

From the Chairman
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Gordon

POLARISATION

In August 1999 the Director General of Fair Trading reported to you under the Financial Services Act 1986 on 'The Rules on the Polarisation of Investment Advice'. The main conclusion of the DGFT's report was that the rules on polarisation are significantly anti-competitive. He recommended that collective investment schemes should be taken out of the polarisation regime.

In the light of the DGFT's report you now need to reach a view about whether the anti-competitive effect of polarisation is necessary to protect investors. The Economic Secretary asked the FSA Board to advise on this question to help you in your decision making. The conclusion we have reached is that we cannot advise you that polarisation is necessary to protect investors in the long-term. We are therefore proposing to consult on a progressive move to delivering the same or greater consumer protection through other methods which we expect to be much less restrictive of competition. I explain in the following paragraphs the background to our advice.

To help inform our views we commissioned a report, from London Economics, which looked at the possible market outcomes of the recommendation made by the DGFT as well as other possible options for changing the polarisation regime. We published that report and invited comment on it before the FSA Board formulated this advice. Among other things, the report concurred with the findings of the DGFT that the current polarisation regime does have some adverse effects on competition and innovation and viewed solely from the

competition perspective, therefore, there is a strong case for making changes to polarisation.

The FSA is, however, not concerned solely with the competition aspect of polarisation. The statutory objectives set out in the Financial Services and Markets Act require us to secure the appropriate degree of protection for consumers and promote public understanding of the financial system. We have been mindful of the fact that when polarisation was first introduced it was justified by the previous regulators on investor protection grounds despite its potential to distort competition. The most important issue for the FSA Board to address has therefore been whether or not there is a case for maintaining polarisation on consumer protection grounds notwithstanding its adverse effects on competition and innovation. In considering this question we have taken particular account of the views of the FSA Consumer Panel.

Vigorous competition is likely to contribute powerfully to securing a fair deal for consumers. The arguments for a regulatory intervention, such as the polarisation rule, which imposes serious constraints on competition, must be sustainable on strong consumer protection grounds.

The view the FSA Board has reached is that such consumer protection considerations are not decisive and that it should be possible to liberalise the distribution arrangements in the market while maintaining the interests of consumers. Indeed, the Board believes that the pro-competitive impact of a relaxation of the polarisation rule would over time work to the advantage of consumers. We have a number of reasons for our views:

- a) the first is that the regulatory environment has changed substantially since polarisation was introduced in 1988. Polarisation met a need at a time when the status of advice to consumers was often unclear and when there was a lack of transparency about commissions. Over the years since 1988, regulators have introduced a range of measures including status disclosure, commission disclosure, and training and competence requirements which have provided much more information to consumers on the salespeople and advisers through whom they transact business. Further important developments are planned. We have already announced our intentions for the publication of comparative information. We will shortly be publishing a discussion document setting out how we think product information might be improved so as to allow consumers to make better-informed decisions. And we are now working on how to improve status disclosure because, whatever the outcome on polarisation, it is important for consumers to understand better the nature and implications of the service which is being offered by the firm with which they are dealing. Against this background the blunt instrument of polarisation has

a much less important role in protecting consumer interests than when it was first introduced.

- b) perhaps the strongest argument advanced in favour of polarisation is that, though it may unhelpfully constrain competition, at least consumers know where they are, and any change would create further confusion. In our view, this argument is weak. Research evidence suggests that roughly 20% of consumers do not understand what type of adviser they are seeing (and qualitative survey evidence suggests that the proportion may be even higher than this). Confusion over status seems to be highest in the bancassurance part of the market with 31% of consumers believing that banks are the best place to get independent advice, even though banks largely have tied distribution.
- c) recognition that consumer detriment can arise not only through the purchase of inappropriate products but also through the failure to make appropriate financial provision. We therefore believe that consumer interests will be best served by improving access and choice coupled with improved disclosure and comparative information. These arguments have a particular resonance in the case of Stakeholder Pensions.
- d) the UK is unique in imposing a structural constraint on distribution arrangements; other countries have not found it necessary to introduce a system such as polarisation in order to protect consumers. Looking forward, the polarisation regime could become increasingly inconsistent with EU developments.
- e) we believe that an important role will remain for genuinely independent advice to consumers. The London Economics report gives comfort that it will still be possible to sustain a robust and healthy IFA sector while at the same time trying to improve competition within the tied sector.

We think that care needs to be exercised in implementing changes to polarisation, particularly at a time when many other changes are under way or in prospect. We are in the midst of substantial preparations for the commencement of the new regulatory regime in mid-2001 and Stakeholder Pensions, for which we are also preparing, become available in April 2001.

