a particular product without being advised specifically to do so.

2.22 We have also shown on this diagram where the current Basic Advice regime might sit relative to these services – a narrower range of needs are addressed with less analysis of those needs than Primary Advice, and with a more limited range of (charge-capped) products than we envisage for Primary Advice.

Description of the proposed services

2.23 We outline in the following paragraphs how the main service types envisaged by the groups' proposals could be implemented, including by regulatory change where necessary. We welcome comments on whether these segment the market for advice in an appropriate way. We describe later how we think these proposals address key market problems.

Professional Financial Planning and Advisory Services - full advice

2.24 This service is likely to be targeted at consumers with more complex needs, typically more affluent consumers who want advice on their full financial needs. It is therefore not a new service but the groups propose that there should be high standards of professionalism (which will mean 'higher' standards for many firms and advisers). Such standards would relate to a combination of qualifications, behaviours and practices.

2.25 High standards of professionalism, as appropriate to their roles, would be expected of all individuals providing full advice to retail consumers on investment products in order to deliver good outcomes and to give consumers confidence and trust in the services supplied. This could apply to a wide range of advisers including, for instance, private client stockbrokers, investment management firms, private banks, high street banks, and building societies and financial advice firms.

2.26 There may be scope for professional guidance from more than one professional body. This guidance would help these professional bodies to set, and to police, higher ethical and behavioural standards for advisers.

2.27 We see scope for two different types of 'full advice' adviser:

- professional financial planners; and
- general financial advisers.

Professional financial planners – qualifying standards

2.28 To become a professional financial planner[11] might require passing examinations equivalent to, for example, the Institute of Financial Planning's 'Certified Financial Planner' status; or the Chartered Insurance Institute's 'Chartered Financial Planner' status; or the Securities Institute Diploma. Some professional financial planners may also be qualified as subject matter specialists, offering expert advice in areas such as pensions and tax planning.

2.29 For a professional financial planner, we may also require that remuneration practices operate in a way that reduces effectively any conflicts of interest that might otherwise inhibit them acting in the consumer's best interests. Our rules already require this, but we may wish to reinforce them for professional financial planners

11 The term 'professional financial planner' is used for the purposes of this paper to describe those advisers providing financial advice services who operate to the highest professional standards. We recognise that the term is already in use and may have other meanings in various sectors of the financial services industry

by requiring all remuneration to be determined with the customer's agreement. This would serve to reduce the conflicts of interest that can lead to inappropriate advice.

2.30 To facilitate this change in remuneration practices, we might re-define the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer and not influenced by the product provider. We could then require that all professional financial planners should be fee-based, according to this wider definition. The definition encompasses arrangements currently categorised as fees. It also includes commission payments, including those expressed as a percentage of on-going funds under management, but **only** where such payments have been determined with the customer's agreement. We would want to understand what forms such agreement might take. We also want to consider how the fee-based concept could be broadened to apply to different sectors of the industry, including direct selling businesses and banks, without giving competitive advantages to any sector.

2.31 Requiring common practices and standards for any adviser to be called a 'professional financial planner' may make it easier for consumers to know exactly what type of service they would receive from these advisers and what they will be paying for that service.

Professional financial planners – independence

2.32 We may also consider changing the conditions for using the term 'independent', which has an important brand value for many firms and advisers. The current definition of independent is based on the adviser's ability to review the entire market (as opposed to being tied to one or more particular product provider) and requires non-commission based remuneration options to be offered to consumers. The UK is unlike many other jurisdictions in having a significant independent advice channel[12].

2.33 If the market were to change as envisaged in this review, we may want the definition of independence to change, to signify more explicitly to consumers the concept of the adviser's freedom from potential provider bias, which we think is a more meaningful definition. The new definition could require that firms predominantly consist of professional financial planners. This would then also require them to be fee-based in accordance with the wider definition above, if we made fees a requirement of all professional financial planners. This approach to remuneration could then make the freedom from potential provider bias (and also, to an extent, from product bias and incentive to churn[13]) more evident to consumers.

2.34 But we are using this review to test whether we might go further. In defining independence, we are interested in whether it would matter, assuming all these changes were to occur, if the product range was limited. We would need to be satisfied that consumers would understand the implications of whatever conditions are set for independence, particularly if we did allow the product range to be limited. If independence were described in terms of the concept of freedom from potential provider bias, consumers would need to recognise that such freedoms only related to the choice of product from a clearly disclosed limited range. If there were

12 See Annex 3 on International comparisons

13 These issues were discussed in a speech in September 2006 by Callum McCarthy entitled '*Is the present business model bust?*' (http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0916_cm.shtml)

no restrictions on the extent to which product ranges could be limited, this would then mean that all professional financial planners could use the term ‘independent’.

Professional Financial Planners – regulatory implications

2.35 We would have to consider wider legal and regulatory implications of such changes, in particular resulting from EU legislation. We highlight possible considerations in Chapter 5. In addition, in DP 07/2[14] we consider some issues related to the current conditions for independence for firms using platforms. We also ask about the implications of platforms in considering more radical ideas for future changes.

2.36 For firms of professional financial planners, the proposals are intended to lead to lower risks of significant bias from remuneration structures which, combined with the highest professional qualifications, could limit the potential for mis-selling and enable more sustainable businesses. Fewer liabilities might arise and the income streams of these firms may become more consistent and provide a sounder financial basis on which to operate. Furthermore, if we adopted a risk-based approach to prudential requirements (combined with our risk-based approach to supervision), we might be able to offer meaningful incentives to such firms to maintain the highest standards.

2.37 We recognise that some firms, including several in the stockbroking sector, have already sought to raise their standards and have adopted practices more consistent with the nature of their services. For instance, when regulated advice is provided as part of a wealth management service, some have already moved to fee-based remuneration and require higher qualifications from their advisers.

Professional Financial Planners – grandfathering

2.38 We anticipate that current advisers would look to map themselves across to the equivalent role in the new distribution world, when such roles have been determined. Currently held qualifications might be carried over to the new world where directly equivalent, but it may not be desirable to ‘grandfather’ an adviser into a role for which that person did not hold either the required qualifications or an equivalent. This could mean many advisers not being able to fulfil immediately the role that they want to play in the new world.

2.39 An alternative approach might be to allow grandfathering, perhaps for a limited period during which time any advisers who do not have the necessary qualifications to be professional financial planners have to undertake relevant training and testing. This might help to move more of the industry faster towards adopting other practices, such as operating on a fee basis according to its proposed wider definition.

Questions

2.40 We have a number of questions on all the above proposals for professional financial planners where we would welcome comments.

> Q1: How will increased requirements and consequential higher costs of providing full professional financial planning services

14 DP07/2: *Platforms: the role of wraps and fund supermarkets*

affect advisory firms? Could the impact be significant enough for them no longer to offer these services, and, if so why?

Q2: Is it helpful to re-define the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer, and not influenced by the product provider? How would this work in the different market sectors?

Q3: Do you agree with defining 'independence' in terms of freedom from bias, even if the adviser only selects products from a limited range? How far should this be taken, if at all? Would an independent label still have value, if these ideas are implemented?

Q4: Should we allow, in principle, the grandfathering of advisers to the new professional financial planner role if they do not have the necessary minimum qualifications or an equivalent? If we did allow this, what might be the consequences and how should we then encourage advisers to secure relevant qualifications? If you think we should not allow grandfathering, why not?

General financial advisers

2.41 These financial advisers may continue to be able to provide similar services to now, but might not have the same range of in-depth knowledge or qualifications as professional financial planners. We may allow a full range of remuneration practices, and then apply a risk-based regulatory approach to provide material deterrents for certain practices unless the risks were clearly being well managed. Many general financial advisers may choose to operate on a fee basis (in accordance with our wider definition above) and there may be material regulatory incentives in place to encourage this. In taking a risk-based approach, we expect that there would be considerably more supervisory scrutiny on firms consisting of these advisers than for professional financial planning firms.

2.42 In taking forward the groups' ideas, we are interested in whether we should either mandate or prevent the use of certain remuneration approaches, as some consumer representatives (including the Financial Services Consumer Panel) have suggested, in particular for general financial advisers. We discuss remuneration issues in more detail in Chapter 3. We are also interested in views on how restricting the use of certain remuneration models might be achieved (recognising some of the issues in Chapter 5, in particular in relation to competition law).

2.43 In addition, we could apply risk-based prudential requirements which may mean a significant increase in the average prudential requirements for firms of general financial advisers, particularly if remunerated by traditional commission arrangements. The potential size of such an increase cannot be evaluated until after we receive the feedback on this DP, on DP07/4[15], and we have undertaken cost-benefit analysis. Where it is a relevant risk, insurers, banks, building societies and

15 DP07/4 – *Review of the Prudential Rules for Personal Investment Firms* – which will be published in early July 2007

those investment firms subject to the Capital Adequacy Directive (CAD) either already hold or will be expected to hold capital against operational risks arising from the giving of financial advice. These prudential requirements fall under our Individual Capital Adequacy Standards (ICAS) regime for insurers and the Pillar 2 regime for those firms subject to the CAD.

2.44 We do not think that general financial advisers should be able to call themselves independent. But they could work within the same firm as professional financial planners. Moreover, the incentives to become a professional financial planner might encourage up-skilling, creating a career path in which being a professional financial planner is something to which all would aspire.

2.45 We would want an increase in professional standards even for these advisers. The benchmark 'appropriate examination' could rise to a level equivalent to the Diploma in Financial Planning (formerly known as Advanced Financial Planning Certificate). Again, it may not be desirable to 'grandfather' an adviser into a role for which that person did not hold either the required qualifications or an equivalent. Furthermore, all advisers might be encouraged to sign up to the ethical code of a professional body because this may be an important and necessary step for advisers of all types.

Questions

2.46 We have a number of questions on the general financial adviser role, and its distinction from the professional financial planner.

Q5: Do you agree with the proposed distinction between professional financial planner and general financial adviser? If greater distinction is needed between general financial advisers and professional financial planners, how might this best be achieved?

Q6: Is there sufficient incentive for advisers to want to be professional financial planners? What further restrictions should we place on the permitted activities of general financial advisers, if any, and why? Should they have to offer a fee option?

Q7: Do you think that this two-tiered approach is desirable and, if so, should this be a transitional feature of the market or more permanent? Should there be any other classification of adviser offering full advice services beyond professional financial planner or general financial adviser?

Q8: What are the arguments for and against mandating the use (or preventing the use) of particular remuneration methods, for instance requiring the use of fee-based remuneration according to our wider definition by all advisers? What might be the market consequences if we took such action? How else might we encourage firms to adopt particular remuneration methods (or discourage the use of some others, for instance traditional indemnity commission)?

Q9: Should we allow, in principle, the grandfathering of advisers to the general financial adviser role if they do not have the necessary minimum qualifications or an equivalent? If so, how should we encourage (or require) any up-skilling to the necessary standards?

Professional Financial Planning and Advisory Services – focused advice

2.47 'Focused advice' has been put forward as another means of better meeting the needs of more consumers. It is advice limited to consideration of a number, often only one, of a consumer's complete financial needs. The consumer may have received some earlier guidance, leading them only to want help in a specific area.

2.48 In providing these services, the adviser would need to collect all relevant information to make a suitable recommendation to the consumer to address the specific issue or need. The adviser is able to limit the scope of the advice, but the depth of the advice cannot be limited. Our current Handbook already permits this type of advisory service, as will our new Conduct of Business Sourcebook from November 2007, but it is evident from feedback that many firms do not appreciate this.

2.49 Either professional financial planners or general financial advisers could offer focused advice if they were suitably qualified in the specific area of advice. By restricting consideration to a small number (possibly one) of a consumer's needs, the costs of providing the advice may be less than a full advice service. This may make it a more viable proposition for some firms, particularly those containing subject matter specialist advisers, than offering full advice. It may rely, however, on an effective means of appropriately guiding consumers towards these services, and on ensuring that consumers have sufficient understanding of the limitations of services being supplied.

2.50 We expect that most consumers using these services would have specific, albeit complex, needs and/or be in higher income groups. But it may also be appropriate for other, less affluent consumers to receive such advice, for instance in relation to their with-profits product holdings, as suggested in our recent Insurance Sector Briefing[16].

Primary Advice

Primary Advice services

2.51 We think that proposals for raising the standards for professional financial planning services could well increase their costs, potentially leaving more consumers without an adviser. Our aim, in line with the groups' proposals, is to encourage the development of services that give wider access to savings products and services for more consumers. Consequently, we are determined to work with the industry to establish a regulatory framework that encourages the supply of services to consumers with less complex

16 The Insurance Sector Briefing: '*Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders*' was published in May 2007

needs. These consumers may not be the target market for professional financial planning services which, in any case, may be more comprehensive than is necessary for them. We are willing to do whatever is required to help this happen, but only if we believe firms will respond, recognising that this may be one area where we would need to deviate from our preference for principles-based regulation.

2.52 Primary Advice is the working name we are using for a new type of regulated advice service that could cover a broad range of a consumer's needs, but where the analysis of those needs would not be as extensive as would be necessary for full financial advice. Primary advisers would establish sufficient information about a consumer to make personalised recommendations based on the main characteristics of the consumer. The process to arrive at the recommendations would be constrained to deliver similar recommendations for all consumers with similar characteristics. The advice might point a consumer towards a limited range of savings, pensions and, possibly, protection products. Primary Advice recommendations might not be as limited as Basic Advice.

2.53 The potential benefit of such a service for consumers is a quicker, more straightforward and therefore less costly advice process than a full advisory process. This could offer a well managed firm more opportunities to price such services more attractively for consumers, with higher margins for themselves to increase viability, encouraging the supply of these services.

Reducing the risks to consumers

2.54 To enable firms to offer this service, and to help them to manage the risks and costs to consumers and to their business, we may need to reduce significantly some of our existing suitability requirements – so far as the standards laid down by the general law allow. However, we would not do this unless we could mitigate the risks of inappropriate advice for consumers. There is a wide range of ways in which giving Primary Advice could be made less costly. Although we would also be willing to consider other measures, our immediate thoughts include, for example:

- Limiting product ranges through some form of product selection to minimise the level of any potential detrimental effects on the consumer of not selecting the most suitable product. Such ranges might encompass, but could be wider than, the current Stakeholder[17] suite. We refer to products meeting such criteria as 'simple' – this is intended to imply that the potential benefits, risks and other limitations can be easily explained to consumers, even though some of these products may still have complex constructions.

- Designing or otherwise endorsing the advice processes used to deliver such services, for instance through the use of 'decision trees' or approval of more sophisticated automated processes designed to match simple products to less complex consumer needs.

- Ensuring more effective ways for consumers to be aware of the nature and limitations of services supplied, and the underlying risks of any products purchased.

17 Stakeholder products are the cash deposit (a form of cash ISA); the medium-term investment product; the smoothed investment fund; the stakeholder pension; and the child trust fund

2.55 So although Primary Advice might not always lead to the **most** suitable product recommendation, it should lead to a consumer purchasing a product that would provide more benefit than if they had made no purchase at all. There may be a more appropriate trade-off between risks, costs and benefits in arriving at a recommendation for these consumers, leading to better outcomes. We will work with the Financial Ombudsman Service towards a framework aimed at giving greater clarity to firms on the suitability of advice in the context of these services. Moreover, if an adviser follows the limitations on processes and products in line with suggestions in 2.54 above, and complies with their obligations in the general law, the likelihood of successful claims will be significantly reduced. This might therefore encourage firms to develop more cost-effective ways of accessing more consumers, some of whom might not otherwise be served at all.

Potential suppliers

2.56 Firms and advisers offering Primary Advice services would need skills and qualifications appropriate to the services they provide. We would expect that a wide variety of firms might be interested in offering this service:

- Some would have access to a broad range and number of consumers, for example banks, building societies and insurers, and so have the scale to make this economically viable. These firms might choose to offer this service through their branches, by telephone or over the internet, possibly alongside non-advised offerings.
- Some financial advisory firms currently providing services to the consumer segments that may most need Primary Advice might find that by becoming a Primary Advice firm, the potential for reduced operating costs could improve their economic viability.
- There may be potential for a number of different types of firm to offer these advice services through employers at consumers' places of work (this is often referred to as 'worksite marketing').
- For some firms, a Primary Advice service could be ancillary but compatible with their core business, for instance mortgage or general insurance brokers. Some could be predominantly professional financial planning firms, but who also offer these services, in some cases providing a 'staging post' in the career development of their trainee professional financial planners.

Regulatory implications

2.57 We expect that firms offering these services would use a full range of remuneration models, including some traditional commission-based remuneration. However, we think that the combination of the risk mitigation measures we describe in 2.54 above, and a more risk-based approach to prudential requirements for personal investment firms, could reduce the risks of consumer detriment. For banks and insurers, as mentioned earlier, we already have in place prudential requirements for risk-based capital assessments which include consideration of the potential worst case losses resulting from the operational risk exposures of these firms.

2.58 Although the possibility of subsequent claims against advisers might be limited under our proposals, there is still scope to use regulation to incentivise better practices. For instance, there might be scope for areas of discretion in delivering Primary Advice, such as in selecting a product from an appropriate short-list. We would want to encourage better management of potential conflicts of interest for the adviser. So, for instance, we may also consider establishing conditions for advisers offering Primary Advice to be called 'independent', to provide a further incentive for adopting better practices.

Refining the proposals

2.59 We know that some will argue that other forms of 'simple' advice have been tried unsuccessfully before, but there are some key differences here, including:

- These services might be aimed at a wider segment of consumers than before. We are very clear that such consumers should be those who have savings (and possibly, protection) needs and the means to meet those needs.
- The introduction of Personal Accounts could leave a number of advice needs unaddressed for many in the target consumer segments, not least because they only apply to earnings below the 'upper earnings limit' which is currently around £35,000 a year, and they do not include provisions for dependants' benefits.
- The Thoresen Review will lead to a national approach to generic financial advice. Although it is not yet known how this will work, one likely outcome is a greater awareness amongst more consumers of their savings needs and of the types of service available to assist those needs. Many more consumers may choose, or be guided towards, Primary Advice, than is currently the case with Basic Advice, for instance.
- The measures we might introduce to limit advisory processes and products could lead to a more attractive balance between risk and return for supplying firms. We do not think that such limits should include price capping, as this might reduce potential returns thereby materially restricting supply, as appears to have been the case with the Basic Advice regime.

2.60 We intend to gather more data on the potential demand for a Primary Advice market as this review proceeds (and we recognise the overlaps with our current review of the Basic Advice regime). This will involve considering not only the size and profile of the consumer segment that such a service is aimed at, but also the appetite of firms to offer such services and the extent to which there is sufficient profit potential to encourage supply. We welcome comments on these and other relevant considerations.

Q10: What are likely to be the characteristics of the target consumer segments for Primary Advice?

Q11: Do you think there is enough potential benefit suggested by this DP for Primary Advice to become a significant advice channel in the UK? If not, what else might be done to encourage firms to enter such a market?

Q12: What should be the conditions for Primary advisers to be called independent?

