Financial Conduct Authority

Thematic Review TR13/5

Supervising retail investment advice: how firms are implementing the RDR

July 2013

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1. Summary

Background

We implemented the Retail Distribution Review (RDR) on 31 December 2012 to ensure that financial advice is from appropriately qualified financial advisers, free from bias and the costs of advice are clear for customers. Central to this was the ending of commission and a requirement that financial advisers operate as either ‘restricted’, only able to recommend certain products and/or providers, or ‘independent’, able to consider all types of retail investment products. All these measures were aimed at improving the quality of investment advice.

For RDR to be effective, consumers should be clear on what they are paying for and be able to compare services. This means how firms explain these points to clients in documents is important. Documents should be clear and concise so they are easy to understand.

We are currently doing a three-stage thematic review to assess firms’ overall approaches to RDR. We have now completed the first stage. This report provides the findings.

Coming just six months after the introduction of RDR we want to know where the industry is with implementing the RDR. Are independent services truly independent? Is the industry already providing the clear documents that clients need or is there, in some areas, more work to be done? So this should be read as an early report card for the industry, pointing to successes so they can be adopted as best practice elsewhere and, at the same time, indicating areas that could be improved.

Along with consumer research published at the same time, this report should provide the impetus needed for those firms who are not quite there yet.

What we did

We sent 50 firms from across the industry an online questionnaire. The firms were chosen to reflect a cross-section of the industry and so included small financial adviser firms, large advisory networks, banks and insurers. We used a qualitative approach which was not designed to be statistically representative. The questionnaire asked firms how they devise, disclose and deliver their services and charges. We also requested copies of firms’ disclosure documentation. We assessed this information and then followed up with some firms, performing a more in-depth review.

We also commissioned NMG[1] for an early piece of consumer research so we could better understand whether real consumers are able to understand how firms charge and what services they offer, post-RDR.[2]

Our findings

Firms have made a lot of progress. Generally, firms had acted to implement the new requirements and were open to our feedback. We were pleased to see that many firms' propositions were in line with the new rules. Some firms had also tried to make their disclosure material clear and engaging.

We identified two main areas where more needed to be done. First, while there was evidence of good practice, some firms were not providing clients with some or all charges in cash terms. Second, some firms fell down by not being clear what ongoing services they would provide. These findings were common in the sample of firms, suggesting other firms may not be meeting these rules.

We also found that while most firms were providing their generic charges in good time before making a personal recommendation, some were not. We were also concerned that some firms, while describing themselves as independent, were not offering a truly independent service. Some firms providing restricted advice were not adequately describing the nature of the firm's restriction.

The consumer research conducted in tandem with this qualitative study clearly demonstrates the importance of firms providing clear information so clients understand the costs of advice and the service they can expect.

The research showed consumers appreciate timely information. This should provide a message to those firms that are not yet giving clients information on charges early enough.

What is more, the research highlighted the need for firms to make it clear to their clients whether they are restricted, and how they are restricted. This is to avoid prolonging the assumption that these firms are independent.

Next steps

We have provided feedback to those firms in our review, but all firms should ensure they are following our rules in these areas. We will carry out further assessments with a wider sample of firms from October 2013 to test whether firms have acted on our feedback.

This report serves as a reminder of the rules that firms should now be following, and – read with the consumer research – indicates what they need to do if they are not doing so already. If firms are not complying with the RDR rules, we may take supervisory or, where appropriate, enforcement action. A factsheet is also available[3].

1 NMG is a specialist, multinational consultancy focused exclusively on the financial services industry.
2 www.fca.org.uk/your-fca/documents/nmg-rdr-consumer-research
3 www.fca.org.uk/your-fca/documents/fca-factsheet-no-007

2. Key findings

Adviser charging

Firms advising retail clients on retail investment products need now to clearly state their adviser charges.[4]

We were pleased to find that many firms had tried to create documents clearly outlining the charges a client would pay. But we also found that some firms are not yet meeting our rules. Improvement was most needed in the disclosure of adviser charges.

