

Rethinking how consumers get advice:

What changing 'polarisation' is all about

The FSA promises sweeping changes to the way individuals access and pay for advice as part of changes in who can sell what. These will change the face of the industry for individual investors. But there will still be a premium on self-protection and knowing exactly what you want from the industry - as outlined in the No Monkey Business 'Code of Safe Practice'.

Different interests in changes to 'polarisation'

The FSA first dealt with 'polarisation' by making an exception for stakeholder pensions. Now it has published a new Consultation Paper (which can be downloaded from the FSA website (fsa.gov.uk/pubs/cp/121/). Because they can get involved in the consultation process, this feature is written for professionals as well as individuals. Editors (and professionals) should note there are three valuable new sources of research and data on the retail investment industry accompanying CP121.

The big picture

Whenever the FSA proposes changes to financial service regulations, it helps to remember that it has two parallel agendas in respect of the consumer:

- To protect them from damage
- To promote self-provision by raising the level of public awareness and by easing access to the means of provision, whether good-value products or advice about products.

The politics of financial self-provision fit like a glove the No Monkey Business philosophy of 'living a life with purpose', in which individual responsibility for planning and realizing financial aspirations, as well as basic needs, is a *personal benefit* rather than just a public policy goal. The FSA's latest Consultation Paper (CP121) inviting comment on its planned changes to the regulation of financial advisers is essentially about *changing the marketplace for investment products to further the public policy agenda of awareness and access.*

In this 'big picture' context, the so-called 'polarisation' of financial advisers, which goes back to the origin of industry regulation and which separated advisers into

independent or tied to a single provider, can be judged to have succeeded only in the narrowest of terms. Most people apparently understand the distinction between independent and tied and so know what sort of adviser they are dealing with (about 80% of the buying public, according to the London Economics research commissioned by the FSA in 2000). Clarity of status was the original objective, so it has achieved it.

But here is a list of areas in which polarisation has been a failure or simply a side-show.

- Preventing mis-selling
- Alerting consumers to conflicts of interest
- Placing a high value on independence
- Encouraging shopping around
- Making the value of products the essential basis of competition
- Encouraging new product competition
- Helping innovation

Spawning a so-called 'independent' advisory sector in the high street may have helped make goal planning and investment more relevant and engaging for individuals, but only at quite high levels of affluence. Any such benefit has been swamped by the failure of large financial institutions to use their customer access to foster relationships based on good value, sound advice and service quality.

The FSA and the research it has commissioned together lend credence to the accusation (as made in No Monkey Business and by many others) that the polarisation regime *actually contributed to the institutions not taking this route*:

- They exploited their legacy of consumer trust to:
 - write contracts with penal terms to lock customers in
 - overcharge for products
 - promote products unsuitable for individuals' real needs
 - tolerate poor levels of customer service
- They used their commercial muscle to enslave much of the independent advisory sector as a 'distribution channel' to which it dictated terms.

In Part II of the book (which places the failures of the industry in the context of a particular history), the market power of life insurance companies and the ineptitude of British banks in the investment field are contrasted with the structure of financial services in other countries. The background to the FSA's Consultation Paper makes a similar contrast. To some extent it must, because any new regime in the UK has to take into account harmonization of financial services across the EU. But the FSA also draws attention to the powerful presence in the USA of broadly-based investment houses in the banking and stockbroking sectors most of whom sell the products of other institutions as well as their own. Polarisation, because it restricted the ability of tied advisers or agents to offer products from outside their own marketing group, prevented this open competition for distribution of products.

So here are three 'big picture' insights:

1. The public policy goal can only be achieved by mobilizing the power of big financial institutions

2. Advice needs to be less exclusive and easier to access through the big financial institutions
3. These new proposals fit easily in a framework where regulation shifts from the processes by which products are sold to the design of the products themselves

1 Mobilizing big business

After the appalling record of abuse of trust chronicled in No Monkey Business, the first insight about mobilizing the big, bad institutions may seem like heresy. Counter-intuitive, it is realistic just because of their customer access. They also have the best access to less affluent households. The downside risks are already being addressed through FSA initiatives to make competition by value the dominant rule of the new marketplace (such as Stakeholder pensions, CAT Standards and official comparative tables). Other changes in these new proposals, to commissions, are also designed to minimize the risks of rewarding the marketing power of the product manufacturers. More such initiatives may follow from the Sandler Report in the summer.