Q13: Is Primary Advice the right name? Would use of the term 'information' instead of 'advice' give consumers more confidence to use these services? What might be the implications of using the term 'information'?

Generic Advice

2.61 The Thoresen Review is considering a range of models for achieving greater access to generic financial advice on a national scale. Generic Advice will not be regulated, hence it is not advice in a FSMA sense, but it will need to fit in alongside other, regulated, advice services. The scope of Generic Advice, including the extent of detailed analysis of a consumer's needs and whether certain 'simple' needs might be addressed as part of Generic Advice, is not yet clear.

2.62 Generic Advice offers the potential for consumers in low income groups to receive some form of financial guidance and help without resulting in an individual product recommendation (and therefore is not a regulated activity). But it need not be limited to such consumers.

2.63 One significant intended outcome of Generic Advice is an assessment of what (if any) route a consumer should take to access the market as a next step. So it acts as a possible entry point to other service types, particularly for less knowledgeable consumers. We believe that this might increase the demand for regulated advice services. We see such a service being particularly important in helping consumers to access the most appropriate service for their needs, as well as possibly encouraging savings behaviours and improving consumers' confidence and understanding in dealing with financial matters.

Non-Advisory services

2.64 These services are already permitted by our rules and are complementary to all advisory services.

2.65 We expect these services to be used by consumers in all segments. Some more affluent consumers may have the confidence to self-serve in this way. Less affluent consumers may be prompted by, for instance, the outcome of Generic Advice received.

2.66 The boundaries for regulated activities, including what activities constitute the provision of information as opposed to advice, may be an area for further guidance. New requirements for a range of non-advised activities are being introduced in our new Conduct of Business Sourcebook in November 2007, largely driven by our implementation of the Markets in Financial Instruments Directive (MiFID).

2.67 Although the scope of the RDR includes non-advised sales, few suggestions for significant market or regulatory changes have yet emerged. However, we are keen to hear of any barriers that inhibit the provision of non-advisory services when these are needed and wanted by consumers.

Q14: What issues in relation to non-advisory services should the Review consider, and why?

Other implications of service propositions

Consumers

2.68 In the view of the groups, all financial advisory firms need to aspire to high standards of professionalism and provide good quality advice and services. This would allow more consumers to be treated fairly and raise the general level of trust in the sector, although there may be a time lag between an actual rise in standards and improved consumer perceptions.

2.69 A wider range of services may make access to the market appear daunting and confusing for some consumers. This need not be the case if consumers have easy access to Generic Advice that offers to navigate them to the appropriate next steps. Next steps may include doing nothing, or being guided to non-advisory sales channels, or to a particular regulated advice service. The consumer would not need to make choices unaided, so it is questionable whether the market really would be more confusing for consumers than currently. Consistent branding of services may make it easier for consumers, and the financial press could have a role in helping more consumers to understand the range of services available.

Q15: What are the possible implications for consumers, if the proposed market for advice is introduced?

Q16: Would the ideas put forward help more consumers to access financial advice relevant to their needs? Do you have other ideas?

Product Providers

2.70 Our wider definition of fee-based advice may mean that product providers would have to compete more on the basis of the quality and price of their products, and the quality of their services to consumers and distributors, rather than driving demand through adviser remuneration. This would be consistent with one of our aims for this review. However, it may have fundamental implications for provider firms' product strategies and their new business mix.

2.71 For those firms offering products for Primary Advice, there are potentially significant implications depending on the nature of any limitations applied to products that can be sold, and whether it is the FSA or the firms themselves who assess adherence to such limitations.

2.72 For product providers offering more complex products, the segmentation of the market for advice could lead to sales of their products being even more focused on more affluent consumers, so average amounts invested might rise, potentially leading to higher profit margins. This might help to offset the effect of no longer being able to use commission to drive market share.

Conclusions

2.73 We set out in 2.4 and 2.5 the main problems that we intend this review to address, using ideas derived from the groups' proposals. It is too early to assess whether individually or collectively the proposals go far enough to address all the problems. We are using this DP to ask for feedback on potential costs and benefits, and to seek views on the potential consequences for different sectors of the industry. We are also planning to undertake further research to help us to draw conclusions and determine an appropriate regulatory framework. We set out some early arguments on the potential costs and benefits of industry proposals in Annex 2.

2.74 We can, however, make some high-level comments on the particular problems outlined in 2.4 and 2.5:

- Complexity of products and services, and consumer understanding: while this review is not seeking to address financial capability, proposals for better segmentation of services together with incentives for greater clarity for consumers and more involvement in determining adviser remuneration could in the longer term improve consumer engagement and influence. Product providers could have more incentive to design less complex products if they were to more often compete on the basis of product and service quality and price rather than on the basis of commission.
- Mis-alignment of advisers' interests with those of consumers: proposals for higher professional standards, incentives for better risk management, and for customer involvement in determining adviser remuneration may reduce this potential risk if adopted by firms, depending on how such proposals are implemented.
- The costs of poor quality advice may not be fully faced by advisers: the combination of proposals for higher professional standards and for customer involvement in determining adviser remuneration may reduce the risks of poor quality advice. Risk-based prudential requirements may provide further incentives to eliminate the practices that give rise to poor quality advice. Primary Advice might be based on a limited range of more straightforward products with streamlined advice processes to reduce uncertainty.
- Costs of implementing regulatory requirements limiting access to financial advice to more affluent consumers: proposals for Primary Advice are intended to provide supplying firms with a lower cost route to consumers (including to consumers who might otherwise become less attractive to suppliers of full professional financial planning services if the proposals in this DP are implemented).
- Advisers do not currently need high enough qualifications nor operate to high enough standards: proposals for higher professional standards would address this.

2.75 We can see potential for a significant change in the reputation of the industry, but much will depend on how firms react to the proposals and on how they adapt to the regulatory environment that may then be implemented.

> Q17: Do you think that the view of the future distribution market for investment products set out in this DP can address the current market problems? If not, why and what could?
>
> Q18: Will many firms make significant changes to their business models? If so, why and how? If not, why not?

Making the transition

2.76 In view of the scope and scale of changes that might flow from this review, we think there will need to be a gradual transition to minimise the upheaval which may inappropriately damage supply, and potentially cause consumer detriment. On the other hand, we cannot allow the change process to take so long that market inefficiencies persist for longer than necessary, and we risk not maintaining the momentum for change.

2.77 Although there is a high degree of inter-dependence between many of the ideas, it does not necessarily follow that some ideas cannot be implemented faster than others. We will want to give more consideration to this matter in the coming months.

2.78 We have brought out a number of issues relating to how the market might transition earlier in this chapter. We are particularly keen to receive views on two subjects:

- How (if at all) advisers should be grandfathered into the new market for advice.
- Whether general financial advisers should be a permanent or transitional feature of the market.

2.79 We are also interested in the role we can play in helping firms to make changes to their business practices and standards.

> Q19: We welcome views on what would represent a sensible transition period for the industry.
>
> Q20: In what ways could we help firms to change their business practices and standards to adapt to new requirements that might emerge from this review?

3 Professional financial planning and advice

Introduction

3.1 We have described in Chapter 2 how the provision of financial advice and services might be tailored to the needs of a wide range of consumers in a way that is economical for both the providers of and recipients of advice and services. We explained how the ideas that have been put forward by the groups, and by others who have input to this review, might lead to a market that could be divided into:

- those full range and specialist financial planners and advisers serving predominantly affluent consumers who need advice on complex financial matters with the full range of products (professional financial planning and advice); and
- those providing more straightforward advice on simple products to consumers (Primary Advice).

3.2 In this chapter, we consider the professional financial planning and advice services by presenting the ideas of the relevant groups and outlining some more detailed questions arising from the work of these groups. We focus on three key areas relevant to these services, which have been considered by three of the groups looking at delivering solutions to address the past problems of the industry:

- standards of professionalism that reflect and clarify the services being offered to consumers;
- regulatory and prudential standards that are consistent with firms' risks from current business activities and that also encourage better management of liabilities from past activities; and
- remuneration structures that are transparent, understandable and do not conflict with acting in the best interests of consumers.

Standards of professionalism to reflect the services provided

Issues to be addressed

3.3 We are told that the retail investment and in particular the financial advice sector suffers from a poor reputation among consumers and other financial firms. One reason for this is the perceived lack of professionalism in the sector. The Professionalism and Reputation Group believed this has arisen as a consequence of related factors such as low academic entry criteria, weak benchmark entry examinations and a sales-led culture. So if we want to improve outcomes for consumers, we need to address these concerns. To do so would mean raising the professionalism of all those giving financial advice, so that they might begin to meet the expectations of consumers, building their trust and enhancing the market's reputation.

3.4 A clear consensus emerged from the group that practitioners need to become more professional and that the services offered in the retail market must be supported by high professional standards, differentiated to reflect those services. We believe the market is best placed to deliver this. We have already seen significant improvements in some parts of the sector, but we want to help the market continue to improve. Regulation has a role to play in providing the incentives for firms to reach higher standards.

3.5 The group has put forward a number of recommendations to achieve greater professionalism:

- higher standards of competence and behaviour in retail advisory staff at all levels;
- clearer presentation of retail advisory services to consumers; and
- an enhanced role for industry and professional bodies.

3.6 We support these ideas and are keen to encourage a distribution market where all practitioners, irrespective of their role or level of seniority, are regarded as professional, just as we expect nurses, radiologists, GPs and surgeons to be professional within the medical profession, irrespective of the different roles they fulfil. In recent years, financial advice practitioners in countries such as South Africa and Australia have managed to improve their professional standing and the UK should be able to learn from these experiences.[1]

Higher standards of competence and behaviours

3.7 The group proposes raising the bar in terms of both qualifications and behaviours. Improving professionalism is about improving technical knowledge, capabilities and behavioural standards, all differentiated according to the level of service being provided.

1 See Annex 3: *International comparisons* for further details

Qualifications

3.8 We think this could mean that for the general financial advisers described in Chapter 2, the difficulty of the benchmark 'appropriate examination' might rise from the level currently represented by the Certificate in Financial Planning[2]/Certificate for Financial Advisers[3], to a minimum level of Diploma in Financial Planning[4]. For Primary advisers, a minimum 'appropriate examination' might be at the level of the Certificate in Financial Planning.

3.9 The group anticipates that becoming a professional financial planner would mean becoming accredited to a minimum equivalent of, for instance, the Chartered Insurance Institute's 'Chartered Financial Planner' status or the Institute of Financial Planning's 'Certified Financial Planner' status. It also felt that advisers without the necessary qualifications to fulfil their target role would need to undertake further study within a designated transition period.

> Q21: Do you agree that these qualifications are at the right level for the roles described?

Role profiles

3.10 To make this happen in practice, the group has recommended the introduction of role profiles for each type of adviser. Role profiles would encompass the technical requirements (for example examinations; capabilities) and behavioural requirements (for example ethics; experience) needed to perform each role. These would also include tailored recommendations for annual Continuing Professional Development (CPD).

3.11 The group felt that distinctions between roles would be drawn by building different role profiles, encompassing similarities in some areas (for example in terms of ethics), but differences in others (for example qualifications; CPD). On our part, we could work with the industry to identify the necessary roles and their relevant profiles but we would see this being for the industry to lead.

> Q22: Do you agree that there would be clear benefits for consumers of introducing role profiles?

3.12 To the extent that the role profiles that emerge from this review are consistent with the overall picture painted in this DP, there will be several characteristics. The group anticipated they would be simple and clear to practitioners and consumers alike; there would be a small number of different roles; and they would need to bring consistency across the advice market. We might need to change our regulatory requirements to help these work in practice.

3.13 However, we are likely to want to stick to our principles-based approach to Training and Competence and recognise that our Consultation Paper CP 07/4 'The Training and Competence Sourcebook' moves us towards a less prescriptive approach to

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2 Offered by the Chartered Insurance Institute and formerly known as the Financial Planning Certificate (FPC)

3 Offered by the ifs School of Finance

4 The Diploma in Financial Planning was formerly known as the Advanced Financial Planning Certificate (AFPC). A similar upwards shift in benchmark has been undertaken in Ireland. See 'Case Study: Raising the Bar' in Annex 3 for further details

qualifications. This purposefully leaves scope for changes to requirements on the retail side if required. In addition, the Financial Services Skills Council is responsible for setting and raising examination standards and would be a key stakeholder in establishing role profiles of this nature.

> Q23: What role should regulation play in helping to make the necessary changes to qualifications and behaviours?

Better labelling of services

3.14 The group was clear that consumers need to understand better the services being offered by firms and that the industry needs to be clearer about the services that firms are offering to consumers. The group wanted to improve the labelling of services and increase the delineation around the service any individual adviser is able to offer, producing a more consistent experience for the customer of what they are getting and what they are paying for.

3.15 Consequently, the group suggested that advisers are given defined labels that are more closely aligned with what they do. This would help to create a career path with professional financial planners at the top. A clear career path would also help to attract high-calibre talent to the market.

3.16 We support these ideas and think these could be consistent with the adviser tiers described in Chapter 2[5]. The descriptions suggested by the group[6] are different to those we have set out in Chapter 2 because we have incorporated the ideas from the other groups, particularly around simple products and services. However, we believe that the proposals in Chapter 2 do bring clarity to the services offered, introduce clearer labels and could help consumers understand the service being provided.

3.17 We think these ideas would mean firms being able to offer a range of services (different advisers with different role profiles) to consumers. This would further enable us to distinguish between firms of advisers operating at the very highest standards of professionalism and those operating below those high standards. Role profiles and labels fit well with the overall path the groups envisage and the distinction drawn between professional financial planners, general financial advisers and Primary advisers.

> Q24: Do you agree that better labelling of available services would help in building the professionalism and reputation of the sector and in making services clearer to consumers?

Enhanced role and focus of professional bodies

3.18 The group concluded that the main way of achieving higher standards of competence and behaviour, and better labelling of services, would be to enhance the role of the professional bodies. We support this idea. It would involve the

5 These labels would be consistent with the role profiles described above

6 The group proposed a four tier model encompassing professional financial planning, financial advice, information based sales (no advice) and generic advice

industry leading the way and is consistent with our move to principles-based regulation. A summary of the group's recommendations for how to enhance this role is provided in Box 2:

Box 2 – The role of professional bodies

Membership

- Strong encouragement by way of incentives for financial advisers of all types to join a professional body such as the Personal Finance Society or the Institute of Financial Planning.
- An environment where membership is desirable and where non-membership is taken as a signal of a poor practitioner.
- Non-compulsory membership of professional bodies. In other words, it may be possible for someone to give financial advice without being a member of a professional body. This is because it would be undesirable to bring those who have no intention of acting professionally into a professional body.

Training

- Involvement of professional bodies in developing and maintaining role profiles, for instance in determining CPD requirements.

Information sharing

- Close liaison between professional bodies and the FSA about the behaviour of individual practitioners so that action can be taken and enforced through barriers to entry and/or exit.
- Greater transparency, making advisers more individually accountable through an improved mechanism for sharing information about the history of advisers[7] – for instance, an expanded FSA Register, or a service run by the professional bodies. This would help employers to recruit advisers with good records, and disincentivise the recruitment of poor advisers.
- Trade and professional bodies that collect tip-offs about individual practitioners from firms and that help to police the market; for instance by notifying the FSA of the misuse of labels describing services to consumers.

Sanctions

- More effective sanctioning power by the professional bodies, involving transparency about decisions taken and disciplinary boards with lay representation.
- Consideration of a new shared disciplinary body to make determinations on inappropriate behaviour i.e. to enforce fines on individuals and potentially 'strike off'. This would be in a professional sense, rather than a regulatory sense.

7 The main legal issues, in particular relating to sharing information about the history of particular advisers, are highlighted in Chapter 5

It could be set up in conjunction with the FSA, with appropriate co-ordination with professional bodies.

Regulatory dividends

- Regulatory dividends for firms with better qualified, better controlled advisers. This could take the form of a risk-based approach which determines the level of regulatory scrutiny, but would be unlikely to result in lower fees. Tiered professionalism among advisers could complement our risk-based approach by enabling us to focus our supervisory efforts on less professional firms.

3.19 We could see a role for strong professional bodies, where good advisers want to belong and are recognised for their commitment to high standards, as has been successful in Australia for example[8]. This should mean poor advisers being declined membership and recruiters looking unfavourably upon a candidate who does not belong to a professional body.

> Q25: Do you agree with these proposed measures to enhance the role of professional bodies and do you think these would make a difference to the professionalism of the financial advice sector?

3.20 Making many of these ideas a reality would appear to lie in the hands of the industry. If there is consensus that this is the right way forward, there is no reason why firms, professional bodies and other key stakeholders cannot start working together now to achieve this change. We will, of course, encourage industry-led initiatives wherever this leads to the achievement of higher standards of professionalism and greater confidence for consumers.

> Q26: Do you agree with the overall recommendations of the Professionalism and Reputation Group?
>
> Q27: Do you have other suggestions for how the overall aim of raising professional standards and enhancing the reputation of the market could be met?
>
> Q28: What role should we play in raising professionalism, as opposed to relying on the professional bodies? Or, can the industry lead the way in delivering improvements?

Regulatory and prudential standards to manage liabilities

Issues to be addressed

3.21 In scoping the RDR, we sought to identify ways to improve the long-term viability of distribution channels by considering the sustainability of the market. We want consumers to have confidence that firms will be able to deliver on their longer-term commitments, and thereby reduce the potential for calls on the compensation scheme.

8 See Annex 3: *International comparison,* 'Case Study: A strong professional body'

3.22 Some have challenged the suggestion that the sector is not sustainable. Of course it is possible to be profitable in the sector while treating customers fairly, and many, but not all, firms have been able to meet compensation payments when required. Our view is that well-managed firms, which treat their customers fairly, should be given regulatory incentives for doing so, and it should be these firms that benefit from regulatory change.

3.23 Industry practitioners see the difficulty in quantifying the liabilities associated with giving financial advice on retail investment products as the biggest barrier to the long term viability of the sector. The nature of these investment products means it may not become apparent that advice received by a customer was inappropriate for many years. Many in the industry have also told us that a material element of this uncertainty arises from the belief that the FSA and the Financial Ombudsman Service (FOS) may judge the advice by the standards of the time it is judged, not the standards of the time it was given. Although our Handbook provides that the FOS will take into account, among other things, what it considers to have been good industry practice at the time advice was given[9], and the FSA has sought to reassure the industry that regulatory requirements will not be redefined retrospectively[10], this concern appears to remain. To help the industry, the FOS has indicated it will commission an independent review which will, amongst other things, examine whether it is making the most effective use of the information it holds to improve the understanding of firms and consumers with the specific aim of clarifying its decision-making[11].

3.24 As well as the uncertainty a firm faces about its own advice, firms face an additional uncertainty relating to the costs they will have to pay each year because of other firms' poor advice, through their contribution to the Financial Services Compensation Scheme (FSCS) to cover the liabilities of firms that have defaulted. In other words, firms face uncertainty about their own advice liability, and the cost to them of others' liability.

