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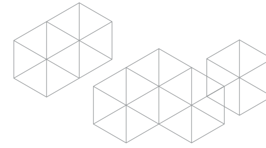

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Towards a fairer deal for consumers and the financial industry

Lessons from the Retail Distribution Review and the ban of commissions in the UK

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Executive Summary

Commission payments in financial services will be banned in the United Kingdom (UK), the Netherlands and Australia in the next year. The objective of this study is to shed light on the rationale for such a drastic regulatory overhaul, to analyse the anticipated impacts of the ban on the financial industry and consumers and to draw lessons from this intervention. In so doing, the UK Retail Distribution Review is analysed in a case study, and experiences from other EU and non-EU countries as well as the academic literature is reviewed. The study concludes: The commission-based advice model is broken. Attempts to address the commission-bias with disclosure do not work. A ban of commissions will stir a new level of competition for product and advice quality. Potential negative impacts on consumers can be mitigated. The fee-only advice model will eradicate the current inherent conflict of interest in financial advice. In sum, a system change in the financial industry is needed to address its malfunctioning and it will lead to more fairness. This change will have benefits both for the financial sector and consumers. That such a change is undertaken in Great Britain with the support of the financial industry and consumer organizations should be regarded as an encouraging signal.

Zusammenfassung

Die Zahlung von Provisionen an Finanzberater für die Vermittlung von Finanzprodukten wird im kommenden Jahr in Großbritannien, den Niederlanden und Australien verboten sein. Ziel dieser Studie ist es, die Gründe für diese weitreichenden regulatorische Eingriffe zu verstehen und die Auswirkungen auf Finanzindustrie und Verbraucher zu analysieren. Aus den Analyseergebnissen werden Schlussfolgerungen abgeleitet. Im Rahmen einer Fallstudie analysiert die Studie sowohl den britischen *Retail Distribution Review* (Grundlage für die Regulierung der Finanzindustrie in Bezug auf den Vertrieb von Anlageprodukten) als auch die Erfahrungen aus anderen EU- und nicht-EU-Staaten. Darüber hinaus wird die akademische Literatur zum Thema ausgewertet. Zentrale Ergebnisse der Untersuchung sind: Das provisionsbasierte Vertriebsmodell ist gescheitert. Überdies hat die Erfahrung gezeigt, dass Ansätze, der Provisionsorientierung durch verschärfte Transparenz zu begegnen, nicht funktionieren. Ein Verbot von Provisionen würde einen Qualitätswettbewerb entfachen. Mit dem Verbot verbundene potentielle negative Auswirkungen auf Verbraucher können ausgeglichen werden. Die Honorarberatung löst demnach den schwerwiegenden Interessenkonflikt der Provisionsberatung. Ein Systemwandel in der Finanzdienstleistungsbranche ist notwendig, um die derzeitigen gravierenden Unzulänglichkeiten abzustellen. Ein solcher Systemwandel birgt Chancen für die Finanzindustrie und Verbraucher und führt zu einem Mehr einem Mehr an Fairness. Dass dieser Wandel u.a. am Finanzplatz Großbritannien mit Unterstützung sowohl von Seiten der Finanzindustrie und der Verbraucherorganisationen vollzogen wird, sollte als ein ermutigendes Signal gewertet werden.

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Abbreviations

ABI	Association of British Insurers
b	Billion
BBA	British Bankers' Association
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
bp	Basis point (1% = 100 bp)
EC	European Commission
ECON	Economic and Monetary Affairs Committee in the European Parliament
EU	European Union
FSA	Financial Services Authority
GBP	Great Britain Pound
HNWI	High-Net-Worth Individual
IFA	Independent Financial Adviser
IMA	Investment Management Association
IMD	Insurance Mediation Directive
m	million
MiFID	Markets in Financial Instruments Directive
PPI	Payment Protection Insurance
PRIPS	Packaged retail investment products
QCF	Qualification and Credit Framework
RDR	Retail Distribution Review
TEW	Total Expense Ratio
UCITS	Undertakings for Collective Investment in Transferable Securities
UHNWI	Ultra-High-Net-Worth Individual
UK	United Kingdom

1. Introduction

1.1. Context of the study

Trust in the financial services industry has suffered a dramatic decline. According to a globally conducted survey, half to two thirds of all consumers in key countries of the European Union have lost trust in their banks during the previous year.[1] The Consumer Markets Scoreboard, published by the European Commission, repeatedly shows that financial services rank last of all other product and services markets in terms of consumer trust, satisfaction and the number of complaints.[2]

There is a debate on the European level, but also in EU and non-EU Member States about how to improve the reputation of the financial services sector and increase consumer confidence and protection. Most major players in this debate agree that the quality of financial advice needs to be improved. They are divided, however, on the question how to best achieve this objective.

In October 2011 the European Commission put forward a proposal for a Directive on markets in financial instruments (MiFID II).[3] The proposal identified, among other things, insufficiencies in investor protection. These insufficiencies resulted in the selection of financial products that were not appropriate or optimal for consumers. Furthermore, the Commission argued that there were uncertainties about the framework for incentives and that existing requirements have not always proven to be clearly articulated to consumers.[4] The proposal therefore encompasses a provision to ban inducements[5] for independent investment advice and portfolio management.[6] The Commission hopes that this ban will "remove the inherent conflict of interest of the firms providing these services, leading to better quality of service for investors."[7]

This proposal has stirred great controversy. While consumer organizations call for a comprehensive ban of commissions and inducements for all types of investment advice,[8] others warn that the Commission's proposal goes too far. They

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[1] Ernst & Young, 'Global Consumer Banking Survey 2012', (2012), p. 4.
[2] DG SANCO, 'The Consumer Markets Scoreboard - 6st edition', (2011), Figure 2.
[3] In parallel with the MiFID review there is a review of the Insurance Market Directive (IMD II). Additionally, the EU prepares a directive for Packaged Retail Investment Products PRIPs which might serve to bundle the current regulatory initiatives (e.g. Undertakings in Collective Transferable Securities - UCITS IV with the Key Information Documents - KID) but also to ensure investment products are treated equally.
[4] European Commission, 'Commission Staff Working Document: On the follow up in retail financial services to the Consumer Markets Scoreboard (SEC(2009) 1251 final)', (2009), pp. 3, 4. and European Commission,
'Commission Staff Working Paper: Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council Markets in financial instruments (SEC(2011) 1226 final)', (20 October 2011), pp. 16, 117.
[5] In this study the terms inducements and commissions are used as synonyms.
[6] European Commission, 'Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (COM(2011) 656 final)', (2011), p. 78.
[7] European Commission, 'Commission Staff Working Paper: Executive Summary of the Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council Markets in financial instruments (SEC(2011) 1227 final)', (20 October 2011), p. 7.
[8] BEUC 'Letter of BEUC Re: the Markets in Financial Instruments Directive', (2012).

highlight that the compliance costs for investment firms were too high, that choice and access to advice could be curtailed particularly for low and middle income consumers and that such intervention would be disproportionate and damage the business model of many investment firms.[9]

In March 2012 the European Parliament's Committee on Economic and Monetary Affairs (ECON) presented the draft report on the Commission's proposal. Rather than banning commissions for independent advisers, the report suggests that the "investment firm shall, prior to the agreement, inform its clients about the expected scale of inducements. The periodic report shall disclose all inducements paid or received in the preceding period."[10]

The question about commissions is not only debated on the European level, but also at the national. Some countries such as the United Kingdom, the Netherlands and Australia have put in place regulations to ban commissions on financial advice to retail consumers starting next year. Other countries such as Germany are debating measures to strengthen independent and fee-only financial advice. In July 2011 the German Federal Ministry for Consumer Protection published a position paper outlining key components for regulating independent financial advice. That paper does not propose a ban of commission, but rather seeks to create a more level-playing field for fee-only advisers.[11] The coalition parties have announced to present a proposal for a regulation of fee-only advice at the end of this year.[12]

1.2. Objectives of the study and research questions

This study aims at contributing to the debate about adequate instruments to improve the quality of financial advice. A particular focus will be placed on commissions. In doing so, the study takes into account academic research and the experiences in the United Kingdom (UK) and other countries. The following research questions are addressed in the context of this study:

- **Point of departure:** What are the challenges that consumers face in financial services in the EU? What are the causes for these challenges? What can we learn from the academic debate about the instruments that could rectify these challenges?
- **Case study UK:** What were the reasons of the UK Financial Services Authority (FSA) to intervene in the financial services market with the Research Distribution Review (RDR)? What are the key components of the RDR?

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[9] 'Commission Staff Working Paper: Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council Markets in financial instruments (SEC(2011) 1226 final)', p. 54.

[10] Committee on Economic and Monetary Affairs, 'Draft Report on the proposal for a directive of the European Parliament and of the Council on markets in financial instruments (2011/0298(COD))', (2012), p. 47.

[11] Bundesministerium für Ernährung , Landwirtschaft und Verbraucherschutz, 'Eckpunkte für eine gesetzliche Regelung des Berufsbildes der Honorarberatung', (2011). For comments on this proposal by the opposition party, SPD, see: Deutscher Bundestag, 'Antrag: Verbraucherschutz stärken - Honorarberatung etablieren (Drucksache 17(8182)' (2011).

[12] VersicherungsJournal.de, 'Koalition will Honorarberater gesetzlich verankern', (3 September 2012).

- **Anticipated consequences:** What are the anticipated impacts of the RDR on financial product producers, intermediaries and consumers? What measures does the RDR encompass to mitigate potential negative impacts?
- **Developments in other EU and non-EU countries:** How do other EU and non-EU countries address the low quality of financial advice and mis-selling?
- **Lessons to be learned:** What lessons can be learned from a review of the academic literature and the experiences of the UK and other countries?

1.3. Methodology

1.3.1. The approach

The study is based on a literature review, a case study analysis and stakeholder interviews:

- **Literature review:** The literature review encompasses academic research about financial advice and instruments to improve them, statements and policy papers by financial service regulators and governments, and position papers of key stakeholders in the debate such as industry associations, consumer organizations and individual companies.
- **Case study analysis:** The UK and its Retail Distribution Review are analysed in a case study. The UK was chosen on the basis, that the UK financial services regulator (FSA) has implemented the most far-reaching measures to improve the quality of financial advice services, that there is plenty of material that can be reviewed and that an analysis of the UK case is logistically feasible as stakeholder interviews could be conducted at reasonable costs.
- **Stakeholder interviews:** The objective of the stakeholder interviews in the UK (and some outside the UK) is to get a better understanding of the reform measures implemented. Furthermore, the semi-structured interviews are used to test hypotheses. A comprehensive list of interviewees can be found in the Appendix.

1.3.2. Methodological limitations

The study faces two important methodological limitations. First, with only one case study, the conclusions should not be overstated. To mitigate this problem, in the last chapter where lessons are drawn, insights from the UK case study will be analysed in tandem with insights from the academic literature and from the review of experiences in other EU and non-EU countries.

Second, as the Retail Distribution Review will be implemented on 1st of January 2013, only *anticipated* impacts on industry and consumers can be studied. These anticipated impacts are derived from the expectations of stakeholders, from examples of how the financial industry prepares for the RDR, and from analyses conducted on the topic in the UK. It would be useful to conduct an impact assessment post-implementation.

2. Advice in Financial Services: Where do we stand?

Investment products constitute an increasingly important element in consumers' every-day life. Due to demographic changes and an increased responsibility for private retirement savings, consumers have to engage with financial services - whether they like it or not. Evidence suggests, however, that consumers often do not choose solutions that are suitable for their needs and that the marketplace for financial services is far from consumer-friendly. It is a market that is complicated and difficult for consumers to access and use.

This Chapter offers an overview of the performance of the financial services market from a consumer perspective. It also reviews the state of the debate in politics and academia about key challenges in the market and ways to correct them. It concludes that a holistic multi-dimensional approach is needed to improve the consumer-friendliness of the financial service market. One important element in such an approach is the need to address the commission-bias. The Chapter shows, however, that there is no consensus in the political and academic domains about how to best address this bias. As a result, the Chapter concludes that it is necessary to test the hypotheses of proponents and opponents of an outright ban of commissions in an in-depth case study of the implications of the Retail Distribution Review in the United Kingdom (Chapters 3 and 4) and to review activities of other countries that have also taken steps to address this bias (see Chapter 5).

