

**Financial Risk Outlook  
Retail Intermediaries Sector Digest  
2010**



**Delivering financial stability**

**Delivering market confidence**

**Delivering consumer protection**

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25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: [www.fsa.gov.uk](http://www.fsa.gov.uk)  
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The Financial Services Authority invites comments on this Sector Digest.  
Comments may be sent to [retail.intermediaries@fsa.gov.uk](mailto:retail.intermediaries@fsa.gov.uk)



# Retail intermediaries and mortgage sector leader introduction



Lesley Titcomb

We are publishing this Digest alongside the Financial Risk Outlook (FRO) to give extra focus to risks and issues relevant to the retail intermediaries sector in 2010. The FRO sets out the main risks presented by the operating environment, and this Digest develops some of those challenges further. It also raises other key issues for firms in the retail intermediary sector, which includes three sub-sectors: financial advisers, mortgage intermediaries, and general insurance intermediaries.

The economic outlook and uncertainty around the shape and pace of recovery point to a challenging environment for the retail intermediary sector. Many consumers will continue to be under pressure as they seek to pay down debt and face the possibility of lower incomes through rising unemployment. In addition, the housing market is expected to remain weak.

In a sector known for its ability to adapt and change in line with shifting market conditions and trends, the last two years have brought about huge structural changes. While many firms have struggled, others have adapted and even thrived. This is illustrated in an update to the analysis that we presented in the 2009 FRO of the number of firms in each of the three sub-sectors and how they are regulated. It is important to bear these trends in mind when reading through the rest of the Digest, as they lie behind many of the risks and challenges that the sector will face over the next few years.

We go on to outline our view of the key risks in the retail intermediaries sector and highlight a number of areas of focus for firms. This sector plays an important role in ensuring consumers can access financial products that meet their needs and have the information they need to make well-informed decisions. While this sector is constantly evolving and facing new issues and challenges, our view is that the underlying causes of risk consistently occur in three main areas:

- There are continuing concerns about the **sustainability of business models** exhibited by many firms in the sector. The current economic conditions heighten this risk, threatening both the long-term sustainability of the sector as a whole and also increasing the potential that advisers under financial pressure will not always treat their customers fairly.
- The overall **quality of advice** offered by firms is key to the future success of the sector and a long-standing area of focus for the FSA. The current market conditions mean that the need for good advice is as marked as ever, so firms need to pay particular attention to this area, ensuring they always meet the needs of their clients.
- The standard of **management and control** is still a key risk to achieving good consumer outcomes. Economic conditions and changes to business models are additional reasons for firms to be constantly evaluating the procedures in place to protect both consumers and themselves.

I hope you find this Digest helpful and I would welcome your feedback.

## Economic background and outlook

*Benign economic conditions encouraged borrowing...*

Section A of the Financial Risk Outlook (FRO) describes how the period leading up to the financial crisis was characterised by benign economic conditions, low unemployment, rising earnings, low nominal interest rates and rising asset prices. This enabled households to extend their debt beyond previous levels, which was primarily secured against their property. Credit was made available to higher-risk consumers that had not previously had access to credit. Homeowners were also able to take advantage of the rising value of their property through mortgage equity withdrawal.

*...which has not been paid off as quickly as anticipated.*

Where households have started to deleverage, it has been concentrated in more expensive, unsecured debt. Overall, deleveraging has been slower than anticipated, possibly in response to consumers keeping liquid savings available or because many households are able to get higher deposit or savings rates than they are paying on their secured debt. However, debt levels remain high. This has left many households vulnerable to income shocks, interest rate shocks and property price falls.

*As economic growth returns, households will still be constrained...*

While our central economic scenario is for steady growth in the UK economy throughout 2010, growth in consumption is expected to be constrained by households focusing on increasing their savings and paying-down debt, particularly given the impact of persistently high unemployment on incomes. With further volatility in asset prices remaining a possibility, the outlook indicates continuing depressed demand for the services of firms in each of the three sub-sectors.