2 Opening up the market for advice

The second insight is part of what mobilizing the institutions means. It calls for some redefining of what constitutes advice and making independence a less arbitrary test of the value of the advice. This may also seem counter-intuitive, particularly for No Monkey Business which trumpets the value of independent planning advice. But it ties in with a few other No Monkey Business 'big ideas':

- growing consumer perception that packaged investment products are just commodities will force the 'manufacturers' to add value through customizable 'decision support' – going beyond *selection* to testing for *suitability*, *goal planning* itself and *self-management of portfolios* of products
- investment technology already holds the answer to making generic advice customer-specific – and at low cost
- there is no reason why advice from investment planners (whether independent or not) should not be once-off, separate from any purchasing or portfolio decisions and affordable – 'surgery' versus 'stewardship' is how one IFA describes it.

3 Dropping the bias to regulating selling methods

The third insight is not as speculative as it once looked. The bias in the first regulatory regime to focus on selling at the expense of product design was presented in the book as an unfortunate accident of history, reflecting the personal thinking of Professor Jim Gower who headed the committee set up by the Government in January 1981 to investigate the need for 'consumer protection'. These accidental personal biases remain a peculiar feature of the British love of commissions and reviews, as in Taylor (football stadia), Mynors (institutional investment) and Sandler (individual investment). It seems in financial services the biases are at last balancing each other out, if only randomly. The research commissioned by the FSA supports a focus on product design as well as selling methods but much more on products can be expected when Sandler reports.

Flawed product design lies behind several of the No Monkey Business 'Code of Safe Practice' conclusions:

- Avoid (and check professionally how to get out of) all products based on with-profits (also a current feature: Whither with-profits?)
- Be aware of what constitutes and flows from all forms of ‘entrepreneurial’ investing
- Actively managed equity funds are bad gambles that most investors, *knowing the odds*, would not make with much of their money (also a current feature: Costs kill)

The FSA’s proposals

This is exactly as they appear in the Press Release accompanying the new Consultation Paper.

‘We propose that:

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

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

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

‘Provider firms’ are what No Monkey Business also refers to as ‘the manufacturers’. These are the life assurance companies, banks or investment houses that ‘package products’. They organize funds for sale to the public, be they unit trust or OEICS, contracts based on a with-profits life fund, or products that require a ‘wrapper’ such as personal pension or ISA. Historically these would have been managed by the same firm

but increasingly the portfolio management (across part or even all of a product range) is farmed out to one or more third parties. Packaging products is a 'commodity business'.

Products as 'commodities'

The commodity nature of packaged products, a description strongly resisted by their manufacturers, stems from:

1. The homogeneity of their mandate (as in all UK growth unit trusts having similar styles of management and same performance benchmark)
2. The much larger population of funds than is required for competitive purposes or to make a contribution to stockmarket efficiency - *there are as many UK funds investing in UK equities as there are securities in the FTSE All Share Index!*
3. The randomness of managers' relative returns (as demonstrated in the book in Chapter 10, The Performance Lie)

'Distributor firms' recognizes that without polarisation marketing groups would be formed to distribute products from a range of different providers, looking more like those that exist in countries that do not have polarisation restraints. In other European countries these are often banks whereas in the USA they are typically firms that originated as retail stockbrokers. The decision of Barclays Bank (still under polarisation rules) to distribute only the products of Legal & General indicates how firms that think their strength is their customer base or branch network can be readily tempted to market products from other firms that are seen as having product strengths. Under the new rules, Barclays will be free to add some of its own products to those of Legal & General and also add those of other third parties. Having strong distributors will help ensure that the factors that determine which products win distribution are specific to the products themselves. The FSA's hope is that they are more likely to be the product terms, particularly cost. But there is still a big difference between perceived brand values and actual product value and consumers are still misled about the value of past performance.

'Independent advice' will acquire some new distinctions, one strengthening it and the other weakening it. The first, about charging methods, comes 15 years too late. The idea that an independent firm is one paid by its customers rather than by the product providers is in fact the significance it should have had at the outset if polarisation was to mean what the first regulations quite deliberately implied (see Chapter 6, Products of a Particular History.) Under the new proposals, a firm calling itself independent will have to have a schedule of fees for service, however derived (such as number of hours at posted charge-out rates or the value of a portfolio under advice or management), *provided that the fees are not conditional on the sale of products*. To the extent that provider-generated commissions are received, they must be paid over to the customer, or used to defray the invoice amount based on the fee schedule. This second arrangement is what is known as 'commission offset'. It remains to be seen whether the FSA is able to sort out the present bias arising from VAT being applied to fees but not to commissions. Perhaps the Sandler report will apply pressure here too.

Most comments on this subject miss a key aspect of bias. *Because they are financially neutral, fee-based advisers are far more likely than commission-based advisers to recommend no-load, no-trail, index trackers*. The impact of this bias on

outcome risk, total costs and unwitting bad gambles is demonstrated in the feature ‘Costs kill’.