3.25 The industry believes this uncertainty is the root cause of a number of problems associated with retail distribution, having several effects:

- uncertainty for businesses, making them more difficult to manage;
- a sub-optimal professional indemnity insurance (PII) market, which has difficulty pricing the risks and where alternative forms of risk transfer have not evolved;
- discouragement of investment in distribution businesses, and discouragement of ownership of distribution businesses by large firms. Instead many product providers prefer to distribute through others;
- creating incentives for advisory firms to close, leaving liabilities behind; and

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9 See section 3.8.1R of our dispute resolution sourcebook (DISP) (http://fsahandbook.info/FSA/html/handbook/DISP/3/8)

10 See document entitled '*Clarifying 'mis-selling': a note by the FSA*' published on 17 July 2003 (http://www.fsa.gov.uk/pubs/other/mis-selling_note.pdf), and speech entitled '*Retrospective action by the regulator – past, present and future*' by Stephen Bland, Director, FSA Small Firms Division, on 8 June 2006 (http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0608_sb.shtml)

11 See document entitled '*Principles-based regulation – Focusing on the outcomes that matter*', published in April 2007 (http://www.fsa.gov.uk/pubs/other/principles.pdf)

- preventing greater access to retail investment products by the mass market because many firms consider the risk-adjusted returns from providing services to be insufficient.

3.26 We set out in Chapter 4 how some of these issues might be addressed through a regulatory framework that provides simple advice around simple products. Here we explore the Sustainability Group's ideas on how to address the root causes and ensure more effective management of the latent liabilities associated with the giving of investment advice.

Effect of liabilities arising from advice – the group's proposals

3.27 The group believed there are three fundamental elements, which are interdependent, to realising a more sustainable distribution sector:

- a risk-based system of financial resource requirements for all personal investment firms which includes regulatory dividends;
- effective oversight of smaller firms by the FSA and others; and
- a binding limitation period on complaints and claims relating to advice.

3.28 In addition, the group proposed a cross-stakeholder agreed statement of consumers', distributors' and providers' responsibilities[12].

Increased, more risk-based prudential requirements for personal investment firms

3.29 The group proposed increased and more risk-based prudential requirements[13] for personal investment firms to ensure more capital and/or insurance cover is available to meet claims, and that the level should be consistent with the requirements for other types of distributors of retail investment products. The group has given considerable thought to how this might work for personal investment firms. It concluded there should be a step change in the quantum and quality of capital held by personal investment firms, with financial resources requirements based on the following high-level principles:

- Simplicity is vital, with a standard minimum approach available to small firms to avoid costs of complexity.
- Financial resources requirements should be risk-based, starting from a higher minimum requirement than at present, but avoiding a 'one size fits all' approach.
- Parameters for setting financial resources requirements might include: turnover, adviser numbers, type of advice, type of remuneration, levels of complaints, existence of back book, qualifications and training. Parameters should capture the risk associated with advice that did not lead to a product purchase (for example, advice not to make or change an investment).

12 This proposal by the group is covered in paragraphs 3.41 to 3.44. The FSA will publish guidance on the responsibilities of providers and distributors for the fair treatment of customers in July 2007

13 For a personal investment firm with fewer than 26 advisers, and which does not hold client money, this is presently capital of £10,000 plus PII cover

- Alternatives to capital such as PII cover should be explored on a like-for-like basis, reflecting the cost of capital versus the cost of insurance.
- Risk-based means taking account of diversification and size of firm. Subject to a minimum financial resources requirement, there should be a regulatory dividend for having robust management, systems and controls.
- Effective PII, including run-off cover or equivalent, should act as a risk mitigant and thus offset some element of capital (but not completely replace the need for capital).
- The ways in which firms may ensure availability of amounts, equal to capital required by prudential rules, should be specified (for example, cash or a bond from a bank).
- Requirement to hold higher levels of capital alone will neither improve firm or adviser behaviour nor enhance consumer protection so should be combined with more robust small firms oversight.

The group envisaged these proposals applying to all personal investment firms. Chapter 2 explains how these link with the proposals from other groups and our wider view of the future of retail distribution. Separately, but in parallel with the RDR, the FSA is undertaking a review of the prudential requirements for personal investment firms[14], as explained further in Para 3.47 below.

> Q29: Do you agree with the group's view that a system of risk-based financial resource requirements for personal investment firms, with a higher minimum requirement than at present, and which includes regulatory dividends, will contribute to better outcomes for consumers and a more sustainable distribution sector?

3.30 The group recommended that personal investment firms that close down be required to make some provision or arrangement for liabilities to customers which may come to light after they cease trading. This could, for example, take the form of having a bond or PII run-off cover in place for a specified number of years after closure, perhaps reducing year-on-year, or restrictions on withdrawing capital from the firm for several years after cessation of trading. If this reduced claims against FSCS, personal investment firms (as a sector) may experience a reduction in FSCS levies.

> Q30: Do you agree that firms that give financial advice should be required to make some provision or arrangement for liabilities to customers which may come to light after they have ceased trading?

Improved controls over advice by smaller firms

3.31 Some representatives of larger firms we have spoken to believe that compliance systems and controls are inadequate in some small personal investment firms. They argue that there is a high risk of significant compensation claims being met by the

14 DP07/4 – *Review of the Prudential Rules for Personal Investment Firms*, will be published in early July 2007

FSCS, and recovered through levies on the industry. They attribute this to ineffective supervision by the FSA. We do not agree that supervision is ineffective[15]. If this were the case we might expect to see a significant shift from networks to direct authorisation, but this is not happening. In the twelve months from April 2006 to March 2007 the figures for network financial adviser appointed representatives show an overall decrease of around 19 per month, an annual decrease of about 3%. These figures include those exiting the market as well as those applying for direct authorisation. In the first quarter of 2007, appointed representative financial adviser firms rose by over 150. There has been an increase of 29 new directly-authorised firms each month over the April 2006 to March 2007 period, equivalent to about 7% in the overall number of financial adviser firms, but only about a quarter of new authorisations were identified as network leavers.

3.32 That said, we are always seeking to improve our risk-based supervision and are currently considering ways in which we could do this, including by more risk profiling of individual firms and targeted action against those with indications of lesser levels of compliance.

3.33 The group made three main recommendations to enhance the effectiveness of the current regulatory framework for smaller firms[16]:

- an individual risk rating for all smaller firms supervised by the FSA;
- collection of appropriate data from smaller firms and other sources to support risk rating of firms; and
- regulatory oversight of smaller firms could place reliance on a wider network of bodies including the FSA, compliance consultants, networks, service providers (subject to no conflicts of interest), trade associations and professional bodies.

3.34 The group's view was that the FSA would thus be able to move to a principles-based approach to regulating small firms, knowing that well-resourced larger firms/bodies were partners in compliance support and oversight. For all parties to have confidence in such a system the various players being relied on would have to be able to prove the value they were adding.

3.35 We do not believe authorising compliance service providers under the Financial Services and Markets Act 2000 would be appropriate because they do not provide financial services to consumers. However, we may be able to use the results of the service providers' guidance to small firms more pro-actively in our supervision and regulatory activity. This may mean that small firms are given incentives to employ compliance service providers to advise on how to ensure the quality of their advice, and provide quality assurance. These incentives could take the form of reductions in risk-based financial resources requirements. We could only do this, however, where we were able to satisfy ourselves that the compliance service provider was itself capable of making assessments that we could take into account.

15 See speech entitled '*Small firms – under the radar*' by Stephen Bland, Director, FSA Small Firms Division, on 22 May 2007, which can be found at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/ 0522_sb.shtml

16 The group defined smaller firms as those which do not have a dedicated FSA relationship management team

Q31: Do you agree that giving small firms incentives to employ compliance service providers will help increase the quality of their advice? Do you have other ideas on enhancing supervision of small firms and what are they?

A time limit on the period within which claims can be made

3.36 At present, the FSA's Rules require complainants to bring complaints to the FOS within six years after the event complained of or (if later) within three years from the date on which the complainant became aware (or ought reasonably to have become aware) that he or she had cause for complaint. But the Rules do not set a 'long-stop' time limit within which claims must be brought, in the way that the Limitation Act 1980 (and the Prescription and Limitation (Scotland) Acts 1973 and 1984 in Scotland) set limits for claims in negligence. A 'long-stop' time limit would mean that a claim could not be referred to the FOS more than a specified number of years (for example 15) after the event complained of, irrespective of when the complainant became aware (or ought reasonably to have become aware) that they had cause for complaint.

3.37 The group proposed changing the FSA's dispute resolution sourcebook (DISP) so that time limits set by the FSA for referring cases to FOS include a 15-year 'long-stop' such as applies currently to cases taken through the courts.

3.38 The introduction of such a 'long-stop' time limit may result in consumers not receiving compensation if they do not become aware that they have cause for complaint until more than 15 years after the event to which the complaint relates. Paragraphs 3.39-3.40 discuss the steps the industry could take to increase the likelihood that valid claims are identified within a 15-year period. Clearly further consideration of the potential detriment to consumers from introducing such a 'long-stop' would be necessary. In addition, the potential benefits to consumers of more firms entering the financial advice sector because of reduced uncertainty about liabilities, and increased likelihood of claims being identified would need to be considered.

Q32: Do you agree that we should consider changing the time limits we set for the periods within which cases can be referred to the FOS by introducing a 15-year 'long-stop', such as applies in the courts?

Q33: What do you consider to be the risks and benefits of introducing a 15-year 'long-stop'?

Q34: Should this 15-year 'long-stop' apply to business undertaken before and after the introduction of this 'long-stop'?

3.39 As mentioned above, DISP includes a time limit on the period for making a complaint of three years from the date on which a customer becomes aware (or ought reasonably to have become aware) of a cause of complaint. The group proposed that the industry, the FSA and the FOS seek to identify 'post sale' circumstances that trigger the start of the period during which a consumer becomes aware of a cause to complain, how these circumstances can be triggered, and how this can be proved. It used the example of mortgage endowments, where the industry sent 'red letters' to customers which made them aware they might have grounds for complaint.

3.40 Arrangements, such as providing regular information to consumers comparing current market value to the original investment, that might trigger valid complaints, would be in the interests of consumers, and could give firms greater certainty about potential complaints liabilities by bringing them to light earlier (of course, poor investment performance is not grounds for complaint, but it may indicate poor advice). We would have to amend our Handbook to make such an arrangement binding on consumers. We may not be able to give firms the certainty in this area that they would like because it may be difficult to specify all such circumstances that would trigger a complaint. However we are willing to consider what clarity we can provide.

Q35: Do you agree that stakeholders should try to identify circumstances that may prompt valid complaints at an earlier stage, and within a 'long-stop' period?

Q36: Do you agree that stakeholders should seek ways of ensuring that measures taken by the industry to prompt valid complaints are taken into account when deciding whether a consumer was aware that he or she had grounds for complaint?

Cross-stakeholder agreed statement of consumers', distributors' and providers' responsibilities

3.41 We have been told many times by people in the industry that consumers have little or no responsibility for their decisions when purchasing retail investment products, but that they should recognise they do have such responsibilities. Some refer to this as 'caveat emptor'. The Financial Services and Markets Act 2000 does not give us powers to impose obligations on consumers which exceed their obligations under the general law. In 2004 and 2005 the FSA's Consumer and Practitioner Panels considered whether consumers should have 'responsibilities'. But they were unable to agree on whether what were considered sensible consumer actions could or should be described as responsibilities for the consumer[17].

3.42 The Sustainability Group recognised that use of the phrase 'caveat emptor' is emotive because for some people it suggested that the buyer is entirely responsible for his/her decisions, and therefore actions. However the group felt that consumers should have some responsibility for their own actions, and that a point between the extremes of, on the one hand, the consumer having no responsibility, and on the other being on his/her own, is desirable.

3.43 The group recommended that the industry, the FSA, the FOS, FSCS, the Office of Fair Trading (OFT), consumer groups, and Government draft and seek agreement on a cross-stakeholder statement of consumers' legal responsibilities.

17 See speech entitled '*What does caveat emptor mean in the retail market for financial services?*' by FSA Chairman Callum McCarthy to the Financial Services Forum on 9 February 2006 (http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0210_cm.shtml)

3.44 In our April 2007 paper 'Principles-based regulation – Focusing on the outcomes that matter' we said we would discuss further with a wide range of consumer groups, practitioners and industry bodies how we might be able to tackle the challenge of achieving, where possible, a greater degree of clarity about the respective roles and responsibilities of consumers and firms in their dealings with each other.

Q37: If it is not possible to agree on consumer responsibilities, would it help to agree on a set of 'sensible consumer actions' when buying a retail investment product, which could be made available to consumers and taken into account when considering complaints, even if these are not legal obligations on consumers? Do you have other suggestions?

Effect of liabilities arising from advice – greater certainty about the standards against which advice will be judged

3.45 In addition to the group's main proposals, during the course of the Review a further idea was proposed that might give firms greater confidence to own and invest in distribution, and improve consumer confidence. This is to develop further the idea behind the Association of Independent Financial Advisers' 'Stakes in the Ground' initiative[18]. This would involve a group with strong industry and consumer representation and credibility preparing a document which records good contemporary market practice for advising in different scenarios and on different types of product. Revised once a year, this would be referred to in considering advice many years after it was given.

Q38: Do you agree that preparing a record of good contemporary market practice, by a group with strong industry and consumer representation and credibility, would lead to greater certainty about the standards against which advice will be judged?

Q39: What do you think the cost of preparing a record of good contemporary market practice, and revising it annually, might be?

3.46 Absolute certainty about whether we or the FOS will conclude a particular piece of advice was reasonable cannot be given. Again, as we noted in our recent document 'Principles-based regulation – Focusing on the outcomes that matter', the FOS plans to commission an independent review. Amongst other things, this will examine whether it is making the most effective use of the information it holds to improve the understanding of firms and consumers with the specific aim of clarifying its decision-making.

The FSA's Review of prudential requirements for personal investment firms

3.47 Separately, but in parallel with the RDR, we are reviewing the prudential requirements for personal investment firms. We will publish a separate DP in early

18 AIFA developed the Stakes in the Ground concept to document current financial services practice and process as a point of reference to be drawn on in future as evidence of how business was conducted at a given point in time. See http://www.aifa.net/news/research.php

July 2007. That DP will set out our market failure analysis of consumer detriment from mis-selling and FSCS levy-payer detriment and the usefulness of capital and other prudential requirements to mitigate this detriment. Within that framework, the DP covers the proposals relating to prudential requirements for personal investment firms raised for discussion by this DP. For example, it considers whether risk-based prudential requirements may be effective within an incentives-based package to encourage better quality of advice by personal investment firms; and whether firms which leave the market can leave resources to fund compensation for claims that arise at a later date.

3.48 We recognise that an incentives-based approach to improve quality of advice by personal investment firms that includes risk-based prudential requirements and, possibly, incentives to employ third party compliance support, may raise barriers to entry (and operating costs) for some prospective personal investment firms, as well as impacting some firms already in the sector. However implementation of a package that reduces advice liabilities, and the uncertainty surrounding them, may make entry to the financial advice sector more attractive than at present.

Q40: What regulatory incentives, in addition to risk-based prudential requirements, do you think would encourage financial advisory businesses to improve the quality of their advice?

3.49 We want both the Sustainability Group's views, and the feedback on the DP on prudential requirements for personal investment firms, to inform this debate.

Transparency of remuneration

Issues to be addressed

3.50 In our view, treating customers fairly is central to building a sustainable business. We discussed in Chapter 2 how the basis of adviser remuneration can lead to biased advice and inappropriate product purchases, and can therefore undermine the long term viability of a firm. In tackling these issues we are aware of the dangers of proposing radical changes that may help to address one problem but may also cause new problems to emerge. This illustrates the need to examine the issues, and potential solutions, with great care to avoid unintended consequences.

3.51 Remuneration issues in this sector, and in particular commission-based sales, are often the most talked about by the industry and by the financial media. The debates typically centre on the virtues of fees as opposed to commission. These debates are often inconclusive, not least because the issues are difficult and there are advantages and drawbacks with all methods of remuneration. Part of the difficulty may be that the advantages and disadvantages often differ according to the nature of the firm and its services, and the typical profile of its customers.

3.52 It is also evident that consumers find the issues difficult. Many consumers do not fully understand how advisers are paid despite significant disclosure requirements over many years. There is a common perception that advice is free if the adviser receives commission, because this is paid for by the product provider. In addition, there is a generally held view that many consumers, particularly in the mass market, will not pay a cheque for advice. Consumer confidence in the industry has not been helped by past mis-selling episodes which have often been blamed on the way that advisers and their firms are remunerated.

3.53 While poor practices may frequently be associated by the media with firms using commission-based models, they are not confined to such firms. In the absence of other controls, any remuneration model could encourage inappropriate advisory activity in any distribution channel. There is anecdotal evidence of this when looking at the industry's record of poor persistency[19] which has long been an issue for all channels, including bancassurance.

3.54 Furthermore, it is clear that the potentially distorting influence of remuneration on the outcomes of advice is recognised by the many product providers who use commission rates as a lever to attract market share: they would not do this if commission was not an effective sales lever. The actions of providers may therefore be exacerbating the problems.

3.55 In looking at remuneration issues for this review we wanted to change the perspective of the debate. We think it is important to distinguish between the processes for determining the remuneration and the methods for paying that remuneration, in order to consider the reasons why remuneration can lead to inappropriate advice.

Process for determining remuneration

3.56 Market-wide discussions have often focused on the methods for paying remuneration. But while there are many issues that are relevant to how remuneration is paid, not least those related to differences in tax treatments between fees and commissions, we think the process for determining remuneration is a far more important determinant of the fair treatment of customers.

3.57 For instance, we think the way that firms are managed when the commission model is applied is the root cause of many of the quality of advice problems when commission is used. In other words, managing remuneration – whatever the model – is a risk management issue, and the risks presented by the conflicts between the interests of providers, advisers and consumers have not been well enough managed by many in the industry.

3.58 So our intention with this aspect of the review is to focus consideration on processes for determining remuneration, with a view to finding ways to make it easier to manage conflicts of interest and thereby lower the risks of inappropriate consumer outcomes.

19 See, for example, our 2006 Survey of the Persistency of Life and Pensions Policies published in October 2006 which shows that only 51% of customers who bought a regular premium personal pension from a company representative in 2001 and 46% of those who bought from an IFA were still paying into them after four years

Is ‘switching’ a symptom of poor practices?

3.59 There has also been much debate on the extent of product bias, provider bias and churn[20]. Although deeper analysis would be needed to be conclusive about the extent of the problem, the level of activity coupled with anecdotal views we receive from industry practitioners, suggest that a significant proportion of switching activity may not be in the consumer’s best interest. For example, 63% of single premium individual pension sales were accounted for by transfers in 2006[21], which might suggest a significant amount of inappropriate activity.

