3 THE CONSUMER

Consumer weakness

3.1 It is widely accepted that consumers of long-term retail savings products are in an unusually weak position. As a result, there has been longstanding policy concern about consumer detriment, leading to extensive regulation of the way in which these products are sold that is unique among consumer goods.

3.2 This consumer weakness is inherent but also arises because of the specific way in which the industry has developed.

3.3 This chapter considers:

- the reasons for this weakness;
- its implications;
- whether there is an identifiable group of consumers to which the analysis does not apply;
- the role of companies as consumers of retail savings products;
- the issue of insufficient levels of saving by consumers, and its implications; and
- work being undertaken by the regulator and Government to improve information for consumers.

Inherent complexity of long-term retail savings

3.4 Retail savings products are inherently more complex than other types of consumer goods. Even to make basic choices between one kind of savings vehicle and another requires the consumer to have some grasp of investment issues: the differences between cash, equity and bonds, for example. Some understanding of product features – the difference between a pension and a unit trust, for example – is also necessary. These are far from straightforward matters, and it is in no way surprising that consumers acknowledge a high degree of confusion when confronted with a prospective savings decision. Consumer confusion has also been increased greatly by a host of other factors, which are considered later in the report.

3.5 Some respondents to the Review's consultation document argued that product complexity, in itself, does not necessarily imply weak consumer influence. Citing other complex high value goods, such as cars and computers, it was suggested that intense competitive pressures generated by strong consumers were very much in evidence in these markets. However, the analogy is not altogether helpful. The ways in which a car delivers its benefits may be complex, but the benefits themselves, such as speed, comfort, reliability and status, are not. By contrast, the benefit of an equity investment as compared to investing in gilts – higher long-term returns but with greater volatility – is inherently a difficult concept for many to understand or to judge.

3.6 Moreover, many of a particular car's purported benefits can be immediately assessed. The same is not true for retail savings products. These have a further difficult and unusual feature: their costs and benefits are delivered over the long term. Additionally, they tend to be purchased infrequently.

3.7 This has important implications for consumer power. With regular repeat purchasing, if customers are dissatisfied with product quality or value for money they can quickly switch to another brand. Thus competitive pressures act in the market to ensure that manufacturers are focused on price and quality issues. Individual consumers of retail savings products cannot gain experience of the product in this way, and so find it difficult to make informed switches of supplier. The problem can be partly tackled by the use of a third party that collects data on products over long periods of time and then makes these available to consumers. But the underlying problem remains.

3.8 The basic savings proposition also has an important and fundamental impact on the nature of demand for the products. Because savings products deliver benefits – higher income later in life – which are deferred for so long, consumers are often reluctant to purchase them, even when confronted with information which suggests that they should. This has important wider implications, but it also affects consumer power. If people are inherently reluctant to engage in the saving process, they are less likely to exert consumer pressure on providers after they have bought the product, by monitoring its performance and switching if dissatisfied. The response is more likely to be to forego savings altogether, in favour of consumption.

3.9 It should be noted that there are also wider social factors at work. There is evidence that consumer interest in financial matters has been blunted historically by the post-war 'safety nets' of the welfare state, and by relatively generous occupational pension schemes provided by many employers. The detriment from lack of individual provision has historically therefore been relatively small. There have been limited incentives for individuals to acquire a better understanding of financial issues.

3.10 A further difficulty is that the concepts of price and quality, as applicable to a retail savings product, are inherently difficult to understand and to assess:

- even those consumers who are aware that savings products have a price often find it difficult to determine what this price is, as there are a number of different possible measures; and
- establishing quality is equally difficult. It involves analysing issues such as investment performance over long periods of time, and understanding different tax treatments.

3.11 In summary, consumers of retail savings products face a number of inherent difficulties:

- the inherent complexity of the product benefits, and the difficulty of assessing these;

- the long-term nature of the products and their infrequent purchase; and
- the impenetrability of the price/quality trade-off.

3.12 The effect of these is greatly increased by the impact of industry practices.

Industry development

3.13 A number of features of the UK retail savings industry have served to compound consumer confusion:

- opaque and inconsistent terminology;
- lack of clarity and consistency in the reporting of product charges;
- proliferation of products; and
- product differentiation that does not reflect true differences in what is being offered.

Opaque terminology

3.14 The industry has historically made extensive use of technical terms, such as bid-offer spread, reversionary bonus, whole of life policy and reduction in yield, which are largely incomprehensible to the layman. This has been particularly true of the actuarially-driven products of the life industry. Moreover these terms have often been used in an inconsistent way – either they may not mean the same thing when used by different providers, or different terms may be used to describe the same feature. This latter problem is particularly the case with charges, for which examples include: administrative charge; service charge; establishment fee; policy fee; expense charge; management charge; fund related charge; and bid-offer spread.

Inconsistent reporting of charges

3.15 As stated earlier, the concept of the price of a retail savings product is a difficult one to grasp – it is not comparable to the price of an ordinary consumer good. This difficulty has been compounded by the inconsistent and confusing ways in which prices are communicated to consumers. The issue of charges is considered in more detail in Chapter 7. At this point it is sufficient to note that:

- price is not directly comparable between life insurance products on the one hand and unit trusts/oeics on the other, because of different tax treatments. The returns achieved by unit-linked funds are broadly after-tax returns, whereas those of unit trusts are pre-tax; and
- there are discrepancies in the ways in which costs are charged. For example, custodians' fees and trustees' fees are currently included in unit trust calculations of explicit charges, but not those for life insurance products.

3.16 In response to these information difficulties, in October 2001 the FSA launched Comparative Tables, initially covering investment products but with the intention to extend product coverage over time. These are described in more detail in paragraphs 3.68 – 3.71 below.