2.1. The market for financial services - the consumer standpoint

For the last three years, financial services ranked lowest in the Consumer Markets Scoreboard. The Consumer Markets Scoreboard is an instrument developed by the European Commission to monitor the performance of product and service markets in the EU regarding consumer trust, satisfaction and complaints. The results show that, in particular, the markets for investments, pensions and securities underperform all other services.[13] Hence, the European Commission concluded that there was "growing evidence that consumers often do not obtain suitable advice on financial services."[14]

Similarly, studies conducted in Germany show that the financial services market underperforms comparatively and this has detrimental consequences both for consumers individually and the economy as a whole:

- A study commissioned by the German Federal Ministry for Consumer Protection refers to a 20-30 billion Euro annual pecuniary damage for consumers caused by insufficiencies in consumer advice.[15]

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[13] SANCO, 'The Consumer Markets Scoreboard - 6st edition', Figure 2.
[14] 'Commission Staff Working Document: On the follow up in retail financial services to the Consumer Markets Scoreboard (SEC(2009) 1251 final)', p. 12.
[15] This figure is not further substantiated, however. Marco Habschick et al., 'Anforderungen an Finanzvermittler - mehr Qualität, bessere Entscheidungen - Studie im Auftrag des Bundesministeriums für Ernährung, Landwirtschaft und Verbrauchrschutz', (2008), p. 12.

- A study by Oehler estimates that German consumers have lost between 100 and 160 billion Euro in the last decade (2001- 2010) due to inappropriate purchases of endowment life insurances and private pension insurances. More than 75 percent of all policies that were made for 30 years and 55 percent of all policies made for 20 years were terminated prematurely.[16]
- The independent German comparative testing organization Stiftung Warentest repeatedly tests the quality of financial advice of banks in mystery shopping tests. In a test conducted in 2010 the organization concluded: "Disgrace for the German banking sector continued". Not one bank was able to solve the test exercises with a rank of "very good" or "good" and six banks were rated "poor" (Postbank, Hypovereinsbank and Targobank belonging to the six). As a result, Stiftung Warentest recommended consumers not to rely on the banks' financial advisers. One of the biggest concerns of the testers was that some banks did not comply with law and did not adequately inquire about their clients personal and financial circumstances and goals for their investment.[17]

While most of these studies are contested and the findings challenged, there is a general acknowledgement in politics, industry and academia that households are not properly equipped with financial products.

2.2. The status of the debate concerning challenges and how to rectify them

Despite the general acknowledgement that consumers are not properly equipped with financial products and often do not make efficient financial decisions, the reasons for this are controversially debated.

Most stakeholders in the debate agree there are many factors impacting how well consumers are equipped with financial services ranging from:

- consumer literacy (e.g. ability to analyse, choose and monitor investments),
- accessibility and comparability of reliable and understandable information about financial products,
- (un)certainty about future needs,
- behavioural biases (e.g. such as overconfidence or hyperbolic discounting),
- transaction costs,
- ease of switching and

[16] Andreas Oehler, 'Bei Abschluss: Verlust? - Das Ende vom Anfang einer Vorsorge: Milliardenschäden durch fehlgeleitete Abschlüsse von Kapitallebens- und Rentenversicherungen', (2012), pp. 10-12.
[17] Stiftung Warentest, 'Die Blamage geht weiter - Banken im Test', *Finanztest,* 08/2010 (August 2010), pp. 25-30. A more recent test of banks in advice for credits showed a similar miserable result. Not one of the tested banks fulfilled the task. Only two banks passed the test with a poor rating, the others failed the test completely. One of the reasons was that the credit offers lacked the mandatory information which would enable consumers to compare their offers. See: Stiftung Warentest, 'Die Kreditversager', *Finanztest,* 06/2012 (June 2012), pp. 13-17.

- availability and access to high quality financial advice.

One of the most controversial issues is whether insufficiencies in financial advice account for some of the insufficiencies listed above and if so, how to address this challenge. In this debate two perspectives can broadly be distinguished. While the first argues that the commission-bias in financial advice creates a conflict of interest that has to be removed by a ban of commissions, the other perspective calls for a holistic approach and highlights the downsides of a full ban of commissions.

In the next sections, an overview of the objectives held by major players in financial intermediation and remuneration schemes is presented and the two perspectives are outlined.

2.2.1. Financial advice - an overview of objectives of the actors and remuneration schemes

The parties involved in a financial intermediation are an individual with an investment need, an investment manager with profit interests and an intermediary with a professional offer. Individuals are looking primarily for advice whereas invest managers need to sell their products. The intermediary must mediate between both objectives.

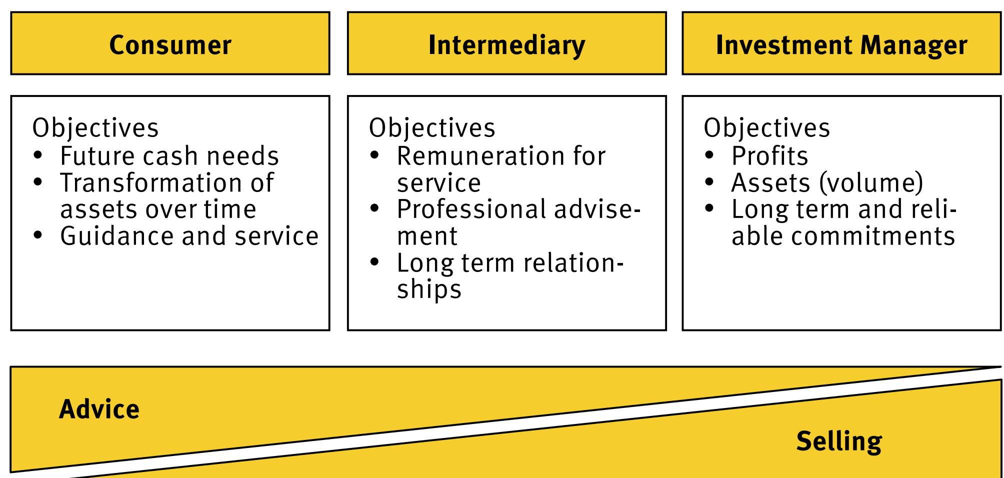

Figure 1: Advice vs. selling - objectives of involved parties

The intermediary offers advice covering an analysis of the consumer's needs, strategic asset allocation, product choice, risk management and reporting. The result of this process is a personal recommendation. All these tasks are currently subject to regulation (e.g. MiFID). Generally speaking there are two price structures for the advice of an intermediary: a commission-based and a fee-based structure.

In the commission-based structure, the consumer pays an annual management fee of 150 basis points (bp) to the investment manager. Around 75 bp are paid as a commission to the intermediary. The exact amount depends on the status of the intermediary. Usually the commission is higher the more volume the intermediary places with the investment manager.

Investment managers pay different commissions and the intermediaries' advice on which product to choose might be influenced by this fact. The result could be sub-optimal for consumers and might have been the result of a commission-bias. The same possibility applies to insurance products respectively.

	Consumer	**Intermediary**	**Investment Manager**
p.a. disclosed to consumer	-150 bp		+150 bp
p.a. not disclosed to consumer		+75 bp (+inducements)	-75 bp

Table 1: Commission based advice - ongoing fee in basis points (bp) of the assets under management (AuM) (typical numbers, variation occur)

In the second case of fee-advice the consumer pays the factory gate price to the investment manager and a separate fee to the adviser. The total amounts are the same as in the commission example, but there is no distortion or bias through commission.

	Consumer	**Intermediary**	**Investment Manager**
p.a. disclosed to customer	-75 bp		+75 bp
p.a. agreed with adviser	-75 bp	+75 bp	

Table 2: Fee-bases advice - separate fee agreement with adviser and factory gate price for investment

The cost of investment is even higher than reflected in the above described ongoing fees,[18] because in the process of investment management there are additional implicit costs which reduce the performance of the fund. Thus, mandatory information such as the total expense ratio (TER) does not encompass the true total costs. A reduction in yield approach would, however, deliver greater transparency. Within some national regulatory frameworks, the latter has already been implemented. In others, there is only information about the TER.

2.2.2. Perspective 1: The commission-bias creates a conflict of interest and needs to be removed by a ban of commissions

In this conversation, there is a debate whether commissions should be banned all together in financial advice. Proponents of a commission ban argue because financial advisers are often paid by commissions from the product provider, the

[18] The typical cost of investment can be around 250 bp and cover i) asset management and other products 50-70 bp, ii) product design 70-90 bp, iii) dealership 5-15 bp, v) adviser practice 40-60 bp, v) adviser 40-60 bp.

interests of the consumer and the adviser are misaligned. Rather than focusing on the investment needs of consumers, advisers are incentivised to focus on maximizing their commissions.

As a result, in the debate about MiFID II, European consumer organizations call upon European Parliamentarians to ban commissions and inducements for all types of investment advice.[19]

Their stance is supported by research that shows that:

- **While consumers heavily relied upon investment advisers, they were not satisfied with these services.** A survey conducted in Germany shows that while 80 percent of German investors consult a financial adviser,[20] 56 percent of respondents report negative experiences and only 11 report positive experiences with their advisers.[21]
- **Commissions drive up retail prices for financial service products**. Armstrong argues the increase in price was "due to competition between firms to offer high sales commissions to have their product promoted, which artificially inflates the marginal cost of selling a product."[22]
- **The involvement of financial advisers lowers portfolio returns net of direct costs, worsens risk-return profiles, and increases account turnover and investment in mutual funds in comparison to self-managed accounts consistent with the incentives built into the commission structure**.[23] Hackethal et al. conclude that "many advisors end up collecting more fees and commissions than any monetary value they add to the account."[24]
- **Advisers encourage return-chasing behaviour and push for actively managed funds that have higher fees, even if the client starts with a well-diversified, low-fee portfolio.** Mullainathan et al. highlight that "advisers are unwilling to lean against biases that help them further their own economic interest, e.g. maximize fees."[25]
- **There was both *anecdotal*[26] and *empirical evidence* that commissions, rather than the suitability of financial products drive sales.** Chalmers and Reuther conclude in their analysis that "funds paying higher broker fees receive economically and statistically significantly higher retirement contributions from broker clients. Our evidence that broker incentives influence broker recommendations highlight the agency conflict that can arise when financially unsophisticated investors seek advice from financial intermedi-

[19] 'Letter of BEUC Re: the Markets in Financial Instruments Directive'.
[20] Nick Chater, Steffen Huck, and Roman Inderst, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective - Final Report', (2010), p. 41.
[21] Roland Klose, 'DSW Aktionärskompass 2011', (2012), Slide 4.
[22] Mark Armstrong, 'Economic models of consumer protection policies', *MPRA,* /Paper No. 34773 (16 November 2011), p. 14.
[23] Andreas Hackethal, Michael Haliassos, and Tullio Jappelli, 'Financial advisors: A case of babysitter?', *Journal of Banking & Finance,* 36 (2012), 509-524, pp. 510, 521.
[24] Ibid., p. 523.
[25] Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar, 'The Market for Financial Advice: An Audit Study', *NBER Working Series,* /Working Paper 17929 (March 2012), p. 18.
[26] Chater, Huck, and Inderst, 'Consumer Decision-Making in Retail Investment Services', p. 43.

aries."[27] Consumers seem to understand this. A survey shows that only 13 percent of German respondents fully trust their advisers. Moreover, more than two third report that the advisers primarily focused on their own interests and that these interests at least partially influenced their recommendations.[28]

- While a ban on commission will to lead to lower earnings for banks and other intermediaries in the short term, these decreases would be offset by the benefits of a more balanced and ethical business model and an improvement in the reputation of the banks.[29]

Furthermore, proponents of this perspective argue that by tightening disclosure requirements on commissions and inducements, the commission-bias cannot be rectified.[30] They point to research that shows that under disclosure:

- Consumers find it difficult to understand how inducements may affect the independence of the service they are being provided.[31]
- That consumers often made worse investment decisions due to an inadequate framing of the information and to information-overload, which prevented consumers from digesting other payoff-relevant facts.[32]
- Advisers feel more justified to give biased advice, because they disclosed the conflict of interest. Additionally, advisees seem to adhere more to the given advice, as non-adherence would signal outright distrust in the adviser.[33]

Finally, evidence suggests that the current regulations about disclosure are not properly respected. A study on financial advice conducted for the European Commission concludes that very few advisers mentioned the conflict of interest or inducements in the 1,200 mystery shops which were conducted across the 27

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[27] John Chalmers and Jonathan Reuter, 'What is the Impact of Financial Advisors on Retirment Portfolio Choices and Outcomes?', *NBER Working Series,* /Working Paper 18158 (09 June 2012), p. 4. See also: Michael Finke, 'Financial Advice: Does it Make a Difference?', (5 May 2012), p. 12.