Adviser charge disclosure

The use of cash terms[5]

Since the launch of RDR, a firm must disclose its charging structure in writing[6] and, where possible, in cash terms. Consumer research suggests that providing examples of adviser charges in pounds and pence significantly helps consumer understanding. It also suggests that consumers struggle to calculate the cost of advice when they have to work out how much they will need to pay from percentages.

The research indicates that the use of pound examples at different price points helps to ensure consumers can compare the cost of advice. So it is important that firms get this right.

Some firms we approached were providing very clear examples of the cost of advice in cash terms including:

- cash examples when minimum fee levels apply showing how and when the minimum fee might apply;
- cash examples where adviser charges were tiered by investment level to demonstrate how to calculate the adviser charge when different tiers applied; and
- indicative cash costs for recommendations on different product types.

Where firms were not providing cash terms we identified two main issues:

- Some firms provided no cash terms at all. Typically this applied for firms that charged a percentage fee which were not supported with examples in cash terms.
- The adviser charge for the initial advice was in cash terms, but the ongoing adviser charge was not. Again, this typically applied to firms whose ongoing charge is a percentage, for example 0.5%, of the amount invested. In this scenario, the firm should provide an example of an amount invested and the adviser charge that would be charged in cash terms.

4 COBS 6.1A
5 COBS 6.1A.19G
6 COBS 6.1A17R

Even if cash terms are included, firms should also ensure that their disclosure is sufficiently clear for a client to understand the total likely costs. The best examples we saw included examples that a client could easily apply to their own financial situation.

Example of good adviser charge disclosure
One firm that had a flat percentage charging structure provided a range of cash examples linked to how much a client wanted to invest. It gave scenarios of investing £20,000, £50,000 or £100,000. We felt that a client who had this information would be better able to understand what the costs are likely to be for their particular financial situation than if they had a single example that might not be so relevant.

Example of a poor adviser charge disclosure
A firm used a charging structure that described the adviser charge as a minimum of £1,500 to a maximum of £5,000 with no additional detail. A client would be unable to apply this to their own circumstances and assess what the likely adviser charge may be.

The use of hourly rates

We found some firms' charging structures that included hourly rates did not provide sufficient information for a client to understand the likely cost to them.

This is because a client will not necessarily understand what the approximate cost may be to them for the advice unless there is an estimated indication of the number of hours it will take to provide the service.[7]

Consumer research suggests that when firms charge an hourly rate for advice, participants find it difficult to apply the rates to their own situation and estimate the likely cost. This is because they are unaware how long the advice process takes.

Firms can help consumers to understand by providing examples, for example the typical cost for an investment need. The research showed it also helped consumers if the document clearly highlights that the client will get a personalised quote before they are liable for any charges. This is to stop them fearing they are 'writing a blank cheque'.

7 COBS 6.1A.17R

Example of a good adviser charge disclosure based on hourly rates
One firm that charged by the hour gave scenario-based cost estimates relevant for its target market. It provided a review of pensions as an example and then listed an estimated breakdown in a clear table that showed:

- the estimated number of hours for each role (by adviser, administrator etc)
- the hourly rate for each role
- a total cost for each person, and
- the overall total estimated cost of the service.

Adviser charges disclosure timing

Providing the generic charging structure

A firm must provide a client with its generic charging structure in good time before making a personal recommendation.[8] This helps inform the client about the likely cost of the advice. It should also allow a client to make a judgement on the value of the service to be provided.

Most firms we assessed provided their charging structure at the beginning of the initial meeting with the client. Some firms provided their charging structure before the meeting, which consumer research shows that consumers value.

Consumer research suggests that consumers want to receive information on cost and services before a meeting with an adviser. A transparent document that outlines the services available and the related costs helps to build trust in a new advice relationship. Consumers said they would feel more confident and informed if they received the documents in advance.

We found one firm that did not provide its charging structure until the second meeting, at the same time as delivering its recommendation. We felt that this did not put the client in an informed position early enough in the advice process.