Proliferation of products

3.17 The retail savings industry is characterised by the following features:

- there are very large numbers of products;
- some products are fundamentally the same but are marketed as being different; and
- other products are different largely because of tax and regulatory reasons.

3.18 The sheer quantity of products on offer is itself overwhelming. For example there are some 1,600 different unit trusts and oeics currently available in the UK, and a further 1,600 private pension funds on offer.

3.19 Seemingly different products often have effectively identical underlying features. In some instances this is because of tax or regulatory differences. For example:

- unit trusts and oeics are fundamentally almost identical to most unit-linked life funds, but the two have entirely different tax treatments, such that their performance cannot be readily compared; and
- from an employee perspective, a Group Personal Pension (GPP) and an insured pension scheme are very similar indeed, but there are important differences in regulatory treatment[1].

Consumer weakness: implications

3.20 The preceding section has set out the root causes of consumer weakness. This section considers its implications.

3.21 Weak consumer influence is an important feature of the industry and leads to many of its special features. The structure of the industry, and the way competitive forces operate, both derive from the inability of consumers to exert meaningful influence. In addition, the regulatory regime, which has a considerable impact upon industry behaviour, is fundamentally a response to consumer weakness.

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[1] Insured pension schemes are occupational schemes and are not regulated by the FSA, unlike personal pensions. Resulting differences include:
- they can be promoted by the employer and are often branded with the employer's name;
- they must have at least one trustee and a trust deed;
- there are limits on outgoings of insured schemes, rather than limits on payments as for GPPs; and
- insured schemes do not need to inform their members of their charges.

3.22 To some extent, consumer weakness is a fact of life in retail savings. Nonetheless, initiatives which promote consumer influence, with consequential enhancements to competitive intensity and efficiency, must be given a high priority. The Review believes that consumer weakness in the savings industry can, to a degree, be mitigated, and many of its proposals seek to achieve this.

3.23 As noted above, the inherent complexity of savings products and processes underlies consumer weakness. Additionally, and not surprisingly, the Review found widespread evidence that complexity contributes to consumer distrust of the industry. Research conducted by both the Financial Services Consumer Panel and the ABI has highlighted the lack of trust by consumers in both advisers and product providers[2] (although there tends to be a high level of trust by consumers in their own advisers where they have them). Distrust contributes to insufficient saving.

Consumer segmentation

3.24 A number of submissions to the Review argued that the characterisation of retail consumers as weak and unable to exert effective influence implied that all consumers were the same, which was not the case. In particular, many unit trust providers argued that their customers were frequently sophisticated consumers of financial products.

3.25 It is certainly true that not all consumers are bewildered by the complexities of saving and unable to discriminate effectively across products. In particular, it seems to be the case that greater financial sophistication is correlated with greater levels of affluence and higher socieconomic class (Figure 3.1).[3]

3.26 But the same evidence suggests that financially unsophisticated customers are found in non-trivial numbers at any level of income and in any socioeconomic class. There is a significant proportion of affluent people who are not financially literate, and equally there are some consumers further down the wealth scale who are. Indeed while one might expect the more affluent to be more likely to save and therefore to be more financially aware, there is evidence[4] that people from poorer backgrounds can have highly sophisticated budgeting skills, since their spending and saving need to be more carefully planned.

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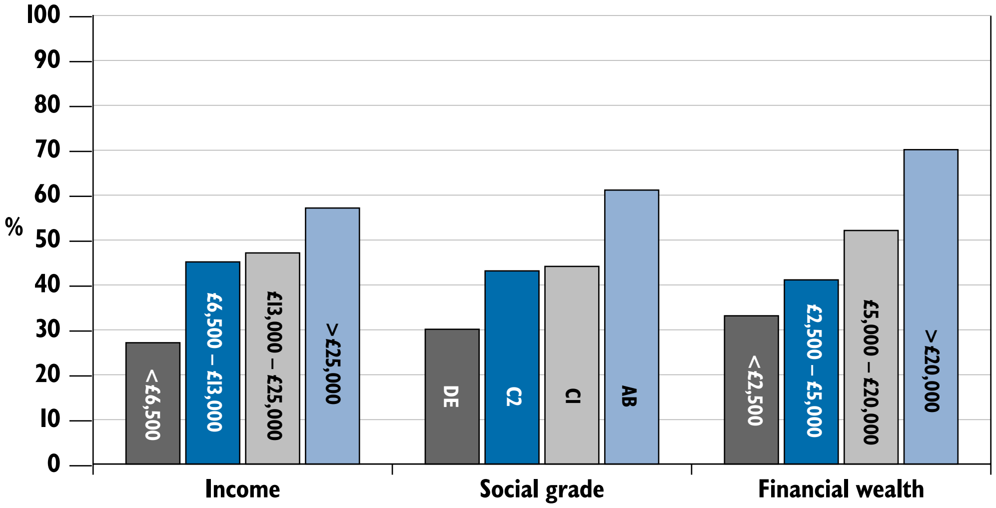
[2] The FSCP survey asked respondents to score advisers between 1 (no trust) and 7 (complete trust) – the average mark was 4.6. The ABI survey followed the same approach, but asked about product providers and used a score of 1 for "complete trust" and 7 for "no trust" – the average mark was 4.48. Sources: FSCP Annual Survey 2000; and BMRB SALTR awareness, October 2000.

[3] For the purpose of the FSCP report, people were defined as financially literate if they definitely agreed with the statement "I enjoy finding out about new investments and savings schemes", or definitely disagreed with the statement "I find it difficult to understand financial leaflets and materials", or said that they read the personal finance pages of the newspaper at least once a week.

[4] FSA consumer research 4, "A cycle of disadvantage: financial exclusion in childhood", November 2000.

Figure 3.1: Financial literacy (per cent of group)



Source: Financial Services Consumer Panel, Annual survey of consumers 2000.