[28] Fidelity, 'Europäische Studie zur Qualität der Anlegerberatung: Anleger verlieren weiter Vertrauen in die Finanzberatung und entscheidet selbst', (2011).

[29] Peter Reedtz, 'Conflicts of Interest in Investment Advice to Private Customers - A Call for Greater Transparency and Better Alignment of Interests', in Morten Balling et al. (eds.), *New Paradigms in Banking, Financial Markets and Regulation?* (Vienna, 2012), p. 203.

[30] 'Letter of BEUC Re: the Markets in Financial Instruments Directive'.

[31] Chater, Huck, and Inderst, 'Consumer Decision-Making in Retail Investment Services', pp. 9, 20. and Andreas Hackethal et al., 'Messung des Kundennutzens der Anlageberatung - Wissenschaftliche Studie im Auftrag des Bundesministeriums für Ernährung, Landwirtschaft und Verbraucherschutz (BMELV)', (2011), p. 35.

[32] Chater, Huck, and Inderst, 'Consumer Decision-Making in Retail Investment Services', p. 9-10. and Jean-Baptiste de Franssu, *Rethinking Asset Management: From Financial Stability to Investor Protection and Economic Growth* (Brussels: Centre for European Policy Studies - European Capital Markets Institute, 2012), pp. 123-124.

[33] Roman Inderst and Marco Ottaviani, 'Financial Advice', *Journal of Economic Literature,* 50 (2012), 494-512, p. 505.

EU Member States.[34] These results are supported by findings of the German Federation of Consumer Organizations (vzbv). Vzbv published results of a non-representative sample which shows that banks did not properly provide consumers with information about commissions and kick-backs. In two thirds of the cases, the banks neglected their obligation to answer consumers' request for information about commissions and kick-backs. And in the one third of situations where consumers did receive a response, the response was unsatisfactory in 94 percent of the cases.[35]

2.2.3. Perspective 2: Financial advice should be improved, but with a *holistic* approach and not a ban of commissions

The second group argues that while there might be insufficiencies in financial advice, the above referred to damages to consumers were not caused primarily by insufficient advice. Ahlswede argues, for example, that even if the damages mentioned above were correct, both consumers and advisers had underestimated liquidity needs in the future. She emphasises that such an underestimation should not be confused with mis-advice. Mis-advice was characterized by the fact that the recommended product was already unsuitable at the time of the recommendation.[36]

As a result, proponents of this perspective argue that improving the quality of advice would therefore require a holistic approach: consumers' financial awareness and education should be improved, advisers should be better qualified and products and costs should be made more transparent and comparable.[37]

Regarding a ban of commissions, this group doubts whether it would improve financial advice. They highlight a range of dangers related to an out-right ban. A ban:[38]

- would raise the costs for advice so that access to advice, particularly for lower and middle income consumers, would be curtailed.[39] Furthermore, banks and other financial advisers might focus on wealthier clients, limiting access to advice for other consumers.[40] Both outcomes could result in a widening of the savings and insurance gaps.
- could lead to new biases: When advisers are paid on an hourly basis they might be inclined to advice on complex products. If they are paid on an on-

[34] Synovate, 'Consumer Market Study on Advice within the Area of Retail Investment Services - Final Report: Prepared for European Commission, Directorate-General Health and Consumer Protection', (2011), p. 10.
[35] Initiative Finanzmarktwächter der Verbraucherzentralen, 'Offenlegung von Provisionen und Rückvergütungen im Wertpapiervertrieb: Gesetzlicher Anspruch und praktische Wirklichkeit', (2011), p. 3.
[36] Sophie Ahlswede, 'Honorar vs. Provision: Vergütung allein entscheidet nicht über Qualität', (Deutsche Bank - DB Research, 2012), p. 4.
[37] Ibid., pp. 9-13.
[38] A concise summary can also be found at: Franssu, *Rethinking Asset Management: From Financial Stability to Investor Protection and Economic Growth*, pp. 122-123.
[39] Otilia Silvia Loidl and Samantha Burgin, 'RDR, MiFID II und Honorarberatung - das Ende der Provisionsberatung?', *Recht der Finanzinstrumente,* 04 (16 July 2012), pp. 237-238.
[40] Finke, 'Financial Advice: Does it Make a Difference?', p. 16.

going fee, they might be inclined to re-allocate investments to justify their service.[41]

- would lead to a concentration of market power: A ban of commissions would lead to a consolidation of the financial advice market, reducing the number of players, limiting competition and reducing access to advice.[42]
- should be an instrument of last resort and only be applied if disclosure has been proven (or can reasonably be expected) to fail.[43]
- would create an incentive for advisers to illegally collect payments from a limited number of product providers, which would again lead to a bias in advice.[44]

2.3. Conclusion

The debate about these key challenges and their solutions points to a number of conclusions:

First, to make the market of financial services more consumer-friendly, a holistic approach needs to be adopted. Such an approach encompasses a range of instruments ranging from financial literacy, enhanced transparency about and comparability of financial services and their costs, easier switching and improved financial advice.

Second, there is ample evidence that the commission-bias in financial advice creates a conflict of interest, which can negatively impact the quality of advice. The question, however, is, whether the costs and benefits of banning commissions justify an outright ban of commissions or whether alternative instruments can be found to address this bias.

Third, potential alternative drivers to improve financial advice services independent of a ban of commissions are:[45]

- Labelling of the type of advice service: Are consumers aware whether the adviser is independent (paid by a fee-only) or dependent (paid by the product provider via commissions) by means of the labelling of the advice? Is there a clear distinction between advising and selling?
- Labelling of the scope of advice: Do consumers know whether the adviser is able to give advice on the whole range of financial products or whether he/she is specialized on particular investment products or tied to products from particular product providers?

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[41] Scientific Advisory Board on Consumer and Food Policies at the German Ministry of Food, Agricutlure and Consumer Protection (BMELV), 'The Quality of Financial Investment Advice for Private Investors: Problems in the Advice Process and Potential Solutions', (2010), p. 7.
[42] Andreas Friberg and Magnus Listermar, 'Market power relationships among life insurance intermediaries', (2011), p. 37.
[43] Inderst and Ottaviani, 'Financial Advice', p. 511.
[44] Uwe Focht, Andreas Richter, and Jörg Schiller, 'Intermediation and (Mis-)Matching in Insurance Markets - Who Should Pay the Insurance Broker?', *MRIC Working Paper Series,* (24 January 2012), p. 18.
[45] See also: Franssu, *Rethinking Asset Management: From Financial Stability to Investor Protection and Economic Growth*, p. 118.

- Professionalism: How well are advisers qualified, engage in continuous professional development and are accredited to professional standard bodies?

Fourth, a ban on commission will have impacts on the financial service industry, intermediaries and consumers. Care needs to be taken that:

- Access to advice is not curtailed, particularly for low- and middle-income consumers.
- The commission-bias is not replaced by a fee-bias.

Finally, both proponents and opponents of a ban of commissions have plausible arguments for their positions, hence it is necessary to test their hypotheses empirically in a case study.

3. Case Study UK: The Retail Distribution Review

This Chapter seeks to test the hypotheses of the proponents and opponents of a ban of commissions which are presented in Chapter 2 in a case study analysis. The Retail Distribution Review (RDR) as it will be implemented in the United Kingdom was chosen for this test.

The Chapter is divided into two main sections: The first section summarizes the genesis and rationale of the RDR. The second section describes major elements of the RDR. In Chapter 4 the anticipated consequences of the RDR will be analysed.

3.1. Genesis and rationale of the RDR

Since the mid-1980s the UK addressed mis-advice and mis-selling with different approaches.[46] In 1987, financial advice and distribution was *polarized* into independent advisers and tied agents. While the former had to act in compliance with 'best interest' requirements and give advice on a whole range of products, the latter acted as the agent of a product provider and could only give advice on the provider's products. Disclosure requirements were put in place to ensure that consumers knew what type of advisers they were speaking to.

However, this depolarized regime could not prevent major mis-selling scandals such as endowment mortgage policy mis-selling in the early years of the new 21st century. As a result, the financial regulator and consumer organizations highlighted the danger of inadequate incentives for financial advisers from the onset.[47] In 2002, for example, the British Financial Service Authority (FSA) expressed concerns with remuneration structures and proposed improving disclosure about the type of adviser and their remuneration.[48]

An inquiry into endowment mortgages by the Treasury Select Committee came to similar conclusions in 2003 when it criticized that the long-term saving industry was "wedded to an inappropriate sales and commission led business model which is damaging the reputation of the industry and undermining consumer confidence in long-term savings." It therefore called for "fundamental reform of the way the long-term saving industry conducts its business. Such reform would not just serve to restore domestic consumer confidence, but it would deliver world class financial institutions and help the UK claim the position of international venue of choice for savers and fund managers alike."[49]

Partly as a result of these scandals, *polarization* was replaced by *depolarization* in June 2005. This reform allowed firms to choose whether to be tied to one product provider, multi-tied, untied commission-based 'whole of the market' firms,

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[46] For a good overview of the evolution of the regulatory approach see: Niamh Moloney, *How to protect investors: Lessons from the EC and the UK* (Cambridge: Cambridge University Press, 2010), pp. 267-273.
[47] A short overview of the genesis of the debate until 2005 can be found in: Charles River Associates, 'Study on intermediary remuneration: A report for the Association of British Insurers', (2005), Chapter 1.
[48] FSA, 'Reforming Polarisation: Making the market work for consumers', (Consulation Paper 121, 2002), Chapter 5.
[49] Treasury Committee, 'Restoring confidence in long-term savings: Endowment mortgages', (Fifth Report of Session 2003-04, 2004), pp. 39, 40.

or independent advisers selling 'whole of the market' products and offering a 'fee option'. Depolarization also aimed to increase competition in the market.

To mitigate the risk of a commission-bias, a new disclosure regime was introduced. Firms were required to disclose the maximum commission they received on products as well as the market average for a range of products in the form of an Initial Disclosure Document - the so-called 'menu'.

In 2007, the results from a review of the 'menu' were published. The objective of the review was to analyse whether there had been any material benefits arising from the introduction of the menu relative to the situation before its introduction. Benefits could be a reduction in commission levels, reductions in the dispersion of commissions, a reduction in provider bias or a shift in advisers' remuneration away from commissions and towards fees. The authors of the review concluded that they found "little evidence that the menu has had a significant effect on the market in the four areas examined."[50]

Moloney argues that after more than twenty years of intervention, the FSA concluded that regulation had focused on the "symptoms arising from problems rather than the root cause" and that insufficient progress had been made towards a market which delivered services which reflected consumer needs. Furthermore, she highlights that the "UK experience has also been that investors find it difficult to decode labels and do not equate commission payments, even with specific disclosure, with potential prejudice to the independence of advice."[51]

This conclusion is best reflected in the often cited critique voiced by then Chairman of the FSA, Callum McCarthy. At the Gleneagles Savings & Pensions Industry Leaders' Summit in September 2006, he argued that the current distribution system for financial services to retail consumers "serves neither the producer of the service nor the consumer of the service. It is doubtful whether it serves the intermediary either."[52] He explained his critique in the following way:

- **Provider of financial services:** The present distribution system rewarded business volume rather than quality. This had the negative impact that persistency of policies was low. He demonstrated around half of consumers who bought regular premium personal pensions were no longer paying into them after four years.
- **Consumers:** Consumers were suffering from product and provider biases and churn. Product bias led to advice that was not consistent with the consumer priority needs. Provider bias resulted in less suitable or even unsuitable sales. And churn led to consumers paying unnecessary commissions, charges or fees when induced to switch from one product to another despite the benefits of such a move only materializing after a long period during which the switch has been to the consumer's detriment.
- **Intermediary:** Evidence suggested that the present model was not profitable for intermediaries either.

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[50] CRA International 'An Empirical Investigation into the Effects of the Menu - Report prepared for the Financial Services Authority', (2007), p. 4.
[51] Moloney, *How to protect investors: Lessons from the EC and the UK*, pp. 268, 269.
[52] Callum McCarthy, 'Is the present business model bust? - Speech at the Gleneagles Savings & Pensions Industry Leaders' Summit' (2006).

