

**From Hector Sants
Chief Executive**

Andrew Tyrie MP
Chair, Treasury Committee
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Dear Andrew

Retail Distribution Review

We welcome the Treasury Committee's continuing interest in the FSA's Retail Distribution Review (RDR). The RDR is an important aspect of our programme to address fundamental flaws in the market for investment products and services in the UK and we will of course submit formal written evidence to your inquiry in January. In the meantime, I hope it will be helpful if I set out why we remain committed to modernising the industry through the RDR to address a market that was not working, and does not work, well for consumers, advisers or the firms which provide these products and services.

Problems in the market

In recent years, mis-selling scandals and a lack of consumer trust have severely damaged the reputation of the retail investment market, with nearly £15bn having been paid in compensation for mis-sold personal pensions and endowment policies. However, this is not just a historic issue. Our supervision has shown that problems continue to exist in the market and there is widespread agreement that fundamental changes are needed in the market to address these problems. Specific examples of unsuitable sales and an illustration of the associated annual cost of consumer detriment based on detailed reviews we have carried out are as follows:

Mis-selling review	% of unsuitable sales	Illustration of annual consumer detriment
Pension switching (2008)	16%	£43m
Unit trust vs. equity ISA (2005)	12–20%	£70m
Investment bond vs. equity ISA (2005)	12–20%	£92m
Personal pensions (2005)	Analysis indicated a link between commission payments and market share	Up to £18m

These figures, which amount to an annual consumer detriment of £223m, underestimate the scale of the problem as they are based on just four incidences of mis-selling. Ongoing supervisory and enforcement action means we are unable to cite more recent examples; however, we estimate that the average annual detriment arising from the sale of unsuitable products to be nearer the range of £0.4bn to £0.6bn.

At present, around 70% of consumers do not seek advice from an investment adviser.¹ Trust in advisers is higher for those that use an adviser than those that do not but it is worth noting that 40% of those who have recently used an adviser say that they do not trust financial advice. Our consumer research has found trust to be a more important factor than price for selecting an adviser² and that confidence can be established in advisers through the demonstration of knowledge and qualifications³. Achieving greater trust in the investment advice sector could lead to greater engagement in investment advice, and so to more consumers seeking advice.

RDR proposals

The high incidence of mis-selling in this sector arises from fundamental flaws in the market. We launched the RDR in June 2006 to work with the market to identify and address these flaws and have developed our proposals in conjunction with industry, consumer groups, trade associations and professional bodies following the FSA's most extensive and far-reaching consultation process to date.

The RDR is designed to provide a clean and sustainable market for the future. It will ensure customers get good quality advice, products and services suited to their needs from advisers displaying higher standards of professionalism and expertise. The regime needs to change and this change will be supported by our intensive supervisory approach including a greater focus on individuals. Our policy proposals aim to do this by:

- increasing the professional standards of advisers;
- improving the clarity with which firms describe their services to customers so that they know whether they are getting advice which is truly independent (covering the full range of possible investments) or is restricted in some way (for example advising on a particular range of products, or on products from one or a limited range of product providers);
- addressing the potential for commission bias to distort consumer outcomes; and
- ensuring personal investment firms have adequate capital resources for complaint redress.

¹ *Baseline Survey of Financial Capability*, FSA (2006): 'In the last 5 years, have you received any professional advice about planning your personal finances? By that I mean things like planning for retirement, tax planning, or investing money, but please do not include advice related to running a business'

² February 2008, BMRB Social Research, *Services and Costs Disclosure*, FSA Consumer Research Paper 65a (www.fsa.gov.uk/pubs/consumer-research/crpr65a.pdf)

³ November 2008, Strictly Financial, *Assessing investment products*, FSA Consumer Research Paper 73 (www.fsa.gov.uk/pubs/consumer-research/crpr73.pdf)

Our rules on adviser charging, service description and capital have already been made by our Board. We believe all these reforms are necessary in order to equip retail investment advisers to deal with the challenges they now face and to remove distortions in the way the market has operated in the past. This will provide better protection for consumers and better outcomes for consumers.

Professionalism

We are, of course, aware of the concern that has been voiced in recent weeks by individual advisers and some of your parliamentary colleagues about the impact the RDR, and in particular our professionalism proposals, may have on this sector. We do not agree that the RDR will threaten the availability of good quality advice.

To achieve our aim of a more professional advice market, under our proposals all advisers will be required to adhere to common professional standards, including reformed qualifications and effective continuing professional development. If consumers are being advised on how to invest their life savings or choosing the right pension to support them when they retire, they expect an adviser to be professional and for that professionalism to be closer to the standards of, for example, a lawyer or accountant. At present this is not the case.

The new measures come into effect at the end of 2012, by which time existing individual advisers will have had four years to prepare, including meeting the qualification requirements. We were clear in November 2008 about our intention to raise professional standards, including modernisation of qualifications and we said that those who are on course to complete, or already hold an appropriate qualification⁴ could continue to give retail investment advice.