3.27 It is also true that, generally speaking, the unit trust/oeic industry tends to have more sophisticated consumers; the typically riskier nature of these investments and the more direct exposure to particular markets is likely to be more attractive to consumers with more money to invest and with greater confidence in their understanding of financial markets. The fact that sales of mutual funds direct to the public are an important distribution channel (14 per cent of sales[5]) would support this contention.

3.28 At the same time, the notion that mutual fund consumers are, as a rule, financially sophisticated must also be viewed with caution, given the evidence. For instance:

- there are wide dispersions in the price of effectively identical tracker funds from 0.3 per cent to more than 2 per cent; and
- a recent survey[6] found that past performance was by far the most common reason why investors had chosen the funds they had, even though this has been shown to be a poor predictor of future performance.

3.29 In other words, although there are individual consumers who may have a high degree of financial literacy, there is no segment of the population that can clearly be identified and classified as such. The Review has concluded that the significant majority of consumers find savings products confusing and have little confidence in their ability to discriminate between products and providers. As such, the basic characterisation of consumers as weak, whilst a generalisation, is fundamentally correct.

[5] Source: IMA.
[6] AUTIF, 1998.

3.30 However, the segment represented by consumers with lower incomes is important for a different reason: specifically, the broader policy concern about insufficient saving, which particularly applies to this group. This is considered in what follows.

Insufficient levels of saving

3.31 Consumer reluctance to engage in the savings process was referred to earlier. With most consumer goods, the concept of people with sufficient income not buying "enough" of that good would be meaningless: by definition, people would choose to buy as much of a particular good as they wanted at the price available.

3.32 Retail savings products are different. Decisions to buy retail saving products are decisions about the balance of current versus future consumption. There have been long-running concerns among policymakers that, on any view of future required income, current savings levels are insufficient to provide adequate income for retirement. For example, a survey in May 2002[7] found that 40 per cent of women and 25 per cent of men had no idea how much they needed to save for retirement, and estimates of the level of savings needed were on average much lower than advisers would recommend.

3.33 Some recent modelling work in this area has been undertaken on behalf of the ABI[8]. This argued that savings levels were insufficient across different income and age groups, as shown in Table 3.1 below.

Table 3.1: Average annual savings shortfall per household (£)

Age \ Income	<£9,500	£9,500 – £13,000	£13,000 – £17,500	£17,500 – £25,000	£25,000 – £35,000	£35,000+
<25	720	1,034	1,262	1,839	2,501	2,902
25-35	1,047	1,469	1,401	1,886	1,618	761
35-45	1,102	2,052	2,142	2,291	2,555	None
45-60	512	2,426	1,739	2,830	4,061	None

Source: Oliver, Wyman & Company.

3.34 Clearly the precise extent to which saving is insufficient is highly subjective. There are multiple uncertainties, including:

- the long time frame over which the shortfall needs to be projected means calculations will be extremely sensitive to the various assumptions that need to be made, e.g. interest rates, equity market growth, consumer behaviour; and
- modelling the insufficiency of savings requires a judgement of the target income required in retirement. There is no universally accepted definition of what level of income is required for a "comfortable" retirement.

[7] Research carried out for comdirect by RSGB market research agency.

[8] Oliver, Wyman & Company, "The future regulation of UK savings and investment: Targeting the savings gap", September 2001.

3.35 Nonetheless, the basic proposition that UK consumers are not saving sufficient amounts to meet their expectations in retirement is hard to dispute, given the evidence available.

3.36 Part of this shortfall can be attributed to some inevitable features of consumer behaviour:

- it is in part a rational (or at least understandable) response to the length of the timescales, and therefore the uncertainty, involved. Consumers will tend to prefer the tangible "consumption now" to the intangible "hope of being able to consume in future";
- the belief, not necessarily well-grounded, that the state will provide for people's retirement is likely to play a part in this as well; and
- even if consumers can identify correctly their target incomes, working out the necessary level of saving is extremely difficult. The strong performance of equity markets over the last twenty years will also have had an important, and possibly misleading, effect on perceptions of future return.

3.37 But insufficient saving is also clearly affected by other features of the industry. Consumer confusion and lack of trust contribute to consumer unwillingness to save.

3.38 Insufficient saving by lower-income groups is of particular concern, for three reasons:

- the ABI study suggests that the level of insufficiency is usually greater in these groups;
- even if it were not, insufficient saving is of greater concern in this group because they are less well-off to start with and therefore are at greater risk of falling into poverty; and
- as a result, they are more likely to have to fall back on the state and create pressures on public expenditure.

3.39 The Review has therefore paid particular attention to identifying the barriers that may be preventing consumers, particularly lower-income ones, from accessing retail savings products; and to developing proposals to overcome these.

The corporate consumer

3.40 The scope of the Review is retail savings, implying that the customers are individuals; trusteed occupational pension schemes were considered by the Myners Review.

3.41 However, there are two types of product which do fall within the remit of the Review in which the employer plays an important role: insured pension schemes[9] and Group Personal Pensions (GPPs). More broadly, there has been wide discussion in the industry of whether employers could play a role in making the market function more effectively. These issues are considered below.

Insured schemes

3.42 An insured pension scheme is one in which an employer contracts with an insurance company to provide a pension scheme in its entirety: investment, administration and payment of benefits. It may be either a defined benefit (DB) or a defined contribution (DC) pension. It is usually used by the smallest companies: a typical scheme has 20-30 employees and less than £1 million in assets.

3.43 With insured schemes, as with other occupational pensions, there must be a trustee or board of trustees. In DC schemes, the trustee may be (and almost always is) the employer, acting as a corporate trustee. The trustee responsibility therefore flows through to the directors of the company, so that in practice they are in a similar position to individual trustees.

