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RDR is dead, long live RDIP

The FSA brought an end to its Retail Distribution Review (RDR) on 25th November with publication of the long-awaited Feedback Statement. The high level proposals have now been finalised and are being taken forward in a Retail Distribution Implementation Programme (RDIP). Perhaps this would more properly have been christened the Retail Distribution Reform Implementation Programme, but understandably the FSA has shied away from that. The abbreviation that would have resulted might have been a step too far for those sectors of the market where support for the final shape of the strategy for change is at its most strained.

We now have a much better picture of what the final reforms will look like and the purpose of this article is to summarise the main changes that the FSA now wants for the retail investment market. The detail remains to be resolved and will be

the subject of further consultation in June 2009. The FSA has signalled that the high level proposals are now decided by not seeking feedback from stakeholders at this stage. However, the initial reaction from AIFA has been hostile. It claims that small and medium-sized IFAs are feeling ignored, although the force of the response by Director-General Chris Cummings at the FSA's RDR Conference launching the Feedback Statement suggested that he might have used the word "threatened" rather than ignored. We expect that the FSA can look forward to continued vigorous lobbying from that quarter over the next seven months, which may test its determination to follow the path it has chosen to publish.

The FSA has decided that the existing retail distribution model is fundamentally flawed in a number of respects and has put forward firm proposals to remedy this. It has

defined the outcomes it wants to achieve through reform of the process as follows:

- 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 customers fairly; and
- a regulatory framework that can support delivery of all these aspirations and which does not inhibit future innovation where this benefits consumers.

To achieve these objectives, it plans to make significant changes in the areas of:

- clarity of services;
- remuneration;
- professional standards;
- consumer access and liability management; and
- prudential requirements for personal investment firms.

Clarity of services

The FSA has abandoned the model advanced in its interim report published in April this year which proposed a split between independent advice and sales. There were concerns expressed that under that proposal advice might be available only to high net worth customers, and that everyone else would have to be satisfied by a different service known as guided sales. Practical difficulties also emerged in that consumers need guidance to include some level of recommendation that would legally constitute advice.



For this reason, the following revised distribution landscape is now proposed by the FSA.

- Fully independent advice will be unbiased and unrestricted, and only available from firms equipped to undertake comprehensive and fair analysis of relevant markets.
- Non independent advice which will be available from firms advising on a limited range of services, from the products of a limited range of providers (or one provider), or from some combination of those. There is room for simplified sales processes, and the earlier concept of guided sales, to develop in this space. A key feature of operations in this sector is that advisers will be required to disclose that their advice is not independent and is clearly designed to result in the sale of a product.
- Execution only sales of products at "factory gate pricing".

It is clear that the FSA recognises the need to make sure that disclosure is clear and precise so that customers understand the level of advice they can expect to receive. A further feature is that all advisers, whether independent or not, will be required to incorporate elements of the Money Guidance principles under development into the advice process, and take a more holistic approach that might prioritise guiding consumers towards services giving advice on matters such as debt reduction. One could foresee circumstances where this could inhibit product sales.

Ironically, AIFA was quickly into the ring to criticise these revised proposals on exactly the same basis as others had criticised the earlier ones, with Chris Cummings eloquently declaring that his members would not be driven into "high net worth ghettos". The clear declaration from the FSA that future independent advice is not intended to equate to the current IFA market has cut no ice in Austin Friars House. However, it seems evident that medium-sized and smaller firms of IFAs are unlikely to have the capacity genuinely to undertake comprehensive analysis of all relevant markets and to update that analysis sufficiently frequently to keep it current. It is evident that the FSA expects many of those firms to offer products from a restricted range of providers in future. Perhaps that is the best possible indication of the scale of the challenge faced by those firms who set out to meet the regulator's expectations in the field of market analysis.

Remuneration

The FSA objective is to remove product provider influence over remuneration



for independent advice, and by doing so to remove any inclination towards product bias. The FSA would have preferred that product providers have no part whatsoever in the remuneration of independent advisers. However, it was forced to recognise that fee-only advice is not palatable to consumers, though it remains determined to remove anything that looks, smells, tastes or acts like commission. For the present at least, for practical reasons that include issues of taxation, providers will have to be able to facilitate payments to the adviser through the customer's product. There will be an explicit requirement that every payment made by the provider to the adviser must be matched in both amount and timing by an equivalent charge taken from the product.