*...and there are still a number of economic risks that could impact the sector.*

The FRO also highlights a number of risks to this central scenario, which would have a further impact on the sector. Pressure on public finances is likely to lead to spending cuts or tax rises, and there is a risk that a rapid fiscal tightening would not only squeeze household incomes, but could also reduce the attractiveness of specific financial products if tax relief is withdrawn. Instability in emerging financial markets could lead to sharp asset-price corrections, further undermining the confidence of UK consumers in equity-based financial assets. Finally, the FRO highlights that household finances remain unstable and could be vulnerable to unexpected changes in income or interest rates. Such shocks would place downward pressure on household consumption and saving, and could make debt-servicing more expensive. This could lead to higher levels of arrears and a reduction in demand for new lending, financial advice and insurance products.

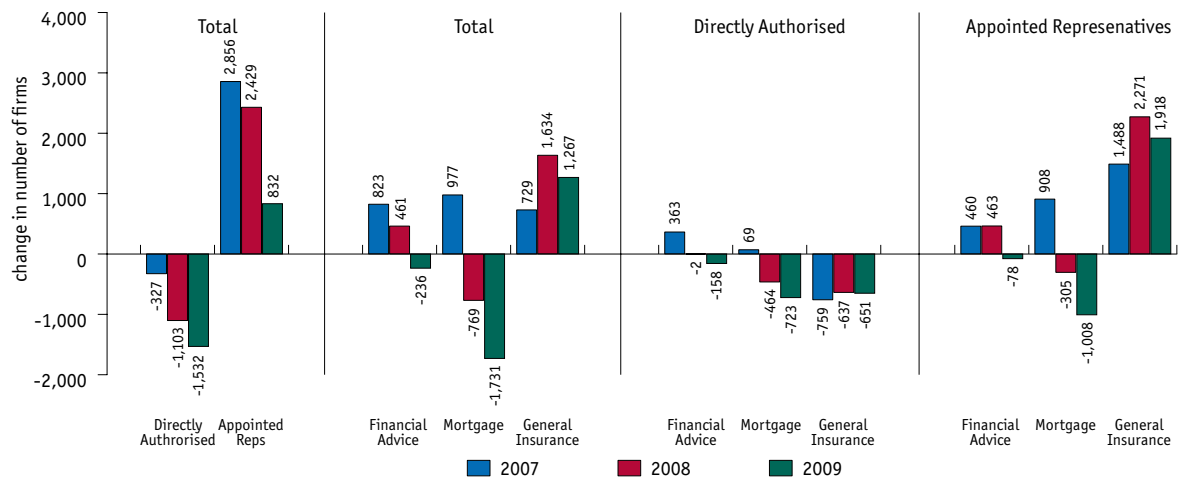
### The structure of the sector

*2009 was a year of rapid change in the sector.*

2010 is expected to be another challenging year for the retail intermediary sector. In a continuation of the population trends we saw last year, issues in the mortgage market and changing patterns of consumer demand have meant that most firms have struggled to maintain income levels, with many closing or selling their business. While this is to be expected in current conditions, it causes considerable upheaval for the firms involved and also for their clients. In the longer term, we expect a recovery in the sector in line with the wider economy, but in the meantime it is important that firms continue to treat their customers fairly and, if necessary, exit the market in an orderly fashion.

In 2009 the overall number of firms in the sector contracted, mainly due to a net reduction of over 1,700 mortgage intermediaries (see *Chart 1*). In total, the number of firms in the mortgage intermediary sub-sector has reduced by over 25% since the peak of the market in the fourth quarter of 2007, having been impacted by the severe restriction in demand and supply of mortgage lending, reflecting both the financial crisis and a sharp fall in house prices. The financial advice sub-sector, despite growing in 2008, saw a 1.6% decline in the number of firms in 2009. In contrast, the general insurance intermediary sub-sector has seen continued strong growth, with the continuing decline in the directly authorised population more than offset by strong growth in the number of appointed representatives.