3.44 The trustee/company is responsible for selecting the provider of the scheme, but it is standard practice for this to be done on the advice of an IFA, typically on a fee basis. The management of the scheme is governed by a trust deed and a set of rules. Employer involvement in investment strategy varies from arranging for the provider to offer a range of funds in which to invest contributions, through employers selecting a default fund but offering other options as well, to no choice at all. Since the product is classified as an occupational one, the employer may promote it to the employees without coming under the jurisdiction of the Financial Services and Markets Act 2000 (FSMA).

3.45 Relationships between employers and scheme providers tend to be long-standing. A provider is seldom changed, other than in the event of an insolvency or takeover, although persistently poor service may lead to this.

3.46 Insured pension schemes were initially extremely popular following the introduction of contracting-out[10]. As rebates for contracting-out became less generous, their popularity declined. There are no accurate statistics on the assets currently under management in such schemes – estimates are at less than £100 billion. New sales are relatively modest[11].

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[9] In its response to the Myners Review, the Government asked this Review to consider the issue of investment decision-making by insured pension schemes.

[10] The objective of contracting-out is to allow individuals to move out of the state scheme for their second-tier pension and into the private sector. National Insurance rebates act to replace the State Earnings Related Pension Scheme (SERPS) and state second pension benefits, so that the increase in private pension benefits is broadly offset by the loss of state benefits.

[11] One industry source estimated that insured schemes now accounted for only 10 per cent of sales of pension schemes to employers, with the rest being either stakeholder schemes or GPPs.

Group Personal Pensions

3.47 These are a collection of personal pensions arranged largely for administrative convenience through a single provider; the employer may or may not contribute to these plans, although most do. In these schemes, the employer has the role of selecting the provider. Approximately 9 per cent of private sector organisations offer GPPs. These are most common amongst medium sized companies[12], and cover 9 per cent of the private sector workforce.

3.48 A GPP scheme is simply a collection of personal pensions. It is therefore taxed as a personal pension, not an occupational one. The product is a regulated one under FSMA. There is no trustee: the employer's only role is to select the provider, which is usually done on the basis of advice from IFAs. Unlike insured schemes, where a fee is the normal method of remuneration, the IFA may well be commission-remunerated. The choice of investment funds is then entirely up to the employee. Smaller employers will have only one GPP provider; larger ones may have more than one.

3.49 From an employee perspective, however, a DC insured scheme and a GPP may look very similar. Both would have a provider selected by their employer and typically a range of funds from which the employee could select.

3.50 Respondents to the Review expressed the concern that employers tend to be insufficiently active in their selection and monitoring of both GPP and insured scheme providers. In particular, the National Association of Pension Funds said:

> *"The majority of employers who run insured pension schemes are small and medium sized. They have neither the time nor the expertise to involve themselves in the detail of their schemes...Many will not have one individual whose sole or even main job is to manage the pension scheme. They are unlikely, themselves, to examine...the investment performance of their scheme."*[13]

3.51 Particularly with insured schemes, there must also be a concern that employers are exercising influence over investment decision-making through selecting funds, without adequately considering the basis on which they are so doing.

GPPs and insured schemes: conclusion

3.52 Clearly smaller employers will have only very limited resources to devote to the role of purchasing pensions, and it is important not to place unrealistic expectations on them. The Review believes that this can be best resolved by a short and simple version of the Myners principles which reminds employers of the key issues they need to address. This will help improve the general level of awareness without imposing undue regulatory burdens. Proposals for this are set out in chapter 10.

[12] In this instance defined as firms with 50-499 employees. Source: "Employers' pension provision 2000", DWP, 2002.
[13] Taken from the NAPF response to the Review, published by the NAPF.

Workplace marketing and advice provision

3.53 There has been increasing interest in recent years in expanding the role of the workplace as a means of delivering financial services to individuals. The introduction of the stakeholder pension has seen a requirement placed on employers[14] to have pension arrangements for their employees in place. There have also been calls, for example by the actuarial profession[15], for greater use of the workplace as a conduit for financial advice. It has been suggested that Government should intervene to encourage this, by providing tax incentives for employers who provide workplace-based advice.

3.54 It is true that using the workplace as a means of selling retail savings products offers potential advantages for both consumers and providers/advisers because of the reduced transaction costs for both parties:

- advisers and providers can interact with larger numbers of people with an efficient expenditure of time and marketing resource;
- for marginal consumers unwilling to make the effort to visit an IFA in their spare time, a workplace meeting is attractive; and
- more sophisticated consumers will be aware that companies can buy "in bulk" and therefore may be able to negotiate price discounts not available to individual purchasers.

3.55 In addition, companies may choose positively to encourage this process and even to offer financial advice for their employees as a form of benefit.

3.56 Large employers are obviously best-placed to do this, often retaining employee benefits consultants (EBCs), typically retained on a fee, as opposed to commission, basis. The pressures EBCs are able to bring to bear on product providers – through the combined "access" to the accounts of the corporates they represent, and the detailed analysis of products they perform – can be considerable.

3.57 The advantages of workplace marketing diminish in smaller companies by their very nature. There is less opportunity for dedicated staff to be employed by the company to facilitate provision of such services, and EBCs do not tend to market themselves to smaller firms with less attractive economics for them. Where smaller firms do seek advice, they therefore tend to use IFAs. The selection of the IFA in this circumstance will be very similar to that by individual consumers. IFA remuneration will typically be through commission on sales – albeit potentially at a discount to individual rates to reflect the "captive" market and consequent lower distribution costs.

[14] See Chapter 5 for exact rules on stakeholder.

[15] See the lecture "In place of Micawber: empowering financial consumers", given by the Chairman of the Inquiry into Provision of Financial Information and Advice, July 2001.