3.60 The Sustainability Group recognised, as we do, that there can be potential benefits for customers from switching providers or funds, particularly to lower cost alternatives (for example, Stakeholder pensions). However, it felt that not all switching was resulting in better outcomes for consumers, either directly or indirectly. Poor profitability arising from lower persistency may lead providers to increase charges and/or to withdraw from lines of business.

3.61 We consulted in 2006 on removing the reporting requirements for persistency required by our Supervision Manual (SUP16.8). It was subsequently decided to continue data collection until we have considered the issues in the context of the outcome of the Retail Distribution Review.

3.62 The Sustainability Group proposed that we and the industry consider setting up a data collection system, which along with existing intelligence, is used to identify for instance, the top 25% of distributors by volume of switching, so that the FSA can focus regulatory scrutiny on them.

3.63 We are mindful that poor persistency is a symptom of the problems we are trying to address in this review. In particular, if more advisory firms operated on a fee basis, according to the wider definition of fee-based we describe in Chapter 2, and especially if professional standards were raised across the industry, the risks of inappropriate switching activity might be significantly reduced. In developing our approach to collecting data to monitor risks of poor quality advice we would need to reflect these considerations.

> Q41: What data should be collected, and from whom, to help us to focus our attention on those firms most likely to be causing consumer detriment when advising consumers to switch product?

What different outcomes were proposed?

3.64 The Impact of Incentives Group focused its attention on more appropriate processes for determining remuneration. It started with the proposition that intermediary remuneration is the customer’s money. It argued that it is therefore important for it to be clear to consumers what services they are paying for and how much they are paying for them. The present regulatory requirements for hard disclosure of

20 We define ‘churn’ as replacement of a consumer’s holding of one investment product with another similar product as a means of generating remuneration for the adviser rather than because there is a clear advantage for the consumer

21 ABI statistics

remuneration, as well as the 'Menu', in theory provide a lot of information for consumers, but it is not clear whether consumers understand this well enough to use it. As part of the review of the Conduct of Business Rules, we recently published research by Charles River Associates[22] which supports this point.

3.65 The group thought that remuneration arrangements should reflect the services provided to consumers and should be more often determined, or at least influenced, by discussions between the consumer and their adviser, rather than being the result of negotiations between providers and advisory firms as is most often the case now. A consequence would be that the basis of competition amongst product providers would move away from remuneration towards the quality and price of products and services. Such a move could fundamentally affect the product and distribution strategies of a product provider, and radically alter their business mix. So this is a revenue issue for all firms, both providers and distributors.

Trail Commission

3.66 Greater clarity on the services being (or to be) supplied, and their costs, would also help to resolve another common area of debate. It can often be unclear what 'trail' commission is for. Is it a delayed payment for initial services, or does it cover the provision of ongoing services? And if the latter, how aware is the customer of this arrangement?

3.67 The group concluded that it needs to be made clear to all parties whether and how remuneration, particularly on a trail basis, is contingent on the actual delivery of ongoing services. We see such implications as a commercial rather than a regulatory issue, but one which might be resolved in the context of the principle of providing consumers with greater clarity on the services to be supplied. As a matter of good practice, advisers should be meeting the reasonable expectations of clients, and where trail payments are, for example, agreed as delayed payments for initial services, or where they cover ongoing administration costs, the right to stop such payments would not seem to be appropriate.

3.68 We recognise the importance of trail commission to intermediaries, and that it may not be a helpful regulatory intervention if we made rules around consumers' ability to switch off trail regardless of what it was designed to pay for.

3.69 It may be more helpful for firms if we articulated principles at a high level to minimise unintended consequences for consumers and for the market. For instance, the principle of greater clarity about what services are being supplied and how much is being paid for them could mean that some would split out the cost of advisory services from other product costs. But this may be less easily achieved where firms are distributing their own manufactured products, or where advisers carry out significant services in addition to providing advice. A principles-based approach should allow different firms to interpret the obligation so that their actions are more proportionate and relevant to their business.

Q42: Do you agree that greater clarity for consumers on what services are being supplied, how much they are paying for

22 '*An Empirical Investigation into the Effects of the Menu*' – http://www.fsa.gov.uk/pubs/other/CRAreport_menu.pdf

them, and more influence for consumers on remuneration generally will help to address inappropriate advice risks?

Q43: How, if at all, should we intervene on the issue of consumers' rights to switch off trail payments?

How might the outcomes be achieved?

3.70 In delivering the outcomes of greater clarity for consumers on services and costs, as well as more influence for consumers in the process for determining remuneration, the Impact of Incentives Group focused on one particular idea. It considered the concept of Customer Agreed Remuneration (CAR), the name given by the group to an approach sometimes known as 'Factory Gate Pricing'. This is sometimes considered as a remuneration method in its own right, but it may more correctly be considered as a method for deriving the remuneration.

3.71 We recognise that there can be inconsistent use across the industry of terms like 'fees', 'commission' and, potentially in time, 'Customer Agreed Remuneration'. This is not only unhelpful to consumer understanding, but also means that it is hard to generalise arguments about such methods.

3.72 The group suggested that it would like to see CAR applied to as much of the market as possible, both in terms of products and firms, but did not propose 'blanket' prescription. We describe CAR in more detail below, based on the work of the group, because the concept may be unfamiliar to many people and its implications are important to the main proposals of this review.

3.73 It is important that remuneration models fit the circumstances. For instance, the trend towards wraps and other platforms, and the corresponding advisory commitment to providing ongoing services to a consumer, should increasingly mean that a pattern of regular payments is more appropriate than an upfront payment. This could emerge under a fee or commission arrangement, with or without customer agreement in determining remuneration (although we expect all fee arrangements, almost by definition, to be customer agreed).

3.74 We recognise that moving from a model that relies heavily on up-front revenue involves a temporary reduction of income during the transitional period, which may have inhibited the number of such moves. Some practitioners believe that recurring revenue models create more value for the owners and encourage a more long term business strategy but there may be a short-term financial strain that has to be borne to get there.[23]

Customer Agreed Remuneration

3.75 In summary, the basic concept of CAR is that:

- Products are priced by manufacturers excluding charges to cover the costs of remuneration to advisers for their services.

23 Authorities in The Netherlands have recently moved to encourage greater use of trail commission rather than up-front commission. See Annex 3: International comparisons, for further details

- Advisers and customers agree the level and pattern of remuneration, in the context of a discussion of all services being supplied (and to be supplied). This is very much like a fee discussion.
- Additional charges are then added to the product charges to reflect agreed remuneration.

3.76 The outcome of this process is a similar financial transaction to commission, in that the provider pays the adviser and the costs of this are covered by the charges on the consumer's product. Alternatively, the outcome could be the customer paying a fee by cheque (or otherwise agreeing a deduction from their initial investment). But while the method of payment may be commission or fee, the interactions between the parties that lead to such payments being made are very different, and are based on an agreement between the consumer and adviser and not on any agreement between the provider and adviser.

3.77 This is why we consider CAR not as a different remuneration model, but as a different way of determining remuneration. The CAR process encompasses a traditional fee arrangement. Importantly, it also encompasses commission arrangements but only when there has been some form of agreement or acknowledgement from the consumer on payments to be made. It excludes, in particular, arrangements where providers and advisory firms agree commission arrangements without any involvement from the consumer.

Implementation Issues

3.78 This description of CAR is deliberately high level, but it shows how it could make it easier for firms to manage conflicts of interest between themselves and consumers[24]. But this 'pure' form of CAR presents challenges on many fronts such as the inability and unwillingness of many consumers to engage in this way with their adviser to 'agree' remuneration, the cost implications for product provider systems which may push up product charges, the risk that providers may find other forms of 'indirect' remuneration to continue to apply competitive pressures, and the possibility of additional product charges for unrecovered costs of remuneration on early surrender of a product. Under CAR it may also be more difficult to build in cross-subsidies, which are implicit in a commission model where, because the commission is proportionate to the premium paid, customers taking out policies with large premiums may subsidise customers arranging smaller policies.

3.79 The view of the group was that these issues are not show-stoppers. The issue of consumer capability is one where we would particularly welcome views. It may be that several different forms of CAR could evolve, including one where the concept of 'agreement' of remuneration is replaced by some form of clear disclosure which, amongst other things, addresses the principle of describing the services being supplied and what the consumer pays for them. This may be most relevant when CAR is applied in the context of Primary Advice.

24 Similar thinking has been applied in Sweden, where increased transparency requirements have led some market participants to adopt a form of CAR. See Annex 3 for further details

Implications for consumers

3.80 We have suggested in Chapter 2 that we might re-define the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer and not influenced by the product provider. This may help to create a more useful distinction for consumers – that is, remuneration derived in conjunction with the consumer as opposed to other forms of remuneration. Such a distinction may then provide a clearer indicator for consumers of the risks of inappropriate advice. It would still be possible under this definition for the remuneration to be contingent on a product sale, if that is what is agreed with the customer. We have also suggested in Chapter 2 that professional financial planners might have to use fee-based remuneration based on this wider definition. We have defined fees in this way, and not simply as CAR, to include more clearly circumstances when remuneration is not contingent on a product sale or when commission is rebated back into the product with the agreement of the customer, both of which could be acceptable practices for professional financial planners.

3.81 A key aspect of CAR is the relationship between the payments for intermediary services from the consumer to the provider (by way of product charges over and above the basic product cost), and the customer-agreed payments from the provider to the intermediary. The group considered two alternatives:

- Matching – where the timing and amount of payments are the same, i.e. the consumer pays additional charges on the product to match precisely the timing and amount of payments from the provider to the adviser (noting that there may be complications for life insurers depending on their tax position).
- Non-matching – where the timing and amount of payments are different, so that there is an element of funding from the provider on an economically equivalent basis. For example, the adviser might receive an upfront payment from the provider but the consumer may pay an additional annual management charge.

3.82 The group's preference was for some form of regulatory or professional (for example, guidance from the Board for Actuarial Standards) constraint on economic equivalence, so that the translation of the remuneration payments into additional product charges would be governed by a set of rules. This would limit 'uneconomic' competitive behaviour by providers, although such competition might benefit consumers by lowering charges. On the other hand, rules could be needed to limit the upside profit potential for providers through over-charging. Industry guidance in this area might helpfully be 'confirmed' by us. We welcome views on these points.

Q44: What do you think is the most appropriate approach under CAR to matching payments (in terms of amounts and timing) from the consumer to the provider, and payments from the provider to the intermediary, and why? What role, if any, might there be for regulation, or for guidance from other parties, to establish uniformity of approaches in the market?

3.83 The group also noted that the financing of the adviser's remuneration could be offered by a third party, unconnected to the product provider, although this was regarded as a longer-term development.

Q45: Do you agree with the concept of third party financing, and if so, how might this operate?

Benefits of CAR

3.84 The group agreed that CAR offers benefits to advisory firms, who wish to move towards a fee-based revenue model but who are concerned about the willingness of some of their customers to pay for services in that way. It encourages firms to explain the value of their services, thereby eroding some consumers' perceptions that advice is a free commodity. In addition to bringing greater clarity about the cost of advice, CAR also brings transparency about the cost of products. This enables advisory firms and their customers to compare the cost of different products and from different providers, enabling them to shop around.

3.85 CAR offers consumers the opportunity to engage in a fee-like discussion but then to spread their payments, thereby overcoming one of the perceived consumer barriers to paying fees. It is possible that a by-product of these discussions may be increased capacity for price discrimination by advisers. This is explained in more detail in Annex 2.

3.86 There may also be tax advantages for consumers in having the arrangement treated as commission. We are also aware that the VAT treatment for fees is perceived as unclear, which has further dissuaded firms from adopting fee-based arrangements in the past. Indeed we are aware that some firms on a fee-based model always charge VAT because this is easier than deciding when VAT is strictly applicable. HMRC VAT Notice 701/49[25] seeks to clarify the position, setting out that the VAT treatment of financial advice is determined by the nature of the service provided rather than the method of remuneration and giving guidelines for firms to use.

3.87 CAR also offers benefits to product providers and is already possible under our rules. Some firms, for instance Prudential and Scottish Life, are already using CAR for certain products. While Prudential's introduction of CAR is fairly recent, Scottish Life has been operating on this basis for several years and believes that the quality and profitability of the business transacted on this basis has increased since it introduced CAR.

Q46: What do you think are the main barriers, including taxation, which would prevent firms from moving to a CAR model? How might these barriers be addressed?

Q47: Do you agree that CAR could assist advisory firms to move towards a fee-based revenue model (according to the current definition of fees)? Could this help to erode the perception that advice is a free commodity?

25 Available at www.hmrc.gov.uk

Q48: What are the main challenges to implementing CAR, and what might be the implications for consumers, firms (of all types) and the FSA?

Q49: What market mechanisms (if any) do you envisage could contribute to reducing the risk of advisers exploiting the extra information they might possess on consumers' willingness to pay? Would the risk of this price discrimination be a concern for consumers and how might this risk be mitigated?

4 Primary Advice

Introduction

4.1 We discussed in Chapter 3 how higher standards of professionalism could make advice more costly and its supply more selectively focused on more affluent consumers. This might then widen the gap between those who can afford full financial advice and those who cannot.

4.2 At the same time, the Thoresen Review is likely to have an impact on the number of people seeking simpler forms of advice for more straightforward needs. This is because the Government wants to see everyone having 'access to appropriate financial products and the confidence and capability to use them to make a positive difference in their lives'[1]. It is likely that Generic Advice will look at ways of providing 'generic' (i.e. personalised but unregulated) financial help and guidance that does not result in an individual product recommendation. In the long term, this is likely to mean that there will be more people seeking, or being guided towards, forms of regulated advice.

4.3 In addition, our ongoing financial capability work is seeking, over time, to equip consumers with skills and resources to increase their financial awareness and help them engage with the financial services industry. This should also have an impact on the future demand for regulated advice and, albeit over some time, help improve consumer power in this market.

4.4 For these reasons the groups have proposed the development of alternative, less complex services. This chapter focuses on the ideas and potential solutions the groups put forward to bring greater accessibility to products and services to a broader cross-section of consumers.

4.5 We are keen to understand if the ideas would indeed open up access to advice on an economic basis for suppliers. We also want to know if these ideas will address the problems discussed in Chapter 2, such as the lack of affordability of financial advice for many consumers who also struggle to understand what they are buying.

1 Speech by the Economic Secretary to the Treasury, Ed Balls MP, to the Resolution Foundation Conference, London, 14 March 2007

4.6 Separately, we have had requests from many in the industry who have said that they would deliver a more simple form of advice to the market if regulation made it more cost effective to do this. We have encouraged the industry to design business models and to suggest associated regulatory changes to address this perceived market gap and yet, to date, no one firm has come forward with a formal proposal. We are willing to do whatever is required to help this happen, but only if we believe firms will respond.

How is this different?

4.7 There have of course been previous initiatives to encourage the provision of savings and investment products to a wide range of consumers. The introduction of Basic Advice in April 2005 is one such example.

Box 3 – Basic Advice

This was introduced as a new form of regulated advice regime for the sale of 'Stakeholder products'[2] which were designed by the Government to be a suite of simple, low-cost, risk controlled products. The adviser explicitly only advises on one product in each category (so as to remove the complication of advising between two similar products).

Basic Advice is a short, simple form of financial advice. It uses a set of scripted questions to identify the customer's financial priorities and decide whether a product from within a range of low-cost 'regulated' savings and investments products is suitable for the customer. Whilst we developed and published a script for the use by firms when providing Basic Advice, most have chosen to use their own scripts which we do not approve or endorse.

Basic Advice establishes only broad financial priorities and takes limited account of an individual's particular financial circumstances. The assumed market was low to middle income savers (in the income group up to £30,000 a year) as this was where the greatest problem of a savings gap was perceived.

4.8 Although Basic Advice and Stakeholder products were developed to tackle many of the problems that we see in the industry, we are told that the potential risks of advice, the charge caps on the products, and the small amounts invested by each saver have combined to make the products uneconomical for suppliers, resulting in little take-up. The issues relating to Basic Advice were borne in mind when the Consumer Access Group was developing the ideas for Primary Advice discussed in this chapter. For instance, the group proposed no charge capping of products and suggested that there should be a wider range of products available.

4.9 We are looking at whether these are the real reasons for the low take-up of the Basic Advice regime. We had planned publishing the results of this review[3] by the end of the second quarter of 2008, but we anticipate that the outcomes of the RDR could

2 Stakeholder products include an equity based Collective Investment Scheme or life policy, a pension, a Child Trust Fund and a deposit account

3 Basic Advice Post-implementation Review

well influence the scope and timetable of that work, so we will review the timetables to ensure consistency.

Areas of focus considered by the Consumer Access Group

4.10 To deliver solutions that would make a real difference and be useful to consumers, the group focused on consumers who:

- have the resources to take out medium- and long-term savings and protection products, but have not yet done so. This could be for a number of reasons, for example, the length of the advice process or due to a lack of confidence in the process; or
- are currently saving and/or protecting their lives and families, but do not appear to be doing so optimally (in terms of amount, asset allocation, or level of protection).

4.11 Once the group had identified the area on which to focus, it set out to identify models for regulated advice that would serve the segment described above and deliver good outcomes for consumers at an affordable price.

The group's proposals

4.12 To ensure that all consumers are able to access the regulated advice market, the group developed some ideas for alternative, less complex services and products which are cost effective to deliver. The group thought that the market for these types of products is generally not well served at the moment. These views very much align with the outcomes that we are trying to achieve.

4.13 The group acknowledged that there was a need for a Generic Advice service to enable any consumer, regardless of income level, to understand their financial position and needs. As previously mentioned, this area is currently being covered by the Thoresen Review which is due to report around the end of 2007. Although it does not form part of this review, such unregulated guidance and help would need to fit into this overall landscape. We will work closely with the Thoresen Review to ensure that the two are aligned as far as possible. The scope of Generic Advice, including the extent of detailed analysis of a consumer's needs and whether certain 'simple' needs might be addressed as part of Generic Advice, is not yet clear. But it is likely that it could act as an entry point to other service types, particularly for less knowledgeable consumers.

4.14 To deliver new services that consumers buy, a change may be required not only on the demand side (by having more capable and confident consumers) but also from the industry, with an emphasis on providing easily recognised and understood service types tailored to the needs of different consumer segments rather than product-oriented services.

Primary Advice

4.15 The group considered both focused advice, which was discussed in Chapter 2 and a service that we have referred to in this paper as Primary Advice.

4.16 The Primary Advice service would not consider a consumer's needs in great depth but would enable an adviser to give broad advice matching a consumer to appropriate products. This would also be based on matching their needs/circumstances to that of a segment of the population by, for example, identifying the individual with people in similar circumstances or with similar needs. (This concept could be likened to an off-the-peg suit as opposed to a bespoke suit.)

4.17 In order to facilitate Primary Advice, the group considered different consumer segments and preferences and how the market should respond to these. The use of segmentation would allow simple advice to be delivered cost effectively by firms.

4.18 Although it may not be tailored to individual consumers, Primary Advice would provide suitability at the level of consumer segments and focus on the end outcomes for consumers – essentially a 'fit' to straightforward financial products which are suitable for a particular segment. Although this may lead to suboptimal outcomes for some, overall it would put consumers in a better position than having no access at all. There would also need to be exception routes for consumers who may need to be considering other options (for example in dealing with debt).