Providing the total adviser charges to an individual client

The client should understand how much they will end up paying as early as is reasonably possible. The costs have to be in cash terms, or convert non-cash terms into cash examples.[9] The documentation should also make clear to the clients at what stage of the advice process charges begin to accrue.

8 COBS 6.1A.24R, but note COBS 6.1A.24AG
9 COBS 6.1A.22R

Example of a good disclosure of the total adviser charges payable
A firm used an individual 'letter of engagement' setting out what services it would provide the individual client and the adviser charges (in cash terms) that applied. The firm required the client to sign the document to signify their agreement to the charge before work began. This ensured that the client was clear on the cost of the service and the service to be provided.

Initial charge payable by instalments
We found two firms that allowed clients to pay the adviser charge for advice on a single premium product by instalments. Since RDR, advisers should be clear that they cannot charge for advice on a single premium product by instalments. Since the end of last year, clients can only pay by instalments for advice on regular contribution investments.[10]

Services

Firms providing advice to retail clients on retail investment products must explain whether their services are independent or restricted.[11]

This means that if a firm offers independent advice to retail clients on retail investment products, the advice should be free of any bias or restriction. If there is a restriction or bias either by provider or product the adviser must disclose that the advice provided is restricted and explain the nature of the restriction. We found that nearly all firms were disclosing whether they were independent or restricted.

Where issues existed with the description of services, they could be divided into two themes:

- firms representing themselves as independent that are not independent in practice, and
- firms not clearly disclosing the nature of their restriction.

Independent status
We visited a few firms where advisers described themselves as independent but we had concerns about the validity of the claim. We found examples of the situations where we considered firms may not be independent in practice were:

- almost all business being placed with one platform (see example below), and
- having a pre-determined list of products or investments (see example below).

10 COBS 6.1A.22R
11 Finalised guidance: Retail Distribution Review: Independent and Restricted Advice June 2012

Examples of firms not acting independently in practice
One firm directed 98% of its business to one platform provider. The firm also confirmed to its clients at a very early stage in the initial meeting that the advice would include using this platform.

Another firm described itself as independent and offered different service levels. The firm offered a service consisting of a standard panel of managed funds and, for an additional cost, a service where they constructed a completely bespoke portfolio. In practice, 99% of clients were advised to invest in the managed funds. The firm did not have the resources to provide an independent service for all clients.

We did not believe that either firm was acting independently.

Clarity of service disclosure

So that clients can be clear what services they are getting, firms have to be upfront about whether they are independent or restricted before they give advice. A firm must explain whether it is independent or restricted in good time before it provides services[12] and include the term 'independent advice' or 'restricted advice' in its explanation of its services to its clients.[13] It is important that a client is informed about the breadth of the service they will receive.

Where a firm provides restricted advice, it must explain the nature of the restriction. We have not prescribed wording for firms to use when describing their restricted service, but firms should ensure that it is clear, fair and not misleading.

We were concerned that a client would be unable to understand the nature of some firm's restrictions from some of the explanations we saw.

Consumer research shows that consumers find it difficult to understand the meaning of some firm's restrictions from the descriptions provided. Participants wanted to see more detail about whether the firm's restriction was by product area, providers used, or a combination of both. A generic description of what restricted means, followed by details of how this applied to the firm helped consumers to understand the meaning of the restriction.

12 COBS 6.2A.6R

13 This is when a client only pays an adviser charge when they buy the recommended product.

Examples of firms not clearly explaining the nature of their restrictions
One firm did not use the word 'restricted' in its disclosure, while another firm stated it offered 'restricted advice' with no further explanation.

Another firm explained that its advice is restricted but did not sufficiently disclose the nature of the restriction. The firm's advisers each had a different restriction by provider or product type. So it could not generically disclose the nature of its restriction as it had no set or defined restricted status.

We were concerned that, for each of these examples, a client would be unable to understand that the firm offered a restricted service or would not understand the nature of the firm's restriction.