The new requirements will apply to all those giving investment advice to retail customers, regardless of the type of firm they work for (e.g. banks, insurers, independent financial advisers, stockbrokers or wealth managers). They will not apply to those who advise solely on mortgages or general insurance. I should point out here that due to the enhanced consumer protections provided by stakeholder products, **the RDR will not apply to those giving advice under the Basic Advice regime.**

Our experience is that advisers are now, on the whole, getting on with attaining qualifications, where they need to. According to research⁵ carried out in March 2010, 49% of all individual investment advisers were already appropriately qualified. A further 40% expected to have completed the qualifications by the end of 2012 and only 4% were steadfast in their view that they will not seek to attain a new qualification. Of the remainder, 1% expected to complete after end-2012 and 6% fell into the 'not known' category. Connected to this, one of the main awarding bodies, the Chartered Insurance Institute (CII) indicate they have seen a 65% increase in candidates sitting their qualifications in 2010 compared to 2009.

⁴ Our current proposals are that advisers holding certain existing appropriate qualifications may need to carry out activity to fill knowledge gaps through structured continuing professional development (a form of grandfathering).

⁵ Research published in March 2010 by NMG, a financial services consulting and research firm.

The qualification standards have been developed by the industry itself⁶ following extensive consultation by the FSA and the Financial Services Skills Council (FSSC). The response to our June 2007 interim report and the FSSC's own 2009 consultation on the qualification standards (which cover content and level) showed strong support for qualifications to include practical application of knowledge: QCF level 4⁷, which is the vocational equivalent to the first year of an academic degree, is the lowest level that achieves this. The reformed qualifications now include investment risk and ethics as well as practical application of knowledge, as part of the syllabus – we believe these changes are fundamental to equip the modern adviser to give good quality advice.

A minority of individual advisers have expressed concern about the time it may take them to attain the qualification they need. The FSSC's consultation and working groups established that the new syllabus would map to a diploma sized qualification under the QCF. The Office of Qualifications and Exams Regulations (OfQual) guidelines suggest the average learner takes 370 hours to complete a diploma: this includes directed study, homework, assessment and preparation time. This is the expected time that a new entrant would take: we would expect those advisers with considerable experience to find that the time they need to study will be significantly lower than that. The main qualification providers for this sector have indicated to us that it is taking between 6-24 months for most advisers to complete their qualifications.

The majority of respondents to our consultation were opposed to the use of grandfathering, meaning existing practitioners should not be exempt from meeting the new qualification standards⁸. Those respondents (who included consumer and IFA representatives) told us that they felt that this would not achieve a level playing field for investment advisers and would not provide a consistent message for consumers about professionalism of the sector. Our experience in allowing grandfathering rights for mortgage brokers has been that it has seen a continuation of mis-selling, resulting in nearly 100 brokers being disqualified to date for incompetent and unethical practices. Whilst complaints can indicate potential issues, due to the long-term nature of investments the absence of complaints does not necessarily mean consumers have received suitable advice. This puts advisers in a difficult position because their customers very often do not understand the position they are in until many years later. Therefore, without applying the new qualifications to the whole industry, problems of mis-selling may continue under the new regime, further undermining confidence in the industry and at a cost to consumers.

We understand that many advisers find the prospect of taking further exams daunting and are sympathetic to this. In June 2009 we responded to consultation feedback and feedback from some individual advisers that we spoke to, and agreed to allow for a move away from written examinations to allowing other types of assessment to be used in awarding qualifications. We have, and continue to, work with the qualification providers, IFA firms, and their representatives to make these types of assessments

⁶ The FSSC established industry working groups to draft the qualification standards

⁷ The Qualifications and Credit Framework: the UK implementation of the European Qualification Framework

⁸ Our definition differs to that used in other member states where the regulator sets the regulatory examinations and grandfathering is simply recognition of certain other qualifications as opposed to allowing unqualified individuals to operate.

available. Since then, we have seen the launch of three qualifications that do not rely on written examinations to determine an award, spanning qualifications for the various types of adviser that are within the scope of the RDR. Additional qualifications using assessment methods other than written exams continue to be developed. There are also qualifications that do involve written examinations but are very much based on case studies and are highly relevant to the role of an adviser. For example, one qualification involves a candidate making recommendations based on a specimen fact find that is provided to the candidate two weeks prior to the examination itself.

The link between higher professional standards and better consumer outcomes is also borne out by several pieces of research in this area. Recent thematic reviews of industry performance that we have carried out show a clear link between advisers' professional qualifications and the quality of their service. We will expand on the research in this area further in our written submission; however, two examples of this research are as follows:

- Our data from early 2010⁹ on platforms shows the advice of advisers meeting current qualification standards was deemed to be 'suitable' in 11% of cases and 89% of advice was either 'unclear' or 'unsuitable'. The advice of advisers with a similar qualification to the new standard was suitable in 43% of cases, 'unclear' in 32% and unsuitable in the remaining 25% of cases. Cases from the few advisers who had attained qualification in excess of the new standards indicated that 71% were classed as 'suitable' advice and were 'unclear' in 29% of cases.
- A review of the quality of financial planning advice by an expert panel from Australia (ASIC 2003 study)¹⁰ also showed that plans completed by advisers with a 'certified' / qualified status (around QCF Level 6) scored better than unqualified advisers.