4.19 The group also considered using specific models as a way of matching the consumer to a population segment. To achieve this, the group thought it possible to come up with a set of industry-wide decision criteria applicable to most consumers which would lead to advice on what course of action should be taken. Primary advisers would establish sufficient information about a consumer to provide personalised recommendations based on the main characteristics of that consumer. The process to arrive at the recommendations would be standardised in some way to deliver similar advice for all consumers who have similar characteristics. The advice might point the consumer towards a limited range of protection, savings and pensions products.

Q50: What should be our role in endorsing the criteria for segmenting consumers for Primary Advice? What role is there for the industry to provide appropriate standardisation?

4.20 It would be important that a consumer was made aware of the scope and limitations of the advice, so effective disclosure, both in terms of its delivery and content, will be key to consumers' understanding.

4.21 The group thought that there may need to be a number of other characteristics associated with Primary Advice:

- the use of portable fact finds and possible navigation of consumers to a full or specialist professional financial planner;
- the possible need for new and shorter forms of 'suitability' tests;
- limiting advice to products which meet set criteria. Examples of products could include appropriate protection products, cash/equity ISAs and generic investment products with certain characteristics which could include the low risk of capital loss (although this could make them more likely to produce conservative returns) and pre-defined diversified asset mixes;

- the need for those offering the service to explain the scope of the offering to consumers in a way that makes it clear what the consumer is taking responsibility for; and
- a variety of new and existing entry routes to Primary Advice for consumers, including on-line and off-line forms of Generic Advice and other forms of self-help that may evolve.

Q51: To what extent is there unmet demand for some form of simple advice, bearing in mind that the wider proposals in this DP and other market developments could alter the demand in the future?

Q52: Do you think that a Primary Advice service would benefit consumers and, at the same time, provide sufficient consumer protection?

Implications of debt for savings advice

4.22 Another important question raised by the group and others during this review is whether consumers should always be advised to pay off their debts before thinking about investing or saving. Whether or not consumers should save would of course depend on the individual consumer's circumstances, the nature and the amount of their debt alongside their ability to meet these. The group noted that consumers with mortgages are still encouraged to save and there are some consumers for whom certain forms of savings alongside debt would allow them access to liquidity at short notice. In such cases, advice may well be needed to help consumers with their cash flow management. Moreover, many consumers with debt may well benefit from buying protection products before taking out investments.

4.23 So there is no easy answer to this question and we are keen to explore this issue further through this review, especially in the context of appropriate decision and advice processes for Primary Advice which we discuss later in this chapter.

Q53: What are your views on the extent to which people with existing debts should be encouraged or discouraged by financial advice to make investments and to save?

Q54: Are there any particular exceptions and how should we consider this in the context of decision processes for Primary Advice?

Tax, Benefits and Primary Advice

4.24 We are keen to understand whether there are any existing tax or benefits (for example, means testing) implications which could mean that the Primary Advice model would be less likely to work. We would pass such comments to the relevant government department who would need to consider the wider impact of any proposed change within its framework.

Q55: What are the tax or benefits issues that could hinder the development and/or success of a Primary Advice service? What are your views on how these might be resolved?

How we can help make these ideas work

4.25 We recognise that there are regulatory steps that we may need to take to enable firms to offer the Primary Advice service, and to help them to manage the risks to consumers of poor advice. There are a number of possible measures which we discuss below in the context of the group's ideas.

Standardised and portable fact finds

4.26 The group envisaged that standard portable fact finds could be automated and replicable for individual consumers to match their needs with simple products. Firms could then rely on appropriate, recent data collected on a consumer from other sources (including from a Generic Adviser) to minimise duplication, reduce costs and improve the customer experience when gathering 'know your customer' information. These standardised and portable fact finds would of course need a 'sell-by date' to ensure they remain current.

Q56: Do you think that these standardised and portable fact finds will help with the provision of advice to a wider range of consumers and help contain costs?

Q57: How should we strike the appropriate balance between verification of data and reliance on that data by other firms when using a portable fact find?

The range of investment products

4.27 The group envisaged that the available range of investment products could be wider than the Stakeholder product suite. They would not be subject to charge caps that might limit the margins available. They could be approved or endorsed by us. The group felt that the best solution would be for us to set certain criteria on what products might be sold in certain categories through this route.

4.28 As discussed in Chapter 2, limiting product ranges through some form of product selection would minimise the level of any potential detrimental effects on the consumer of not selecting the most suitable product. One way to approach the issue of criteria would be to develop a set of 'simplicity criteria' which could then be used as the basis of eligible products. Note that 'simplicity' is in terms of investment outcomes for consumers, for example products with outcomes and risks which are simple to understand, which does not necessarily mean that the products themselves are simply constructed. Characteristics to be considered might include:

Characteristics related to risk
- o Risk of capital loss
- o Expected return
- o Volatility of potential return
- o Guarantees
- o Fund type

Characteristics of charges
- o Commission
- o Exit charges or early redemption penalties

Other product characteristics
- o Access to capital with/without loss
- o Tax and eligibility for benefits implications
- o Premium levels and contractual length of payment term
- o Short, medium, long term investment
- o Ease of access to up-to-date information on progress of investment

4.29 A few easily understandable criteria would need to be selected from the list, and it would need to be made very clear to consumers that they were chosen to define simple products and not, for example, the absence of risk or fairness of charges. Some such products might exist now and could include an equity index ISA (tracking a major world index); or a guaranteed equity bond (with 100% return of capital at clearly defined time periods). Risk ratings for products could also be considered but we note that a parallel system of 'simplicity criteria' and risk ratings would need to be carefully overlapped.

Product approval

4.30 Assuming a satisfactory and clear set of 'simplicity criteria' could be developed, there are a range of options available as to how far we would go to approve or otherwise endorse such products and thus limit the potential for inappropriate products to be sold.

- We might be able to leave it to firms to self-certify that certain products meet the criteria agreed. Alternatively, trade associations could agree collectively to a set of products that met certain criteria. We might 'confirm' such approaches. This would be consistent with our preference for principles-based, market-led solutions.

- At the furthest extreme we could take responsibility for vetting and pre-approving individual products which would be akin to product regulation. The basis on which we were offering approval would have to be made quite clear to the consumer - there would be no protection against fraud, market movement, or counterparty risk. There are also a number of legal issues relating to this which would need to be explored in depth such as our ability to require the pre-approval of products under FSMA. Similarly, such an approach would not be consistent with our move to principles-based regulation and we would have to be sure that an exception was appropriate for these purposes.

4.31 Whichever route is used, the FOS has agreed to work closely with us to help make it a success.

Q58: Do you agree that using product criteria would help firms deliver appropriate products to the target market for Primary Advice?

Q59: Do you think having FSA-endorsed products would help? If so, how would this work?

Q60: Do you have any other suggestions or options for limiting risks of inappropriate products being sold via Primary Advice?

Suitability

4.32 To enable firms to offer Primary Advice cost effectively, and to help them to manage risks to consumers we may need to reduce significantly some of our existing suitability requirements – so far as the standards laid down by the general law allow. As we outline in Chapter 2, we aim to work with the FOS to agree a framework to give greater clarity on the suitability of advice, as appropriate to delivery of these services, and help firms to understand better the level of their obligations. However, we would not do this unless we could mitigate the risks of inappropriate advice for consumers.

Q61: Do you agree that different suitability standards would encourage delivery of Primary Advice and what should these be?

Decision processes

4.33 To further contain the risks to consumers, we might seek to design or otherwise endorse the advice processes used to deliver Primary Advice, through the use of 'decision trees' or approval of more sophisticated automated processes designed to match simple products to less complex consumer needs. Moreover, if an adviser follows these limitations on processes, then the framework we agree with the FOS could mean that there would be no grounds for future claims against the adviser for inappropriate advice. Moreover, if an adviser follows these limitations on processes and complies with their obligations in the law, the likelihood of successful claims will be significantly reduced.

4.34 The aim is to keep costs down as far as is possible and appropriate, and for the process to enable consumers to understand the products that would be best suited to their needs, at the same time as limiting the risks of inappropriate advice. There are a number of different ways that processes could be designed and delivered. It could be led by us or by the industry. There could be online tools to assist consumers to understand their financial needs, designed (by us, by the industry as a whole, or by individual firms) for use by firms as part of giving advice. In both cases, this could involve the use of some form of decision tree.

4.35 If the decision tree encompassed more limited advice than a full suitability assessment the firm would need to ensure that the customer fully understood the nature of the limitations. If they did not (and the requirements for firms were sufficiently clear) then there may be consequences for the firm.

4.36 Debt could be built into or excluded from the decision tree but this would clearly change the outcome for the consumer. How far a person should be advised to save or to purchase protection products at the same time as having debt was discussed earlier in this chapter.

Q62: Do you think that decision trees would be a useful means of ensuring that consumers had access to some type of information/advice?

Q63: What other ways might be used to standardise the advice process for Primary Advice?

Application of risk-based prudential requirements to Primary Advice businesses

4.37 Risk-based prudential requirements and risk-based supervision for firms could take account of the consumer protection built into the Primary Advice process. For example, they could reflect the extent to which Primary Advisers have the skills and qualifications appropriate to the services they provide, and the extent to which the Primary Advice process eliminates conflicts of interest in remuneration. Banks and insurers offering these services are already subject to risk-based prudential regimes and they could reflect similar factors in their capital assessments.

Q64: How should risk-based prudential requirements and risk-based supervision for firms that give Primary Advice take account of the risk and consumer protection issues associated with it?

Further research

4.38 We are planning further consumer research to understand the extent of possible demand for Primary Advice and will be undertaking this during the discussion period. This is likely to run in parallel with our Basic Advice research on consumer experience and we will assess consumer needs both now and into the future.

4.39 We are also asking firms whether the ideas we have put forward in this DP are sufficient to stimulate supply of a simple advice service, to commit capital to it and whether there is anything further we need to do to help this happen.

Other ways of increasing access for more consumers

4.40 In addition to Primary Advice and focused advice, the group also looked at some other models such as that of an ‘assisted purchase’ model which more closely resembles execution-only, but in which the customer is supported through information and guidance to making the right product choice. The group was not satisfied that the risks to consumers in such a model could be overcome for the area of the market that the group was focusing on so did not pursue this further.

4.41 Although we note that non-advised purchases are frequently completed by more financially capable consumers, there might be ways to improve help and guidance for a broader cross-section of consumers on the purchase/execution of investment products sold in this way. There are a number of product providers (for instance, Friendly Societies) who currently only sell their products on a non-advised basis, in some cases targeting similar consumer segments to those who might be best suited to Primary Advice. We would like to understand whether current regulation may be inhibiting the scope for firms to give even clearer information on the benefits and features of particular products in distributing them in this way.

4.42 For this to work better for consumers, clearer definitions of advice may need to be considered, acknowledging the possible implications of UK and EU legislation in this area (see Chapter 5). We recognise much of what is termed as 'advice' is actually information (for example describing a product) so there should be scope for more clarity in this area.

Box 4 – Alternative ideas on consumer access

Outside the groups, both we and the industry have been thinking about new and different ways of enabling consumers to access products and services. Some ideas include:

- *Distribution through supermarkets:* Clearly some retailers have access to large customer bases and this could be an alternative way to distribute financial services to the mass/middle market with brands that consumers already know and trust. As the environment is perceived as non-threatening, consumers are more likely to engage. This has tended to work with commoditised products for example protection, and some organisations already offer advice on protection products over the telephone.
- *Workplace:* The workplace is another means of reaching a large number of consumers. One of the FSA's financial capability initiatives 'Make the Most of your Money' provides tools and resources for employers to give employees financial education and information at work.
- *Using methods currently employed by Friendly Societies:* The social element of friendly societies may encourage consumers to access financial products and services. There is no advice offered but products are recommended by word of mouth from members within the organisation (studies have shown that consumers often turn to friends and family for guidance). These societies are also able to offer tax incentives to encourage people to invest, for example, through tax advantaged child savings plans.
- *Understanding the consumer perspective:* It is important to understand the consumer perspective to know what will best meet their needs. Many companies

undertake customer research, mostly by asking consumers to answer defined questions. We have seen some alternative approaches. For example, AEGON UK has shared with us its work to improve its understanding of the consumer perspective. It started by giving consumers a blank sheet of paper. The approach was to get consumers to think, unprompted, about what would help them by way of advice and product availability. Information was gathered through workshops where consumers were asked to consider their feelings towards longer-term financial planning, using diaries, timelines and other tools as well as getting them to design their ideal approaches to accessing products and advice. Some key themes emerged from this work such as consumers' lack of confidence to plan for the long term, their desire for experiences which were like other retail buying experiences, and their acknowledgement of the need for help in keeping up the discipline of saving.

Q65: Does the boundary between advice and information need to be clarified? What other regulatory changes might help delivery of non-advised products to consumers in a clear and meaningful way?

Q66: Do you think that an 'assisted purchase' model could work?

Q67: Are there any other models that you think could work?

Q68: Is there an argument for more radical approaches, such as further compulsory savings (beyond the levels envisaged by Personal Accounts)?

5 Legal and regulatory considerations

Introduction

5.1 This Discussion Paper sets out ideas put forward to date in the course of the Review, with the aim of opening the debate to a wider audience and to encourage further proposals. In this chapter, we consider the wider legal and regulatory framework in which we operate. Once the final proposals have been established, we will consider all available regulatory mechanisms that may be used to achieve the solutions. We are determined to improve market outcomes for consumers and will therefore consider all practicable means of achieving the aims of this review.

5.2 Many firms are already moving in the directions suggested in earlier chapters; they are not prevented from doing so by regulation. Regulation should of course address market failures and not restrict innovation or dictate market structures. Frequently in the course of our discussions, firms have expressed concern that there is a 'first mover' disadvantage for any single firm to experiment with business changes such as those proposed in this paper. One of the conclusions that some have drawn from this is that it is the job of regulation to ensure change. While our preference is for industry-led solutions, there may be opportunities to remove regulatory barriers and to underpin these solutions through regulatory enablers to encourage good practice and support firms as they begin to change.

Possible regulatory changes

5.3 Some of the changes to regulation that may be required to implement the proposals discussed so far are described below. We emphasise that these are based on the ideas that have been put forward, and that through the consultation on this DP we want to gather more information which we can then use to inform the way forward. We will also undertake the necessary cost-benefit analysis which will build on the preliminary thoughts contained in Annex 2.

Professional standards

5.4 The groups have suggested that minimum competence standards should be set at appropriate levels for the services supplied by different market segments. They also recognised the importance of ethical and behavioural standards.

5.5 The Financial Services Skills Council has responsibility in the UK for setting appropriate examination standards in this area. We intend to work with them and the industry in developing proposals for higher qualification standards to assist with our existing outcome-focused requirement for advisers to pass an appropriate examination.

5.6 The development of ethical standards could also fit within this process or may more appropriately be an industry-developed solution.

5.7 Suggestions from the Professionalism and Reputation Group that more information is shared within the industry on individual practitioners and that there are greater sanctions against individuals who exhibit inappropriate behaviours may need changes to our regulation, albeit within the limitations that we would face in this area (notably from the Human Rights Act discussed below).

Remuneration

5.8 The groups argued that consumers need a greater understanding of the services they would receive from all parties involved in a transaction and the cost of these services. Their conclusion was that one way to achieve this is for remuneration to be determined by agreement between the adviser and the consumer rather than between the provider and adviser.

5.9 The market has shown signs of developing in this direction in recent years. However, we may need to intervene if this development does not reach far enough with market forces alone. For instance we have proposed that professional financial planners would be required to be remunerated on such a basis. We might need to introduce regulatory incentives for product providers to support intermediary firms in their adoption of Customer Agreed Remuneration. Providers may also need regulatory disincentives to dissuade them from competing on the basis of intermediary remuneration and to encourage competition on the basis of the quality and price of products and service. Provisions introduced here would, of course, need to be consistent with our obligations under the Markets in Financial Instruments Directive (MiFID) insofar as business falling within the scope of the Directive is concerned.

5.10 Equally, all advisers (including direct sales personnel) might need to be deterred more firmly from applying practices that allow remuneration to get in the way of acting in the best interests of their customers. Disincentives could come in the form of increased supervision or higher regulatory costs (such as increased prudential requirements) for firms with practices that may be regarded as being of higher risk. We would be focusing on outcomes for consumers. Firms with good market practice would receive a regulatory dividend but those with riskier market practice would need additional FSA supervision. Overall, this should encourage all types of firm to treat their customers fairly. Again, we would need to ensure that any steps taken are compatible with MiFID.

5.11 We may need to consider different actions for different types of firm. One extreme regulatory change would be to ban certain approaches to remuneration, for example by banning providers from offering some types of commission. There are material regulatory challenges to such an approach, which we describe later in this chapter. Whether or not this happens, we will want to consider proportionate and effective regulatory sanctions for those whose practices do not deliver good outcomes for consumers.

Prudential requirements

5.12 A key proposal is for risk-based prudential requirements for personal investment firms to improve sustainability and help meet future liabilities. When combined with the proposals for segmenting the advice market, risk-based prudential requirements may be appropriate for all personal investment firms and might result in an increase in capital for some firms, particularly if remunerated by traditional commission arrangements.

5.13 In parallel with this review, we are undertaking a separate review of prudential requirements for personal investment firms. We will publish a separate DP[1] in early July to open up a debate about the extent to which prudential requirements for personal investment firms are an effective means of reducing consumer detriment in this sector.

Primary Advice

5.14 Proposals for Primary Advice are some of the most significant in this review. We will understand the regulatory implications better when we have received feedback on this DP. However, we believe that many of the proposals could be implemented within the framework of the current rulebook and, indeed, in the new Conduct of Business Sourcebook that applies from 1 November 2007. For example, proposals for portable fact finds could operate under these rules.

5.15 We would, however, need to consider the extent to which any reduction in the standards of the suitability test for Primary Advice could be accommodated under the reformulated suitability rules in the new Conduct of Business Sourcebook. Much will depend on whether Primary Advice is placed outside the scope of MiFID. If so, then we have more flexibility. In any case, the flexibility available within the suitability requirement is subject to general law, which we discuss later in this chapter.

5.16 Proposals regarding the selection of products to be sold within Primary Advice may require new regulation depending on the extent to which the FSA approves products and any requirements that we set for the sales process.

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Focused Advice

5.17 Focused advice is limited to one or more needs of a consumer, agreed between the consumer and the adviser. This type of advice is already available under the current regulatory framework and will continue to be so under the new Conduct of Business Sourcebook.

Disclosure of adviser status and remuneration

5.18 It was clear from all the groups that disclosure requirements would be a key regulatory enabler for their ideas. So we are interested, for instance, in views on how consumers can be given clarity on the nature and limitations of services supplied, in language they can comprehend.