Major changes to the polarisation regime, if implemented rapidly and without adequate preparation, would bring a risk that consumer detriment could increase through confusion over adviser status. There are two broad ways of dealing with this risk. One is to improve product disclosure so that misunderstanding over adviser status has less impact because consumers understand the products better. Status disclosure itself could also be modified and improved to cope

with a more diverse distribution system. Work on improved product disclosure is well advanced but that on status disclosure would need to be accelerated. We recognise, too, that changes will require full and careful consultation, and that the financial services industry will need time to prepare for a change which may have a significant impact on its structure. The polarisation regime has conditioned the development of financial advice for more than a decade. Its removal would take time to unwind. Against that background the Board sees a case for a staged approach whereby we can make a number of worthwhile improvements in the short run and deal later next year with more fundamental changes to polarisation as results come from our work on improved disclosure. Our belief that a measured approach to change is needed has been reinforced by the views of the FSA Consumer Panel.

The three areas where we would propose to consult soon on changes to polarisation in the short-run are:

Stakeholder Pensions (SHPs) - in our May 2000 Discussion Paper on the FSA's approach to the regulation of the conduct of SHP business we set out our proposals for an appropriate regulatory regime bearing in mind the minimum standards incorporated in SHPs and the fact that many purchases by consumers would be non-advised. The arguments we advanced then are relevant in the present context. Moreover, the economics of the product mean that not every product provider will be able to sustain an SHP in house. We will therefore be proposing that the rules should be changed to the effect that firms in the 'tied' sector will be able to offer one, or more, SHPs from other providers. Meanwhile, firms which hold themselves out as acting as the customer's agent will, as now, be subject to obligations to search the market before recommending a SHP, where such a recommendation suits the customer's needs. We believe that these changes will work to the benefit of consumers because they will increase access to SHPs and choice in the 'tied' sector.

Direct offer advertisements - there has recently been considerable development of the 'fund supermarket' concept over the Internet whereby a firm provides to consumers details not only of its own funds but those of other providers. We wish the fund supermarket concept to continue because of the increased choice it offers to consumers. But fund supermarkets are only one means of 'direct offer' distribution and we think any changes to polarisation should apply to other distribution methods such as mailshots and supplements in newspapers. We currently have the unsatisfactory position whereby some firms are confined to distributing only their own products by direct offer means whilst certain 'IFA' firms can use direct offer methods to distribute the products of several providers. Such 'IFA' firms may not have any information about the personal and financial circumstances of the customers they are targeting. We propose to remove direct offer advertisements from the polarisation regime and the effect

of this will be that all firms will be able to use direct offer mechanisms to distribute the products of one or more providers. A consequence of this proposal is that those firms who may currently benefit from the 'halo effect' of being IFAs when using direct offer methods will no longer be able to do so.

ISAs - the measures I have described above in relation to direct offer advertisements will, among other products, include ISAs. But we think we should go further for ISAs meeting CAT-standards which themselves reduce certain risks to which consumers are exposed. Currently, tied advisers cannot offer a maxi-ISA with the life insurance component from their company, and the unit trust from a range of other companies. Similarly, an adviser tied to a unit trust provider could not offer a maxi-ISA with a choice of life company policies. We propose to remove these constraints in the case of CAT-standard ISAs.

The FSA would therefore propose to consult in two stages:

Firstly, later this year we would consult on rule changes affecting the polarisation of Stakeholder Pensions, direct offer advertisements and CAT-standard ISAs. In the light of the considerations outlined above, these changes would not be contingent on the improvements in disclosure which I have outlined;

Second, around the middle of next year we would propose to consult on more fundamental changes to the polarisation regime.

In the meantime we would continue to develop, in parallel, our improvements to the disclosure regime. In the second consultation we would consider a range of further options. They would include the complete abolition of polarisation, but we would also canvass the arguments for and against more limited options such as 'gap' filling where a firm does not have a particular product in its range. In looking at these options we would also take account of the different means by which intermediaries are remunerated (fees, commissions). As these further changes depend for their success on the development of a more effective disclosure regime, on which we will not be consulting until the middle of next year, it follows that we will have to publish the Conduct of Business Sourcebook, effective from N2, on the assumption that polarisation continues for the time being, except for the proposed short-run changes I have outlined above.

The DGFT made some other recommendations in his report additional to his main finding that polarisation is significantly anti-competitive. The annex to this letter sets out the FSA's views on those other recommendations.

We look forward to hearing whether, in your view, the approach outlined above meets the arguments put forward by the DGFT in his report.

I am copying this letter to the DGFT.

Tom

Howard

Howard Davies

DGFT's recommendations to the Treasury

1. **The FSA should retain polarisation but only for advice on investment products, including personal pensions, linked to life assurance.**

This was the main recommendation in the DGFT's report and has been addressed in the main body of the letter. But there are some additional points which it is relevant to mention concerning the removal of unit trusts alone from the polarisation regime.

This scenario was least favoured by London Economics for lack of delivery of competition benefits and the potential it created for greater consumer confusion. The majority of respondents also agreed with this analysis.