Hence McCarthy concluded that “so long as providers continue to compete over the attractiveness of their commission proposition, the fundamental flaws in the present model will remain.”[53]

As a result of these concerns the RDR was launched in June 2006. The objectives of the review can be summarized as follows:[54]

- Improve the clarity with which firms describe their services to consumers.
- Address the potential for adviser remuneration to distort consumer outcomes.
- Increase the professional standards of advisers.

3.2. The RDR at a glance

The RDR will fundamentally change the operating models of both financial product providers and advisers. It is specifically concerned with retail investments and covers the advised sale of all packaged products including pensions, annuities, onshore and offshore bonds and collective investments. It will be implemented on 31 December 2012.

The RDR is comprised of three main components: adviser charging, disclosing advice services and professionalism. Figure 2 illustrates these components and their specific measures.

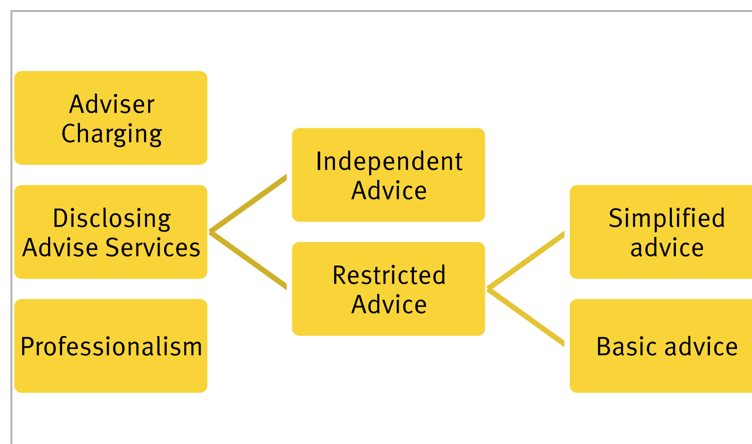

Figure 2: Key components of the RDR

The three components have to be viewed together. Nevertheless, the most influential measure is adviser charging, as it forces the restructuring of operating models of both product providers and financial advisers. The declaration of the nature of advice (independent vs. restricted advice) and the according rules and requirements influence the kind of service offered. The introduction of a homo-

[53] Ibid.
[54] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', (Policy Statement 10/6, 2010), p. 37.

geneous professional standard addresses the way how individual advisers should do their business.

Due to the focus of this study, the third component of professionalism will not be analysed in great detail. In short, improved professionalism will increase the competencies of advisers by requiring all advisers to obtain an annual Statement of Professional Standing (an ethical code) as evidence that they subscribe to the new standard to treat consumers fairly,[55] higher qualifications (QCF level 4 qualifications - equivalent to year 1 in university) and continuing professional development (of at least 35 hours per annum).[56]

In the following, adviser charging and the disclosure rules will be elaborated. Furthermore, platforms and new rules for in-house incentives will be addressed.

3.2.1. Adviser charging: From commissions to fees

3.2.1.1. The new rules

The RDR requires all adviser firms that offer investment advice to retail consumers to introduce adviser charging. Instead of being paid by commissions from the product providers in return for recommending their products, advisers will instead be paid by consumers. The FSA argues that adviser charging will make the process of adviser remuneration more transparent, and consumers will know exactly what they are paying. This will lead to increased consumer confidence since the advice they receive is not biased by commissions.[57]

The rules are applicable only in cases where a firm makes a personal recommendation to a retail client. Hence, recommendations to professional clients and eligible counterparties are excluded from the rules.[58]

Retail investment products include pensions, annuities, bonds, ETFs and collective investments.[59] These products are sometimes referred to as packaged or complex products. Simple products such as individual stocks are not included in the product definition as they will not be included in PRIPs. Pure protection products will not fall within the Adviser Charging rule, but commissions on these products must be disclosed and the advice declared as independent or restricted. Advice on mortgages must also be defined as independent or restricted.

Adviser Charging has implications for adviser firms, product providers and vertically integrated firms:

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[55] FSA, 'Distribution of retail investments: Delivering the RDR - professionalism: Feedback to CP10/14 and CP10/22 and final rules', (Policy Statement 11/1, 2011), pp. 11-18.
[56] Ibid., pp. 19-27. See also: FSA, 'Competence and ethics - Feedback to CP10/12 and final rules', (Policy Statement 10/18, 2010).
[57] FSA, 'Adviser Charging', http://www.fsa.gov.uk/about/what/rdr/firms/adviser-charging, accessed 03 September 2012.
[58] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', p. 27. "a life policy; or a unit; or a stakeholder pension scheme; or a personal pension scheme; an interest in an investment trust savings scheme; or a security in an investment trust; or any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in a financial asset; or a structured capital-at-risk product"
[59] Ibid., Appendix A.

Firms that give retail investment advice (such as banks, independent financial advisers, wealth managers, stockbrokers and product providers on their own products) will have to design their own charging schemes, communicate them upfront to their clients using a price list or tariff and reach an agreement with their clients. There is no specific definition of charging structures. They can include hourly, percentage and fixed fees, as well as charges for different levels of service such as initial interviews.[60] The RDR states, however, that charges should reflect the services being provided to the clients, not the particular product provider or product being recommended.[61]

Product providers will not be allowed to pay commissions to adviser firms, even if the adviser firms intends to rebate payments to their clients. Yet, product providers can facilitate the agreed adviser charging if the consumer gives permission for the product provider to collect the charges through the product. The amounts and the time periods of the payments from the product provider to the adviser must match – kickbacks, rebates as well as factoring is not permitted. (Factoring is an advanced payment of future charges over a materially different time period, or on a materially different basis to that in which it recovers the adviser charge from the consumer.)[62]

Vertically integrated firms such as Bancassurers also need to adopt adviser charging as long as a personal recommendation is made. Furthermore, the RDR envisions integrated firms separate their product and advice charges to clients. The allocation of costs and profits between adviser charges and product charges should be such that any cross-subsidisation is not significant in the long term.[63]

On-going charges will still be possible. The requirements for on-going charges are:[64]

- They must be in connection with an on-going service (for example a regular review of the performance of the client's investment).
- The firm should confirm the details of the on-going service and its associated charges.
- The firm explains how the client can cancel the services and cease payment of the associated charges.

3.2.1.2. Legacy business and the transition to adviser charging

As the new rules only apply to business conducted after the end of 2012, there will be an interim period where adviser firms will need to distinguish between "old" and "new" business to determine whether or not they can continue to receive legacy[65] commissions on products sold in the past. [66]

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[60] Ibid., pp. 37-39. and http://www.fsa.gov.uk/about/what/rdr/firms/adviser-charging.
[61] Ibid., p. 25.
[62] Ibid., pp. 30-34.
[63] Ibid., p. 35.
[64] Ibid., p. 27.
[65] For legacy business the product provider can still pay trail commission to the adviser. With a change of adviser trail commission can be re-registered if the contract between previous adviser and product provider permits to do so. Clients must be informed about the redirection of trail commission, the amount of commission that is transferred, and the new adviser must provide the customer with an ongoing service.
[66] FSA, 'Quarterly Consultation', (Consultation Paper 10/22, 2010), p. 25.

The FSA put forward the following approach. Firms are expected to assess whether:[67]

- the product in question is essentially unchanged, but has been amended or extended under options available to the clients from inception, in which case commission can continue to be paid. Furthermore, if regular payments are increased automatically every year or there is automatic rebalancing of a portfolio at set intervals, with no new advice post-RDR, commissions can continue to be paid.
- the change is such that it leads to the product becoming a different product, or requiring a new contract with the customer, in which case the new Adviser Charging rules will apply.

3.2.1.3. Other issues

The consultations about the RDR have brought about a number of questions regarding the adviser charging rules. The following table summarizes the FSA approach to these specific questions.

Further guidance on specific issues
Non-advised services[68]
Non-advised services do not fall under the same regulation as services related to advice. For non-advised services advisers can choose whether they will be paid by commissions or through the adviser charging agreement. Nevertheless, services related to personal recommendations (advice) such as arranging the execution of a transaction or conducting administrative tasks associated with the transaction must be subject to the adviser charging agreements. This measure aims to prevent the mislabelling of a service as non-advised when it is a personal recommendation.
Inducements[69]
No payments or other benefits are allowed from product providers to advisers if they do not enhance the quality of the service to the clients. This extends to non-monetary benefits such as software and trainings.
Distributor Influenced Funds (DIF)
Advisers will not be allowed to differentiate charges for substitutable products, especially if they have an interest in that product. This applies, for example, to a distributor influenced fund (DIF) where the advisers receive shares in return for a recommendation. They will not be allowed to charge more.

[67] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', pp. 29-30. and FSA, 'Distribution of retail investments: RDR Adviser Charging - treatment of legacy assets: Feedback to CP11/26 and final guidance', (Policy Statement 12/3, 2012).
[68] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', p. 37.
[69] Ibid., pp. 40-41.

3.2.2. Disclosing Advice Service: Enhanced status disclosure

A second objective of the RDR is to increase the clarity about the kind of advice firms offer. Can they give advice on all possible investment options available or only specific areas? Hence the RDR requires advice firms to describe their advice services as either independent or restricted.

3.2.2.1. Independent advice[70]

Independent advisers will need to make recommendations based on a comprehensive and fair analysis of the relevant market, provide unbiased and unrestricted advice and meet the client's best interest.

The relevant market comprises all investment products available in the UK for the specific need of the client. If an adviser firm is not able to entirely cover its client's needs, it should not be labelled as independent but rather as restricted. It should be noted that firms that specialise in a particular market - such as ethical and socially responsible investments or Islamic financial investments - can qualify as independent. The FSA highlights however, that the firm should take care to choose a suitable label: Rather than claiming "XY Independent Financial Advisers", it should call itself "XY - providing independent advice on ethical / Islamic financial investments". [71]

In the case of adviser firms recommending their own products or a product by a parent company, the firms have an obligation to show that they conducted an unbiased and unrestricted analysis when they recommend their own products. If the reward for recommending own products is higher than for others, it will not be considered as unbiased.

For practical purposes, financial advisers will still be allowed to use panels. Panels reduce complexity because advisers do not have to screen the entire market for investment solutions for every single client. Instead, they can use panels if they demonstrate that the panel they are using is suitable to serve their client's needs and if they review these panels regularly.

3.2.2.2. Restricted advice[72]

Advisers must label their service as restricted if it is not independent. This is particularly the case if the adviser only offers a restricted range of products to their clients. Restricted advisers need to explain also orally to their clients why their offer is a restricted service when they engage in spoken interaction with clients.

In explaining the kind of restrictions firms can, for example, explain that they review the whole market for a particular product on which they give advice. Firms should not, however, give the impression that they have restricted their product range to those products that are most suitable for particular clients.

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[70] Ibid., pp. 12-14. and FSA, 'Retail Distribution Review: Independent and restrictived advice - Finalised guidance', (2012), p. 3-7.
[71] FSA, 'Retail Distribution Review: Independent and restrictived advice - Finalised guidance', pp. 4, 5.
[72] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', pp. 14-17. and FSA, 'Retail Distribution Review: Independent and restrictived advice - Finalised guidance', pp. 7-8.

It is important to note that the adviser charging rules apply accordingly and that restricted adviser firms need to meet the suitability requirements. That means that these firms need to carefully assess whether the restricted range of products they are advising on is suitable to the client. Hence it would not be appropriate to recommend a product that most closely matches the needs of the client, from the restricted range of products offered, when the product is not suitable. Furthermore, advisers will have to meet professional standards (QCF level 4 qualification and Continuous Professional Development).

3.2.2.3. Specific types of restricted advice

The category of restricted advice services contains two specific types: simplified and basic advice. Compared to full advice these two services do not have the same depth of analysis but still are holistic in their approach The following section describes them.

3.2.2.3.1. Simplified Advice

Simplified advice[73] is a streamlined advice process which will typically be automated. It should address straightforward needs of consumers. It entails a limited form of advice that does not involve an entire analysis of the client's situation and needs. Usually simplified advice is automated and process-driven such as Internet or telephone services. Simplified advice is restricted advice because it does not consider all retail investment products that may be suitable for consumers. Hence it must comply with the requirements for restricted advice. At the same time it is not basic advice (see following section).

Therefore the FSA explains that the simplified advice process might be used by consumers who cannot or do not want to pay for full advice. It may be appropriate for consumers who:[74]

a) have their priority needs met, that is, they do not need to reduce existing debt, they have adequate access to liquid cash (i.e. savings), and have any core protection needs met;

b) have some disposable income or capital that they wish to invest; and

c) do not want a holistic assessment of their financial situation, but rather advice on a specific investment need.