5.19 In Policy Statement 07/6[2], we summarised our current thinking with regard to the Initial Disclosure Document and Menu. The Retail Distribution Review is a key component in the future development of these documents. We continue to work on the regulatory requirements for disclosure of information about firms, including the level of service to be provided and the cost of providing that service. This is an area subject to EU Directives, such as MiFID, which we discuss later in this chapter.

5.20 Proposals for different types of intermediary service may also require regulatory change. It may be that we would need to regulate to prescribe how firms and advisers may describe themselves. We recognise that there are further limitations here due to EU legislation such as MiFID. For example, we have notified the European Commission of our requirement that advisers must satisfy certain conditions in order to be able to call themselves 'independent'. Amended or additional prescription of the labels for different market segments, and any new barriers to carrying on certain types of business or departures from EU standards, may require similar notification.

Disclosure of product information

5.21 We are working with the industry and other stakeholders on the further development of product disclosure documentation for investments, and in doing so we will take into account, where appropriate, the ideas in this paper. As part of the introduction of the new Conduct of Business Sourcebook we are developing examples and case studies showing good and poor practice to act as guidance for the industry.

Legal and regulatory landscape

5.22 Were we to make any of these changes to regulation to enable the proposals to work, we would need to consider a range of other issues, including our move to principles-based regulation, EU Directives and domestic legislation. We discuss some of these issues in the remainder of this chapter.

2 *Reforming Conduct of Business Regulation – Feedback on CP06/19 and CP06/20*

Principles-based regulation

5.23 Our current regulatory framework, in the context of the retail distribution of investment products, is covered by various parts of the FSA Handbook, notably the Conduct of Business rules. We consulted in 2006 on changes to our Handbook to move away from detailed, product-specific rules and toward higher-level, principles-based regulation and to reflect MiFID requirements. We will replace COB with the new Handbook text, COBS, on 1 November 2007.

5.24 Our objective in moving toward principles-based regulation is to achieve better outcomes for consumers, not just in how they are treated by firms but also through access to better products and the benefits of more efficient, innovative and competitive markets. The move recognises that there is not a single method by which firms can comply with the rules, but that firms should be given greater flexibility to decide how to run their businesses, while allowing them to judge how best to deliver the desired outcomes to the market. Detailed rules have not always succeeded in delivering this as they can be inflexible and can divert attention from the outcome towards the process. In some cases, they have added to the cost of regulation and even acted as a barrier to entry.

5.25 Proposals discussed in this paper include a range of options. Some suggestions may mandate certain actions and require new, detailed rules (for example, were we to mandate the use of certain remuneration structures over others). In moving toward principles-based regulation, we do not rule out the use of detailed rules if this is the best method to achieve a certain outcome. Other methods of implementing the proposals may be more compatible with principles-based regulation. For example, we could encourage industry guidance as we are, for example, with the 'MiFID Connect' group of industry associations to aid firms with the introduction of MiFID.

5.26 Some of the proposals also call for trade or professional bodies to take a stronger line with regard to ensuring the professionalism of their members. Trade bodies have already expressed concern that they should not become second tier regulators to fill a perceived regulatory vacuum in the principles-based regime. At the same time, they may have responsibility to their members to help achieve the changes they have identified as desirable. We would need to consider the implications of this in further detail.

5.27 Compatible with principles-based regulation, our risk-based approach to supervision could be used to encourage change without introducing new detailed rules. Certain proposals would allow firms to reduce regulatory costs by taking action to reduce the risk involved in their advice processes. For example, the use of a remuneration system that reduces the risk of product or provider bias, the gaining of higher qualifications or membership of professional bodies could all be taken as evidence of lower risk. We may also consider giving credit to firms using third party compliance support[3].

3 At an extreme, this could involve the FSA forming a view about the quality of services provided by compliance consultancies

5.28 Some FSA oversight would still be required to ensure that standards were maintained but our risk-based approach might be used to reward such practices. Overall, consumer outcomes should be improved, with firms choosing to use lower-risk practices or with greater FSA supervisory focus on those using practices that may be regarded as being of higher risk.

5.29 Requirements relating to reporting to the FSA will need consideration so that we gather the correct information, proportionate and consistent with the regulatory risks.

Regulatory certainty

5.30 We have been mindful throughout this review that regulation and the way that firms have interpreted some regulatory requirements in the past may have distorted the flow of new capital into the market and inhibited market developments. For instance, it may have limited the supply of services into parts of the mass market. So we see a reduction in regulatory uncertainty as an important regulatory outcome.

5.31 One approach is to work with the industry and the FOS to clarify current expectations and help to manage future liabilities. This should help firms design appropriate systems and controls that do not gold-plate Conduct of Business requirements. For example, firms may have avoided Basic Advice for a number of reasons, including a cautious approach to the regulatory requirements and a concern that they might actually be judged against higher standards. Greater regulatory certainty may help firms to avoid the over-engineering of rules in implementation.

Q69: Can you provide material examples of how regulatory uncertainty has created a barrier for your firm?

Q70: Do the proposals put forward in this DP go far enough to improving the position? If not, what other measures could we introduce?

EU legislation

5.32 Relevant EU Directives have sought greater harmonisation of the European financial services market. New regulation arising from the Retail Distribution Review, or the removal of regulatory barriers, will need to be compatible with these requirements. The main European Directives that may affect the proposals are:

- Capital Adequacy Directive (CAD): a personal investment firm that is subject to CAD must have initial financial resources of €50,000[4], which we would need to take into account when considering any risk-based capital requirement for personal investment firms;
- Distance Marketing Directive: this sets the minimum standard information that has to be given to the consumer about the firm and the product or service being

4 A personal investment firm that is subject to CAD must have initial capital of maximum of €50,000 or professional indemnity insurance (PII) or other comparable guarantee against liability arising from professional negligence of €1 million per claim and €1.5 million in the aggregate, or a mixture of capital and PII that achieves an equivalent level of cover. If the investment firm in addition carries on insurance mediation activity then the requirements are higher: €75,000 initial capital or PII of at least €1.5 million per claim and €2.25 million in aggregate (or a combination of the two)

offered, and cancellation rights set out in the Directive regarding contracts entered into at distance;

- Insurance Mediation Directive (IMD): for investment life products, the requirements of the IMD mean that intermediaries must obtain certain information about a consumer's demands and needs and must explain to the consumer the underlying reasons for any advice given on a particular insurance product. The IMD also prescribes minimum professional indemnity insurance for all insurance intermediaries[5];

- Markets in Financial Instruments Directive: any proposals affecting business covered by MiFID may fall into the areas harmonised by the Directive. In such cases, the measures must be consistent with MiFID and its implementing measures. They might also need to be justified under Article 4 of the MiFID Implementing Directive; and

- Undertakings in Collective Investments in Transferable Securities (UCITS) Directive: the Directive places requirements on the information that must be disclosed by UCITS managers; the Directive does not directly apply to intermediaries.

5.33 Any changes to the regulatory framework as a result of the Review's proposals would need to be compatible with these Directives.

5.34 MiFID may have the greatest potential impact on implementing the proposals. This Directive supports our own principles-based approach to regulation and limits regulators' ability to introduce new detailed rules for firms conducting MiFID business. In addition, our requirements must not fall short of the Directive's standards. Were we to consider the introduction of new rules or different standards for MiFID business, we would need to consider a number of factors:

- Article 4 notifications of super-equivalent requirements: in certain areas, MiFID imposes a number of tests for Member States wishing to impose additional requirements beyond those contained in MiFID and its implementing measures. Such additional requirements may only be implemented in exceptional circumstances, but we are fully prepared to make cases where necessary to achieve the outcomes of this review. As far as MiFID business is concerned, this could affect the introduction of rules to implement some of the proposals discussed in this review for MiFID business, including:

  o Disclosure: MiFID includes relatively high-level information disclosure requirements. Any additional specific requirements for disclosure might be seen as super-equivalent within MiFID scope. This might include any specifications concerning disclosure of remuneration, for example, or detailed requirements for annual statements.

  o Independence: We have notified the European Commission of a set of measures under Article 4. This includes the current conditions that advisers have to meet to call themselves 'independent'. As far as MiFID business is concerned, we

5 The IMD requires insurance intermediaries to hold PII or other comparable guarantee against liability arising from professional negligence of €1 million per claim and €1.5 million in the aggregate

would need to consider whether a modified use of that concept was consistent with MiFID.

  o Market entry: any requirements which had the effect of restricting entry to a particular market segment or activity, beyond the requirements of EU legislation, could be open to challenge.

- Sub-equivalence: proposals may also be sub-equivalent to MiFID where they seek to impose lower standards than MiFID requires. For example, MiFID describes the suitability process in high level. As at present, the high-level suitability standard will incorporate a degree of flexibility so that firms are able to design proportionate practices (subject to certain minimum standards). However, some of the suggestions for the new Primary Advice process could be below MiFID standards and, if so, could not be enacted for MiFID business. So we could look to implement Primary Advice outside of MiFID scope (see below).
- Non-MiFID business: not all firms and investment business falls within MiFID scope and it would be possible to introduce new rules for non-MiFID business only. For example, we could look to implement the proposals (such as the Primary Advice process) outside of MiFID scope as we have done with Basic Advice. At the same time, we would consider the regulatory and competition implications for allowing different standards for different types of business.
- Passporting firms: where we implement super-equivalent requirements, they would not apply to firms passporting into the UK from elsewhere in the EEA but may apply to UK firms passporting to other countries. We would need to consider the regulatory and competition implications of allowing different standards for different types of firm.

Domestic legal considerations

5.35 The main considerations under domestic law that are relevant to the proposals derive from:

- Financial Services and Markets Act 2000 (FSMA): new regulation is subject to a strict policy process involving consultation, cost benefit analysis and our assessment that the rules are the most appropriate method to meet our statutory objectives. FSMA also affects the way in which we perform our regulatory role. For example, it may restrict our ability to work with professional bodies to apply sanctions to individual practitioners.
- Competition law: our ability to change regulation in certain market segments must not distort competition in the market in a way that overrides the regulatory benefits. For example, this might be relevant to remuneration practices which, if limited by agreement, may be anti-competitive in effect, particularly if this affected only one market segment[6].
- General law: imposes the same obligations on financial services firms as it does on other businesses. One example of this in practice is that suitability

6 We have discussed the ideas put forward by the groups with the Office of Fair Trading

requirements cannot be lowered below the standards already imposed by the general law (for example, the duty of care). We do not have power to move obligations from firms to consumers that exceed consumer obligations under the general law.

- Human Rights Act 1998: may restrict our ability to impose further sanctions on advisers as discussed by the Professionalism and Reputation Group.
- Tax law: would need to be considered with regard to proposals on the accounting of commission, fees or other inducements.

Other relevant workstreams

5.36 There are a number of concurrent workstreams whose outcome may lead to regulatory changes that will facilitate the achievement of the outcomes identified in the Review. We will act to ensure consistency as we develop the proposals arising from this review. These workstreams include:

- Basic Advice Review: as part of the post-implementation review, we have been conducting an examination of the extent of the market for Basic Advice and how this can help to explain the current take-up of the Basic Advice regime. We originally anticipated publishing the post-implementation review, including an assessment of consumer and industry issues, by the end of the second quarter of 2008. We will now review the scope and timescales of this review because of the obvious links with the proposals for Primary Advice.
- Depolarisation Review: we have been considering possible changes to policy requirements in a depolarised market for retail investment products. Our original intention was to publish a Consultation Paper by the end of this year, but we will again need to consider the timelines in the light of the responses to the Retail Distribution Review.
- Prudential rules for personal investment firms outside the scope of MiFID: as previously noted, we are undertaking a review of these rules and will publish a DP in early July 2007.
- Responsibilities of providers and distributors: we will be publishing a feedback statement on DP 06/4 in July 2007. This will include a revised Statement of Responsibilities of how TCF Principles should be applied, based on current market structures.
- Training and Competence Sourcebook Review: Consultation Paper 07/4 seeks views on proposals to implement a simplified, more outcome-focused T&C regime. We aim to publish a Policy Statement in the third quarter of 2007 and for the new rules to come into effect on 1 November 2007.
- Wraps and other platforms: in parallel with this review, we have published the results of our review of the regulatory implications of wraps and other platforms in DP 07/2.

7 European Commission White paper on enhancing the single market framework for investment funds, 15/11/2006

- Review of the Simplified Prospectus: the European Commission has called for a review of the Simplified Prospectus[7] with work to be undertaken by the Committee of European Securities Regulators and Member States. It is hoped that non-legislative improvements, based on testing with consumers and industry, can be made by mid-2008 before being given a legally binding force by amendments to the UCITS Directive.
- European Commission Green Paper on Retail Financial Services in the Single Market: the Commission aims to identify and address problems in the market and to take appropriate, targeted action and to present a final report later in 2007. This may be very relevant to the Retail Distribution Review, so we are committed to working with the European Commission as it conducts its own review.

Concluding remarks

5.37 Our Review suggests a range of challenging proposals. We are determined to raise standards for consumers and will act as necessary to facilitate change and remove regulatory barriers.

5.38 Going forward, we would encourage the market to respond fully and openly to these proposals; both to comment on them and to suggest further ideas. Following this, we will need to undertake further research to provide evidence of market failure and the costs and benefits of regulatory change, and to act in a way that is consistent with EU and domestic legislation.

Summary list of questions

Chapter 2 – The Future of Retail Distribution

Professional Financial Planning and Advisory Services – Full Advice

Q1: How will increased requirements and consequential higher costs of providing full professional financial planning services affect advisory firms? Could the impact be significant enough for them no longer to offer these services, and, if so why?

Q2: Is it helpful to re-define the term 'fee-based' to mean any advisory remuneration derived in discussion with the customer, and not influenced by the product provider? How would this work in the different market sectors?

Q3: Do you agree with defining 'independence' in terms of freedom from bias, even if the adviser only selects products from a limited range? How far should this be taken, if at all? Would an independent label still have value, if these ideas are implemented?

Q4: Should we allow, in principle, the grandfathering of advisers to the new professional financial planner role if they do not have the necessary minimum qualifications or an equivalent? If we did allow this, what might be the consequences and how should we then encourage advisers to secure relevant qualifications? If you think we should not allow grandfathering, why not?

General Financial Advisers

Q5: Do you agree with the proposed distinction between professional financial planner and general financial adviser? If greater distinction is needed between general financial advisers and professional financial planners, how might this best be achieved?

Q6: Is there sufficient incentive for advisers to want to be professional financial planners? What further restrictions should we place on the permitted activities of general financial advisers, if any, and why? Should they have to offer a fee option?

Q7: Do you think that this two-tiered approach is desirable and, if so, should this be a transitional feature of the market or more permanent? Should there be any other classification of adviser offering full advice services beyond professional financial planner or general financial adviser?

Q8: What are the arguments for and against mandating the use (or preventing the use) of particular remuneration methods, for instance requiring the use of fee-based remuneration according to our wider definition by all advisers? What might be the market consequences if we took such action? How else might we encourage firms to adopt particular remuneration methods (or discourage the use of some others, for instance traditional indemnity commission)?

Q9: Should we allow, in principle, the grandfathering of advisers to the general financial adviser role if they do not have the necessary minimum qualifications or an equivalent? If so, how should we encourage (or require) any up-skilling to the necessary standards?

Primary Advice

Q10: What are likely to be the characteristics of the target consumer segments for Primary advice?

Q11: Do you think there is enough potential benefit suggested by this DP for Primary Advice to become a significant advice channel in the UK? If not, what else might be done to encourage firms to enter such a market?

Q12: What should be the conditions for Primary advisers to be called independent?

Q13: Is Primary Advice the right name? Would use of the term 'information' instead of 'advice' give consumers more confidence to use these services? What might be the implications of using the term 'information'?

Non-advisory services

Q14: What issues in relation to non-advisory services should the Review consider, and why?

Other implications of service propositions

Q15: What are the possible implications for consumers, if the proposed market for advice is introduced?

Q16: Would the ideas put forward help more consumers to access financial advice relevant to their needs? Do you have other ideas?

Conclusions

Q17: Do you think that the view of the future distribution market for investment products set out in this DP can address the current market problems? If not, why and what could?

Q18: Will many firms make significant changes to their business models? If so, why and how? If not, why not?

Making the transition

Q19: We welcome views on what would represent a sensible transition period for the industry.

Q20: In what ways could we help firms to change their business practices and standards to adapt to new requirements that might emerge from this review?

Chapter 3 – Professional financial planning and advice

Higher standards of competence and behaviours

Q21: Do you agree that these qualifications are at the right level for the roles described?

Role profiles

Q22: Do you agree that there would be clear benefits for consumers of introducing role profiles?

Q23: What role should regulation play in helping to make the necessary changes to qualifications and behaviours?

Better labelling of services

Q24: Do you agree that better labelling of available services would help in building the professionalism and reputation of the sector and in making services clearer to consumers?

Enhanced role and focus of professional bodies

Q25: Do you agree with these proposed measures to enhance the role of professional bodies and do you think these would make a difference to the professionalism of the financial advice sector?

Q26: Do you agree with the overall recommendations of the Professionalism and Reputation Group?

Q27: Do you have other suggestions for how the overall aim of raising professional standards and enhancing the reputation of the market could be met?

Q28: What role should we play in raising professionalism as opposed to relying on the professional bodies? Or can the industry lead the way in delivering improvements?

Regulatory and prudential standards to manage liabilities

Q29: Do you agree with the group's view that a system of risk-based financial resource requirements for personal investment firms, with a higher minimum requirement than at present, and which includes regulatory dividends, will contribute to better outcomes for consumers and a more sustainable distribution sector?

Q30: Do you agree that firms that give financial advice should be required to make some provision or arrangement for liabilities to customers which may come to light after they have ceased trading?

Q31: Do you agree that giving small firms incentives to employ compliance service providers will help increase the quality of their advice? Do you have other ideas on enhancing supervision of small firms and what are they?

Q32: Do you agree that we should consider changing the time limits we set for the periods within which cases can be referred to the FOS by introducing a 15-year 'long-stop', such as applies in the courts?

Q33: What do you consider to be the risks and benefits of introducing a 15-year 'long-stop'?

Q34: Should this 15-year 'long-stop' apply to business undertaken before and after the introduction of this 'long-stop'?

Q35: Do you agree that stakeholders should try to identify circumstances that may prompt valid complaints at an earlier stage, and within a 'long-stop' period?

Q36: Do you agree that stakeholders should seek ways of ensuring that measures taken by the industry to prompt valid complaints are taken into account when deciding whether a consumer was aware that he or she had grounds for complaint?

Q37: If it is not possible to agree on consumer responsibilities, would it help to agree on a set of 'sensible consumer actions' when buying a retail investment product, which could be made available to customers and taken into account when considering complaints, even if these are not legal obligations on consumers? Do you have other suggestions?

Q38: Do you agree that preparing a record of good contemporary market practice, by a group with strong industry and consumer representation and credibility, would lead to greater certainty about the standards against which advice will be judged?

Q39: What do you think the cost of preparing a record of good contemporary market practice, and revising it annually, might be?