Consultation on the practical aspects will clearly be needed as there must be limits on the flexibility that providers can be required to provide in terms of paying such charges. Products that require ongoing advice present particular challenges in relation to the myriad of ways that advisers might adopt to escalate periodic charges in order to maintain their real value.

The FSA has also stated that it will be monitoring closely for other forms of provider influence on advisers, especially in the run up to the end of 2012 when the new remuneration rules will become fully effective. It has set its face against firms seeking to use the existing arrangements to their advantage with "closing down sales" and similar offers designed to promote product bias that may be unfair to customers. The FSA clearly expects firms to travel as much as possible towards the new remuneration model before the deadline.

The FSA will also demand that there is a clear split in the disclosure of charges between those associated with advice

costs and those relating to product costs charged by the provider, so that it is clear to the customer what he is being charged for the advice. This applies equally whether or not advisers are independent. Clearly, where advisers are directly employed by providers, the provider inevitably has a role in determining the level of remuneration of the adviser, but there will be equivalent levels of disclosure.

As this demonstrates, it is not simply the charges paid directly or indirectly by consumers to firms of advisers that are in the sights of the FSA here. Remuneration of individual advisers within firms by commission is objected to. Also, regimes that require the mandatory achievement of sales targets on pain of dismissal put similar pressures on advisers to put their own interests or needs ahead of those of customers, and will likewise be rooted out. This implies real challenges for firms in structuring remuneration packages to reward desired outcomes, which inevitably will at some level include productivity. Firms will need other measures of effectiveness of advisers to support employment policy and drive reward packages.

Professional Standards

There will be a Professional Standards Board, based on the model of other professions and with similar powers. It will have jurisdiction over all the advice channels and enforce the same standards and competency levels on all advisers, whether they are fully independent or not.

It is proposed the board will have jurisdiction over matters including:

- professional standards;
- minimum qualifications;
- ethics and breaches of ethics;
- minimum CPD standards;
- public awareness; and
- practising certificates.

Clearly the introduction of a Professional Standards Board is a very large step in moving the advice industry towards a fully fledged profession. The FSA has decided to establish the board itself in the first instance, but is aware that there are advantages in having an independent board. Those details are for future consultation, and if the board is to become independent at some stage there will be issues of demarcation of responsibilities between itself and the FSA to be considered and resolved. A marker has already been put down, however, that the board will be independent of existing professional bodies and, in particular, that those bodies will hold no seat on the new board.

All investment advisers will have to operate at a benchmark qualification of at least QCA level four. Certain specialists, possibly including pension transfer advisers, may have to achieve higher levels of qualification and the FSA has indicated that it expects to incorporate that requirement as it moves forward.

It should be noted that there will be no "grandfathering" of existing advisers into the new regime and that QCA level four will have to be achieved by 2012 by all advisers. However, it will be possible for those who already hold QCA level four, or who are on course to complete it by 2012, to fill any gaps in the final knowledge requirements by CPD, and hence "bridge" into the new qualification. All other advisers will have to achieve the required level by examination.

A proposal that the future entry level qualification to undertake the new examinations should be at degree level is not immediately being taken forward. Nevertheless, firms might be prepared for

this ultimately to become the standard, particularly when and if the standards board becomes independent. Until then, the FSA would have to balance that hurdle with their other regulatory obligations, which include promoting the availability of proper advice to all sections of the community.

Consumer access and liability management

The FSA recognises that firms offering a guided sales service need more certainty concerning how guided sales services will be judged in order that uncertainty over potential liability for those sales can be estimated. The FSA will continue to offer help in this area.

The rules around Basic Advice introduced in April 2005 are to be removed as there are few firms currently operating in this area. It is expected that any firms that wish to continue to do so will advance their case through waiver requests, which the FSA will deal with on a case-by-case basis.

Proposals for a 15-year longstop to be put in place to time limit complaints have been considered and rejected by the FSA as it could not find a justifiable case for doing so. It does acknowledge that firms are feeling someone beleaguered by a regime that appears to hold them responsible not only for their own failings but also for those of consumers. It recognises that should not be the case, indeed we think the FSA would say that it is not the case, but it will be moving forward with a Discussion Paper on consumer responsibility with the aim of placing greater emphasis on the extent to which consumers actually make the decisions for themselves and must accept responsibility for that. Firms can probably expect to see

continued emphasis on their obligation to provide sufficient information in a readily digestible form to facilitate that.

