

Financial Services Authority

Consultation Response

Retail Distribution Review - CP09/18



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1 EXECUTIVE SUMMARY

The overall principles of CP09/18 are sound and clearly aimed at consumer protection. There are operational challenges still to be resolved in the detailed execution but that is only to be expected. Much more important than any of this detail though is a fundamental flaw in the approach to RDR: the assumption that better financial advice can be delivered by regulating the sale of one category of financial product – investments.

Much of CP09/18 proceeds on the basis that there is a clear one-to-one linkage between a piece of advice and the investment product it leads to, so that by regulating the sale of that product we can ensure the cost of advice is fair and transparent. But you cannot tie one piece of advice to a single product in this way. A holistic financial review, of the sort the FSA favours, may lead a client to buy none, one or many financial products ranging from protection to investments. It is therefore a little quixotic to try and improve the quality and impartiality of that advice by regulating one class of product sale that may or may not result.

The only sensible way to deliver a policy objective of clear separation between financial advice and product sales is to separate them completely and recognise that good advice should have nothing to do with product sale. That means regulating advice without reference to product, restructuring disparate COBS variants in the process.

It should also mean a ban on provider payments to advisers rather than ever more complex rules to try and achieve the same thing by regulating those payments. The FSA may fear a provider backlash from such radical change but that need not be the case. If providers were given a fair and simple way to run off existing commission arrangements too, they could sweep away a whole jungle of cost and complexity from their current operations and invest in making products more attractive to the consumer.

The alternative, if CP09/18 is implemented broadly as drafted, will be yet another layer of complexity (and cost) in the tangled web of both adviser and provider systems and processes. To substantiate this claim, we have sought to identify as many of the operational consequences of the proposals as we can in answers to specific consultation questions below.

2 INTRODUCTION

As an enterprise architecture consultancy specialising solely in Financial Services, Altus works with clients in both the LP&I and protection sectors in the UK and continental Europe. Having extensive experience in both system and business issues throughout the sales process we welcome this opportunity to respond to the FSA's latest consultation paper on the Retail Distribution Review.

To provide a more coherent argument, we have provided a general response pulling out general issues we see in the consultation paper. After that we answer those individual questions where we feel our experience and expertise qualifies us to do so.

3 GENERAL RESPONSE

In general we support the FSA's objectives of providing a professional market for financial advice that allows consumer needs to be addressed in a transparent manner, free of potential conflicts of interest. However, we do not believe that approaching the issue from a product perspective is the right way to achieve this.

Good financial advice should consider all of a consumer's financial needs and may result in multiple recommendations for different types of product from different providers. But much of the content in CP09/18 seems to assume a much simpler one-to-one correspondence between advice and product and then proceed from that basis. This is not surprising given that the scope of the CP was limited to a particular subset of products (retail investments) from the outset – a scope which is itself a legacy of the artificial separation between COBS and ICOBS. Nevertheless, it is an assumption which is flawed and which will lead to practical problems and unintended consequences if CP09/18 is implemented as drafted.

We have identified the specific problems we anticipate in response to particular questions below but many of them stem from this basic oversimplification of the relationship between advice and product. The only logical way to address this and ensure the impartiality of advice that the FSA is seeking, is to regulate advice directly and insist that advisers are paid by their clients in the same way as in most other service industries.

4 RESPONSE TO PARTICULAR QUESTIONS

Q7: Do you agree that the professional standards set out in Chapter 5 should also apply to simplified advice processes?

We agree with the principle that advisers must attain appropriate professional standards before they can advise on financial services products, and agree that as a practical matter, advising on certain retail investment products requires higher levels of professional standards than other, simpler, financial services products. We also agree that in simplified advice processes the firm is providing a personal recommendation to the client.

Within a simplified advice process, it is not necessarily the individual “adviser” and their knowledge of the market that is responsible for ensuring the appropriateness of the advice. The firm itself has that responsibility, embodied in the form of the detailed processes, systems and procedures it uses to deliver simplified advice to clients.

A firm’s simplified advice process may involve several different individuals at various stages in the advice value chain (fact find, needs analysis, product type recommendation, provider and product recommendation). As the consultation paper recognises, the ability to use appropriately skilled staff at each stage is an important cost driver for firms’ cost models.

The FSA’s regulatory framework should recognise the potential to deliver the required professional standards through a combination of rigorous and well-defined processes, systems and procedures. The regulatory framework should provide sufficient flexibility to support potential new business models for advice (e.g. self-service fact-find via website, or automated recommendations from expert systems), and not assume a continuation of business as usual.