3.58 It is clear that the workplace as a market place for retail savings products can deliver benefits, for the reason outlined above: that transaction costs can be reduced, leading to improvements in the efficiency of the industry, and more people can obtain access to savings. These benefits are reflected in the growing interest by providers and advisers in using this channel, and this trend is welcomed. However, the Review is not persuaded that there is any need for Government to intervene directly in this market by providing additional incentives, over and above those already present. Such intervention would not have consistent impact across the population of consumers, and would add complexity and therefore a burden, particularly to smaller employers.

Regulatory intervention

3.59 The analysis in paragraphs 3.4 – 3.19 above has set out a series of reasons why the savings market is difficult for consumers to understand. In response, regulatory intervention has sought to tackle the problem directly through:

- information disclosure of various types; and
- consumer education.

Key Features Documents

3.60 The analysis highlighted the difficulty that consumers face in obtaining clear and comparable information from companies about products. Considerable work is underway to improve the way in which information is presented to consumers, including through the ABI's Raising Standards initiative[16], the FSA's work on both point-of-sale and subsequent disclosure and Comparative Tables, and the Department for Work and Pensions' (DWP) pensions forecasting proposals.

3.61 In 1995, the Securities and Investment Board (SIB) introduced the "disclosure regime", and with it the Key Features Document (KFD).

3.62 The intended purpose of the KFD was to aid consumers in making comparisons between products when undertaking a purchase. The FSA regulates the KFD in terms of what information must be provided, and the style and structure of the document[17]. This is heavily prescriptive in parts (e.g. illustration of the effect of charges) but less so in other areas. The KFD describes the product and other important features, including what the customer will pay for it and how often, the risk profile, and the tax treatment. There are variations in the information required in a KFD depending on the type of product. Raising Standards has further clarification about the content and structure of information which firms have to meet to be compliant.

[16] The Raising Standards Quality Mark Scheme was launched in October 2000. It is a voluntary scheme open to all providers of pensions, protection, or investment business. The standards cover clarity and comparability of information, appropriateness of the product purchased, and quality of service. As of May 2002, nine brands were accredited, representing over 34 per cent of the life and pensions market (new business). Source: Pensions Protection Investments Accreditation Board.

[17] Conduct of Business sourcebook, chapter 6.

3.63 While there is evidence[18] that the cost of products has reduced since this disclosure regime was introduced, it is widely accepted that KFDs do not perform the function originally envisaged for them. FSA research[19] has found that most consumers do not use KFDs for shopping around. It revealed that many customers do not read KFDs, or only skim them; and those who do read them often have difficulty understanding the material and in some cases, misunderstand it.

3.64 In particular, in an advised sale, prevalent practice appears to be that the consumer is presented with the KFD of the recommended product only, towards the end of the advice process, once the decision on the product selection has largely been taken. Hence the KFD plays a limited part in assisting the customer to compare different products, or the same type of product across different providers.

3.65 The length and complexity of the KFDs appears in part the result of compliance concerns. By including all possible relevant information about the nature of the product in the KFD, providers (and intermediaries) feel they can be better protected against accusations of mis-selling. This issue of compliance "gold-plating" is an important factor in regulatory costs generally (see Chapter 5).

3.66 As a result, whilst there is widespread consensus that KFDs need to be stripped down if they are to be of use as comparison tools, the concern that consumers should have all relevant information has a tendency to prevent this.

3.67 These concerns have prompted the FSA to review point-of-sale disclosure and how it could be improved. A consultation paper is due later this year. The Review has recommendations to make to the FSA on this subject, which are set out in chapter 10.

Comparative Tables

3.68 Comparative Tables are a recent and significant intervention by the FSA seeking to empower consumers through the provision of better information. Comparative Tables were launched by the FSA in late 2001, initially covering investment products, with the intention that product coverage should extend over time. They are web-based, and are designed to help consumers compare similar products available from various providers, containing information mainly on product charges. They use Reduction in Yield (RIY) as the measure of cost, but shown in monetary terms rather than as a percentage, using projections of future return. They are considered in more detail in Chapter 7.

[18] From Personal Investment Authority (PIA) annual surveys.

[19] Research for the FSA by Reflexions Communication Research. See the FSA discussion paper "Informing customers: a review of product information at the point-of-sale", pp. 3–4 and Annex B, November 2000.

3.69 As part of its early set of consultations[20], the FSA identified that there was a lack of provision of clear, meaningful characteristics of products to enable comparison between them. Comparative Tables were therefore seen as an important tool in filling this gap. The FSA decided it should manage these tables itself – its public awareness objective includes "the provision of appropriate information". In addition, FSA provision was seen as the best source for this information, as its independence and lack of commercial pressures meant it did not encounter the conflicts of interest that a private provider might face. Consequently consumers were likely to place greater trust in information given by the FSA.

3.70 There are significant challenges in attempting to compile these tables. There is considerable underlying complexity in the area of charges, which is explored in Chapter 7. More broadly, because of the way that products and advice are bundled together in the retail savings industry, the FSA's Comparative Tables are in fact showing the costs of products together with advice, rather than the cost of the product alone.

3.71 A choice must be made between maximising accuracy and comparability on the one hand, and improving accessibility and comprehensibility on the other. Tables that enabled a full and accurate comparison of all retail savings products would be difficult for a lay person to understand. The FSA has rightly sought to strike a balance between extremes in this area, but these tables are still in their infancy and it is too early to judge definitively their success thus far.

Pensions forecasts

3.72 Rightly, there is concern that consumers lack information on the level of income their current savings behaviour and pensions arrangements will deliver for them in retirement. Individuals tend to over-estimate the amount of post-retirement income they will have, and therefore underestimate the extent to which they need to save.

