

121 newsletter

Financial Services Authority

Reforming Polarisation: Making the market work for consumers

January 2002

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This newsletter provides a summary of FSA Consultation Paper 121 – Reforming Polarisation: Making the market work for consumers

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Executive Summary

In March 2001, we announced the conclusion of the first stage of a review of polarisation and implemented limited changes to the polarisation regime by liberalising sales of stakeholder pensions and removing requirements on making direct offer financial promotions.

This consultation paper sets out the results of the second, wider-ranging, stage of the review and makes further policy proposals taking account of findings from an extensive research programme. It goes on to discuss potential changes to the regulatory regime beyond the polarisation regime itself. We now seek views on the options for change. Responses supported by data and research findings will be particularly helpful.

The paper is in four main parts:

- Chapter 2 – explains the history of the polarisation regime, why we are reviewing it and how we have approached the second stage of the review.
- Chapter 3 – describes the research undertaken during the second stage and analyses relevant legal issues, international comparisons and the implications of European directives.
- Chapter 4 – reviews three main options for reforming polarisation against the Director General of Fair Trading's (DGFT) recommendations of August 1999. It outlines our preferred option of abolishing polarisation, subject to enhanced controls on firms giving independent advice and continuation of regulations designed to ensure clear accountability for advice given to consumers.
- Chapter 5 – outlines:
 - a new two-tiered adviser structure as one way to improve access to advice;
 - the role of product design standards;
 - 'unbundling' the cost of advice from product costs;
 - the introduction of portable fact finds; and
 - the possibility of making use of citizens advice bureaux (CABx) to deliver advice to the less well-off.

Research and analysis

At paragraphs 6.4 – 6.8 of CP80 we explained the importance of founding this stage of the review on a broad-based programme of research focused on the likely behaviour of consumers. We have added to the programme envisaged then as further research requirements became clear. There are three companion volumes published with this consultation paper containing reports of the research undertaken for us by external contractors. The research covered:

- **consumer research:** consumer understanding of advice and the motivators in using one type of adviser over another; consumer understanding and attitudes to fees and commission; design work and consumer testing of a new disclosure proposition about advisers' status;
- **IFA Panel research:** a survey and in-depth analysis of the basis on which IFAs select products and providers; and
- **commission bias:** a major study of the correlation between business volumes and commissions in the IFA sector and **mystery shopping:** to test for the existence of product bias in tied and independent sectors.

We have also studied:

- **international comparisons and the implications of EU developments;**
- **remuneration practices in the tied sector;**
- **some of the legal implications;**
- **low-income consumers:** to consider the affect of the current and any proposed regime on this segment of society;
- **IFA customer base:** to consider its penetration of the low-income segment;
- **economic pressures on the industry;** and
- **fees and commission:** to consider the economic and behavioural factors.

Key points from the research

In forming our overall approach we have sought to ensure that we meet our statutory objectives, as set down in the Financial Services and Markets Act 2000 (FSMA), in the most appropriate way. We have also considered the principles of good regulation. In particular:

- the need to minimise the adverse effects on competition;
- the desirability of facilitating competition between firms regulated by the FSA;
- the desirability of facilitating innovation; and
- the principle that a burden or restriction should be proportionate to the benefits.

Against those objectives and principles we have concluded that if polarisation did not exist we would find it difficult to justify introducing such a regime under the new legislative framework. Based on our research, we do not believe that polarisation is delivering today enough consumer benefits to justify it as a continuing intervention in the market. The architects of polarisation expected the providers distributing through the tied channel to focus their competitive energy on winning consumers by competing on the value for money of their products. Instead, that energy has been turned on competition to capture sales distribution. So, users of the tied channel have been disadvantaged.

Polarisation has helped develop the independent financial adviser ('IFA') sector, bringing with it the benefit of independent advice and the potential to recommend lower-charging products. But the evidence for this outcome is not strong. And polarisation has also led to disbenefits for many consumers. Even with effective status disclosure, many consumers continue to use the tied channel while stating a preference in principle for independent advice because it offers them an element of choice. In practice, their choice of adviser is not driven by status but by trust. They would prefer to go to a tied adviser of a known product provider rather than to an unknown IFA. The evidence suggests that the majority of consumers effectively have restricted access to independent advice. We also found that consumers do not shop around between advisers, so the reality is that relatively few consumers give themselves an effective choice under polarisation. Regulators and industry alike must make sense of this reality.

Also, the product range of the tied adviser may not be complete and consumers may end up with a less than suitable product. Where the products are suitable, they may still offer poor value. So doing nothing leaves many consumers using the tied sector

with simply the (non-) choice of the products the tied adviser has available. For the industry, it means that independent unit trust managers and friendly societies may continue to have only limited distribution opportunities for their products. Overall, then, we do not think that we can propose leaving polarisation as it is.