Chart 1: Changes in the number of retail intermediary firms



Source: FSA

Note: Analysed by primary categories of business.

## Sustainability of business models

*Networks face particular challenges.*

The 2009 FRO highlighted that network firms are under significant pressure, and events of the last year have borne this out in the case of some firms that have left the market. With the further rapid growth of a number of individual networks, we still see firms that are under just as much pressure as small, directly authorised firms, as economic conditions reduce profitability without a corresponding reduction in costs. Networks face particular challenges in ensuring they have a sustainable business model, with high standards of monitoring and compliance. They also need to make a number of important strategic decisions in response to key industry changes, such as the Retail Distribution Review (RDR).

### Financial advice firms

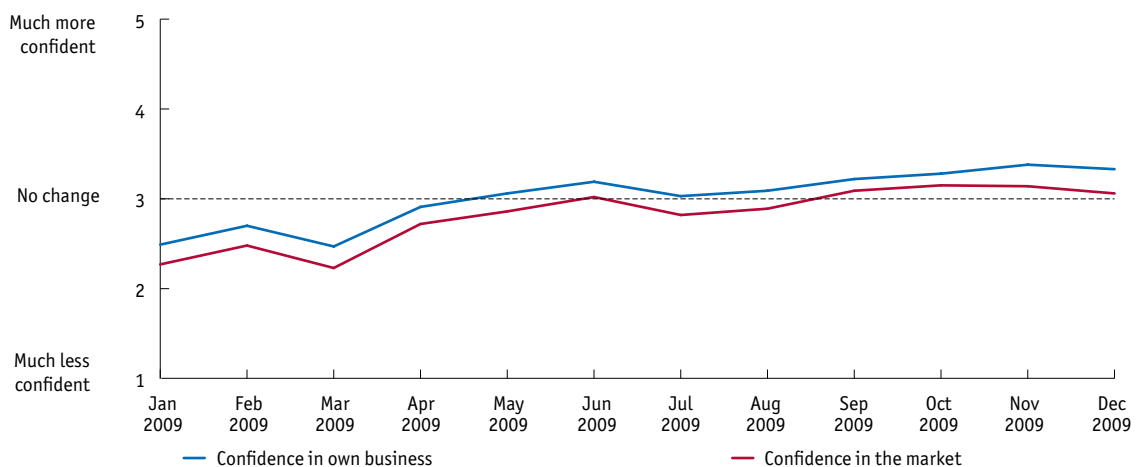
*Income is depressed...*

Income streams are still under considerable stress in financial advice firms and many firms have looked to move into new areas in an attempt to sustain income levels. Nearly 60% of Independent Financial Advisers (IFAs) report that their annual income decreased during 2009, with an average decrease in this group of 27%.<sup>1</sup> Conversely, a significant minority (17% of IFAs) report that their annual income increased on average by 18%. Overall, the average IFA has seen their total annual income decrease by 4%.

*...but confidence is rising.*

But while incomes are depressed, confidence actually rose among financial advisers throughout 2009 (see *Chart 2*). Consumer demand started to improve due to the rising stock market and investors continuing to need advice on finding an attractive combination of risk and return. As illustrated in *Chart 3*, IFAs report that consumer confidence in stock market based investments and the housing market are now starting to have a positive effect on their businesses.