3.73 At present, individuals can request a pensions forecast from the Pension Service which shows their basic state pension and any SERPS (or its predecessor scheme) they may have accrued. Separately, members of occupational schemes can also receive information on these arrangements. Members of DB schemes may request a benefit statement from the scheme, which will show the number of years of service, the accrual rate and pension that would result (assuming no salary increase) either on immediate retirement or on retirement at normal pension age. It will also give the value of the accrued death benefit. For a DC scheme, the member will be sent an annual benefit statement detailing the contributions they have made in the last year, and the total of the National Insurance rebate contributed to the scheme if they have contracted out.

[20] FSA, CP28, "Comparative information for financial services", October 1999.

3.74 From April 2003, DC schemes will be required to include a "money purchase illustration" in the annual benefit statement which will forecast the pension the member is likely to receive based on the contributions to date. This will mean that members of both DB and DC schemes will have their forecast benefits presented as an income stream.

3.75 The DWP is also planning to introduce a "combined pensions forecast", where the statement issued by pension providers includes the state pension forecast as well as the pension forecast relating to the scheme. This is a voluntary scheme which requires scheme members to consent to their personal information being disclosed by the DWP to their pension provider. Pilots were being run in early 2002 with the target to issue 15 million statements by 2005/06.

3.76 There are also complex issues to be resolved in producing these statements. For example, many people have saved in more than one pension and so will get statements from each provider making it difficult for them to distil the information into their total expected retirement income.

3.77 Nonetheless, the production of the pensions forecast is clearly a useful step forward which will help alert consumers to the need to consider their future savings requirements. The Review strongly supports the efforts of the DWP to bring these about.

Consumer education

3.78 Information is only of use to consumers to the extent that they can understand it. Survey work in recent years has pointed to poor levels of financial literacy in the UK:

- half the adult population cannot go beyond simple addition and subtraction[21];
- 50 per cent of people agreed or tended to agree that they found it difficult to understand financial leaflets and materials that they received[22]; and
- 30 to 40 per cent of people admitted to finding investment products complicated, compared to 9 per cent for savings accounts[23].

3.79 The need for financial management skills is becoming increasingly important. As well as the Government looking to individuals to make greater financial self-provision, the flexible job market and the greater propensity of individuals to change jobs during their working life is making financial planning more complex. The importance of financial literacy goes significantly beyond

[21] ONS, "Adult literacy in Britain", 1997.
[22] Financial Services Consumer Panel annual survey of consumers, "Consumers in the financial market", 2000.
[23] FSA Consumer Research 1, "Better informed consumers", April 2000.

enabling people to engage in the long term savings market. For example, the increasing demand for, and availability of, credit means that the need for skills in planning and managing debt is also growing.

3.80 This increasing need for financial literacy led the Government to give the FSA a specific remit in this area, with its statutory objective “to promote public understanding of the financial system”. In addition, consumer education is seen as one of the tools to enable the FSA to meet its second consumer-focused objective: “to secure an appropriate degree of protection for consumers whilst recognising their own responsibilities”.

3.81 The FSA’s overall regulatory agenda is to improve the fairness and effective working of the retail financial services market. Consumer empowerment, where possible, contributes to achieving both of these, and enables direct regulatory intervention to be lighter. Giving the FSA statutory responsibilities in this area therefore logically fits with its wider regulatory duties.

3.82 The FSA issued a consultation paper (CP15) in November 1998 setting out its proposals for consumer education. There are two overarching elements to this work: consumer education in financial literacy; and consumer information and (generic) advice.

3.83 In late 1998, the FSA put forward proposals on how financial education should be embedded in the school curriculum as part of the review of the National Curriculum for England that was taking place at that time. Subsequently personal finance education was introduced largely as a non-statutory part of the national curriculum in England in September 2000[24]. Arrangements for other parts of the UK differ, but all do, or are expected to, include personal finance education as part of the curriculum[25].

3.84 The FSA is seeking to provide support to the implementation process by:

- assisting in the development of educational materials such as “Money Counts”, which helps link the personal finance and numeracy curricula;
- hosting an annual education conference to raise awareness of the subject; and
- working with the educational charity Personal Finance Education Group (pfeg), which has launched a quality mark for accredited personal finance education resources, and raised funds from the financial services sector to be applied towards personal finance education in schools.

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[24] Most of the personal finance education falls within personal, social, and health education (PSHE), which is non-statutory. A small element falls under Citizenship, which will become compulsory at key stages 3 and 4 from September 2002. Parts of the mathematics curriculum (which is statutory) are also relevant to personal finance education.

[25] In Scotland, Learning and Teaching Scotland has put forward a position paper on financial capability in schools. In Wales, financial capability is part of personal and social education. In Northern Ireland, the curriculum is under review, with the expectation that personal finance education will form part of the mathematics programme of study.

3.85 The FSA has also developed a number of other initiatives aimed partly at addressing educational deficiencies in the short term, and partly at providing ongoing educational support for individuals once they have left school. These include:

- consumer helpline: this service provides general personal finance advice;
- consumer help website: plain language information and explanations of different financial products and services are posted;
- publications: the FSA has produced a number of consumer information booklets and factsheets, and distributes these through advice agencies, public libraries and post offices, as well as the website and helpline;
- promotion of services: the FSA has sought to raise its profile in providing information and advice through the media and exhibitions;
- workplace initiatives: seminars on financial education to run in workplaces are under development; and
- adult education: the FSA is developing online learning programmes.

3.86 The Review is entirely supportive of this work, which is clearly valuable. However, it is striking that, although the range of initiatives undertaken by the FSA is extremely broad, consumer education (together with the provision of information and generic advice) only accounts for less that 3 per cent of the FSA's budget.

3.87 In 2001/2, the FSA's budget for these activities was:

- £0.3m for schools activities;
- £2.7m for adult education and information, including publications; and
- £1.8m for Comparative Tables.