We felt that client understanding would increase where a firm had provided a clear, succinct explanation of its restriction and the impact on its advice. The consumer research supports this view.

Example of a firm clearly explaining the nature of its restriction
One firm made its client aware before the initial meeting in writing – and again at the start of the initial meeting – that if it made an investment recommendation, it would be for the firm's own products. If the client's needs could not be met by these products, the firm acknowledged it would be unable to offer the client a suitable recommendation.

Clarity of ongoing service

A client should be able to make an informed decision about whether they wish to take up or cancel a firm's ongoing service. This means the firm's explanation of the service, the fact that the service is optional and that the service can be cancelled should all be clear.

Most firms included a review as a part of their ongoing service. However there were some examples where firms did not give enough information on what the review would include or whether it was automatic or the client needed to request it. As the word 'review' may mean different things to different people, firms should make it clear what these involve and how they are arranged.

Example of a firm clearly explaining its services
One firm provided three service options to its clients, which included one transactional service and two different levels of ongoing services. The disclosure documentation used a table to clearly illustrate the differences between the two levels of ongoing service. This allows clients to easily understand what they will receive for the ongoing charge. The firm also clearly explained that advice on any necessary changes to the portfolio would be covered by the ongoing adviser charge.

During the course of the review, we also found some firms were failing to clearly disclose the client's right to cancel the ongoing service in their documentation.

Example of a firm not clearly explaining a client's ability to cancel the ongoing services
Some firms only explained a client's right to stop the ongoing services (and therefore the charges) with a general reference to 'terminating the agreement'. We felt that this phrase would not make it clear enough to a client that they were able to stop the ongoing charge or explain how they could do this.

Controls

Suitability of restricted advice for individual clients

A firm should be able to define the types of client for whom its restricted proposition services are, and are not, suitable. A firm should have controls appropriate to its size to ensure that it does not advise clients for whom its proposition is not suitable.

We found that, in general, firms that had identified their target market and then tailored their services and charges accordingly were able to best describe the clients for whom their restricted service was not suitable. We felt that these firms had better managed the inherent risks of mis-selling in their business models.

Contingent charging

A number of the firms in our review sample charged on a contingent basis.[14] If a firm operates such a business model, we consider this to be a higher-risk approach than a time-cost charging model due to the need to sell products to generate revenue.[15] Firms operating contingent charging should ensure they have adequate controls in place to manage this risk.

Clarity of documents

We felt that clients were more likely to understand and engage with the more visually appealing documents, a view supported by the consumer research. The more engaging documents were designed with the client in mind rather than with a simple focus on complying with our rules. Firms doing this well used methods such as:

- including tables to illustrate different service levels or types or adviser charges; and
- using colour to differentiate key sections and to make the document more appealing to read.

14 This is when a client only pays an adviser charge when they buy the recommended product.

15 Our previous mystery shopping work identified some firms recommended an investment product where a non-product recommendation, for example, repaying unsecured debts, such as loans would have been the right option for the customer: www.fsa.gov.uk/static/pubs/other/thematic_assessing_retail_banking.pdf.

We felt that documents clearly signposting what service would be provided and when the client would pay or incur a charge were more likely to be helpful to clients. Documents with small fonts or with the charges at the end of a lengthy terms and conditions document were unlikely to engage clients.

We also found that some firms explained their charges and services across multiple documents. We felt that some clients may struggle to piece all the information together. In some firms, there was a lack of consistency in the content across these documents.

Some firms' documents included financial language such as 'relevant market' and 'holistic' which we felt the average client would not understand.

The consumer research comments extensively on this area, so we encourage firms to review that document.

Next steps

This report serves as a reminder of the rules that firms should now be following, and indicates what they need to do if they are not doing so already. We will carry out further assessments with a wider sample of firms from October 2013 to test whether firms have acted on our feedback. If we find firms are not complying with the RDR rules, we may take supervisory or, where appropriate, enforcement action.

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