Chart 2: IFA confidence

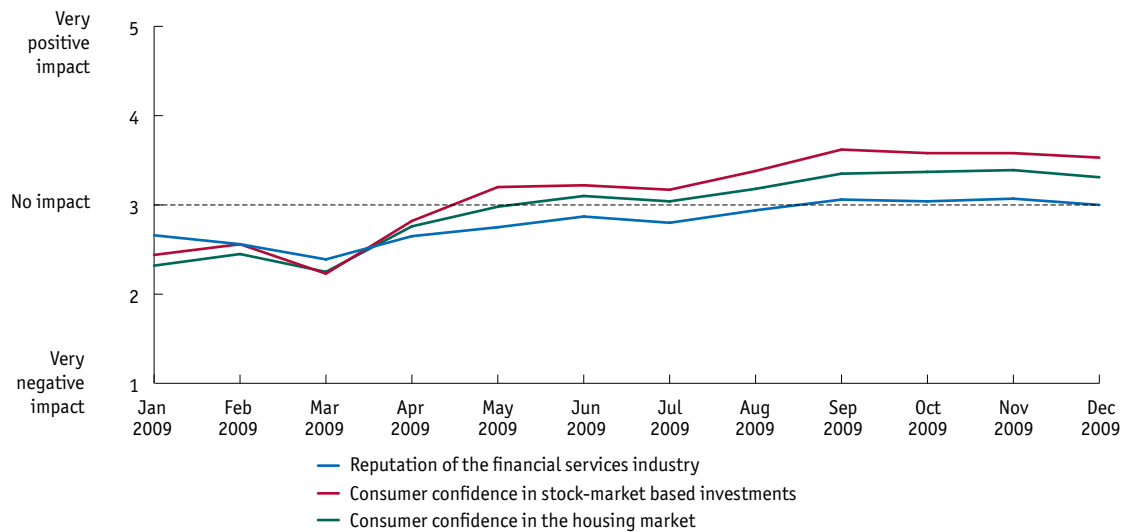


Source: NMG IFA Census, Quarterly Report, Q4 2009

Note: Respondents were asked about their confidence, compared to six months ago, in both their own firm and the financial services market. Mean scores were calculated using 5 for 'much more confident' to 1 for 'much less confident'.

<sup>1</sup> IFA Census Quarterly Report, NMG, Quarter 4 2009.

Chart 3: Impact of consumer attitudes on IFA businesses



Source: NMG IFA Census, Quarterly Report, Q4 2009

Note: Respondents were asked to score impact of each factor on their business over the following year. Mean scores were calculated using 5 for 'very positive impact' to 1 for 'very negative impact'.

*The RDR will improve the sustainability of the financial advice market, but is a particular challenge for firms...*

We have taken a number of actions aimed at improving the sustainability of the financial advice market, particularly concentrating on improving the capital position of firms in the sector. To address the sustainability issues in the retail investment market in the longer term, we have set out our proposals for the RDR and increased capital requirements for Personal Investment Firms. Firms and advisers now have to decide how to respond to these changes. While opinions vary, most believe that 10% to 20% of advisers in financial advice firms will leave the market. For example, one recent study found that 13% of IFAs do not intend to achieve a Level 4 qualification or implement adviser charging.<sup>2</sup> Most in this group were aged over 55 years and are more likely to be reliant on commission-based sales.

*...and a source of risk.*

The RDR is being implemented at the end of 2012 and there are other important changes that are planned or have potential to take effect on a similar timescale; for example, increased capital requirements for Personal Investment Firms, National Employment Savings Trust (NEST) and changes being proposed in Europe. Many of these will improve the sustainability of the sector over the longer term, but, if firms do not make adequate progress in preparing for their implementation, the combined effect could be detrimental to individual firms. With regard to the RDR, it is important for firms to act now to implement their plans for achieving the qualification requirements and developing a remuneration model based on adviser charging.

Where owners of firms are planning to leave the market and are looking to sell their businesses, there is a risk that, in an attempt to build up their book to increase the attractiveness of the firm, they increase income through selling significant amounts of commission-based products. Ultimately this is unlikely to be a successful strategy as most will be able to realise significant value from the business only if they have developed a significant amount of recurring income, built upon a manageable, regularly-serviced client bank.