3.88 The Review recognises that there are competing demands for the FSA's resources. But while it is important to be realistic about how much consumer education can achieve, the expenditures directed towards improving standards of financial literacy are, by any measure, low. Additionally, the educational activities undertaken by the FSA are extremely wide-ranging and therefore complex to deliver. These are issues which the Review considers further in its recommendations.

Summary

3.89 The analysis of consumer issues has found that:

- while consumers are not a homogeneous group, they typically find retail savings products confusing and hard to understand, and have a low level of trust in the retail savings industry;
- similarly, once engaged in the market, consumers have difficulty in discriminating between the products on offer; and
- employers can play a helpful role as purchasers on behalf of their workforces, but it would be unrealistic to expect any significant expansion of this role.

3.90 It is therefore unsurprising that:

- consumers, particularly low income ones, are not saving enough; and
- they are able to exert limited influence upon the way the industry operates.

3.91 Government and regulators have sought to enhance the empowerment of consumers:

- the FSA has introduced Comparative Tables, although it is still too early to determine their effectiveness; and
- the production of pensions forecasts is helpful, although the combining of forecasts from individual providers would be a considerable further step forward.

3.92 The FSA has a wide remit on consumer education, but competition for resources within the FSA creates a danger that this work remains under-resourced and with too low a profile.

3.93 Clearly the underlying problem of consumer weakness is to an extent structural and inevitable. But the Review believes that progress can be made in this area partly through broader measures of simplification and greater transparency, and partly through specific proposals on the provision of consumer education. These are to be found in Chapter 10.

3.94 Consumer weakness has also had a very important impact on the development of the industry, through:

- the shaping of distribution structures to overcome consumer weakness and reluctance; and
- consequent regulatory intervention prompted by the need to protect consumers and by the way in which the distribution system works.

4 DISTRIBUTION

Introduction

4.1 Given the difficulties faced by consumers in discriminating across savings products, the distribution system plays a critical role in the savings industry. This chapter considers:

- the role that advisers play in distributing regulated financial products and services to consumers;
- the types of adviser that exist in the market;
- how distribution is paid for, and the important impact that this has on the behaviour of both advisers and providers, and on the functioning of the market more generally;
- trends in distribution, such as the growth of the Independent Financial Adviser (IFA) channel and the development of funds supermarkets;
- the polarisation regime and its proposed abolition; and
- the nature of competition in distribution and its implications.

4.2 There is a key basic distinction in distribution between sales that are in regulatory terms "advised" and those that are "not advised". The majority of sales in this market at present are advised, and most of the concerns about the distribution regime are raised by such sales. This chapter therefore considers mainly advised sales, although the non-advised or "execution only" process illustrates some interesting facts about the market, and is examined later.

REGULATORY DEFINITION OF ADVICE

The precise definition of advice is set out in the Financial Services & Markets Act 2000 (Regulated Activities) Order 2001, Chapter XII, Paragraph 53:

Advising a person is a specified kind of activity if the advice is:

(a) given to the person in his capacity as an investor or potential investor, or in his capacity as agent for an investor or a potential investor; and

(b) advice on the merits of his doing any of the following (whether as principal or agent):

(i) buying, selling, subscribing for or underwriting a particular investment which is a security or a contractually based investment, or

(ii) exercising any right conferred by such an investment to buy, sell, subscribe for or underwrite such an investment.

From a regulatory perspective, the provision of generic information is therefore not considered advice, but rather information.

Role of advisers

4.3 In practice, the role of the adviser includes a very wide range of activities:

- persuading consumers that they need to save;
- discussing broad financial goals with them;
- providing generic advice about products, investment, tax and the like;
- providing specific recommendations about specific products;
- executing the purchase of those products; and
- managing the savings portfolio on an ongoing basis.

4.4 Advisers are widely used because they bridge the needs of both providers and consumers. Providers wishing to sell retail savings products are confronted with consumers who:

- lack understanding of the products; and
- are reluctant to save.

4.5 Consumers face their own challenges:

- they may be so daunted by the overall complexity of the market that, to do anything at all, they feel the need to obtain advice;
- they may understand the basic types of product, but may conclude that the range of different products is so great that they need additional resource to research the market;
- they may understand the products on offer, but may wish to have specialist advice on product features, tax treatment or investment matters. Tax is particularly common as a driver of demand for advice among upper income groups; and
- they may be fully capable of doing all the relevant research themselves but, being time-constrained, would rather pay an intermediary to research, execute and manage their investments on their behalf.

4.6 The needs of both product providers and consumers are met by the distribution channel, and specifically by a widespread reliance on a face-to-face process. In this way, the adviser/salesperson is able both to persuade consumers of the need to save, and to assist them in overcoming the challenges of product selection and purchase.

4.7 The predominance of the "advised sale" has two important implications for the functioning of the market.

4.8 First, it transforms the nature of competition among product providers. Consumer weakness means that the majority of consumers rely heavily on their advisers. As a consequence, the real customer for the product provider tends to be the adviser, rather than the consumer.

4.9 Second, it has a fundamental impact on the economics of distribution. Advice inevitably has a significant fixed cost element. However modest a consumer's income and however simple his financial affairs, a certain minimum amount of time has to be spent gathering relevant information about him and informing him of all the options. While it will generally take longer to advise more affluent individuals with more complex needs, the increase in time is not normally proportional to the increase in wealth. A consumer with £100,000 to invest does not take ten times longer to advise than a consumer with £10,000 to invest.

THE ADVICE PROCESS

A "model" face-to-face advice process would typically include the following elements:

First meeting with customer

1. Terms of business letter issued to client (sometimes issued in advance of first meeting).
2. Fact-find, in which adviser would endeavour to establish:
    - basic details on customer;
    - income and tax position;
    - requirements (protection, pension, investment); and
    - customer's risk appetite (cautious, balanced, adventurous).

"Back office" functions, carried out by the adviser or support staff.