Q40: What regulatory incentives, in addition to risk-based prudential requirements, do you think would encourage financial advisory businesses to improve the quality of their advice?

Transparency of remuneration

Q41: What data should be collected, and from whom, to help us to focus our attention on those firms most likely to be causing consumer detriment when advising consumers to switch product?

Q42: Do you agree that greater clarity for consumers on what services are being supplied, how much they are paying for them, and more influence for consumers on remuneration generally will help to address inappropriate advice risks?

Q43: How, if at all, should we intervene on the issue of consumers' rights to switch off trail payments?

Customer Agreed Remuneration

Q44: What do you think is the most appropriate approach under Customer Agreed Remuneration (CAR) to matching payments (in terms of amounts and timing) from the consumer to the provider, and payments from the provider to the intermediary, and why? What role, if any, might there be for regulation, or for guidance from other parties, to establish uniformity of approaches in the market?

Q45: Do you agree with the concept of third party financing, and if so, how might this operate?

Q46: What do you think are the main barriers, including taxation, which would prevent firms from moving to a CAR model? How might these barriers be addressed?

Q47: Do you agree that CAR could assist advisory firms to move towards a fee-based revenue model (according to the current definition of fees)? Could this help to erode the perception that advice is a free commodity?

Q48: What are the main challenges to implementing CAR, and what might be the implications for consumers, firms (of all types) and the FSA?

Q49: What market mechanisms (if any) do you envisage could contribute to reducing the risk of advisers exploiting the extra information they might possess on consumers' willingness to pay? Would the risk of price discrimination be a concern for consumers and how might this risk be mitigated?

Chapter 4 – Primary Advice

Primary Advice

Q50: What should be our role in endorsing the criteria for segmenting consumers for Primary Advice? What role is there for the industry to provide appropriate standardisation?

Q51: To what extent is there unmet demand for some form of simple advice, bearing in mind that the wider proposals in this DP and other market developments could alter the demand in the future?

Q52: Do you think that a Primary Advice service would benefit consumers and, at the same time, provide sufficient consumer protection?

Implications of debt for savings advice

Q53: What are your views on the extent to which people with existing debts should be encouraged or discouraged by financial advice to make investments and to save?

Q54: Are there any particular exceptions and how should we consider this in the context of decision processes for Primary Advice?

Tax, Benefits and Primary Advice

Q55: What are the tax or benefits issues that could hinder the development and/or success of a Primary Advice service? What are your views on how these might be resolved?

Standardised and portable fact finds

Q56: Do you think that these standardised and portable fact finds will help with the provision of advice to a wider range of consumers and help contain costs?

Q57: How should we strike the appropriate balance between verification of data and reliance on that data by other firms when using a portable fact-find?

Product approval

Q58: Do you agree that using product criteria would help firms deliver appropriate products to the target market for Primary Advice?

Q59: Do you think having FSA-endorsed products would help? If so, how would this work?

Q60: Do you have any other suggestions or options for limiting risks of inappropriate products being sold via Primary Advice?

Suitability

Q61: Do you agree that different suitability standards would encourage delivery of Primary Advice and what should these be?

Decision processes

Q62: Do you think that decision trees would be a useful means of ensuring that consumers had access to some type of information/advice?

Q63: What other ways might be used to standardise the advice process for Primary Advice?

Application of risk-based prudential requirements to Primary Advice business

Q64: How should risk-based prudential requirements and risk-based supervision for personal investment firms that give Primary Advice take account of the risk and consumer protection issues associated with it?

Other ways of increasing access for more consumers

Q65: Does the boundary between advice and information need to be clarified? What other regulatory changes might help delivery of non-advised products to consumers in a clear and meaningful way?

Q66: Do you think that an ‘assisted purchase’ model could work?

Q67: Are there any other models that you think could work?

Q68: Is there an argument for more radical approaches, such as further compulsory savings (beyond the levels envisaged by Personal Accounts)?

Chapter 5 – Legal and Regulatory Considerations

Regulatory certainty

Q69: Can you provide material examples of how regulatory uncertainty has created a barrier for your firm?

Q70: Do the proposals put forward in this DP go far enough to improving the position? If not, what other measures could we introduce?

Annex 2

Cost-benefit analysis

Introduction

1. From an economic perspective the problems in the market described in Chapter 2 are indicative of market and possibly regulatory failures that amply justify further efforts to improve on the market outcome. Of course, whether particular interventions will produce net benefits is an empirical question best addressed when specific, detailed proposals have been formulated.

2. The costs and benefits of such proposals need to be analysed not just individually but as part of the complete set of interventions that may result from this review. Ultimately, the impacts of all such interventions will be seen in the quality, quantity and price of the relevant financial services consumed. (Quality includes the notion of suitability, as well as intrinsic quality issues such as product features.)

3. In view of these considerations, this annex will not attempt to offer a detailed cost-benefit analysis of the high-level solutions discussed in this Discussion Paper. Rather, it will explain in general terms how these solutions address the relevant market and possible regulatory failures, and the benefits that these solutions may consequently generate. It will also describe some of the risks – possible negative market impacts – that could arise from implementing such measures, and seek information about these risks to enable us to mitigate them – and maximise benefits – in any specific interventions that we decide to carry forward.

Potential Benefits

4. The UK's markets for retail investments do not function well because of consumers' information problems. While regulation has sought in various ways and with some success to mitigate these problems, it has also, arguably, created new problems. For example, regulatory insistence on a single (high) standard of advice may well have distorted the relevant markets because the advice that many consumers truly demand – and that can be supplied at an affordable price – is in fact advice at a range of standards. Thus, while some of the solutions considered in this paper would, if implemented, alter the workings of the market, they mostly appear to be less distortive than the current regulatory arrangements because they reflect the

underlying heterogeneity of demand for advice. Therefore, in principle, they appear likely to produce benefits, relative to the current regime.

5. A further fundamental argument that some of the solutions considered here are likely to produce benefits is that the single high standard of advice currently offered in the market as a result of regulatory requirements is likely to increase transaction costs beyond the efficient level because it entails matching individuals' circumstances to specific products, which differ from each other in various details. But if it is the case that the financial needs of significant blocks of consumers are essentially the same, then parts of the relevant markets can work more efficiently through a 'commoditised' approach. Such an approach appears to be facilitated by the solutions considered here.

6. At a more detailed level, the following benefits may be associated with the solutions outlined in this paper:

   - The quantity of the simpler forms of financial advice provided should increase to the extent that the proposals about lower levels of advice, portable fact finds, decision trees and standardised products reduce the cost of providing simpler financial advice and so make it economically viable for firms to sell products to greater numbers of consumers. An increase in the quantity of financial advice would be likely to lead to a corresponding increase in the quantity of financial products that are sold. Assuming that the incremental sales are suitable, this should yield benefits for firms and consumers.

   - The quality of financial advice is likely to increase due to increased training for financial advisers, along with higher professional standards. This is most likely to be the case in relation to full advice.

   - To the extent that the new advice process opens up the market to consumers who would otherwise not have sought financial advice, then the quality of advice received by these consumers will be higher (assuming that some advice is better than no advice and products that are sold are suitable).

   - The general quality of financial advice may increase to the extent that a new remuneration system removes the incentives that can lead to provider bias occurring.

   - This could also mean that providers will not compete with each other around commission levels and instead compete for consumers based on the price and quality of their products. This could lead to increased product quality and/or reduced product charges.

   - There is also potential for better quality products if product standards reduce product differentiation that is not cost-effective or useful to the consumer.

   - Assuming that firms find it economical to produce lower levels of advice with the aim of selling products to middle and lower income consumers, then it is likely than there will be an increase in the variety of financial advice, which in principle is a benefit.

   - The price of financial advice may decrease to the extent that Customer Agreed Remuneration (CAR) gives consumers more power over the price that they pay and they exercise this power by negotiating with their adviser and shopping around more.

Risks

7. Even if the solutions considered in this paper are more market-sensitive than the current regulatory regime, it is possible that some of them, notwithstanding the potential benefits described above, will have some perverse or undesirable effects. We are also aware of the need to tread cautiously when intervening in dynamic markets, given their propensity to evolve in ways that could not be, or were not, foreseen when seemingly beneficial measures were put in place. As already mentioned, we will try to ensure, through careful design of our interventions, that any undesirable effects are kept to a minimum.

8. At this stage, we have identified some potential risks arising from the proposals that have been set out in this paper. These are described in further detail below:

   - The package of proposals may not reduce the costs of offering simpler advice sufficiently to make it economically viable for firms to target the middle market. In this case, given that the cost of full advice is likely to increase as a result of some of the measures, overall access to advice could be reduced. In that case, sales would be negatively impacted to the extent that consumers in this market are reluctant to purchase investment products without advice.

   - Increased costs associated with, for instance, higher financial resources requirements may force firms to exit the market or stop new firms from entering the market. This could lead to reductions in the quantity of financial advice on offer and thus to the cost of reduced consumption.

   - Under a commission-based system there is limited discussion of remuneration between the customer and the adviser. A CAR system will mean that discussions between the customer and the adviser about remuneration will become the norm. So advisers are able to obtain much more information on the willingness of consumers to pay for financial advice. If customers do not exert their power to reduce prices then there is the potential for advisers to exploit the extra information that they will possess and engage in price discrimination. This could result in increased consumer detriment.

   - The overall package increases barriers to entry to the market for full advice. This could lead to the market share of independent agents reducing and the market share of tied agents, appointed representatives, or direct sales forces increasing. This would give product providers greater influence over the financial advice market, enabling them to use tools of industrial control such as vertical agreements that may not be beneficial to consumers.

   - Product standards may inhibit product innovation that could otherwise lead to the availability of more products nearer the efficient frontier (or to a favourable shift in the efficient frontier). This would lead to some consumers obtaining products that are less suitable (including in the sense of quality-adjusted price) than they otherwise would have done.

International comparisons

1. As part of the Retail Distribution Review we were keen to understand how the UK market compares to others and whether any lessons could be learned. So we undertook some work to assess, around the five themes of the RDR, the factors influencing the way in which financial advice and distribution operate in other countries. It provides some areas for comparison with the UK market and offers examples of behaviour and good practice in other countries. We intend to explore this further.

Context

2. We have purposefully looked at other mature retail marketplaces: some with shared characteristics to the UK (for example the US, Canada, Australia, The Netherlands); some we know to be different (for example France, Germany); and others that provide opportunities to learn something new (for example Switzerland, New Zealand).

3. We obtained information, views and opinions variously from international regulators, regulated firms, consultancy firms and market information services.

4. The UK is not the only country taking a comprehensive look at distribution in the round; both the European Commission and the US Securities and Exchanges Commission are undertaking reviews. The Commission is undertaking a project due for completion in 2007 entitled 'The EU market for consumer long-term savings vehicles: Comparative analysis of products, market structure, costs, distribution systems and consumer saving patterns'. The SEC has commenced its 'Investment Advisers/Broker-dealer study' on similar lines. Likewise, the French 2005 Delmas-Marsalet report, recent new regulation in The Netherlands and ongoing work in New Zealand show that there is significant interest in retail distribution around the world.

5. The terms used in different markets, although the same words, often tend to have different meanings. One person's broker is another person's financial adviser, and another's salesman. Whilst we have made every effort to use terms consistently, this can make comparisons difficult.

6. Our overall findings are set out below. The remainder of the annex provides further detail, structured around the five themes of the RDR.

Overall Findings

7. If an ideal distribution system is one in which all consumers take educated financial decisions off the back of sound impartial advice, then it is straightforward to conclude that none of the countries considered have achieved this. While other countries have experienced similar problems and investigated solutions, none has yet arrived at a distribution nirvana.

8. Financial capability clearly does have a bearing on the demand for advice (which, in turn, influences the number and complexity of products then offered). However, it is also clear that, even in countries where mandatory pensions contributions are made, consumers still have no real appetite to engage with financial services.

9. There is certainly no one world-wide model for retail distribution; there is not even consistency across Europe. In some countries, providers appear to be experimenting by taking channels that work in other countries and adding them on to (not replacing) their existing models.

10. In terms of myth-busting, no one country has developed a dominant true financial planning model (not even the US or Australia). Some countries have many financial planners – but this label can be equivalent to the way the term 'adviser' is used in the UK. Some may be financial planners but the majority are either salesmen or advisers or a bit of both.

11. Indeed, no other country has such a large percentage of its distribution network attempting to give independent advice as we do in the UK. In some respects, this puts the UK substantially ahead of other countries, if we believe that independent advisers provide the best chance of providing impartial advice to consumers.

12. Remuneration is dominated by commission world-wide. As a consequence, concerns around bias and churn feature highly in most countries. Some are tackling this by way of disclosure, others are trying to alter the balance of incentives. Some smaller economies have banned commission but, to put this in context, the number of intermediaries affected by this is small compared to the UK.

13. New technology (such as wraps) has encouraged a move away from initial commission in Australia. However, the structure of the distribution market has had a bearing on why so many advisers could move business on to a platform (i.e. access and support by the network principals). There remains a significant volume of intermediary firms not using wraps.

14. Our conclusion is also that any debate about the sustainability, impartiality and quality of advice given by distributors in other countries has not become as high profile or widespread as in the UK. There are various reasons for this, including a perceived absence of problems (France, Spain); low consumer interest or lobbying (New Zealand); stronger caveat emptor cultures (US); and tied advice being an accepted norm (Switzerland). That said, the regulatory reforms underway in many

countries will mean more regulatory focus on intermediary issues. Once those regimes have been in place for a few years, we could see similar concerns and debates being raised to those coming to a head now in the UK.

15. Despite differing financial capability strategies, business models, remuneration structures etc, there are no models that have succeeded in tackling such issues in a way that has worked better than in the UK. Although this is the case, we should not hold back in looking to improve the UK position.

Consumer Access

What drives the need for financial advice?

16. Before looking at the distribution models prevalent in other countries we wanted to understand the factors that drive demand for advice in those markets. To a greater or lesser extent, we believe all of the following play a part.

Consumer wealth

17. It is generally accepted that consumer wealth is a driver of both demand for financial advice and the complexity of products offered. Countries where large sections of the population have typically been wealthy have developed more complex financial products to meet more complex (and tax-efficient) needs. Conversely, where populations have been comparatively cash poor, consumers have been content with the simple products offered, typically by banks and bancassurers. Spain is a good example of an economy that is now emerging from this position into one where large numbers of people have amassed wealth. Not only are new products entering the market to cope with more complex needs but correspondingly, albeit slowly, a demand for independent financial advice is emerging around making the best use of these.

Consumer behaviour

18. Historical behaviour should not be overlooked. People often do what they have always done. In Germany and Switzerland, it has long been typical to buy insurance from an individual's personal tied agent. In France, Spain and Italy an individual's personal local bank services most of his or her financial needs. Historical legacies remain strong drivers of behaviour today.

Tax and other state benefits

19. Government rules around taxation and/or state benefits are a partial driver of consumer need for advice. Variations in tax limits from vehicle to vehicle often dictate where consumers put their money. The more complex the tax rules and the number of variations and limits, the greater the need for financial advice. In some countries (such as UK, US and Australia), this is particularly acute in the area of pensions and is in stark comparison to the position of most of mainland Europe.

Extent of state pension provision

20. Individual countries have designed pension systems to suit the needs of those countries. Consequently, design, coverage and most importantly, payouts in retirement, vary enormously. Countries such as Spain, Italy and Denmark have provided residents with state pensions of between 65% and 80% of the average income workers enjoyed when employed. In light of this generosity (coupled with a family structure geared towards supporting elderly relatives), consumers have not needed to save by way of private or occupational pension schemes, and have consequently not required advice on their retirement affairs.

21. In contrast, the state pension systems of the UK, Canada and the US have provided comparatively low levels of retirement income[1]. Emphasis has long been on consumers to ensure that they have additional retirement savings, typically through occupational pension schemes and, increasingly, private pensions. In these countries, markets in different products have developed and, with rules around private and occupational pensions invariably complex, this has presented a clear source of demand for expert advice.

22. However, despite their differing systems, all the countries considered here have now recognised the consequences of an ageing population. Countries have chosen to deal with the increased need for more retirement savings in different ways.

- In broad terms, most have already amended, or are in the process of amending, their pension systems to create a three pillar system of state, occupational and private pensions. For the first time, consumers in countries like France and Germany are likely to need to at least part-fund their own retirement and will presumably need help with unfamiliar pension products/rules – resulting in an increased need for financial advice.

- New Zealand chose to boost state input into the national pension system (but is also promoting a non-mandatory, but tax-advantaged, auto-enrolment scheme called KiwiSaver to encourage extra saving).

- Australia chose to enforce compulsory occupational pension schemes (superannuation) in order to shift the burden of saving away from government and onto firms and consumers.

Financial capability

23. We reviewed (at a high level) the financial capability of countries to assess whether there was a demonstrable link between increasing capability and an increasing demand for advice. We found that the UK is not alone in having consumers who decline to take an interest in financial services; who spend rather than save; and who are likely to be sold products rather than pro-actively seeking considered financial advice. This is in spite of governmental and non-governmental efforts in most countries to promote financial literacy and to boost savings.

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1 Gross replacement rates for someone on average earnings are: UK = 30.8%, Canada = 43.9%, US = 41.2%. OECD average is 58.7%. (OECD Pensions at a Glance – Public policies across OECD Countries, 2007)

24. While some more advanced countries are making headway – the US launched a National Strategy for Financial Literacy in April 2006 that incorporates the demands of 20 separate governmental agencies (let alone charities and firms) and Australia has had a National Consumer and Financial Literacy Framework in place for 18 months – the UK appears to be at least as far ahead in terms of its financial capability work. Too frequently, it appears that efforts between interested parties (such as government, regulators, financial services firms, charities) to tackle financial capability have been disjointed.

25. Perhaps the exception is where countries have focused on quite a narrow scope. For example, New Zealand has had a well-established consumer education service since the mid-1990s, initially explicitly focused on retirement advice. The Retirement Commission raises awareness of the need to plan for retirement; provides education on financial management and planning tools; and runs a well-known consumer-focused website offering impartial financial information that receives around 100,000 unique visitors a month.

26. Even in countries where the state relies heavily on consumers taking individual responsibility for their affairs (for example the US), consumers still appear unwilling – or oblivious to the need – to engage. Indeed, even in countries where there is a system of mandatory contributions (for example superannuation in Australia), most workers stick with default enrolment into vanilla funds managed on their behalf, rather than taking an active interest in, or advice on, fund selection. This may be one of the factors relevant in thinking about the extent to which the introduction of Personal Accounts in the UK will affect demand for advice.

27. Of those considered, only one country, The Netherlands, is tackling financial capability by way of greater product disclosure. The Dutch are aiming to help consumers assess the risks associated with individual products by insisting that the literature for all retail financial products carries a risk warning. This takes the form of a pictorial logo that tells the reader the riskiness of the product (on a scale from very low risk to very high risk) and an indication of whether the consumer's capital is at risk.