So, our approach to this second stage of the review has been radical. We have analysed the impact of the regulatory framework that we inherited from previous regulatory authorities. In parallel, we have looked to identify the market failings in the system, which reflect actual consumer behaviour and might call for a different kind of regulatory intervention. Having identified the failings, we set out the outcomes we would like to achieve.

Conclusions from the research

The overall conclusion is that there are significant market failings in the life assurance and collective investment scheme market and that these failures cannot be dealt with simply by changes to the way in which the industry is permitted to distribute its products. There is a strong case for wider changes in regulating this market. Our primary aim is to design measures that will help to improve consumer outcomes. The industry too should benefit from increased growth in the market for its products and the more efficient companies have the opportunity to develop their business. There may well be significant winners and losers – as is to be expected in a market where competition is working effectively.

The principal market failings we have identified are:

- competition currently operates, via the commission system, to secure IFA distribution power for product providers, which is to the detriment of consumers (paragraphs 3.32-3.43);
- consumers' behaviour, in response to the signals given by polarisation, shows that the regime has not in practice delivered good value for many middle-market consumers (paragraphs 3.55-3.60);
- the remuneration systems for both tied advisers and IFAs give an incentive to sell a product, and in some cases that product may be unsuitable for the consumer (paragraphs 3.32-3.43);
- too few consumers are making (adequate) provision for their financial future and, in particular, for retirement (paragraphs 3.50-3.54);
- the bundling together of the cost of advice and the cost of the product prevents consumers gaining a proper understanding of the role of advice and its cost (paragraphs 3.3-3.11);
- the regulatory system itself may put impediments in the way of consumers who might be minded to shop around (paragraphs 5.12-5.28).

Proposals

This consultation is aimed squarely at deciding in which direction regulatory policy should be headed. It is in two distinct parts. The first – set out in chapters 3 and 4 – deals with the polarisation rules and puts forward options for change and the reasons at this stage for preferring one of them. The second part – described in chapter 5 – invites discussion on a 'greener' set of proposals covering wider issues that our research suggests may also require attention. We propose to consider the responses to this consultation paper with a view to consulting again later this year on draft rules giving effect to the changes to polarisation once they are settled. Separately, we will also consult again when we have decided how to proceed with the greener set of proposals considering views expressed after publishing this consultation paper.

We propose that:

- polarisation as such should be abolished, and new, improved disclosures to consumers should be introduced. With polarisation removed, the market would be likely to segment into:
 - provider firms which continue to offer only their own products and are free to distribute through the tied, independent and direct channels;
 - provider firms which choose to increase the range of products they offer by adopting products from other provider firms. They are free to distribute through tied, independent and direct channels;
 - distributor firms¹ which distribute and advise on the products from a range of different providers; and
 - independent advisers responding to the continued demand for independent advice;
- firms that wish to hold themselves out as offering independent advice should be remunerated on a defined payment basis to remove the potential for commission bias;
- limits on product provider investment in IFA firms which currently trigger the 'better than best' rule should be abolished. Independent firms should disclose to consumers any stake a product provider has in the firm or in connected firms; and
- steps be taken to streamline the advice process and constructing a 'buyers guide' to make consumers better informed and more confident to choose an adviser right for them.

We also put forward for discussion, as potentially helpful for improving the functioning of the market for financial advice whatever the way forward for polarisation, the following measures:

- a two-tiered system of advisers with the lower tier of less intensively qualified advisers, advising on only a limited range of lower risk products; and
- proposals for unbundling the cost of advice or marketing from the cost of the product.

The aim of these proposals remains the same as for the first stage of the review. We are seeking the same or greater consumer protection than polarisation offers through other methods that we expect to be much less restrictive of competition.

We have included several help boxes in the main text in response to previous suggestions to help the lay reader to understand the complexities of the market.

The consultation

We welcome responses from anyone with an interest in the way the proposed changes to polarisation will affect them or those they may represent. We need your responses by Friday 19 April 2002.

¹ We have called these firms distributor firms for the time being to differentiate them from any current practice. Their final name would have to be tested to establish that it helps explain to consumers the status of the adviser to them.

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 19 April 2002.

You can send your response by electronic submission using the form on the FSA's website (at www.fsa.gov.uk/pubs/cp/cp121_response.html), by e-mail or in writing to the following:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

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Document:	Reference
Consultation Paper 121 – Reforming Polarisation Making the market work for consumers	CP121
Polarisation: research into the effect of commission based remuneration on advice	POL\RES1
Polarisation research: IFA use of panels	POL\RES2
Polarisation: Consumer Research	POL\RES3

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