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Thinking ahead

Distribution of retail investments: Delivering the RDR

Retail Distribution Review 11

July 2009

Introduction

The Financial Services Authority (FSA) has now published its Consultation Paper (CP) 09/18, *Distribution of Retail Investments: Delivering the RDR*. This builds on proposals included in previous publications. In many areas, the FSA has firmed up its proposals and presents draft rules for industry feedback, while in others, the consultation remains more open. What's clear is this is the industry's last chance to influence the final rules. And where we are seeking change, we should be prepared to back up opinions with as much factual evidence as possible.

Here we give an overview of the current set of proposals, describe next steps and highlight what we believe this may mean for your firm.

The main points

- A new standard of independent advice, linked to a newly defined category of 'retail investment products', that extends beyond packaged products
- Advisers to disclose in future whether they're providing 'independent advice' or 'restricted advice'
- Clear intention to replace commission with Adviser Charging (AC) for both independent and restricted advisers, with a ban on provider factoring
- New consultation on if/how AC should apply to group personal pensions, with feedback requested by 31 July
- Further analysis to be undertaken into the protection and mortgage markets
- Mandatory new professionalism and qualification requirements (QCF level 4) for independent and restricted advisers
- 'Simplified advice processes' (previously known as advised guided sales) to be subject to the same AC, professionalism and qualifications requirements as other forms of advice
- Basic Advice rules for stakeholder products to remain
- Implementation deadline remains 31 December 2012, but firms can change their business model sooner

Key elements

Independent advice

In future, independent advice will be defined as 'unbiased, unrestricted and based on a comprehensive and fair analysis of the relevant market'. Analysis must now cover all 'retail investment products', a new category which goes beyond packaged products to include annuities, unregulated collective investment schemes, all investments in investment trusts and structured investment products. This is in line with the aims of the European Commission's 'PRIPs'[1] proposals to introduce equivalent regulation across 'substitutable' solutions. The FSA reminds us of the need to consider cash deposits and national savings and investment products.

A firm won't be able to class itself as independent if it limits itself to advising on its own products, even if these invest in a wide range of underlying investments. Distributor-influenced funds are also under scrutiny and to qualify as independent, an adviser would have to 'assess rigorously' the suitability of such a product at individual client level. The construction and frequency of review of panels will also get closer FSA attention. The FSA is undertaking a thematic review of the wraps and platforms market (including disclosure, transparency of charges and incentives issues) and the use of a single wrap or platform, particularly if not based on completely open architecture, is unlikely to be compatible with independence.

An independent adviser will be able to offer specialist/limited advice on a particular 'relevant market' such as retirement planning or ethical investments, provided this is disclosed in a clear, fair and not misleading way.

Labels

In future, advice will be split between 'independent' and 'restricted', with advisers being required to disclose their label verbally and in writing. The restricted advice model will cover a wide range of approaches from not quite whole-of-market through multi-ties to bancassurance models and Basic Advice (see further on). Such advisers will be required to articulate their scope of coverage and the nature of any limitations.

Adviser Charging

Adviser Charging (AC) will be compulsory for both independent and restricted advisers from the end of 2012, but with an exception for Basic Advice (see further on). Policies sold on the pre-AC basis can continue to pay commission, as can increments to these policies. With customer (and provider) agreement, AC can still be paid for by deductions from the policy.

Very disappointingly, the FSA is now planning to ban provider factoring. This means that providers will no longer be allowed to pay advisers upfront and recoup this from product charges over time. The FSA accepts that modest regular savers may be affected by the factoring ban, as they're unlikely to be able to pay a fee upfront. The choices are for the adviser to arrange credit facilities for the customer (subject to the Consumer Credit Act) or to agree to take payment in instalments, with deductions taken from the policy at the same time as making payments to the adviser.

Advisers will present their standard tariff or price list to all customers, before providing advice, reflecting their chosen basis of charging (for example, fixed fee, hourly rate or percentage of funds).

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[1] Packaged Retail Investment Products, European Commission Communication of May 2009

The FSA will expect the same charges for substitutable products. Hard, cash disclosure will follow with any material deviation explained.

Ongoing adviser charges can only be taken if these are paying for agreed ongoing adviser services. The one exception to this is where the adviser is accepting payment for initial advice in instalments. Customers can cancel AC for ongoing services if they no longer need them. This may involve rebating these back into the policy.

Product providers will be banned from structuring charges in ways that conceal the distinction between product and adviser charges, for example, initial allocation rates above 100% or other 'negative charges'. Advisers will be banned from accepting commission (on new business) even if this is rebated or offset against AC.