Q9: Do you agree with our proposals on Adviser Charging for firms that give advice?

We agree with the principle of firms being paid for the advice they provide and the requirement to set out charges in advance to their clients. However the detail of the proposals does not sit very comfortably with this objective in some places.

For example, one of the charge bases listed in paragraph 4.7, percentage of funds invested, could be seen to perpetuate a bias to sell rather than to advise. In practice this model may not actually materialise, as consumers could be tempted to take the advice and execute directly.

In general terms, any scheme in which charges vary over time in proportion to some other factor has the potential to confuse. Practically, it would also be very difficult to reconcile with the requirement in paragraph 4.8 for adviser firms to communicate the specific amounts an individual is charged.

By far the biggest problem in this area though, is the proposal to allow adviser charges to be deducted from investments. A good financial review covers all a client’s financial circumstances and may lead to multiple recommendations for various types of product from different providers. Assuming that the cost of that advice can be arbitrarily allocated to some subset of products which may result is over-simplistic and completely undermines the separation the FSA is seeking to establish between advice and sales. It also leads to numerous operational difficulties that we discuss in our answer to Q10.

The clearest way to deliver separation between advice and sales is to require advisers to charge their clients fees in the same way as most other professional service providers.

Q10: Do you agree with our proposals on Adviser Charging for product providers?

Ban on commission

We agree that the ban on providers paying commissions to advisers recommending their products is an appropriate response by the FSA to mitigate both the potential for adviser bias, and the potential for the appearance of such bias.

The new regulations will necessarily bring significant change to provider processes and systems, which are significantly driven by the current importance of adviser commissions. As the proposals stand, providers will need to continue to support commission payments for existing policies (including at least some increments to existing policies), while also implementing adviser charging for business sold after December 2012. This will add complexity and cost to provider operations and the FSA may want to consider options for removing this 'dual-operation' overhead.

Ban on negative charges

We agree that the ban on the various "negative charge" structures sometimes offered by providers is appropriate, given the FSA's aim of ensuring that the distinction between product and advice charges be clear to consumers.

The restrictions on negative charges will limit the extent to which existing products and systems can be easily re-purposed and made RDR compliant. Even where products are currently offered in "Nil Up" commission form, the products and the systems that support them may be non-RDR compliant due to their use of negative charges, commission factoring, the use of ongoing charges in respect of initial advice, or the inability to vary ongoing charges in respect of ongoing services.

Deducting adviser charges

In addition to the problem of perceived linkage noted in our response to Q9, there are several practical problems with the proposal to allow adviser charges to be funded by deductions from investments.

Given that advisers will be in control of these charges and that they may, as currently envisaged, vary over time, there will need to be a complex ongoing interaction between adviser and provider systems. This will need to determine amounts to be deducted, apply corresponding product charges, credit these to adviser accounts and make appropriate payments. Provider remuneration systems would need to be extremely flexible to deal with this arrangement and current systems are unlikely to be able to support this.

It would also be extremely difficult to provide the flexibility required in investment administration systems to deduct appropriate product charges to fund adviser charges. Most funds apply charges at a global level using a small number of different share classes to offer a limited range of different terms to advisers. The overhead of adding new share classes is considerable and the practical difficulties of swapping clients between share classes as ongoing charges vary (for example where the adviser ceases to provide ongoing services which were paid for via an ongoing charge) would be unmanageable.

Assuming the deductions are spread over several years, what happens if a consumer cancels or surrenders their policy? Will the product provider be expected or allowed to deduct any outstanding adviser charges from the settlement to pay the adviser or will this be left to the adviser?

Moreover, it seems likely that adviser firms will as a commercial necessity provide their own mechanisms for convenient collection of adviser charges from clients, independently of any facilities offered by particular providers for particular products (perhaps via network-provided arrangements), to enable them to properly consider products from the whole of the relevant market, without inducing "sticker-shock" in clients by requiring a lump-sum up-front payment for the advice.

Given all the practical and policy difficulties that provider-facilitated charging would entail, and the likelihood that the market will in any case provide alternatives to meet consumer needs, we suggest that it would be much clearer for the FSA to rule this option out and prohibit payments from providers to advisers. Providers would then have the option to buy out any outstanding trail commission liabilities and decommission large swathes of complex systems.