Such an approach would create anomalies. For example, a unit trust and an insurance-based fund may have exactly the same underlying investment vehicle but only the insurance-based product would remain polarised, creating market distortion.

It may not be possible to achieve comprehensible disclosure of status upon initial contact with the customer. The salesperson will not discover the customer's needs until the fact-find. Their status will depend on what product recommendations result from the fact-find. Therefore establishing whether they are acting in an independent or tied capacity (or both) is not possible at the start of the sales process.

Furthermore, there is the risk that relaxing the rules on unit trusts could cause a change in the behaviour of some IFAs. With partial depolarisation some IFAs might continue to claim the benefits of independence even when tied to unit trust provider, but under full depolarisation they would lose all the advantages that go with independence if they were to multi-tie. In consequence, it can be said that this recommendation would lead to IFAs doing a less good job for their customers on unit trusts than now, while full depolarisation would not have that effect.

2. The FSA should not relax the rules regarding the independence of IFAs.

Under any of the scenarios envisaged, independent financial advisers may be expected to flourish. There can be no question of anyone holding themselves out as the customer's agent, and therefore the provider of independent advice, being allowed to do so unless they are genuinely independent. The FSA's short run proposals will not have any effect on this point. For the more thorough going review to take place later, a number of issues will be analysed leading to proposals where appropriate:

- i) the interaction of product and status disclosure and any proposed adviser status changes, to ensure consumers understand with whom they are dealing;
- ii) the difference between fees and commission as an appropriate means of remunerating independent advisers;
- iii) the operation of the panel system for searching the market to ensure it produces the best outcome for the consumer.

3. The FSA should introduce rules to require the separation of the negotiation of commission from panel selection.

The larger IFA firms, national and network IFAs, already make this separation. For the sole trader and other very small IFAs there is no viable way of implementing this recommendation. There are also limits to the effect that such a separation can or should have on IFAs. Some products' commission levels may be below the level at which an IFA can profitably run his business. Placing the providers of those products on the IFAs's panel would not be economically rational.

Other examples of good practice in the selection of panels are:

- clear, open and objective criteria for inclusion of product providers on panels so the process is transparent, with a particular focus on customer benefits;
- no set number of product providers on panels, with all those meeting the criteria being included;
- adequate research resources and product reviews at least yearly;
- provision for advisers to make product recommendations "off-panel" on reasonable grounds without unjustified obstacles being placed in their way;
- clients to be informed clearly of the panel's operation and objectives.

As part of the longer run review of polarisation the FSA will consider the sufficiency of these good practice standards and whether they need to be given the force of regulatory rules.

4. The FSA should consider permitting lead product providers selling through tied advisers to add specialist products under the brand name of the specialist provider as long as the lead provider takes full responsibility for the specialist products.

The FSA envisages just this approach for the introduction of stakeholder pensions in April 2001. It follows that the longer run review would examine a broader application of the concept, relying on the experience gained from stakeholder pensions.

There are, however, a number of ways of implementing this recommendation and a number of considerations in play. It will be of critical importance to ensure that consumers are not confused into thinking that an adviser offering a number of brands is independent. This points to the need for reforms of polarisation to go hand in hand with appropriate product and status disclosure.

5. The FSA should directly authorise financial advisers with multiple ties.

We agree with the DGFT that if advisers with multiple ties were allowed, they should be directly authorised.

6. The FSA should require all investment advisers to disclose any arrangements or ties, including ownership, they might have with product providers before giving advice.

Sufficient disclosure of information about the status of advisers and the products they recommend is an essential element of successful investor protection. The FSA will publish shortly a discussion document seeking views on the results of research it has conducted into product disclosure. If changes to adviser status are to occur following the longer term review, they would need to be supported by a sufficient status disclosure regime. It is also likely to be necessary to take suitable consumer awareness measures. In developing any changes to the polarisation rules the FSA will plan to introduce appropriate supporting status disclosure and consumer awareness measures at the same time.

7. The FSA should consider whether more could be done to make clear to investors who receive advice from commission-funded advisers that payment for advice is included in the commission paid to the adviser and it is possible to negotiate a rebate.

Transparency and clarity reduces information asymmetry and so is good for consumers. The FSA is looking at measures that will not only review the type of information provided but also its effectiveness. Consumer awareness of the implications of information disclosed is another area to explore. As for requiring advisers to disclose the ability to negotiate rebates, we believe this is a commercial decision to be made by advisers. For example, an adviser may receive a low level of commission for advising on a regulated product such as a stakeholder pension. The adviser is entitled to be paid fairly for the work done and there may

be no margin to share with the consumer. In any event, there is evidence that competition amongst IFAs is reducing the level of indemnity commission. Between 1998 and 1999 it fell from 67% to 56% of first year's premiums. Factors such as the introduction of stakeholder pensions will have had a bearing but so will the growing prevalence of commission rebating.