Prudential requirements

The FSA are farther advanced in their thinking in this area. At the time of writing, a Consultation Paper on capital requirements is imminent and I expect that it will have been published before you read this. We will be examining the proposals in this area in detail and you can expect to see our thoughts in print very soon. However, a few headlines are already known.

The absolute minimum capital requirement for Personal Investment firms will increase for the first time in fourteen years from £10K to £20K. In addition, there will be a sliding scale of further capital requirements in respect of liabilities that fall outside a firm's PI cover. Early indications are that this may be of much greater significance for some firms than the restoration of the real value of the absolute minimum capital requirement. There will also be proposals on the quality of the capital to be held.

This has to be seen in the context of a belief within the FSA that consumer confidence demands as much that advisers will still be around when their investments mature as that providers will be, as it is often only at that stage that any shortcomings in the quality of the advice emerge. We expect that escalating capital requirements will continue to drive the amalgamation of adviser firms, and may have a more fundamental impact on some business models. Watch this space!

Commentary

I have summarised the FSA's views and proposals, but obviously space does not allow me to cover all the issues raised in their document of over 200 pages. Its proposals are clearly far-reaching in that the payment of the advice industry by commission, which has long been seen by the FSA as being at the root of many poor sales practices, is to be phased out. When this is combined with the foundation of a Professional Standards Board, which will clearly throw a sharper light on the professionalism of individual advisers, it is apparent that the advice industry will look very different in a few years to how it looks now.

The timescale is tight - not impossibly so, perhaps, when one considers that the regulation of the industry was introduced over a period of just eight years, but certainly challenging enough. There are certainly some commentators claiming that insufficient allowance has been made for the impact of the present financial turmoil, a claim which FSA will deny.



Firms need to consider the new distribution structure and how they might fit into it. It is our view that many firms wishing to remain in the independent advice sector will be under pressure to move up-market to high net worth customers. This may be the only way that they can generate sufficient fee income per client to cover the additional costs of research and analysis associated with continuing to be a fully independent adviser. The anticipated higher cost base, when combined with the new capital requirements, may well result in larger independent advisers being formed by takeovers and mergers. Even so, adequate capitalisation may be a challenge.

It should be noted that the FSA does not envisage the present IFA industry being the same as the shape of the independent advice sector that will emerge from the implementation process. AIFA, from its reaction to the FSA's paper, clearly thinks there is a threat to small and medium sized IFAs that was not present in the interim paper released earlier this year. We have to agree that it will be particularly challenging for them to fulfil the conditions needed to continue to offer fully independent advice, but there is no suggestion that firms operating in the alternative space will need to be in any way tied to providers, or in their thrall. There is a lot of middle ground between offering the products of a single provider and offering from the whole of the market, and plenty of scope for different business models in this area. Adequate capitalisation is at the heart of the challenge for those business models rather than finding a space within which to continue to give the good quality of professional advice that is their heritage.

What can firms do?

Firms will have to wait for the FSA to produce their detailed Consultation Paper in June 2009 to get down to the nitty gritty, and it may be 2010 before they can know what they have to do in exact detail. However, they can start to make moves towards a post-RDR implementation world.

Advisers will have to decide where they fit into the proposed structure. Will they

be able to meet the new criteria for being fully independent, or not?

Given the costs of professionalism and the new capitalisation, they will also have to decide whether the business can continue to be viable in its present form, or whether some form of merger or amalgamation has to be considered. RDR is as much about reshaping the advice industry's business model as it is about compliance. Arguably, there is a conclusion that the former is a pre-requisite for the latter.

Advisers will also have to follow the progress of the establishment of the Professional Standards Board, and monitor the implications for them of the professional code as it develops. Adviser firms will also have to check that all advisers have obtained, or are working towards, QCA level four in order to achieve this before the deadline in 2012.

Whilst the main thrust of the reforms is to change the structure of the distribution industry, there are clearly going to be impacts on producer firms. They will no longer be able to incentivise sales by offering advisers higher rewards, so they will have to be certain they are offering competitive products that customers want, and back this up with efficient administration. As adviser firms amalgamate or merge, providers will find that some of their traditional distribution channels may close, but new opportunities will emerge.

Firms should not underestimate the work that may be required when RDR comes into full effect and should start planning their strategic response now.

How can OAC help?

If you would like to discuss anything in this article, or for more information, please contact:

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