Other aspects

We do not believe that the proposed requirement for product providers to validate and monitor advisers' charges is reasonable or practicable. If, as we suggest, the logical outcome of the RDR is the creation of an advice market separate from the market for products, then it would be odd to attempt to regulate that advice market indirectly via product providers.

This proposal appears to assume a continuing link between advice and product sale, whilst many of the other proposals in the consultation paper (rightly, in our opinion) seek to remove possible sales bias. It's easy to imagine an adviser providing a full financial review to a client with moderately complex affairs, resulting in several product sales. Some of these products might not offer the option to deduct adviser charges (e.g. investments with NS&I). If a pension, or other product with tax advantages, was also recommended it's unclear why the adviser shouldn't (if the provider offers the option) suggest deducting the fee for the entire review from this one policy. As no product provider has knowledge of the overall review conducted, the fee may appear "indecent" in relation to the one policy, even if the review offered excellent value to the client and deducting the fee from the policy saved the client money (e.g. through tax relief).

Although customers are likely to be more vigilant about charges they pay directly compared to charges deducted from a product, the current proposals would not catch advisers who charged "indecent" fees, but did not ask product providers to deduct them from the product. If the FSA believes regulatory monitoring of adviser fees is necessary, then it should do so directly, and should not attempt to use product providers as a proxy.

Q15: Do you think changes are needed to the way that we regulate wrap platforms and fund supermarkets?

Reading CP09/18 leaves us uncertain as to the full impact of the RDR proposals on wrap platforms (particularly large "provider backed" platforms) and fund networks. We therefore believe further changes are required here to provide a clear regulatory framework, and to ensure fair outcomes for consumers.

One area for confusion is over what constitutes the "product" and the degree of choice required to satisfy the "whole of relevant market" requirements. If a tax wrapper is a "product", then it would seem an IFA who restricted themselves to a single platform where only the platform provider's tax wrappers are available couldn't satisfy the "whole of market" requirements. However if the "whole of market" requirement relates to the underlying investments, then the adviser may satisfy it. Some platform providers view their own ISA or SIPP wrappers as a benign concept for tax treatment and would argue that the brand name on the wrapper has no tangible affect on the breadth of underlying investment choice – it's unclear how this would be viewed under RDR.

Another area that needs clarification is the treatment of any benefits that use of a platform may yield for an adviser. Would providing extensive portfolio analysis tools to advisers as part of a platform offering constitute "free provision of important software", which the RDR rightly seeks to control?

Altus see the issues highlighted above as further symptoms of the problems caused by basing regulation around product sales. We feel the area of platform usage is sufficiently complex to warrant additional clarification – preferably with illustrative example cases.

Q19: What consumer detriment, if any, would arise if we implemented the RDR proposals for the sale of retail investment products but took no action on regulating the sale of pure protection products under ICOBS by retail investment firms? We would welcome any evidence on this.

A major thrust of the proposals contained in the consultation paper is to create a trusted role for advisers, whom consumers are paying to act in their interests. Allowing advisers to advise on some products on a commission basis, whilst others must be done on an adviser charge basis fundamentally undermines this approach.

We cannot see how it would be practicable for advisers to operate two different systems. A typical financial review (the sort of service we would expect to see advisers listing in the tariffs the consultation paper envisages) would necessarily encompass both protection and investment products. It seems perverse that an adviser's income from such a review could depend on how well protected their client already was. This could be avoided if advisers engage in complicated commission rebating to the client when commission-paying protection products are purchased, but we suspect advisers would prefer the simplicity of a single system.

As the consultation paper itself recognises, the appearance of a possible conflict of interest is at least as dangerous to a trusted relationship as an actual conflict of interest. We do not see how consumers can be expected to trust IFAs to truly act in their interests as long as they may recommend products that pay commission. Indeed the adviser charging disclosures required for retail products might serve to highlight the potential conflict of interest, thereby undermining IFAs' credibility.

Altus believe that the advice market the RDR seeks to create would be stronger, and more trusted, if provisions to avoid adviser bias similar to those envisaged for retail investment products were applied to all products sold by advisers.

5 ABOUT ALTUS

Altus is a business and systems solutions company focused exclusively on the needs of the financial services industry. Our practical experience of both the business of financial services and the supporting IT systems means that we can help solve the right problems with the right technology. Our mission is to be at the forefront of the networked financial services business of the future.

Our management team has extensive experience across a wide range of financial services activities, our staff are highly-skilled and enthusiastic and our client list includes some of the largest financial services companies in the UK and Europe.

Further details are available from our website at www.altus.co.uk or by contacting us.



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