The Financial Services Consumer Panel has investigated the current status of the provision of service and finds that there is no organisation offering simplified advice.[75] Instead, organisations would rather reduce the scope of advice and offer specific services as assisted non-advised services. [76]

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[73] FSA, 'Simplified advice - Finalised guidance', (2012).
[74] Ibid., p. 2.
[75] Nick Hurman and Ian Costain, 'Researching the "Advice Gap" - Report for the Financial Services Consumer Panel', (2012), p. 3.
[76] Ibid., p. 5.

3.2.2.3.2. Basic Advice[77]

Basic Advice is a form of simpler advice with products restricted only to one stakeholder.[78] Basic Advice will still be possible for stakeholder products under the RDR regime. The Adviser Charging rules do not apply but the labelling of the service has to be “restricted advice”. Hence, commissions will be allowed. Nevertheless, stakeholder products already carry consumer protections such as charge caps and simple terms.

3.2.2.4. Other types of service

In addition to independent and restricted advice there are additional approaches to reach out to all consumers. These types of services and measures include Generic Advice, auto-enrolment with opt-out mechanism for pensions, and information services such as Money Advice Service[79] - a FSA initiated and industry funded (statutory levy) ‘advice service’ counselling on broader topics.

Generic Advice explores the current financial situation of consumers, recommends strategies and enables them to take the next steps.[80] It does not encompass personal recommendations on products and does not administer purchases. It is not regarded as regulated advice. [81]

3.2.3. Platforms

Platforms perform an increasingly important role in the intermediation of investment products. They serve two main goals in the retail investment market: administration and distribution. The assets under administration amounted to a total of 229b GBP representing around 16 percent of total assets in the UK. The compound annual growth rate was 16 percent (2003-2011).[82]

The current charging of an annual management fee of 150 bp is split into 75 bp for the fund manager and a rebate of 75 bp. This rebate is then again split into a typical adviser commission of 40-50 bp and a platform charge of 30-50 bp. [83]

Platforms require special treatment as they offer services related to recommendations and advice. On the one hand, they are only vehicles for consumers or advisers to facilitate transactions. On the other hand, product providers may influence platforms by paying commissions and rebates in cash or shares to them. Often consumers are not aware of the charges for or benefits of product providers to the platform service. The elements of the current discussion on platforms are

[77] FSA, 'Simplified advice - Finalised guidance', p. 5.
[78] FSA, 'A basic advice regime for the sale of stakeholder products - Feedback on CP04/11 and near-final text', (Policy Statement 04/22, 2012).
[79] About Us – Money Advice Service: https://www.moneyadviceservice.org.uk/en/static/about-us, accessed 16 September 2012
[80] FSA, 'Financial Capability: Developing the role of generic financial advice', (2005), p. 6.
[81] Hurman and Costain, 'Researching the "Advice Gap" - Report for the Financial Services Consumer Panel', p. 13.
[82] Deloitte, 'Analysis of the introduction of rebate bans on the platform market', (2012), p. 8.
[83] Ibid.

not fully included in the RDR yet,[84] but will be binding from 2014 moving forward. The main elements are:[85]

- All commissions and fees must be disclosed to the client.
- Cash rebates will not be allowed but rather will be rebates of the fund manager's commission in the form of additional shares or units, which can be passed to the consumer.
- Platforms have to act to the clients' best interest.
- Communication has to be in defined quality.
- Platforms can facilitate to pay Adviser Charging but need to follow rules as product providers do, as well as client instructions.
- Payments to the adviser can be made from client's cash account at platform.

3.2.4. Incentive structures

Recognizing that not only commissions create a bias and can lead to mis-advice and mis-selling, the FSA has also investigated in-house incentive structures. The results of these investigations and a consultation paper were published in September 2012.

In the investigation, 22 authorised financial firms with in-house sales teams and more than 20 sales staff were reviewed. The review showed that 20 out of the 22 firms had features in their incentive schemes that increased the risk of mis-selling. For example, firms had not properly identified the risks posed by their incentive schemes to ensure effective controls were in place. Some schemes were so complex that management did not understand them; sales quality generally had much less of an impact on staff incentives than the quantity sold; and some sales managers earned a bonus on the volume of sales made by the staff they supervised. The latter practice created conflict of interests for managers who also played a significant role in overseeing the sales of their staff, the risks of which were not adequately managed.[86]

Worst examples include one firm that operated a 'first past the post' system, where the first 21 sales staff to reach a target could earn a 'super bonus' of 10,000 Pounds. In another firm the basic salaries of sales staff could move up or down by more than 10,000 Pounds a year depending on how much they sold. In yet another firm, sales staff were allowed to earn a bonus of 100 percent of their basic salary for the sale of loans and PPI, but the bonus was only payable to those who had sold PPI to at least half their customers.[87]

Managing Director of the FSA, Martin Wheatley, explained that this bonus-based approach played "a role in many scandals we have seen over the years. Incentive schemes on PPI [Payment Protection Insurance] were rotten to the core and made

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[84] A Policy Statement is announced and will be published by the end of 2012.
[85] FSA, 'Payments to platform service providers and cash rebates from providers to consumers', Consultation Paper 12/12 (June 2012).
[86] FSA, 'Guidance Consulation: Risks to customers from financial incentives', (2012), p. 10.
[87] Martin Wheatley, 'The incentivisation of sales staff - are consumers getting a fair deal? - Speech', (2012).

a bad problem worse." He also said that while "public attention has been on the huge rewards on offer to the few, the effect of more modest rewards on the many needs to be dealt with."[88]

The FSA therefore proposes that financial firms put in place effective controls and governance which includes:[89]

- Robust risk-based business quality monitoring and adequate controls to mitigate the risk of inappropriate behaviour during sales conversations.
- Management information (MI) to identify, and act upon, trends or patterns in individual sales staff activity that could indicate an increased risk of mis-selling. Using this management information to inform the approach to monitoring sales staff incentive risks.
- Proper management of sales managers' conflicts of interest.
- Effective oversight of incentive schemes by appropriate senior management, including approval of the incentive schemes.
- An effective risk identification and mitigation process, including regular reviews of incentive schemes and the effectiveness of controls, taking into account customers' interests.

[88] Ibid.
[89] 'Guidance Consulation: Risks to customers from financial incentives', p. 21.

4. Case Study UK: Anticipated Consequences of the RDR

The RDR will have impacts on financial product providers, intermediaries, vertically integrated firms and consumers. The objective of this section is to summarize the anticipated impacts on those stakeholders.

Since the RDR is not yet implemented, this section is based on the results of stakeholder interviews and their expectations about impacts, published statements of key players, and studies estimating potential impacts.

4.1. Anticipated impacts on financial product providers

Insurance companies[90] and investment managers[91] are the two industries offering retail investment products or solutions. In the UK the financial industry landscape is a broker driven market with independent financial advisers (IFAs) holding 76 percent share in total insurance volume and intermediaries holding 46 percent of total volume in investment management.

The associations of both groups - the Association of British Insurers (ABI) and the Investment Managers Association (IMA) - support the RDR and its goals in general.[92] They agree that the commission-bias has eroded trust in the financial service industry. Richard Saunders, Chief Executive of the IMA explained for example: "The RDR's objective of ensuring a better deal for consumers through greater transparency in the retail market is welcome. Increased professionalism and enforcing professional standards will be critical to helping to achieve this. We also support wholeheartedly the aim of removing commission bias.”[93]

Despite this general support both groups also point to some insufficiencies in the RDR:

- The IMA is concerned that insurers will be able to facilitate advisers charging through the product producers whereas this will not be possible for investment managers. This will lead to an unlevel playing field between insurance and investment products.[94]
- The IMA, the ABI and the British Bankers’ Association (BBA) are not convinced of the RDR’s approach towards simplified advice. They highlight that the necessary level of qualification for simplified advice is the same as for full advice and this undermines the business case for supplying the more streamlined service. This is expected to result in financial insti-

[90] 2010 figures according to: ABI, 'UK Insurance - Key Facts', (2011), p. 14.
[91] 2011 figures according to Investment Management Association: http://www.investmentfunds.org.uk/fund-statistics/full-figures/, accessed 03 September 2012.
[92] Interviews conducted with James King and Jacqueline Thornton, Association of British Insurers, and Andy Maysey, Investment Management Association.
[93] http://www.investmentfunds.org.uk/Current-topics-of-interest/rdr/
[94] Interview with Andy Maysey, Investment Manage Association, conducted on the 23rd of August.

tutions limiting their advice services to either full advice (independent or restricted) or no advice (execution only).[95]

In general terms, there is a consensus that the RDR does not impact the *core business* of asset management directly. There will be indirect effects, however:

- Some studies estimate that the market for financial advisers will consolidate. Some advisers will leave the market. Other adviser firms will merge or join networks (see also section 4.2). Both developments will lead to a reduction of complexity for the investment manager and empower advisers as investment managers have to compete more.[96]
- There could be a rise in demand for non-advised and streamlined advice products. Additionally, workplace based solutions will fill the gap especially with the enactment of auto-enrolment solution where employees have to opt-out.[97]
- Different share classes will have to be introduced to take account of the different remuneration needs (legacy and new business).

There will also be a shift in the demanded *product mix*:

- Performance will become more relevant in investment decisions. Rather than increasing sales by means of commissions, the products will have to perform better to be competitive and attractive to consumers and intermediaries. Hence the quality of the product is expected to become more important.
- Alternatives that formerly had the disadvantage of not offering commissions (passive funds including ETFs) are likely to become more attractive.
- Discretionary business will become more attractive to advisers who cannot or do not want to cover the complete range of the advice and investment process.[98] If the RDR succeeds to reduce churn, new business will go down whereas net new business should remain stable.

Furthermore, the significance of platforms will increase (section 3.2.3). According to a survey, 47 percent of advisers will increase business with platforms and 37 percent of providers think the share of products distributed via platforms will increase. Platforms can lead to a stronger position of advisers via-à-vis product providers in terms of factory gate prices. They can enable advisers to offer a more holistic service and they offer efficient ways to facilitate the Adviser Charging.[99]

In sum, product providers in general support the changes and are preparing themselves for a future market under new rules. Without commission being part of their propositions, quality aspects will become the unique differentiation cri-

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[95] Interviews conducted with James King and Jacqueline Thornton, Association of British Insurers, Peter Tyler, British Bankers' Association and Andy Maysey, Investment Management Association.
[96] Deloitte, 'Responding to the Retail Distribution Review - Shaking up investment management?', (2011).
[97] Ibid.
[98] Ibid.
[99] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules'.

terion. There are six success factors in such a quality competition: i) company, ii) products, iii) remuneration, iv) sales support, v) sales service and vi) IT support.[100] Since commission is only one aspect of remuneration the other success factors become more relevant.

A simple model of (self) regulation

In some economies the regulation of commissions is initiated or strongly supported by the financial industry (e.g. The Netherlands, United Kingdom). Obviously, industry needs to see an advantage if they advocate for regulation and firms should be better off when coordinating their actions. We set up a simple model that should serve the aim to explain different approaches.

The model

For the purpose of the model consider product providers of retail investment products such as insurance companies and mutual funds. There are two alternatives: They pay advisers through commissions or let the consumers pay directly. It has been industry practice that providers pay their sales partners commissions taken from the initial and on-going fees the customers pays for the product. The outcome of this strategy is: On the one hand higher sales because more consumers are addressed or assets are reallocated (churn), but on the other hand it also leads to reputational and litigation costs due to misselling. These additional costs make it less attractive for providers to compensate the sales persons themselves. If one provider unilaterally stopped paying commissions he would have lost his business. Nevertheless, a collective action like a ban of all commissions is not only better for each individual provider, but also for all providers in total. Thus, cooperation would be optimal, but it will not happen because there is no incentive to deviate unilaterally from the traditional ways of doing business. The underlying game according to game theory is a Prisoner's Dilemma. Cooperation can be achieved by agreeing on binding rules for every provider. That is why in this case the industry wants to be regulated.

Discussion of the model

Depending an which business figures an industry looks, the effects become more evident. The urge to change the system is weakest if the only indicator is new business. It gets stronger if the book of business is taken into account, and is the strongest if profit is the central decision criterion.

The driving force whether an industry calls for regulation or not might therefore be the costs of sales. If the reputational costs and the costs of litigation are not high enough, the collective optimal outcome for the providers will be to stay with the established system.

If there is additionally strong business of tied agents or direct sales through own sales force remuneration, issues become more complex.