Sustainable business models

28. In terms of distribution structures, the countries in this study largely started from the same place. Tied advisers initially dominated (as they did in the UK), working in local communities to establish themselves, selling their products to a non-financially literate market and, in doing so, helping to educate consumers about the products they sold[2]. The way that countries have moved away from this model – and the speed at which they have done so – has now created (in generalised terms) three main models. Using UK terminology, we would describe these models as bancassurance, tied and multi-tied. We expected to see a fourth model – financial planning – but this did not really come through. None have a strong independent channel similar to the UK model.

2 This education by-product effect tends to be lost in models where tied advisers have disappeared

Bancassurance

29. In France, Italy and Spain, banks are the main distributors of life assurance, accounting for over half of total premiums[3]. In these countries, products are usually sold using a 'captive' model or, to a lesser extent, a 'joint venture' model.

30. It is not surprising that banks sell insurance products that are similar or related to deposits (such as savings-type life assurance), while at the same time diversifying their client offering and potentially improving customer loyalty. Banks are also good distributors of unit-linked life products (including structured, guaranteed capital products) because they operate in a similar way to mutual funds.

31. There are, of course, some life companies in these countries that, in the main, choose to distribute through a tied model. But it is interesting to observe that those trying to compete directly with the banks for market share have decided to do so by following a path similar to some UK firms. In other words, rather than expanding the number of tied staff, they have added small independent agents/brokers as a new distribution channel.

32. It is also interesting that, in countries where bancassurance has not previously played a major role, there are signs this may be changing. For example, banks in The Netherlands are striving for more cost-efficient contact with their customers (telephone and internet banking) because they have not only lost out on the sale of non-traditional banking products (such as life and pensions business), but recognise that they have also begun to lose customer relationships. Consequently, Dutch banks have started refurbishing branches to reinvent themselves as customer-friendly 'financial centres' with more convenient opening hours and with staff able to service banking as well as most other financial needs.

Tied

33. Although it is dangerous to generalise across countries, some markets are still dominated by tied advisers. This is the case in Switzerland and Germany, especially in traditional regions (for instance rural areas) where long-standing relationships remain important. The German market is interesting due to the high number of part-time intermediaries who help to service the mass market, often acting as door-openers to full-time advisers from the same company. The implementation of EU regulation is expected to result in many intermediaries exiting the market. And, of those that remain, signs of a shift to 'multi-tie' are underway.

34. It is in light of this shift that the German market has seen growth in the multi-tied propositions of the 'Struktervertrieb'. These are large intermediary firms that to date have focused on selling products, but are increasingly building long term relationships with clients. This reflects an increased demand for independent financial advice and, apparently, a realisation by banks and insurers in these countries that exploiting independent distribution networks can be more cost effective than running their own. It is a move partly resonant of the UK life offices closing their direct sales forces in the 1990s and turning to intermediary firms for their distribution.

3 Datamonitor European Life and Pensions Databook, 2005

Multi-tied

35. Many countries operate what we would describe as a ‘multi-tie’ model. The Netherlands, for example, has a predominance of advisers who advise across more than one product and typically from more than one provider firm. Others have what we describe in the UK as a network structure in place. In the US and Canada, both use the concept of a Managing General Agent as a go-between the provider and the intermediary. In Australia, many intermediaries gain their licensing from a provider firm and, in exchange, receive technological and product support from a subsidiary of that provider. Indeed, the growth of wraps in this market has, in fact, been driven by the providers working to minimise the inefficiencies of having to work through innumerable small firms of advisers.

36. It is clear that intermediaries in these countries are strongly incentivised to join networks. There appears to be a belief that, in addition to being provided with robust technology and support, the network parent is far better able to research and advise on products such that advisers are then able to service their customers better (both from the time they can devote to them as well as the quality of information they can provide).

Independence

37. We found no other country that operated a model similar to the UK, whereby many firms were neither tied nor multi-tied but were, in fact, free to engage with any provider, and therefore reliant on the ‘independent’ brand.

Financial planning

38. We looked to the US, Canada and Australia to try to learn lessons about how a financial planning model works, not least because of the number of financial planners in each of these countries. We found that nearly all intermediaries in these countries call themselves financial planners, almost regardless of the type of service they actually offer. Comparatively few actually offered true financial planning services. In many ways, it appears to be the same as the emerging picture in the UK, whereby all financial advice intermediaries call themselves advisers. But there are starting to be clear divisions in the service they are actually offering (some being transaction focused, the majority giving some advice around a transaction, a few giving true financial planning).

39. It is fair to say, however, that true financial planning is an area of growth in these countries, comparable to the UK. However, as in the UK, no country surveyed here has true financial planners who attempt to, or appear to have any appetite to, service the lower end of the market.

Impact of incentives

40. Whether an adviser is tied or multi-tied or whether they are called a salesman, an adviser or a financial planner, almost all the advice on offer worldwide is commission-based. Most is based on similar structures to the UK, namely heavily

front loaded, a mix of initial and trail, fees taken by way of commission, or a salary and commission mix.

41. Levels of remuneration received by individual advisers also vary according to the structure in which their firm is involved. The licensing agreements, between licence holders (providers) and advisers in Australia, can mean raising or lowering the level of commission taken by advisers on a case by case basis. ‘Struktervertrieb’ workers in Germany have to pay away a large portion of their earnings to their parent firm and individual advisers higher up the food chain, reflecting the ‘pyramid-style’ recruitment strategies employed.

42. None of the European countries reviewed operate a significant fee-based financial advice system. Indeed, outside Europe fees are not particularly prevalent either, although they are growing. Fee-based payments are now becoming more commonplace (but not dominant) in the US, Canada and Australia. However, as with the UK, we understand that there are ways to pay fees which avoid a one-off payment (for example commission rebating; or a percentage fee based on funds under advice). In conclusion then, there has not been a significant shift to pure fees in other countries.

43. Two common themes in other countries mirror problems experienced in the UK. These are churn and bias.

Churn

44. A lock-in period of ten years is customarily used for many life policies in Switzerland, effectively preventing churning. In Northern America, churning is reputedly commonplace. This is attributed to the fact that distribution there is dominated by agents who derive around 70% of their income from upfront commission, and who need to hit sales targets set by the providers to achieve the remaining 30% in the form of bonuses. If an insurer were to refuse the business on the grounds of churn, it runs the risk of not receiving further business from that agent/broker.

Bias

45. All those countries operating a commission-based system have seen allegations of recommendations that are biased in favour of high commission products. Two markets are widely spoken of as being examples of possible ways forward for the UK, namely the US (because of its alleged successful fee-based model) and Australia (because wraps[4] have supposedly eliminated most initial commission business). However, allegations of commission bias continue in both countries.

46. In terms of solutions, disclosure of remuneration is a hot-topic in many jurisdictions. Canada and Australia, for instance, have both placed emphasis on the availability of fee-only advice and this has been included in disclosure requirements designed to ensure the customer knows exactly what they are paying for.

4 Strictly speaking, Australia has Investor Directed Portfolio Services (IDPSs) which encompass Master Trusts and wraps, but the differences are negligible in this context

47. Under one approach suggested by the French AMF[5], producers would report how much commission had been paid out per distributor and per product so that the regulatory authorities could use averages and outliers to identify problem participants.

48. A recent Swiss Federal Court ruling said that independent financial advisers (a minority distribution channel in Switzerland) must rebate commission to the consumer, unless the consumer has willingly signed a document forgoing it. Apparently, consumers may be able to negotiate a lower fee for advice in return for signing the waiver.

49. More radically, the Dutch authorities recently intervened in their market after research identified non-optimal advice from brokers. Believing that consumers would be unwilling to pay fees, they have instead decided to alter the balance of incentives. Their intention is to make trail commission on life and protection business equally as attractive to advisers as initial commission by legislating that initial commission is limited to 50% of payment. The logic is that the other 50% is worth waiting for (rather than putting in the effort of churning a policy for only a new 50% reward). The merits put forward are that this does not interfere significantly with market conduct; it will not radically affect cash flows; and it will help to embed value in advisory businesses.

50. And, while not mandated like the Dutch, we have found other examples of countries moving towards more of a trail commission model. For example, the Australian market, apparently in light of the transparency brought by superannuation, developed technology like wraps. These have helped advisers voluntarily move towards a trail commission model over the last 10-15 years such that 70-80% of a typical adviser's remuneration comes in this way. However, while most retail funds are now held on wraps, a great number of smaller financial advice firms are not geared up for using this technology.

51. We are also aware that more drastic steps have been taken in smaller economies, notably in Denmark, Finland, Sweden and Israel.

52. Denmark and Finland have legislated to prohibit initial commission on life and pension sales. The actions of these countries have recently been held up as examples of innovative regulatory practice, where the authorities have taken radical steps to move to a regime that is fairer to consumers. However, it is important that these initiatives should be seen in their proper context:

    - the retail markets in these countries are not as large or complex as those of the UK, especially in terms of the range of advisory propositions; and
    - in both countries, the ban on initial commission applies only to independent brokers, which (unlike in the UK) only account for a small proportion of sales. As such, the ban is not as radical a move as might be supposed.

5 Delmas-Marsalet Report, November 2005; Autorité des Marchés Financiers – the financial regulator for securities and exchanges

53. Finland and Denmark both changed commission rules on the explicit basis that receiving commission from providers impairs the independence of brokers. Finland was the first Nordic country to ban brokers from receiving commission from insurers. Since September 2005, brokers have been paid through a fee; from 2008 this will have to be from their clients, but until then it can be paid by a third party (which could be the provider).

54. Danish legislation came into force in July 2006 requiring insurance brokers to be paid by the consumer rather than the provider (this only applies to brokers, as no other Danish intermediaries hold themselves out as independent). Due to mergers, a decrease in broker numbers seems likely, but limited movement has been seen so far.

55. In Finland, Denmark and Norway a distinction is drawn between life intermediaries that have a responsibility to act on the behalf of the customer and those that act on behalf of the insurance company. Changes to commission rules have only affected the remuneration structure of those who are obliged to act in the interests of customers. The impact of new remuneration requirements will, at least initially, depend on the share of the distribution market that these channels have. In the longer term, the requirements themselves may lead to changes in the structure of retail distribution in the Nordic markets. It is estimated that channels affected by new remuneration requirements currently have around a fifth of each of the Finish and Danish markets and half of the Norwegian market. By comparison, UK IFAs hold two thirds of the life and pension distribution market[6].

56. Increased requirements in Sweden since 2005 necessitate disclosure of the price of mediation, how it is decided and any commission or other remuneration paid by 'someone else other than the customer'. This was a contributory factor in two large providers declaring that they would no longer pay commission to intermediaries. In addition, the Swedish Insurance Federation has discouraged its members from entering into agreements concerning the size of compensation for intermediaries in life insurance. These providers now present their insurance premiums net from commissions. They call this system 'net premiums' but it appears to be an example of Customer Agreed Remuneration[7]. It is anticipated that the share of the Swedish distribution market held by independent financial advisers will grow, however this may be as much due to the increasing complexity of the financial market as the commission disclosure requirements.

57. However, none of the major economies considered – even those that have a relatively small intermediary market – has an appetite for banning commission outright.

Professionalism and reputation

58. We attempted to capture comparative information in three broad areas: the way in which the sector itself strived for professionalism; whether regulation had made a difference; and whether mis-selling has been a feature of the market.

6 Datamonitor UK IFAs 2006 (2005 figure)

7 Also referred to in this Discussion Paper as 'Factory Gate Pricing'

Professionalism

59. On the whole we understand that those who sell life products in the UK are not viewed as professionals. This also appears to be the case in other countries. In some respects, however, the lack of professionalism does not appear to be such an issue. We have attributed this, in part, to how the industry holds itself out. For example, in Germany and Switzerland where tied agents dominate, they are clearly thought of as salesmen and this is accepted. It is perhaps also important as to why, as part of the reforms in New Zealand, they are actually looking to define the term 'financial advisor', with one lobby group arguing strongly that it should not be linked to transactions/sales.

60. Qualifications – regulatory or otherwise – also appear to play a part. Most countries now have regulatory qualifications (Switzerland has recently introduced a benchmark qualification for insurance intermediaries of all types). These are either minimum exam standards (for example Canada has recently introduced a new national standard for life insurance – agents now need to attain a certificate from the Life License Qualification Program) or tiered training for advisers according to the complexity of the product being advised upon (for example France and Australia).

61. The US appears to have the greatest number and variety of qualifications on offer outside of the regulatory requirements. There are around 320 undergraduate degree, graduate degree, and certificate programmes in the US that are directly geared towards the Certified Financial Planner (CFP) designation. As a consequence, many US financial advisers are educated in financial services to degree level. We believe that this is a contributory factor as to why people – both inside and outside of the US – tend to regard financial advisers there as professionals.

62. In South Africa, the Financial Planning Institute has emerged as the sole professional body for financial advice intermediaries. It operates a three stage hierarchy of designations – Registered Financial Planners (5,400 holders), Associate Financial Planners (2,700) and Certified Financial Planners (3,200). Underpinning the designations are tough academic requirements. For instance, an Associate Financial Planner requires a bachelor's degree and two years minimum experience.

Case study: A strong professional body

The Financial Planning Association of Australia (FPA) is the dominant professional body in the field of financial advice in Australia with around 12,000 members, 5,300 of which are qualified to Certified Financial Planner level. Membership is voluntary and there are minimum qualification entry requirements that are higher than the entry standard demanded by the regulator.

FPA membership is desirable from an adviser's perspective. Membership carries an air of professionalism that advisers want to have. There is a code of ethics, rules for professional conduct and compulsory CPD requirements for members. The FPA takes sanctions against members and can expel members. While there is no official link to the regulator, FPA sanctions may influence whether the regulators allow continued authorisation.

The FPA undertakes considerable work with consumers to promote the benefits of getting financial advice from an FPA adviser.

Case study: Raising the bar

In Ireland, the Financial Regulator introduced new minimum competency requirements in January 2007. In broad terms, while other exam providers can create new qualifications, there is now one qualification, Qualified Financial Adviser (QFA), that is supported by three different professional bodies and which is now dominant. It has taken five or more years to merge the courses and raise the bar in terms of what the regulator now demands as course content. QFA is now the benchmark qualification for anyone advising on any retail financial products (including life policies, shares, savings, pensions, mortgages, protection and consumer credit).

Regulation

63. Regulatory regimes in different countries retain unique structures. Federal systems such as in the United States mean complex networks of regulators. Others appear to be moving towards a more unified working relationship (Canada) or, as in the UK, a single regulator (for example Germany has already created BaFin and the Swiss are about to adopt a unified model).

64. If there is a trend, it is towards greater conduct of business (CoB) focus, not least in Europe on account of financial services related EU Directives. Regulatory regimes which previously focused almost solely on prudential issues are gradually putting an increasing focus on the quality of the sales process. Recent financial services legislation in The Netherlands and Switzerland has been CoB focused and recent work in New Zealand indicates that new legislation will be introduced because current regulation 'is failing to ensure that intermediaries are accountable to

consumers; that intermediaries have the experience and expertise to match consumers with products; and that consumers are able to make informed decisions about intermediaries'[8].

65. An interesting requirement in the Danish market is that licensing of insurance brokers by the Danish FSA demands that 'forsikringsmaegler' (insurance broker) is included in the firm name. This is intended to help consumers distinguish between distribution channels, and by implication, whether the adviser is committed to acting in the interest of the firm or the customer.

Mis-selling

66. Few territories have experienced a public UK-style mis-selling scandal (despite remuneration by commission dominating around the globe). There appear to be several reasons for this:

    a) In markets with generous state pensions (France, Spain), little complex advice has been given on life insurance and pensions until recently. Consumer needs have been simple and products low-risk.

    b) Several countries have had prudentially focused regulators with low interest (or authority) in assessing conduct of business.

    c) In sales regulated markets some regulatory authorities have not actively looked for past problems.

    d) Some issues do not get labelled as mis-selling in other countries when arguably the UK might do so. One example might be the vanishing premium issue in the US.

67. Australia, for instance, did not necessarily have the laws, regulatory structures and redress mechanisms to address mis-selling when it did occur. In the late 1980s and early 1990s, we are told there was mis-selling of life insurance products. These had high fees and heavy exit penalties. The potential returns were often exaggerated (e.g. 15% projected forward 30 years). It was rarely explained that the consumer would not even recoup their contributions for four to eight years.

68. Partly as a result of suspected mis-selling activity, the Dutch regulator (the AFM[9]) gained greater CoB powers in January 2006 with a new financial services law that requires firms to disclose certain information before a sale and imposes greater duty of care obligations, but we understand the AFM will not be looking for inappropriate selling by intermediaries before this time.

69. One country which did experience a scandal is the US, where the 1990s saw considerable action by both litigators and state and federal regulators (who issued large fines and amended regulatory rules) in response to intentional misrepresentations and fraudulent inducements made by representatives of insurance companies selling life policies with 'vanishing premiums'.

8 Discussion Document, Financial Intermediaries July 2006, Ministry of Economic Development

9 Autoreit Financiële Markten – the main financial regulator (excluding prudential supervision)

70. In assessing mis-selling activity, the conclusion we have drawn is that it is certainly possible (if not probable) that mis-selling did occur in the past in several countries but that with the exception of the UK and the US, it was simply not detected or not acted upon.

Members and observers at the groups

Each of the five groups was asked to reach broad consensus on issues relevant to their theme and to be addressed by their group; to identify both industry solutions and key barriers to delivering these solutions; and to engage the distribution market, as far as possible, in the achievement of these solutions.

The groups consisted of the following individuals –

Sustainability of the distribution sector	
Chair: Members:	Jo Dawson Jonathan Asquith Kate Avery Gill Cardy Alistair Cole Charles Eppinger Patrick Gale Sam Tymms

Impact of incentives	
Chair: Members:	Mike Yardley John Baxter Iain Black Stephen Bland Stewart Cazier Peter Hales Nathan Parnaby Chris Rhodes

Professionalism and reputation	
Chair:	Roderic Rennison
Members:	Nick Cann Geoffrey Clarkson Irene Dorner Joanne Evans Tim Kirley Andrew Pomfret Sandy Scott Mandy Spink Tony Tudor

Consumer access to financial products and services	
Chair:	Otto Thoresen
Members:	Matthew Bullock Rodney Bulmer Paul Etheridge Shaun Mundy Will Nott Nick Poyntz-Wright Peter Vicary-Smith

Regulatory barriers and enablers	
Chair:	Dan Waters
Members:	David Barral Martin Bischoff Clive Gwilliam David Harrison Ewan Smith John Sutherland Ian Trevers

Representatives of the following organisations attended all or some of the group meetings:

- Association of British Insurers
- Association of Independent Financial Advisers
- Association of Private Client Investment Managers and Stockbrokers
- British Bankers' Association
- Building Societies Association
- Financial Services Compensation Scheme
- Financial Services Consumer Panel
- Her Majesty's Treasury
- Investment Management Association

In addition, many organisations and individuals have contributed directly to the Review so far. Like those listed above, they have given us their views on the problems and potential solutions to the distribution of retail investment products and services, either in meetings or through formal submissions.

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