### Mortgage intermediaries

*Wider economic conditions have impacted heavily on mortgage intermediaries.*

The mortgage intermediary sector has been substantially affected by the economic downturn. Falling house prices have resulted in fewer consumers moving house and requiring a new mortgage, and the challenges faced by banks and building societies have resulted in stricter lending criteria and higher interest rates being charged on products. This has meant that demand for remortgages has also substantially reduced as consumers choose to pay the lender's standard variable rate rather than remortgage.

<sup>2</sup> IFA Census Quarterly Report, NMG, Quarter 4 2009.

Despite these factors, confidence is starting to rise. In the fourth quarter of 2009, 39% of mortgage intermediaries said that they were more confident in their own business than they were six months previously.<sup>3</sup> However, this has not yet been reflected in improved business performance, with over three-quarters of advisers saying that current economic conditions are having a negative impact on their cash flow, and 59% reporting that they are seeing a negative impact on the level of capital reserves they hold. Furthermore, stricter lending criteria mean that they are on average unable to help 24% of potential purchase clients and 38% of clients looking to remortgage, mainly due to reduced loan-to-value limits and better deals being available direct from lenders.

*We are taking steps to ensure a more sustainable market in the future.*

The barriers to entry are relatively low in this sub-sector, and as the mortgage market recovers we would expect firms to re-enter the market, including in specialist areas which tend to be heavily intermediated. In the short term our focus is on ensuring that firms exit the market in an orderly fashion, but in the longer term we are taking steps through the Mortgage Market Review (MMR) to ensure that, however the market develops, it is sustainable for lenders, intermediaries and consumers alike. Our approval process will take a close look at the business models of firms applying for authorisation which, supported by the extension of the Approved Persons regime, will improve the quality of the intermediary market that re-emerges.

### General insurance intermediaries

*General insurance brokers appear to be coping better with the economic conditions.*

The number of firms in the general insurance intermediary sub-sector continues to grow. Some firms are thriving in difficult conditions, including those that have sought new opportunities to sell protection products to risk-averse consumers.

There is still a great deal of interest in investing in the market, with 36% of firms having been approached by a consolidator in 2009, and nearly a quarter of brokers themselves looking to acquire a fellow broker during 2010.<sup>4</sup> However, this sub-sector also faces significant challenges. Commercial lines are under particular pressure, as small business clients look to reduce their insurance costs, or go out of business. Pressure on household incomes has led to reports of decreased demand for insurance products across the personal lines sector, with some consumers cancelling products such as buildings and contents insurance.<sup>5</sup> General insurance brokers appear to take a more positive view of demand from their own customer base, with around 20% of brokers expecting to see personal lines business account for a greater proportion of their revenue over the next two to three years.

We have also continued to see the trend of directly authorised firms moving to become appointed representatives. In particular, many firms with relatively small amounts of regulated income, perhaps from a secondary component of their business, appear to regard it as the most appropriate way of meeting their regulatory obligations.

<sup>3</sup> *Mortgage Intermediary Census, 'Barometer' Quarterly Report, NMG, Quarter 4 2009.*

<sup>4</sup> *Personal Insurance Broker Survey 2009, Datamonitor, November 2009.*

<sup>5</sup> A YouGov survey carried out on behalf of the ABI found that 22% of respondents had stopped taking out home contents insurance and 17% had stopped taking out building insurance; *Insurance Daily*, 9 June 2009.

## Quality of advice

*The level of unsuitable advice is still unacceptable.*

The level of unsuitable advice we see in the market remains a significant concern. In addition to concerns around the level of professionalism, insufficient knowledge of complex products and remuneration, firms that have been under stress for a considerable period of time may have a tendency to allow standards to slip as they fight to maintain income streams, resulting in an increase in unsuitable sales.

*Firms must ensure they are competent to move into new areas of business.*

We see many examples of firms seeking to move into new business areas in an attempt to maintain income streams. For example, 57% of mortgage intermediaries that have seen a fall in income have diversified into or increased their focus on other sectors.<sup>6</sup> Nearly all (91%) of these firms are now selling income protection and critical illness policies, with a similar proportion selling life insurance policies. Many have also moved into investments, pensions and payment protection insurance.