The independence distinction that risks becoming muddled is to do with the ownership of the firm. There will no longer be different rules for what constitutes a satisfactory basis for recommending the products of a provider that part-owns the IFA firm. This distinction has to go as part of making advice more freely available from product providers – insight number 2. The existing provisions make it technically impossible to recommend such products without regulatory risk because they require a justification (‘better than best’ advice) that is clearly nonsensical! The new rules would require full disclosure of the potential conflict of interest when an adviser recommends the products of a firm that part-owns or controls it. It is then up to the consumer to protect themselves.

No Monkey Business suggests that consumers have been slow to cotton on to conflicts of interest, perhaps relying excessively on short-cuts, such as the good name of a particular provider or even polarisation as a guarantor of independence. The downside risks associated with the weakening of independent advice in the new proposals require a step-up in the education of consumers. It is likely that there will be such efforts as and when these changes are implemented and probably they will coincide with other initiatives prompted by the Sandler report.

There are at present no distinctions, as between tied and independent advisers, in terms of training and competence, knowing your customer or requirements to make ‘suitable’ recommendations and this will not change.

‘Unbundling’ refers to the separation of different cost elements: marketing, advice and the product itself. This proposal is explained thus (CP121 5.8 on page 70):

‘Given the clear evidence from the research about consumer confusion over how advisers are remunerated, more needs to be done to improve transparency of the cost of advice and the commissions paid to advisers. We therefore propose that firms should be required to ‘unbundle’ the cost of advice from the cost of the product and that this unbundled information should be presented in clear, understandable form at the point of sale. There could be three figures disclosed to consumers: the charges they would pay for the product alone, excluding advice; the cost of advice; and the total combined ‘price’ for the product plus advice. For products marketed directly, without advice, we would expect the cost of marketing, instead of the cost of advice, to be unbundled from the cost of the product in a similar fashion.’

The potential market impact

Institutions

Beyond the big picture insights spelt out above, speculating about the market impact of the changes, if they go through in much the same form as proposed, is possibly mainly of interest to professionals and editors. But remember: it is consumers, not board room strategists, who will in fact dictate much of the eventual impact!

Most press reports in the days after the release of CP121 focused on the impact on the IFA sector. However, changes in the way advice is accessed is much more fundamental and informs the intended impact on the role within the ‘mass market’ of the UK’s big financial institutions, either as providers (with their own or a combination of their own and third party products) or as distributors of third party products.

As suggested above, the market impact of mobilizing the institutions depends largely on the consumer's response to the new marketplace. If, as the FSA hopes, opening up competition for distribution of good value products leads to value becoming a more important criterion in building brand acceptance, then advertising emphasis may well move from product-specific performance to more general and lasting brand attributes. This in itself will be educational! It will also be more likely to open the consumer's eyes to the commodity nature of packaged products - a trend that is evident anyway.

The consumer's response will also determine whether the downside risks of weakening independent advice exceed the competitive benefits and the wider access to financial advice for less affluent households. When editors anticipate how this might play out, it is worth remembering their own role in sharpening up consumer awareness of the proper basis for assessing the competing merits of each of providers, distributors and advisers. It would be ironic if financial journalists play up the risks associated with these changes rather than the potential benefits as this belittles their own role in educating individual investors and reminding them of *caveat emptor*.

A logical implication of the changes is that they will increase market concentration. But there is a balancing factor. Smaller managers and specialist managers of packaged products are marginally more likely to find distributors for some if not all of their products. The potential market outcome is therefore the '*hour-glass effect*' whereby commodity producers in the middle range of the industry are squeezed out of business. The FSA has obviously been persuaded by the evidence presented by London Economics in their research for the FSA in June 2000 (*Polarisation and Financial Services Intermediary Regulation* page 43) that concentration is a long way from becoming excessive.

Before polarisation can contribute to this effect, sharply declining profit margins will already have led to a contraction amongst smaller non-specialist firms, even if they are currently able to rely on tied agents or their own sales force for distribution.

The issue the media are focusing on is whether the providers will want to buy IFAs to secure distribution. Whether they should or not, which depends on cost as well as strategic factors, the fact is they may. There is no question that distribution through IFAs has been a cost-effective way to market, even though institutions have also had to pay to support their overall brand or to advertise particular funds. However, these economics have depended on the polarisation regime, the appetite amongst wealthier investors for independent advice and the fact that distribution could be built up across a large part of the country by getting onto the 'best advice' panels of a large number of intermediaries. There are very few individual IFA firms who could provide that coverage.