There will be separate consultations on the way AC might apply to group personal pensions and on implications for the protection and mortgage markets (see later).

Providers who offer to facilitate adviser charging by deduction from products will have to offer a sufficient range of options (structure and level). Before setting up the policy, providers will have to obtain clear instructions from the customer, and not just the adviser, on the amount and timing of AC. The FSA also expects providers to take account of the impact adviser charges will have on product performance. This will involve considering when a requested payment becomes excessive in terms of impact on returns to the customer.

The FSA notes the specific issues fund managers have with collective investment schemes – particularly the inability to vary ongoing charges without setting up separate share classes. Complete flexibility won't be required, and alternative solutions – including deducting adviser charges from platform cash funds or by arranging regular unit encashment – are suggested.

The FSA will consult further on the implications for 'vertically integrated firms', for example where the adviser is employed by the provider. Their starting position is to apply the same approach to AC as with other adviser firms, although it's not clear if this will include the same factoring ban.

The FSA would ideally like key features illustrations to separate product and advice charges, but is deferring consultation until the impact of the European Commission's work on PRIPs and associated disclosure is known. This is a significant issue – the earliest we expect to know more is the end of this year, and any material delay could jeopardise the 2012 deadline.

Incentives/inducements

The FSA is planning to extend to all retail investment products the MiFID requirement that any payments or benefits from providers to advisers must be 'designed to enhance the quality of service to the client'. This, alongside existing inducements guidance, will be a key supervisory focus to avoid reintroducing any form of bias. The FSA reminds us of its guidance on reasonable indirect benefit guidance, and that any significant non-monetary benefits offered by providers to adviser firms (such as training) must be widely available and not offered on a 'reward' basis to specific firms. Adviser firms are warned not to accept benefits such as 'free' software or portfolio modelling tools from providers if they'll become reliant on these. As much of this is not new, the industry will need to assess precisely and urgently what it is and isn't comfortable with.

The FSA is also exploring whether it should extend elements of its recent remuneration code of practice[2] to adviser firms. It highlights the need to tackle conflicts of interest and the importance of non-financial metrics in reward.

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[2] CP09/10: *Reforming remuneration practices in financial services* (March 2009)

Corporate pensions

The FSA is seeking views on exactly how AC should apply to group personal pensions (including stakeholder and SIPP). If an individual member receives a personal recommendation, then AC applies in full. The FSA is seeking views on ideas such as 'arranger charging', where advisory services (albeit often unregulated) are provided to employers. It's requesting feedback in this area by 31 July to allow a further consultation with draft rules later this year.

The FSA also highlights the current lack of clarity over the pensions landscape post-personal accounts, including the level and shape of charges, but helpfully notes that there will be circumstances where a group personal pension could be appropriate (higher employer contributions are mentioned, but justifying higher charges for wider investment choice will be questionable).

Mortgages and protection

The broader application to the mortgage market will be considered as part of the ongoing MCOB review, which is expected to conclude in the autumn. In addition, there will be further analysis of the protection market. The FSA is asking what outcomes consumers might face if investment and protection are regulated differently in future, and is concerned over advisers shifting to selling pure protection products because of remuneration differences. This is already prompting widespread comment that AC without factoring is not appropriate in this product area.

Professionalism and qualifications

There are few surprises here with the proposals mirroring previous statements[3] on the level and content of required qualifications. However, we still have no clarity on the 'size' or length of study that will be mandated.

All advisers will need a QCF Level 4 qualification (such as CII Diploma). This must include core subjects (regulation and ethics, personal taxation, investment and risk and application of technical knowledge) plus areas of individual specialism. Some specialist advisers will need to demonstrate additional knowledge. Existing advisers are being encouraged to gain a current QCF Level 4 qualification now, and use continuous professional development (CPD) to fill any knowledge gap identified once the new benchmark is known.

All advisers are likely to need top-up training or CPD to cover the widening of scope of advice to retail investment products.

The review of the Professional Standards Board (PSB), which will be responsible for qualifications, ethics and CPD, is being accelerated with a further consultation in Q4 2009. A decision on its independence from the FSA will be taken in mid-2010, so that it can be operational from the end of 2012.

The FSA has endorsed work-based alternatives to written exams. These will be termed 'oral exams', signifying more than workplace observation. They'll be carried out by independent assessors and are aimed at experienced advisers, setting equivalent standard to written exams. This route will only be available to existing advisers as at 30 June 2009 and will be withdrawn after the end of 2012. All new entrants will be expected to take the new benchmark qualification when it becomes available (from 2010).