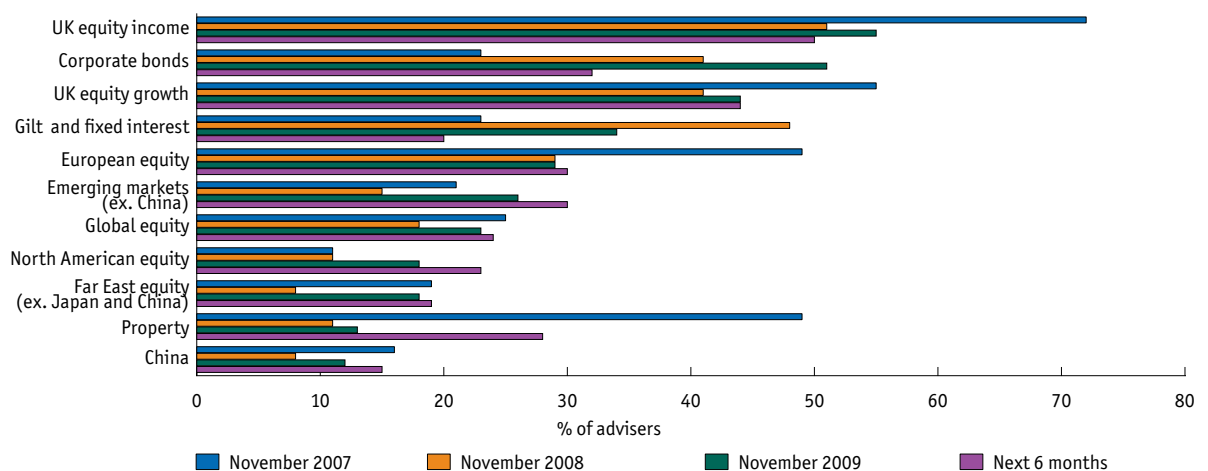
Too often firms diversify into areas that are unfamiliar, with advisers lacking the competence, knowledge or experience to ensure that they are treating their customers fairly. One particular example is where FSA-authorized firms introduce their clients to claims management companies. We have seen firms failing to consider their data protection obligations when referring clients without the appropriate consent and others failing to perform any due diligence on the claims manager they refer to.

*We have concerns about how advisers devise investment recommendations.*

We noted above that the structure of the market continues to evolve, with many firms exiting while others look to expand. Where firms are active in the consolidation market, potentially merging a variety of businesses with differing clients, they should not automatically assume a one size fits all business model. In particular, where the change involves extra cost, for example placing a client on a wrap or other platform, firms need to discuss the implications with each client and ensure it is suitable for their individual needs.

For financial advisers, the low interest rate environment makes it harder to devise strategies for clients with a suitable balance of risk and return. Around half of advisers are now using risk profiling and asset allocation software tools, rather than relying on a self-styled approach.<sup>7</sup> However, we still see evidence that advisers base their recommendations on current trends, rather than devising balanced, diversified portfolios. For example, *Chart 4* shows the large swings in the frequency with which advisers recommend property, emerging markets and corporate bond funds. Even where advisers use an asset allocation tool, we have some concerns as to whether the default suggestions are always appropriate and truly reflect the attitude to risk of the individual client.

Chart 4: Asset classes most frequently recommended by IFAs



Source: NMG IFA Census, Investment Special, November 2009

Note: Respondents were asked which asset classes they had recommended most frequently over the previous six months. In November 2009 they were also asked their expectations for the following six months.

<sup>6</sup> UK Mortgage Intermediary Distribution 2009, Datamonitor, February 2010.

<sup>7</sup> IFA Census Investment Special, NMG, November 2009.

