C/M/S/ Cameron McKenna

Retail Distribution Review

Interim report

April 2008

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Introduction

The Retail Distribution Review (RDR) is intended to help fulfil FSA's retail objective – that retail investors get a fair deal. In earlier papers, FSA has pointed to the serial failure of retail distribution firms, the bias resulting from commission based selling and the need to increase the quality of retail advice to draw a line under the consumer misselling scandals of recent years.

FSA established five industry focus groups to debate the way forward and which published their findings in June 2007.[i] Their proposals, which have enjoyed both industry and regulatory support, are for:

- Higher training and prudential standards for retail advisers
- A reduction in commission based selling
- A new polarisation of retail advice, with full in-depth advice offered to those able to pay a fee for the higher standard, and elementary advice for those unable to and who would otherwise be financially excluded.

FSA's Interim Report, published today, is the outcome of extensive consultation.[ii] The 2007 proposals remain largely intact, although FSA acknowledges that considerable further work is required, and challenges the industry to come up with workable solutions. FSA confirms that the aim of RDR is to enable consumers to have sufficient confidence in the retail financial products market to use it more often, and sees the Interim Paper's proposals as being conducive to this end.

The proposals in a nutshell

FSA proposes a "simpler landscape" populated by

- **Advisers, who must be independent** so that investors can easily distinguish between sales and advice. This is new and controversial, and envisages the elimination of tied advice. It is unlikely to be acceptable to providers.
- **Sellers, who do not give advice.** This is a logical development of the "primary advice" proposed in 2007, recognising that you cannot properly advise an investor without going fully into their needs and demands.
- **Money Guidance**, which is the new concept of generic advice proposed by Thorensen and intended to address current levels of financial awareness in the general population.

What does FSA want the industry to do now?

- Providers are to stop determining **how distributors are paid**
- The industry to develop a common standard for **professional qualifications**
- The industry to work out what rule regime is required for **non-advised sales.**

What will FSA do now?

FSA wants to review the implications of these proposals in greater detail, including the EU, legal and competition issues. It will publish a Feedback statement in October 2008 covering industry responses – especially to the three challenges – any changes to rules and a timetable.

In more detail

The role of advisers

FSA sees advice as having the following characteristics:

- Given by advisers with higher professional standards
- Working for adviser firms subject to risk-weighted capital requirements[iii]
- Paid for by customer agreed remuneration (CAR) determined without provider input[iv] and
- Most important, it is independent – the advice is based on the whole of the market (WOM).[v]

FSA considers that advice should be clearly separated from sales, and proposes that **only independent advice** – WOM – can actually be delivered as be advice. FSA proposes this tentatively "as a basis for further consideration" and clearly recognises that this is likely to be unattractive to providers.[vi] The proposal that a tied adviser must either upgrade to WOM or downgrade to non-advised sales not only goes against the grain of the market and is at odds with EU practice, but is inconsistent with the aim of combating financial exclusion.[vii] Furthermore

- The market has been operating for twenty years with tied and independent advisers distinguishing themselves through mandatory status disclosure without evident problems.
- FSA moved away from formal tied/independent segregation when polarisation was abolished in 2004, and since then firms have been able to adopt different statuses of tied, limited panel or WOM for different products and different customers. This, again, has been broadly successful.

The argument that this change is necessary to enable customers to tell the difference between advice and selling is weak and unsupported by any clear reasoning. There is no correlation between the size of a firm's panel and the degree of independence that it offers, especially if remuneration is agreed at arm's length, nor is the provision of tied advice inconsistent with fair treatment as the paper now apparently (and remarkably) implies. Given that FSA calls for market-led solutions, firms should argue that they can achieve the goal of treating customers fairly without needing to offer WOM advice.[viii]

Sorting **remuneration** is a further challenge, and designing distributor remuneration so as not to create bias will need to be a major focus in the coming months. Possibilities include "factory gate pricing", where the provider sets the product cost and the distributor adds its own sales costs to the total price, customer agreed remuneration where the adviser sets its fees, or even perhaps some retention of commission, provided this is expressly agreed by the customer.

The role of sales

FSA sees the **purpose of sales** as enabling consumers to make simple, straightforward choices and is interested in exploring how this concept can be extended to protection products.[ix] The main challenge, it says, is for customers to understand the nature and limitation of the service. FSA recognises that it may need to give guidance to enable firms to feel comfortable in offering this service in view of current FSA rules and FOS' stance on complaints handling.

The key area for firms is to work on a model that is economically viable and which meets minimum regulatory criteria, and to present this to FSA. While formal know-your-customer and suitability will have to be disapplied, inherent fitness for purpose must remain a requirement. FSA explains that it will be working with FOS what standard will be required for sales, and firms should recall FOS' statement that the minimum standard that it will accept for advised sales is the general legal duty of suitability.[x] This emphasises the importance of clearly distinguishing the elements of sales from those of advice.

FSA says that it needs a "solid case" to make **changes to its rulebook**, suggesting that this might not be necessary.[xi] But it seems clear that a new COBS will be required to allow firms to make sales that are non-advised yet involve personal interaction. These rules, which the industry is being invited to propose, will need to address

- **Who may sell** – need they undergo formal Training & Competence?
- **How they may sell** – should a detailed process be specified?
- **What disclosure should be made** – this seems essential to enable the customer to understand that he or she is not being advised.
- **What products may be sold** – this is surely for the industry to determine, it being a fundamental aspect of Treating Customers Fairly that a product be suitable for its target market.

Winners and losers?

The clear potential winners are

- The **up-market advisers** – the private client wealth managers – who are already operating at the proposed advice level and offer WOM advice.
- Firms with **branch networks** – banks and building societies – who may be able to offer mass-market sales through their existing outlets.

- Providers who are able to **manufacture products** suitable for either or both of advice and sales.

Potential losers are

- Mid-market **IFAs and networks** who cannot meet the criteria for advice
- Providers dependant upon their **direct sales force** if they are unable to retain them.

And investors are potential winners provided the sales process is made widely available and closely controlled to ensure quality of business.

Next steps

The clear next steps for firms are

- To study the paper, considering in particular the implications of WOM and CAR;
- To review how the evolving model fits the firm's plans, and to consider the optimal design for the new rules;
- To lobby FSA with its response. This paper offers firms a remarkable opportunity to contribute to the design of the retail distribution system, and they would be well advised to press this to maximum advantage.

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[i] DP 07/1 June 2007
[ii] RDR – Interim Report April 2008
[iii] See Feedback statement 08/2
[iv] 3.15
[v] 3.1
[vi] 2.9 – 2.11
[vii] 5.11
[viii] 3.8
[ix] 4.5
[x] FSA Board Minutes 26 July 2007
[xi] 5.15, 5.16

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