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[3] FSA publication: *Qualifications update and what you can do now* (25 June 2009, replacing communication of 6 March 2009)

The FSA or PSB will introduce a new Code of Ethics. An indicative draft is included in the CP. All advisers must follow this or an equivalent from their professional body. The requirements for CPD will also increase, with further consultation expected in Q4 this year.

Guided sales or simplified advice processes

In response to earlier rounds of the RDR, the industry has expressed the view that it would be difficult to develop a non-advised guided sales model because a personal recommendation is key to commercial viability. The CP renames advised guided sales as 'simplified advice processes' (SAPs). These will be regulated under current rules and will provide the consumer with a suitable personal recommendation based on an assessment of their needs.

In response to concerns that firms offering novel SAPs would be taking on major risks of FSA or Financial Ombudsman censure, the FSA is now offering to set out some guiding principles.

SAPs may be independent or restricted and AC will be required. The FSA is of the view that qualifications for these advisers should also be set at QCF level 4 although it could be argued that this looks excessive for what could be a process driven service.

Basic Advice

In a surprise u-turn, the FSA has decided not to discontinue the rules relating to Basic Advice – the set of pre-scripted questions about people's income and other circumstances that allows firms to gather the information they need to recommend suitable charge-capped products (stakeholder pensions and other). It will be a form of restricted advice, but AC requirements won't apply and neither will the new professionalism and qualifications requirements. While Basic Advice has failed to take off to date, the FSA may be anticipating new interest in this area.

Other aspects

The CP sets out how the FSA intends to supervise both providers and advisers as we move towards and into the new regime. A consultation on changes to product sales data and persistency reporting is scheduled for Q1 2010. The FSA will challenge increased switching activity.

In light of concerns raised, the FSA will continue industry discussions on the impact of the increased capital resources requirement and the feasibility of the timetable for implementation. This will also cover PII exemptions. However, it still intends to bring these changes into force on 31 December 2009, allowing a transitional period until 31 December 2012.

The CP includes a cost benefit analysis. The FSA estimates incremental compliance costs to be approximately £430 million one-off and £40 million a year (this doesn't cover additional costs firms may incur 'voluntarily' to position themselves competitively in the new environment). The FSA plans to carry out a post-implementation review which, among other things, will measure the benefits the RDR has delivered in practice including improved quality of advice, reduced mis-selling, increased persistency and improved consumer confidence.

Next steps

The FSA still intends to implement all changes by 31 December 2012, although firms will be able to begin to make changes sooner.

A full set of rules is still expected in Q1 2010, although some of the detail is dependent on the European Commission's proposals on PRIPs.

Responses to the CP are requested by 30 October 2009, with an earlier deadline of 31 July for responses to the questions on application to the corporate pensions market.

What does this mean for you?

Throughout the RDR journey, it's been clear that while all adviser firms will be affected, the precise impacts will depend on the firm's business model. The latest CP provides a sufficiently clear indication of the FSA's intentions to allow adviser firms to begin to assess impacts, consider choices for the future and begin to plan for implementation.

Some immediate topics for consideration include:

- For firms which are currently independent, how close is the firm to the new definition, including use of wraps, platforms and distributor-influenced funds?
- For firms which are currently tied or multi-tied, how can their offering be best positioned within the new restricted advice category?
- How will the newly defined 'retail investment market' impact on advice processes and training requirements?
- What proportion of the firm's business relates to products within the immediate scope of the RDR (as opposed to protection and corporate pensions)?
- How can the firm best position Adviser Charging with its clients?
- Will the proposed ban on provider factoring impact on the firm's ability to advise those wishing to make modest regular savings?
- To what extent does the firm rely on free software supplied by providers?
- How close are advisers in the firm to the new minimum qualification levels, and what plans need to be put in place now to close any gaps?

AEGON has always supported the broad aims of the RDR, and we still believe many of the proposed changes will benefit our industry and both current and future customers. However, each new level of detail raises new issues and we'll continue to highlight our areas of concern to the FSA. These include the ban on factoring (which will make it much harder for modest regular savers to access advice), the need for an appropriate application of AC to the corporate pensions market, careful consideration around the protection market, urgent clarification on precise qualification requirements including 'size' (AEGON supports a diploma level of 37 credits), and the need to keep considering how best to develop 'streamlined advice processes'.

It also remains vitally important that the FSA hears direct from adviser firms. We would encourage firms to take this final opportunity to make their views known.

The full Consultation Paper is available at
www.fsa.gov.uk/pages/Library/Policy/**CP**/2009/09_18.shtml

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