*We are vigilant for signs of consumers being treated unfairly.*

While the RDR will improve long term sustainability and consumer outcomes in the financial advice market, the period leading up to its implementation at the end of 2012 poses some additional risks. All distributors, particularly the significant minority of advisers who are expecting to leave the market before 2013, have some incentive to keep recommending commission-based products prior to implementation knowing that this avenue will no longer be open to them in a post-RDR world. As such, there is potential for mis-selling to increase over the short term, and we will be monitoring the market for signs of poor treatment of consumers in the run-up to the RDR implementation deadline. The introduction of NEST presents a similar risk, and we will be vigilant for signs of advisers reinvesting their clients' pensions, when they would be better off remaining in their current pension or waiting until the launch of the new scheme.

As the mortgage market recovers, there is a risk that the poor advice and behaviour seen in the past will reappear. We will be closely monitoring the market. In addition, the MMR has proposed a number of measures to improve selling standards through both intermediaries and lenders. For example, the proposals include greater prescription around affordability assessments, a requirement to verify income, and measures to improve the capability and professionalism of mortgage intermediaries, including through the extension of the Approved Persons regime.

Section D of the FRO identifies a number of further conduct risks that are relevant to retail intermediaries. These are summarised below.

### Issues related to investment and decumulation

*The risk appetite of consumers has changed.*

The risk appetite of many consumers has decreased during the financial crisis and, as a result, these consumers are often looking to hold products that minimise the risk of losses, perhaps offering some form of capital protection. However, some consumers are demanding products that achieve the levels of return they were accustomed to before the crisis. Financial advisers have a key role in helping their clients understand the tension between risk and return. If consumers do not understand the extra risks they may be taking in trying to maintain higher pre-crisis returns, there is a possibility they could be sold inappropriate products. In addition, capital protected products can be complex and may not be fully understood by many consumers. For example, guarantees may be provided by a third party, returns may be capped and it may be difficult to access money before the end of the investment term.

*Retired consumers are particularly at risk.*

With low annuity rates, many advisers are considering alternative ways of generating the levels of income required by their retired clients, for example using income drawdown or lifetime mortgages. The additional risks that these more complex products pose need to be explained clearly to the consumer. There is a risk that such products could be sold inappropriately to consumers who have relatively small amounts of pension savings and who are concerned about maintaining a high level of retirement income, especially where these products generate higher levels of commission than annuities. Where income drawdown is used, advisers need to remind their clients of the need to review their situation on a regular basis.

### Issues related to platforms

*The increased use of platforms brings both benefits and risks.*

The use of platforms continues to grow and platforms now hold about £110 billion in assets according to a recent report, which also estimates that about half of all new investment business is being placed through platforms.<sup>8</sup> The general expectation is for this growth to continue, particularly as some financial advisers view using a platform as one way of helping them meet their obligations under the Retail Distribution Review, facilitating adviser charging through customer cash accounts.

Platforms have the potential to bring significant benefits to both intermediaries and consumers. However, we continue to be concerned that platform services may not always be in the best interests of individual consumers.

The platforms provide a variety of services which are paid for by consumers directly or by product providers. Consequently, this can lead to confusion on exactly what they do and how they charge. They are particularly suited to clients receiving ongoing advice and may help reduce the administrative costs for

their adviser. However, given that they do impose additional costs, advisers need to be able to explain and justify to their clients that they represent good value for money.

Firms also need to be sure that their oversight arrangements are appropriate, particularly if they have previously had a transactional business model and are now moving to a more service-based proposition. Lastly, advisers need to understand the basis on which the platform recommends or features particular funds and products, and be aware of any restrictions in coverage, particularly where a firm states that it is independent.

### Issues related to general insurance

*Consumers often focus on price rather than product features and benefits.*

Section D of the FRO explores some of the pressures that current economic conditions are putting on the insurance industry, which could result in an increased likelihood of conduct risks emerging in some areas.