Policy needs to monitor the costs of miss-advice and miss-selling. Even if industry has no intrinsic motivation to ban commissions, regulation should level

[100] According to the six factor model applied by Roll & Pastuch – Management Consultants.

the playing field for fee-based advisers to be able to offer charging models were the consumer pays.

4.2. Anticipated impacts on intermediaries

The FSA commissioned studies in 2009 and 2010 to assess the impact of the proposed measures of the RDR on independent financial advisers (IFA).[101] Market participants were questioned about how they view the RDR-implied changes. The reports differentiate the responses by authorization status (directly authorised/appointed representatives), firm revenue and number of adviser. The surveys show that 25 percent of the existing IFA firms would leave the market (of which 7.5 percent would have left anyway resulting in 23 percent caused by RDR) corresponding to a reduction of 11 percent of the number of advisers,[102] 9 percent of the revenues of all advisers and 11 percent of the number of clients advised.[103] Disproportionally, small firms with revenues of less than 50,000 GBP would leave the market (46 percent). Firms with appointed representatives were more likely to exit the market than directly authorised firms.

More recent research indicates that the figures published by the FSA might be out-dated, as the industry currently exhibits remarkable developments to comply with the RDR rules.[104] The Aviva Adviser Barometer from UK's largest insurer offering life and general insurance as well as asset management asked advisers to react to the upcoming new rules. When the market research was conducted for the first time in January 2009, about 37 percent of the advisers reported that they will leave the market. The latest figures from June 2012 show, however, that only 3.4 percent will actually do so.[105] Consequently, Andy Beswick, intermediary director at Aviva, said: "We haven't yet seen advisers exit the market to the levels previously predicted."[106]

Furthermore, a survey shows that changes in the way intermediaries and consumers will interact will not be dramatic:[107] Two third of the interviewed advisers said that they do not want their clients to write an extra check for them. Instead, 51 percent will try to let the product provider facilitate payment and another 15 percent will try and let platforms facilitate the payments. Only 15 percent opted for two separate payments: One for the product another for the advice. 16 per-

[101] Oxera 'Retail Distribution Review proposals: Impact on market structure and competition - Prepared for the Financial Services Authority', (2009). and Oxera, 'Retail Distribution Review proposals: Impact on market structure and competition - Prepared for the Financial Services Authority', (2010).

[102] For the segment of appointed representatives the numbers are estimated. Due to the absence of respondents in the segment off firms with more than 19 advisers the assumption was made that the will behave in the same way as firm with appointed representatives in the segment with 4-19 advisers. If the assumption were made that the large firms with appointed representatives behaved in the same way as large directly authorised firms, only 6-8% of the advisers would leave the market.

[103] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', p. 19.

[104] AVIVA, 'UK: Advisers getting fit for the future', ‹http://www.aviva.com/media/news/item/uk-advisers-getting-fit-for-the-future-16972/›, accessed 6 September 2012

[105] It should be noted that the figures might look better due to i) a sample selection bias: Aviva might have questioned only advisers of a certain quality ii) survivorship bias: only the ones which will stay in the market anyway might have participated in the poll.

[106] 'UK: Advisers getting fit for the future',

[107] Ibid.

cent said that they were undecided. In terms of the fee structure, the majority opted for a variable fee based on the amount invested.

The Aviva Adviser Barometer shows that 62 percent of the advisers will differentiate their services to best meet theirs clients needs.[108] This calls into question whether clients will have sufficient levels of advice. The majority of advisers (79 percent) will offer independent rather than restricted advice.[109]

Further findings of the Oxera report include: [110]

- Most firms (80 percent) think that consumers are willing to pay as much as they currently do.
- There will be a shift towards execution only business, whereas the majority of firms do not plan to offer services for unadvised sales. Additionally, firms will consider selling more mortgage and protection products rather than investment products to increase profits.
- The ban of factoring affects the sale of regular premium products in favour of single premium products (which might indicate that consumers' needs are not necessarily taken into account in full array).
- The cost of training is estimated to be at 5-7,300 GBP per adviser.

Generally speaking, the anticipated impacts on intermediaries can be summarized as follows: First, while the RDR might force some intermediaries out of the market, the anticipated impacts currently do not look so grim as was expected two or three years ago. Second, changes in the interaction between intermediaries and consumers will not be drastic. While consumers will negotiate the fees with the advisers, it is likely that consumers will not write a check, but that the Adviser Charging will be facilitated by the product providers. Third, it is expected that intermediaries will - at least initially - focus on more affluent clients as these consumers already have a better understanding of the quality of the service and value it accordingly. Furthermore, this client group can afford the higher price of that RDR-enhanced service. The British Bankers' Association therefore proposed a new retail distribution landscape[111] with Assisted Purchase, Financial Advice and Financial Planning (increasing in both dimensions: complexity of customer need and minimum qualification/service type). The advice threshold is then between Assisted Purchase and Financial Advice.

4.3. Anticipated impacts on vertically-integrated firms

Vertically-integrated firms are expected to react in different ways to the RDR. Some will focus on more affluent consumers, some will still offer services for all

[108] Aviva, 'Info graphic: Adviser getting fir for the future', http://www.aviva.com/data/media-uploads/news/File/ 2012%20infographics/Infographic%20-%20Advisers%20getting%20fit%20for%20the%20future.pdf, accessed 03 September 2012
[109] Ibid.
[110] 'Retail Distribution Review proposals: Impact on market structure and competition - Prepared for the Financial Services Authority'. and 'Retail Distribution Review proposals: Impact on market structure and competition - Prepared for the Financial Services Authority'.
[111] BBA, 'BBA Response to DP 07/01 - A Review of Retail Distribution', (2007), Appendix 1.

consumer groups, some will withdraw totally from the advice market and many will invest more in technology.

HSBC announced to implement a double strategy. First, they will reduce the number of advisers in order to concentrate on the upper market segments (affluent, HNWI, UHNWI).[112] Second, for the mass affluent and retail segments, they will use technology and introduce an execution-only online fund supermarket.

Similarly, Barclays withdrew its financial services from parts of the market offering financial planning only to wealthier customers (›50,000 GBP[113]) and online services to the mass market through Barclays Investment without advice.[114]

The Co-operative banking group withdrew its financial advice services from the market. It has sold its financial intermediation business and signed a contract with Axa instead to offer financial planning services in their branches through this corporate partnership.[115]

Other banks made similar strategic decisions. The Royal Bank of Scotland reduced its staff in certain segments by 50 percent in order to focus on more affluent clients. In contrast, a commitment to offer advice to all customer segments has been given by Nationwide and Lloyds. Nevertheless, their advice processes will be adjusted to fit the new requirements and meet economic objectives.

Two foreign banks already introduced their RDR ready Adviser Charging rules. For strategic reasons most banks decided to offer a restricted service because the status independent would imply offering all financial instruments including those of their competitors.

Credit Suisse’s top management has decided that the bank would not only comply with the RDR rules, but live its spirit. The headquarter in Zurich fully supports the change process and is interested to see how this type of advice service will play out in the marketplace. This pricing model could serve as a blueprint for other countries as well.

4.4. Anticipated financial consequences for the industry

The Cost Benefit Analysis (CBA) of the FSA shows the expected one off as well as the on-going costs of the RDR.[116] The present value for the first five years annualized equals approximately 305m to 370m GBP or 0.3 percent of the new business in retail insurance and by asset managers (2008 figures, total 109bn GBP with 46bn GBP insurance products and 63bn GBP investments products).

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[112] Daniel Grote and William Robins, 'HSBC scraps tied advice service; 650 jobs go', *citywire* ‹http://citywire.co.uk/new-model-adviser/hsbc-scraps-tied-advice-service-650-jobs-go/a584819›, accessed 6 September 2012

[113] Barclays, 'New Tariff Guide - Effective June 2012', (2012).

[114] Datamonitor, ‘Barclays' preparations for the RDR may be replicated by other players‘, http://www.datamonitor.com/store/News/barclays_preparations_for_the_rdr_may_be_replicated_by_other_ players?productid=7BEBF97D-876D-4BFB-A28A-0B060A746F8B, accessed 03 September 2012

[115] Will Roberts, 'Axa Wealth creates 265-strong adviser network in Co-op banks', ‹http://www.ifaonline.co.uk/ifaonline/news/2121356/axa-wealth-creates-265-strong-adviser-network-op-banks›, accessed 6 September 2012

[116] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules'.

The total one off costs range between 605m and 750m GBP.

in m GBP	Intermediaries	Product Provider	Total
One off costs	275-370	330-385	605-750
On-going costs	100-120	70-85	170-205
Present value of the costs for the first 5 years			1,400-1,700
Annualised			305-370

The one off costs for intermediaries include:

- Professional qualifications 115-165m GBP
- Adviser Charging 140-160m GBP
- Disclosure documents and marketing 20-45m GBP
- Independence 5m GBP

The on-going costs for intermediaries are:

- Disclosure: explanation of status and charges 25m GBP
- Adviser Charging 40-60m GBP
- Independence: additional search costs 35m GBP

The one off costs for the provider firms are namely: One-off costs for IT/systems changes, including multiple share classes, product redesign and product disclosure.

It is expected that any additional cost will be passed on to consumers. The management fees for the investments and the fees for the advice will increase. [117] Advisers are cited[118] with the 1 percent rule: as an ongoing fee the adviser will ask for 1 percent, as it is a whole number (integer). NMG conducted a study on behalf of BDO and found: The pricing level will change. Initial Charges will go down to 2.9 percent from the current 3 percent and on-going charges will go up to 0.8 percent from the current 0.6 percent. This leads to an overall increase of costs.[119]

4.5. Anticipated impacts on consumers

Opponents of the RDR argue that the regulatory overhaul will leave consumers worse, rather than better off. They warn that the RDR:[120]

[117] Ibid.
[118] Interview with Andy Maysey, IMA.
[119] BDO, 'RDR to result in higher consumer costs and advisers receiving 'Commission by another name'', ‹http://www.bdo.uk.com/press/rdr-result-higher-consumer-costs-and-advisers-receiving-commission-another-name-bdo-res›, accessed 06 September 2012
[120] FSA, 'Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules', p. 18.

- leads to a reduction in the number of advisers in the market.
- leaves consumers unwilling or unable to pay for advice.
- increases the cost of advice particularly by increasing the standards for professionalism and adverse effects to the supply of advice services.
- widens, or at least not contributes to the narrowing of the savings and protection gaps.
- encourages advisers to focus their business on wealthy clients, who are willing to pay higher fees and bring more regular business.

British consumer organizations and the FSA have countered these arguments. They highlight that:[121]

- Advice has never been free. The fees were often just paid indirectly by commissions.
- If consumers are unwilling to pay for advice because they do not recognise its value, there is an opportunity for the advisers to demonstrate that their service is worth it.
- A continuation of the commission based remuneration system, hiding the cost of advice in the product would only contribute to the common perception that advice was free. This misconception does not help the long-term sustainability of the advice sector.
- The new rules allow consumers to pay the adviser charge via the product if they should be unable to pay for the advice directly.
- The reduction of the number of advisers in the market was relatively low so that there was not a real danger that consumers would be left without access to an adviser (see also Section 4.2).

The Financial Services Consumer Panel argues that: “We believe that once consumers begin to understand that the service being provided is one that is worth paying for, the risk [that Adviser Charging could lead consumers withdrawing from the process] will largely fall away.” And it highlights another benefit of the new rules: “In a competitive market greater transparency about charges and fees should also drive down costs.”[122]

4.5.1. Adverse impact in the interim period

While welcoming the changes introduced by the RDR, consumer organizations warn that unscrupulous financial advisers could try to maximize their profits before the new rules apply. Two dangers are highlighted:

- **Trail commissions:** Due to the fact that trail commissions for legacy business can still be paid in the post-RDR world, there is a danger for mis-

[121] Ibid.
[122] Financial Services Consumer Panel, 'Simplified Advice - Guidance Consultation', (2011), p. 2.

selling in the interim period. Consumer Focus argues that IFAs were building up trail commission business ahead of the changes. Consumer Focus conducted a study which shows that trail commissions of eight of the largest pension providers rose by 10 percent over the last two years while initial commission income declined by around a quarter in the same period. This was particularly concerning since almost three quarters of consumers were not even aware that their advisers were being paid an on-going fee.[123]

- **Churning:** Consumer Focus also argues that their research shows that IFAs were advising consumers to switch or churn to products which provide high levels of commission to the adviser, rather than those that best meet the client's needs.[124]

The consumer organization Which? recommends that consumers "should protect themselves from potential mis-selling by seeking an IFA who already holds a qualification on the FSA's "Level 4" list and who is willing to be paid a fee rather than earning commission on what they sell."[125]

[123] Consumer Focus 'Factsheet: FSA Retail Distribution Review (RDR)'.
[124] Ibid.
[125] Which?, '60 second guide to the future of financial advice', (2011).