It is possible that the IFAs' best customers today will not value in the same way relationships with the same people when they come to see them as advisers, planners or 'customer relationship managers' within a financial conglomerate. This would run counter to the experience in the USA where private clients appear to be happy working with local offices of giant Wall Street firms. But in America personal relationships with an individual broker or planner count for a lot, the levels of professionalism in large firms are seen as higher and the market is dominated by conglomerates that are not primarily viewed as insurance companies.

It is also possible that UK providers do not understand how to manage or motivate an advisory function that is not just a direct sales force. Most IFAs already fall

uncomfortably between two stools, neither pure salesmen nor professional investment planners, and ownership by an institution will further expose this skittish identity.

All of this speculation needs to bear in mind that the life assurance industry will probably soon have another and much bigger issue to deal with, possibly before any strategy in respect of polarization changes takes shape. This is the *high chance ascribed to a widespread loss of consumer confidence in the with-profits sector* triggered by continuing stockmarket pressure on the bonus pool and technical solvency and warnings that far more mortgage endowments will fall short. The reasoning is spelt out in another current feature, Whither with-profits. It is not clear whether such a crisis would lead to an industry-wide response, facilitated by the FSA and the Inland Revenue, or whether it will be a company by company response with competitive impact. Either way, it looms as a huge distraction for senior management and a massive liability for exceptional expenditure.

It seems more likely at this stage that the dominant institutions will favour low-risk multiple distribution channels and use their brand-building power and cost-competitiveness to appeal to end users of any of these channels. If they can get consumers to focus (as the FSA hopes) on value, they will be in a strong position to get themselves onto advisers' panels, whether commission- or fee-based.

As part of a multi-channel approach, we can also expect institutions to support direct access, particularly web-based, on the strength of brand awareness, service, decision-support technology and price. As part of this strategy they are likely to be more willing than at present to rebate direct-access customers part of the commissions currently paid to IFAs. Part of the price institutions have paid for depending on IFAs for distribution is that they have had to bow to IFA pressure not to rebate the intermediary's commission to people who choose to buy the same products direct. This is so IFAs do not lose out to people who take their advice and then cut them out of the buying process. This is clearly anti-competitive and shows why advice and transactions should never be contingent on each other when it comes to paying for service.

It is obvious that all of these marketplace strategies look very threatening for weaker firms of product providers, whether life companies or investment houses. But the FSA rightly shows not the slightest interest in preserving the number of players in the game.

Advisers

Other than whether the institutions are going to send in a gravy train, the key question for IFAs if these proposals go through is whether to stick with commissions or go for the possible marketing reward finally being created for 'independence' of income source. This is really only an issue for firms with significant investment business. It partly depends on whether they see themselves as distributors of products, for which commissions are suitable, or as financial planners, for which fees are more appropriate.

Even where a firm's existing business makes it a suitable candidate for conversion from commissions to fees, there are a number of issues. (This is an area in which Stuart Fowler's company, Investment By Design, has consulted.)

Initially, costs rise and income falls. In most cases, the resources they are applying to investment planning and selection will not match up to those required for sophisticated resource planning and dynamic stewardship of portfolios of products. They will need to beef up their use of investment technology and refocus their training and

competence. They will also find that the productivity of a genuine investment-led practice depends critically on linking front and back office systems which will call for significant IT upgrading or outsourcing.

Front-end loading fees to reflect the cost loading of attracting and setting up new portfolios for new clients (possibly at the expense of the first year's valuation-based fees) can help bridge this gap. But across a large number of firms sizeable outside capital would be required. Because the proposed changes make it likely that the public will be more aware of the value of a fee-based and genuinely independent adviser, strategies for converting, stand a better chance of being financed. These chances are probably improved further if the change in business model also involves investment technology and IT and a strategy for economies of scale, such as through mergers between like-minded groups of professionals.

This is an issue No Monkey Business will return to as it lies at the heart of its mission to see a highly professional, skill-based and technology-driven advisory business model to compete head-on not just with commission-driven advisers but also with money managers and stockbrokers. This has the potential to fill the gap in individual goal-based planning skills as part of turning the decision hierarchy the right way up (see *Investment planners and the decision hierarchy* below), focusing on and rewarding planning and dynamic asset allocation at the expense of trivial implementation decisions.

Investment planners and the 'decision hierarchy'

Part I of the book demonstrates the critical importance of *asset allocation* and the trivial significance of security selection. This makes market behaviour and market exposure the key focus of resource planning, managing risk, fund selection and dynamic portfolio switches.

Part III, which is about a Code of Safe Practice, sets out the criteria for selecting agents. These include a focus on asset allocation and having the right technical resources.

When selecting advisers or portfolio managers these are more important than how they get paid but in almost all cases *the qualifying firms will also be fee-based*.