An increased focus on price over quality and coverage in recent years, as well as the fact that many consumers now shop around for home and motor insurance, has put pressure on profitability for both general insurers and intermediaries. This, in turn, can increase the potential for conduct risks to arise as firms look for ways of reinforcing their income streams. In particular, we are aware that intermediaries who do business through price comparison websites are sometimes taking low or zero commissions and then selling highly-profitable insurance add-ons to the consumer. The risks this poses are similar to those for retailers that act as insurance intermediaries, selling insurance alongside products such as mobile phones, white goods and cars. Consumers may not be in a position at the point of purchase to make an informed decision about suitability, benefits and price. They risk purchasing products with limited benefits that they do not need or that do not represent good value. Policy limitations may only become apparent at the time of making a claim, but because these are invariably low cost products, consumers tend not to complain.

## Management and control

*Oversight and control may still be inadequate...*

As noted above, it is likely that the retail intermediaries sector will continue to experience substantial consolidation over the next few years. As firms grow in size, either organically or through acquisition, they will need to ensure that they put in place controls that reflect their developing business model. In judging the correct level of compliance resource, firms need to take into account the complexity of their ownership and governance structures. One development in the financial advice market has been the entry of unregulated consolidation firms. In these cases it can be unclear who is taking ultimate responsibility for governance within the consolidated group. Firms need to ensure lines of responsibility remain clear and that potential conflicts of interest brought about by a consolidator's business model are actively managed.

*...particularly in current market conditions.*

In the 2009 FRO we highlighted that difficult economic conditions can increase the risk that staff and clients seek to supplement declining incomes by behaving fraudulently. *Section B* of the FRO highlights that where a firm holds client money – which is particularly common in general insurance intermediaries – inadequate systems and controls can lead to client money being inadequately protected and segregated. This can leave clients exposed to the risk that their money may be lost through theft, or downgraded into unsecured claims against the firm. Mortgage fraud has also been a significant issue in recent years. We have proposed measures in the MMR on Approved Persons and the verification of income, which will help reduce the occurrence of mortgage fraud, and we will remain watchful for any increase in fraudulent activity as the market recovers.

*We remain concerned about standards in network firms.*

As discussed above, we have already seen a significant shift towards appointed representative status in recent years. This is likely to continue over 2010. This trend has been particularly strong in the general insurance intermediary sector, as many firms for which insurance is not their main business (for example, motor and other retailers) find it the most appropriate way to meet their regulatory obligations. But even in mainstream insurance brokers, around a tenth of firms are considering joining a network over the next twelve months.<sup>9</sup> We have consistently stated our concerns over the standard of compliance in network firms, including in the FRO 2009, with too many instances of poor monitoring procedures, inadequate levels of compliance resource and concerns over the standards of due diligence carried out on incoming appointed representatives. These concerns and risks remain relevant.

With the sector likely to display stronger signs of recovery over the coming year, it is likely that some intermediaries that have exited the market will seek to re-enter. Both the FSA and networks will need to ensure that such firms and individuals applying for authorisation or as appointed representatives meet the standards we require.

### Key messages

- With the RDR implementation and other important changes now approaching, it is important that firms put plans in place sooner rather than later, particularly with regard to qualifications and remuneration, to ensure the future sustainability of their business model.
- We are actively monitoring the market for evidence of commission bias in the run-up to the implementation of the RDR and will impose sanctions where we find inappropriate behaviour.
- Whatever the business model, firms must always focus on consumers and ensure that they are treated fairly. This is a particular concern where firms (including some networks) are under pressure or are making changes to their business model – for example, those involved in consolidation or considering using a platform.
- In difficult economic conditions, it is important that firms continue to focus on the quality of their advice, concentrating on those areas where they can ensure competence rather than seeking opportunities to increase income in areas with which they are unfamiliar.
- We view the protection of client money and assets as vital and firms must pay due regard to the requirements set out in the Client Asset Sourcebook (CASS). We are concerned that firms which hold and control client money and assets are not always achieving an adequate level of protection.

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The Financial Services Authority  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: [www.fsa.gov.uk](http://www.fsa.gov.uk)

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