5. Developments in other EU and non-EU countries

The regulation of the conflict of interest in financial service advice and the banning of commissions are not only issues that are addressed in the United Kingdom, but also in other countries of the EU and in non-EU countries:

- **Finland:** On 1st of September 2005 commissions were prohibited on the Finish pension market with a three-year transitional period.[126]
- **Denmark:** In Denmark commissions were banned on the Danish pensions market with a five-year transitional period starting from 1st of July 2006.[127]
- **Netherlands:** The Dutch government has banned commissions on a wide range of products such as banking, insurance and investment products starting from 1st of January 2013. The definition of products takes a consumer centric view: comparable and substitutable products are all covered by the ban's definition.
- **Australia:** The Financial Advice package is voluntary from 1st of July 2012 and will become mandatory from 1st July 2013. The package includes three key components: i) A ban on up-front and trailing commissions and like payments in relation to the distribution and advice of retail investment products and the introduction of adviser charging; ii) The introduction of a statutory best interest or fiduciary duty so that financial advisers must act in the best interest of their clients; and iii) Expanding the availability of low-cost limited or scaled advice to improve access to and affordability of financial advice. Scaled advice is advice about one area of an investor's needs, such as insurance, or about a limited range of issues.[128]

There are striking similarities in the rationale for these interventions and in the ways that these approaches were enacted in these countries and in particular between the UK, the Netherlands and Australia. The following sections will summarize key points.

5.1. Insufficient financial advice is identified as a key challenge

In all these countries, there was a recognition that consumer confidence in financial services was low and that the quality of financial advice was unsatisfactory. Mystery shopping tests in Australia showed, for example, that only 3 percent of the tested advisers met a *good* quality grade, whereas 39 percent were rated *poor*. A poor grade meant that the advice was most likely inappropriate for the client which could result in inappropriate risk exposure, unnecessary loss of

[126] Finish Insurance Mediation Act 15.7.2005/570: http://www.finlex.fi/fi/laki/ajantasa/2005/20050570
[127] Danish Insurance Mediation Act No. 401, 25 April 2007: http://www.dfsa.dk/graphics/Finanstilsynet/Mediafiles/newdoc/Oversaettelser/Act%20401_Insurance%20Mediation%20Act.pdf
[128] Australian Government, 'Future of Financial Advice - Information Pack', (2011).

benefits or income, switches into products with higher fees but no offsetting benefits, or failure to achieve objectives.[129]

5.2. Commission-bias perceived as a root cause of insufficient advice

Policy-makers identified the conflict of interest deriving from the commission-bias as one of the key root causes for these insufficiencies. The Dutch Ministry of Finance argues for example: “In the Netherlands, commission-driven selling, together with a lack of transparency towards consumers, has led to mis-selling on a large scale.”[130]

5.3. Disclosure does not rectify the commission-bias

In all these countries a ban of commissions has been adopted as an instrument of last resort after other measures - such as the disclosure of commissions - has not significantly improved the situation.

In the Netherlands, for example, financial intermediaries were first required to hold a license. Then, disclosure instruments were put in place, requiring transparency about commissions upon client’s requests. Next, pre-contractual disclosure or remuneration by intermediaries in cash terms became mandatory.[131] Only as a last option, commissions were banned.

The Dutch Ministry of Finance argues that: “Remuneration transparency is an important first step. However, it appears that even if consumers are informed, they do not always act upon this information by shopping around for less costly and more unbiased advice.”[132] The Ministry highlights that the reasons for this were that: i) Informed consumers did not necessarily make more critical consumers. ii) Most consumers were not able to process the disclosed information and to act on it. Hence they did not discipline the market by means of their purchasing-decisions. iii) Furthermore, consumers were not able to judge the quality of advice. Therefore the commission-paid intermediary still had no clear incentive to act in the best interest of the consumer.

As a result, the Ministry concluded: “Therefore, we need more than transparency in order to bring about unbiased advice and ensure consumer protection. … In order to truly establish a clear position on the role of the intermediary towards its client … the ultimate solution would be cutting the financial relation between intermediary and provider entirely, for example through a ban of commissions.”[133]

In Australia a very similar argumentation was put forward. Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, argues that due “to

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[129] Australian Securities & Investments Commission, 'Shadow shopping study of retirement advice', (Report 279, 2012), p. 8. and Peter Kell, 'The future of advice post FOFA: A speech by Peter Kell, Commissioner, Australian Securities and Investments Commission', (2012).
[130] Dutch Ministry of Finance, 'Letter and Position Paper: Review Insurance Mediation Directive', (2011), p. 2.
[131] AFM, 'AFM publiceert leidraad passende provisie financiele dienstverleners', (2009).
[132] 'Letter and Position Paper: Review Insurance Mediation Directive', p. 2.
[133] Ibid., pp. 2, 4.

the complexity of commission-based remuneration structures, together with low levels of investor financial literacy, mean that the disclosure approach is not working as intended. Rather, the most vulnerable investors - those most in need of good financial advice - are also those most at risk of being sold products that are completely inappropriate for their financial needs."[134]

5.4. Fee-based advice improves quality of advice and has other positive implications for consumers

Policy-makers argued that a commission-free system would lead to higher-quality advice. When consumers have to pay for advice services directly, they are much more critical about the quality of the advice they receive. The Dutch Ministry of Finance argues that: "Consumers are more inclined to act - and discipline the intermediary - when they directly experience how much they pay for advice."[135]

The Australian government highlights that due to an alignment of the adviser and client interests, more consumer-focused advice and greater adviser engagement with consumers will follow. Also the product recommendations will be more suitable for the consumers which will result in less consumer detriment as a result of excessive fee arrangements or sub-optimal investment strategies. Furthermore, a reduction in product fees resulted in significant savings for consumers.[136]

5.5. Negative impacts of a ban of commissions can be mitigated

It was acknowledged however, that banning commissions represented a radical game change with impacts on both industry and consumers. Regarding industry changes, the governments recognized the scale of the changes for product providers and financial advisers, but they also highlighted new business opportunities.

The Australian government argues for example, that some advisers will leave the market since they did not wish to or might not be able to change their business model. However, due to new opportunities - particularly due to the introduction of scaled advice - the government expects even a "short term boost to total employment before settling down to a total level of employment broadly similar to existing levels."[137]

In the Netherlands the government's initiative to ban commissions was supported by key industry players. For example, the vision of the Dutch Association of Insurers on the distribution of complex products was based on the under-

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[134] Chris Bowen, 'The Future of Financial Advice in Australia and Federal Budget Overview - Address to the Association of Financial Advisers', (2010).
[135] 'Letter and Position Paper: Review Insurance Mediation Directive', p. 4.
[136] Australian Government - The Treasury 'Frequently Asked Questions', ‹http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq.htm#_What_are_the›, accessed 03 September 2012
[137] Australian Government - The Treasury 'Frequently Asked Questions for Advisers', ‹http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=faq_adviser.htm#s1o1›, accessed 03 September 2012

standing that all remuneration bias had to be removed and replaced by fee-only advice between the consumers and the intermediary; that product providers set the price of a product upon which the intermediary can add the agreed remuneration with the client; and where intermediaries were responsible for the advice, and product manufacturers were responsible for the product.[138]

For industry, it was important that the free market approach was secured and that the range of financial products on offer (if they were suitable for consumers) was not reduced. Some market players hope that by addressing one of the root causes for mis-selling and mis-advice, the reputation of the entire sector will improve. This should lead to greater consumer confidence, higher sales and less pressure on government to regulate the market. Rather than focusing on volumes, the future financial services market will be based on high quality products and high quality advice.

The Dutch government expects that the number of financial intermediaries will go down. However, currently the number of advisers leaving the market is equal to new entrants. New entrants already have a higher education level compared with those leaving the market, indicating that the market is becoming more interesting for higher qualified candidates. Many already inform their clients about the upcoming changes, have new models in place, or send consumers to other firm to comply with internal and external rules.

Regarding consumers, it is noteworthy that the Australian government put in place the Future of Financial Advice programme with the explicit objective to ensure more Australians have access to high quality and affordable advice.

To address potential negative impacts a number of measures were put in place:

- To facilitate the payment of fees, modalities were introduced by which the payment could be deferred. In Australia, for example, advice and ongoing fees do not have to be paid up front, and in full. The fees can be deduced from a client's investment and be facilitated by the product provider.[139]
- General advice and scaled advice regimes were put in place. The Australian scaled advice regime is based, for example, on the assumption that advice can be scaled to different extents. While adviser charging also applies to scaled advice, the level of inquiries financial advisers have to undertake differs. Hence scaled advice can include single topic advice or multi-topic advice.[140]
- The Dutch government does not expect an advice gap. Free market powers and competition will close potential gaps. Furthermore, new advise services will evolve.

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[138] Association of Dutch Insurers 'Comments of Dutch Association of Insurers: CESR Consultation Paper (CESR/09-958) - Inducements: Good and poor practices', (2009), p. 3.
[139] Minister for Human Services and Minister for Financial Services , Superannuation and Corporate Law, 'The Future of Financial Advice - Information Pack', (2010), p. 5.
[140] Australian Securities & Investments Commission, 'Giving information, general advice and scaled advice - Consultation Paper 183', (2012), p. 12.

5.6. The banning of commissions is necessary, but not sufficient

In all countries discussed, there is a recognition that banning commissions is necessary, but not sufficient to improve the quality of financial advice. The Dutch emphasise, for example, that consumers should have clear expectations of the kind of advice they receive. Consumers must be informed in their orientation phase whether they receive *independent advice*, *advice of a tied advisor* (an adviser that advises products from a limited range of providers) or *direct selling advice of the provider* (an adviser that advises on the company's own products). Furthermore, the Netherlands will increase the qualification level of financial advisers.

6. Conclusions: Lessons to be learned

The objective of this final Chapter is to summarize the key lessons that can be derived from the in-depth case study of the RDR in the UK, the overview of experiences in other EU and non-EU countries and from the review of the academic research. These lessons are summarized in eight theses.

Thesis 1: The financial services market does not work properly. As a result, there are severe detrimental impacts for a large number of consumers, the financial industry and the economy as a whole.

"Some time ago, financial institutions changed their view of consumers from people to serve, to people to sell to."[141]

Martin Wheatley, Managing Director of the UK Financial Services Authority

Despite the growing significance of financial services for consumers to save among other things for their retirement, the financial services sector is in a desolate state on a variety of benchmarks: Not only does it continuously rank lowest in the Consumer Markets Scoreboard of the European Commission in terms of consumer trust, satisfaction and consumer complaints, yet again consumers have lost trust in their banks this year (sections 1.1 and 2.1).

This dismal performance has a price. Consumers too often invest in products that are too expensive or not suitable for them. A number of studies show that this mis-investment creates a substantial economic damage for consumers. Some studies estimate that the damage created from insufficient investment advice in Germany alone was 20-30 billion Euro per year (section 2.1). In the UK the mis-selling of Payment Protection Insurance represents the largest financial scandal of all time. It is expected that the UK financial industry will have to pay up to 10 billion Pounds in fines and compensations.[142]

Not only are consumers harmed on a large scale, but evidence suggests that low consumer trust also harms the financial services industry itself. Numerous studies show that a minority of consumers in Germany trust their banks and more than two thirds argue that the advisers are primarily focused on their own interest and that these interests at least partially influence their recommendations (section 2.2.2). British and Dutch banking and insurance associations therefore speak out in favour of far-reaching measures to improve consumer protection in financial services. They hope that these measures will rebuild trust and confidence in the sector so that consumers will spend more on financial services.

Taken together addressing the current underperformance and creating a functioning consumer market for financial services creates value for consumers and the financial industry and hence contributes to economic growth at a time in

[141] Martin Wheatley, 'The incentivisation of sales staff - are consumers getting a fair deal? - Speech', (2012).

[142] http://www.which.co.uk/news/2012/09/fsa-targets-bank-incentives-that-lead-to-mis-selling-294869/

which the economic outlook in the EU is unstable and growth rates are low or even negative.