Adviser charging

Adviser charging is another key element of the RDR. At present, many consumers using the services of a financial adviser believe they are getting free advice. In reality, they do pay, as charges for advice have simply been added to the cost of the product and then the product provider pays the adviser commission. This creates a potential conflict of interest. For example, research referenced in our March 2010 Policy Statement found evidence of product bias in the equity ISA market, where in 20% of mystery shops with commission-based IFAs and in 12% of mystery shops with a tied-adviser an ISA was not recommended when suitable – instead clients were recommended unit trusts or unit linked bonds that could potentially pay the adviser a higher commission¹¹. Furthermore, our consumer research found that only around half of respondents understood how the value of their product would be affected by commission. This can be damaging to consumers and undermines trust in the investment industry.

Our new RDR rules will prohibit the receipt of commission in relation to advised sales of retail investment products. After that date adviser firms will have to set their own

⁹ This information is based on 12 firms and 46 advisers and 113 cases

¹⁰ [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Advice_Report.pdf/\\$file/Advice_Report.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Advice_Report.pdf/$file/Advice_Report.pdf)

¹¹ CRA (2005) *Study of Intermediary Remuneration*, a study for the ABI

charges for advised sales. These charges should reflect the services being provided to the client, not the particular product provider or the product being recommended. We believe that this will remove the risk that provider influence could lead to product bias (or the perception of it) thereby contributing to improvements in consumer confidence, the fair treatment of customers and the sustainability of the UK retail investment market.

The new rules require advisers to discuss and agree with their customers how they will pay for advice, and there are a number of different charging structures that might be adopted. Payment could be a fixed charge, it could be based on an hourly rate, reflecting the time taken by the adviser to perform the service, it could be based on a % of the amount invested or through some combination of these methods. Some customers with a lump sum to invest may wish to pay for advice upfront. Others may wish to invest a regular amount each month and so be unable or unwilling to pay for advice at the outset. In such cases there are a number of different charging structures that can be adopted, for example, spreading the payment over a period of time. This might be by means of a regular payment to the adviser, or if the product provider agrees, customers would also be able to ask for their adviser's charges to be paid out of their investments. The difference between this and the present system of payment by commission is that it would be for the customer and adviser to agree how much should be paid. The product provider's role is simply to collect and pay the agreed amount.

Capital resources

Holding capital resources against all Professional Indemnity Insurance (PII) exclusions, regardless of whether they relate to regulated business activities or other FSA-instigated events, ensures firms are in a position to redress complaints against which they are not insured. We are simplifying how firms will calculate this requirement and making it consistent for all firms. We are extending the expenditure-based requirement to all firms based on three months of relevant annual expenditure and increasing the minimum capital resources floor to £20,000. We have also set out more specific requirements as to the level of additional capital resources needed where firms have any type of exclusion in their PII policy.

RDR Costs

The detailed cost benefit analysis we have undertaken on all of the RDR changes has estimated the implementation costs, based on industry feedback, to be in the region of £1.4bn to £1.7bn over a 5-year period. This covers professionalism, clarity of services, commission bias and capital requirements for the whole of the retail financial sector, including intermediaries (a broader population which includes IFAs), banks and providers. The total initial costs to both intermediaries and providers are estimated at £600 to £750 million. The proportion of these costs applicable to intermediaries is 18%, banks 30%, and insurance companies a further 37% with the remaining 15% due to other types of advisory firm such as stockbrokers.

Clearly any additional compliance cost for firms, and ultimately consumers, is a matter of concern to the FSA. However, the cost benefit analysis we have carried out shows the annual consumer benefit of RDR to outweigh the annual implementation costs. While we anticipate the ongoing annual costs of the RDR to be between £178m to £221m, this

needs to be seen in the context of the annual consumer detriment from the sale of unsuitable products, which we estimate to be in the range of £0.4bn to £0.6bn. We have been transparent about the implementation costs, but industry also has to be transparent about the cost to consumers of mis-selling.

In terms of market exits, Oxera¹² estimated that, if new firms do not enter or existing firms do not expand, overall turnover would be reduced by 9%, the number of advisers by 11%, and the number of advised clients by 11% as a result of market exit.

This is supported by research examining the implication for individual advisers¹³. In terms of individuals, research indicates that 5% of advisers say that they were already due to retire by 2013, 3% of advisers will retire earlier than planned, a further 3% will leave the industry completely and 2% will take another role within the industry (the remainder gave no response). We conclude that, in economic welfare terms, advisers leaving the market would not create a net cost because the supply of advice in the longer term will not be affected.

Any dilution of the proposals will result in an increase in the cost to consumers through continued mis-selling.

Despite the vocal concerns of some in the IFA community, we believe the RDR is absolutely fundamental to address the root causes of numerous problems we have observed in this sector and to improve consumer outcomes. We will expand further on the points made in this letter in our written submission.

Hector Sants

¹² http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf

¹³ Research published in March 2010 by NMG, a financial services consulting and research firm.