Thesis 2: The commission-based advice model is broken. It neither serves consumers nor industry, as it creates a conflict of interest that can negatively impact consumers.

"*My contention is that we have a [distribution] system which serves neither the producer of the services nor the consumer of the services. It is doubtful whether it serves the intermediary either.*"[143]

Callum McCarthy, former Chairman of the UK Financial Services Authority

The study suggests that there is ample evidence that the commission-based advice model is broken both for consumers and industry. The commission-bias leads to a focus on sales rather than advice due to a mis-alignment of the interests of consumers and financial advisers. Academic research shows that commissions drive up retail prices for financial products due to a competition between firms to offer high sales commissions. Furthermore, the involvement of commission-paid financial advisers often lowers portfolio returns, worsens risk-return profiles, and encourages return-chasing behaviour and a push for actively managed funds that have higher fees (section 2.2.1).

This analysis is also shared by governments, regulators and consumer organizations in the UK, Netherlands and Australia. All of them make the commission-bias responsible for mis-advice and major mis-selling scandals, a focus on volume rather than quality, low persistency of pension policies and churning (sections 3.1 and 5.2).

Furthermore, there is evidence suggesting that the commission-bias also does not benefit industry. The commission-bias damages the reputation of the entire sector and undermines consumer trust and confidence As an indication of its relevance and importance, the British financial industry itself supports the Retail Distribution Review on the whole (section 4.1). Similarly the Dutch banking and insurance associations have supported their government in banning commissions (section 5.5).

Thesis 3: Attempts to address the commission-bias with disclosure do not work.

"*[T]he complexity of commission-based remuneration structures, together with low levels of investor financial literacy, mean that the disclosure approach is not working as intended. Rather, the most vulnerable investors - those most in need*

[143] Callum McCarthy, 'Is the present business model bust? - Speech at the Gleneagles Savings & Pensions Industry Leaders' Summit' (2006).

of good financial advice - are also those most at risk of being sold products that are completely inappropriate for their financial needs."[144]

Chris Bowen, Australian Minister for Financial Services, Superannuation and Corporate Law

"*UK experience has [...] been that investors find it difficult to decode labels.*"[145]

Niamh Moloney, Professor at the LSE

Two approaches are put forward to address the commission-bias: mandatory disclosure and a ban of commissions. The first group who proposes mandatory disclosure highlights negative side-effects of a ban, such as raising costs for advice, an unwillingness or inability of consumers to pay for advice and the risk that a ban of commission could lead to a concentration of the market. This group therefore calls for improved disclosure of commissions rather than a ban (section 2.2.3).

Proponents of a ban on commission point to research that demonstrates that the disclosure of commissions does not rectify the commission-bias. They argue that consumers find it difficult to understand how commissions may affect the independence of the service they are being provided; that there was a danger that consumers made worse decisions due to an inadequate framing of the information and due to information-overload which prevents them to digest other payoff-relevant facts; and advisers might feel more justified to give biased advice, since they revealed the conflict of interest (section 2.2.1).

Experiences in the UK, Netherland and Australia all support the stance of the proponents of a ban of commissions. In all countries disclosure was tested and proved to be an inadequate instrument to address the commission-bias. The conclusion in all these countries was that rather than focusing on symptoms, the root cause for mis-advice and mis-selling had to be tackled (commission-bias), that disclosure was an insufficient instrument to address this bias, and that the commission-bias therefore had to be erased (sections 3.1 and 5.3). It is important though, that this ban is made applicable to all financial advisers and not only some - such as the European Commission had proposed in the MiFID II proposal. The UK House of Lords European Union Committee convincingly concluded that: "Restricting the ban on inducements to independent advisers will be unworkable, since advisers will simply take steps to avoid being classified as independent."[146]

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[144] Chris Bowen, 'The Future of Financial Advice in Australia and Federal Budget Overview - Address to the Association of Financial Advisers', (2010).
[145] Moloney, *How to protect investors: Lessons from the EC and the UK*, p. 268.
[146] House of Lords - European Union Committee, 'MiFID II: Getting it Right for the City and EU Financial Services Industry', in Hl Paper 28 - 2nd Report of Session 2012-13 (ed.), (2012), p. 32.

Thesis 4: A ban of commissions transforms the industry, offers new opportunities and stirs competition for quality.

Starting next year commissions will be banned in the UK, Netherlands and Australia. Such a ban represents a significant regulatory overhaul. While financial *product providers* will not need to change their core business of asset management fundamentally, they will need to introduce new share classes and instruments to facilitate adviser charging. Furthermore, there will most likely be a shift to passively managed investments and, most importantly, the performance of the products will be more in the spot light in the distribution of financial products. Intermediaries will measure financial products more thoroughly with regard to their performance rather than the associated commissions (section 4.1).

For *intermediaries* a world without commissions will look very different. Intermediaries will need to focus increasingly on the quality of their advice and they need to prove that this service is worth its price. While some intermediaries will not be able to rise to this new task, there are indications, that the drop-out rate will not be high and that new qualified actors will enter the market. These new actors will be better trained and ready to engage in this new competition for advice quality (sections 4.2 and 5.5).

Finally, the way in which *vertically integrated firms* react to the RDR indicates that they will apply different strategies. While some are focusing on more affluent consumers, others will still offer an array of services to all consumer groups, still others will totally withdraw from the advice market, and many will invest in technology to facilitate streamlined advice processes.

In sum, product providers, intermediaries and vertically integrated firms will need to focus less on volume and more on quality - the quality of products and the quality of advice. This study shows that not all current players will be able to cope with this new situation. At the same time, the study shows that this new regulatory environment creates opportunities for those who want to compete on quality and that there are a great number of actors that get ready to seize this opportunity. Furthermore, industry in the UK and the Netherlands hope that by addressing this root cause, there will be less pressure on governments and regulators to continuously introduce new (costly) measures to improve consumer protection. In supporting the ban, they hope to play a more pro-active rather than reactive role.

Thesis 5: Potential negative impacts on consumers can be mitigated.

"*We believe that once consumers begin to understand that the service being provided is one that is worth paying for, the risk [that Adviser Charging could lead consumers withdrawing from the process] will largely fall away.*"[147]

UK Financial Services Consumer Panel

[147] Financial Services Consumer Panel, 'Simplified Advice - Guidance Consultation', (2011), p. 2.

Opponents of a ban of commission warn that a ban will have negative impacts on consumers. They highlight that consumers will not be able or willing to pay for advice, that costs for advice will be too high and that particularly low- and middle-income consumers will be left with little to no access to advice, which could aggravate the already existing savings and insurance gaps.

The study shows that these opponents are right and wrong at the same time. They are correct in the sense that the market for financial advice will change significantly for consumers, that there might be regions where access to advice will become more difficult and that consumers might find it difficult to accept that they have to pay directly for the advice service.

Opponents are wrong, however, in so far as potential negative effects have to be weighted against the positive ones:

- Higher professional standards and the ban of commissions will contribute to a better quality of advice and it might prevent large scale mis-selling scandals that have happened in the past.
- Fee compensation reduces the risk of churning and the sale of underperforming investments.[148]
- Financial advice will become a value. Advice was never free, but under the new regime the costs become transparent.

Furthermore, mitigation strategies can be introduced. Simplified advice or scaled-advice systems and stakeholder products (which include consumer protections) are ways to ensure that key financial services that should be easily accessible to all consumers will be available even without or with limited advice (sections 3.2.2.3 and 5.5).

Thesis 6: Fee-only advice eradicates the conflict of interest which is inherent in commission-based advice. However, it must be backed with high professional standards.

The study suggests that consumers have a right to know whether the advice they receive is independent (paid by a fee) or dependent (paid by the product provider via commissions). There needs to be a clear distinction between advising and selling, as only fee-only advice eradicates the conflict of interest which is inherent in commission-based advice.

The UK and the Dutch experiences show that the success of the fee-only advice model depends on two factors. First, fee-only advisers need to be competent advisers. It therefore needs to be ensured that the advisers are properly trained, engage in continuous professional development and are accredited to professional standard bodies that sanction any misbehaviour. In Germany, for example, the Association of Fee-Only Advisers (BVDH) has a codex for its membership which clearly states that fee-only advisers are not allowed to take commissions

[148] See also: Finke, 'Financial Advice: Does it Make a Difference?', p. 16.

or any other form of inducements or even to participate at incentive programmes of product providers.[149]

Second, consumers need to know whether the adviser is able to offer recommendations on the whole range of financial products, whether he/she is specialized on particular financial products or tied to products from particular providers. The scope of advice needs to be clearly labelled (sections 3.2.2 and 5.6).

Thesis 7: Changing the financial industry is a journey. While new challenges will arise, the most pressing issues should be addressed in a timely manner.

Particularly the UK case study reveals three key lessons for the implementation of such a fundamental regulatory overhaul. First, while it might not be easy, it is possible to create a common consensus among key stakeholders - such as regulators, banks, intermediaries and consumer organizations - to start a process to address root causes of mis-advice and mis-selling. If such a consensus is achievable in the UK - a country which is more dependent than any other EU country on the financial services sector - such a success should be replicable in other states.

Second, changing the framework for financial advice should be regarded as a journey. This is best exemplified by the fact that new questions and challenges have come up and will continue to arise throughout this endeavour. Examples are issues around platforms and how they fit into the new adviser charging regime (section 3.2.3) or in-house incentives (section 3.2.4). All these questions can be handled in a pragmatic way. It is important, however, to make the first step and address the issues that are most pressing.

Third, by addressing the important issue of the commission-bias, one should not forget that a comprehensive approach is needed to improve the overall performance of the financial services sector. Consumer literacy, accessibility and comparability of reliable and understandable information about financial products, behavioural biases, transaction costs, hurdles to switching and access to and the availability of high quality financial advice all play important roles in improving the functioning of the financial services market from the consumer perspective (section 2.3).

Thesis 8: A system change in the financial industry is needed to protect and empower consumers and restore trust in the financial industry.

"[W]hile public attention has been on the huge rewards on offer to the few, the effect of more modest rewards on the many needs to be dealt with. We need to deal with how incentives and bonuses are used by firms across financial services to drive sales, and the knock-on effect this has on their customers."[150]

[149] Berufsverband deutscher Honorarberater, Kodex der Honorarberatung (9. August 2010)
[150] Martin Wheatley, 'The incentivisation of sales staff - are consumers getting a fair deal? - Speech', (2012).

Martin Wheatley, Managing Director of the UK Financial Services Authority

Given the large mis-selling scandals and the low quality in financial advice, this study shows that a system change in the financial industry is necessary. Governments, regulators, the financial industry and consumer organizations must work together to create benefits for all stakeholders. A regulatory overhaul is not only necessary, but possible and it could lead to a win-win-situation between consumers and industry. Removing the commission-bias by banning commissions increases competition for quality of products and services and contributes to restoring trust and confidence in a sector with a dismal reputation. The experience in the UK, Netherlands and Australia demonstrate that attempts to address the commission-bias solely with improved disclosure will not solve the conflict of interest inherent in a commission-driven financial service distribution. What is needed is a courageous system change in the financial industry. The industry players should renew their commitment to their most valuable stakeholder: the consumer.

Appendix: List of interviewees

Charles Boinske, Independence Advisors, US

Don Cranswick, Financial Services Authority, Retail Investment Policy

Julian Edwards, Financial Services Authority, Consumer Senior Adviser

Alison Gay, Financial Services Consumer Panel, Senior Associate

Andrew Jackson, Stanton Marris

Christoph Kanzler, Dimensional, Head of Financial Advisor Services, Germany Dimensional Fund Advisors

James King, Association of British Insurers, Assistant Director, Head of Retail Conduct

Dominic Lindley, Which?, Principal Policy Adviser

Harold Mahadew, Dutch Association of Insurers, Beleidsadviseur Distributie & Verkoop

Andy Maysey, Investment Management Association, Senior Adviser - Retail Distribution

Malcolm Murray, transact, Head of Marketing

Lindsey Rogerson, Financial Services Consumer Panel, Member of the Panel

Aniela Sroczyinski, Which?, Senior Advocate

Richard Taylor, Financial Services Authority, Investments Policy Department and Conduct Policy Division

Peter Tyler, British Bankers' Association, Director

Jacqueline Thornton, Association of British Insurers, Policy Adviser

Bruce Weatherhill, CEO of Weatherhill Executive Consulting, Member of the British Bankers Association Private Banking Advisory Panel and Deputy Chairman of the Chartered Institute of Securities and Investments Wealth Management Committee

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