1. Adviser (or part-qualified paraplanner) reviews fact-find and analyses needs.
2. Quotations and "Key Features Documents" (KFD) are obtained from providers (or host company, if tied agent).
3. Quotation(s) reviewed against analysis of needs.
4. Adviser or paraplanner may produce "suitability"[1] letters in advance of second meeting.

Second meeting with customer

1. Adviser summarises previous interview, and confirms there have been no changes in circumstances.
2. Adviser explains the recommended product in detail, and tells customer the specific reasons for selecting this particular product and, if adviser is independent, the benefits of using this provider.
3. Adviser reviews the product illustration with customer and draws attention to commission disclosure.

[1] Conduct of Business 5.3.14R requires a written explanation of a recommendation relating to a product to be provided to a consumer. This is often called a "suitability" or "reasons why" letter. Independent intermediaries should include why a particular product provider has been recommended. Reasons may include product features not available elsewhere, price, service levels, performance track record, investment prospects, medical evidence terms, reputation and financial strength.

4. Adviser states projections.

5. Adviser produces “suitability letter” letter and confirms the fit of the product with the risk attitude of customer.

6. Customer completes the application form.

7. Adviser collects appropriate documentation from customer (e.g. identification documents to comply with Money Laundering Regulations).

8. Adviser collects payment (if appropriate) and gives receipt to customer.

Processing

1. Application form is passed to intermediary’s compliance department for checking. (If an intermediary is from a small independent firm, peer review may apply.)

2. Compliance department forwards application to product provider (or host company if tied agent) for processing.

3. If life policy, product provider puts policy on risk or declines the application.

Ancillary Tasks

1. In addition to the above, the intermediary often has to perform other “unseen” tasks. These might include:

   - liaising with product providers to chase applications;

   - liaising with GPs to chase medical reports;

   - reverting to client for further information; and

   - obtaining valuations on current investments.

Types of adviser

4.10 The structure of distribution in the UK has been defined by the so-called “polarisation regime”, which is considered in more detail below. The regime “polarises” advisers into two groups:

- tied advisers, who may advise on and sell the investment products of just one specified company. Crucially, responsibility for the advice given by a tied adviser lies with the product provider to whom the adviser is affiliated; and

- IFAs, who can recommend the products of any company, and do not represent any particular product provider. The IFA firm or its network (see below) are responsible for their own advice.

4.11 Both these terms embrace a range of different business models. Tied advisers can be further divided into:

- *direct sales forces (DSFs)*: traditionally, DSF salesmen have been employees of the product provider[2];

- *bancassurers*: these refer to high street banks who either manufacture their own savings products, acquire a producer of retail savings products or contract with one for whom they will act as an appointed representative; and

- *tied agents*: these are any individual or company that is legally distinct from the provider but has an exclusive arrangement with it to sell its products. Some tied agents are effectively self-employed full-time salesmen; others are professionals, such as accountants, who sell some savings products as an additional service to clients.

4.12 Equally, there are many different types of structure in the independent advice sector:

- *national firms*: large IFA firms with a comprehensive presence around the UK;

- *regional firms*: typically 10 to 70 registered individuals, concentrated in limited geographic areas;

- *local firms*: fewer than 10 registered individuals per firm. Many are sole practitioners; and

- *networks*: smaller IFA firms can become "appointed representatives" of IFA networks. The networks provide centralised services such as commission negotiation, product panel research and compliance, in return for a fee.

4.13 The IFA sector is characterised by a high degree of fragmentation. Of an estimated £3.4bn of IFA turnover[3], the top four IFA firms generate only 6 per cent[4]. Excluding those IFAs formerly registered with professional bodies, the number of active advisers stands at some 26,000, working in an estimated 11,000 firms. With 37 per cent of IFAs operating as sole practitioners, the reliance on networks has increased over recent years, with almost half of all registered individuals now network members.

4.14 This structure of savings distribution in the UK has seen considerable change over the last decade, with a sharp decline in DSFs and a growth in IFA numbers. The reasons behind these changes, and their implications, are considered in paragraphs 4.53 to 4.66 below.

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[2] Although in some cases the salesmen may in fact be, technically speaking, tied agents, as they are companies in their own right or self-employed individuals, contracted to the provider.

[3] B&W Deloitte.

[4] Financial Adviser/Matrix-Data, October 2001.

4.15 Irrespective of whether tied or independent, in the overwhelming majority of transactions, advisers are remunerated on the basis of commission.

DUTIES OF CARE AND SOURCES OF REDRESS

Any firm, whether a product provider, tied adviser or IFA, that holds itself out as providing financial advice to customers, is potentially liable under the general law for advice given without the exercise of due skill, care and diligence. Such duties of care arise under the laws of:

- *tort:* the general law of negligence may well apply to any financial adviser who holds himself out as having some expertise in the provision of financial advice. Firms have a responsibility to take reasonable care to ensure that advice is suitable for the consumer and a breach of that duty may give rise to a right to sue for compensation;

- *contract:* if there is an advisory contract between a firm and the consumer, then it may contain express terms about the standard of advice which the consumer can expect to receive; alternatively the Supply of Goods and Services Act, 1982, will imply a term into such a contract that advisory services will be carried out with reasonable care and skill;

- *misrepresentation:* misrepresentations by a firm in the course of providing advice or information may give rise to claims for compensation under either the Misrepresentation Act 1967 or for negligent misstatement at common law; and

- *statutory breach of duty:* under section 150 of FSMA, a consumer may have a statutory right of action for loss suffered as a result of a contravention by an authorised firm of rules made by the Financial Services Authority (FSA). This would include losses resulting from a contravention of rules designed to secure that recommended investments are suitable for private customers.

Consumers are, therefore, able to use the court system to gain redress in the event they believe they have been mis-sold to.

However, FSMA, Part XVI and Schedule XVII, provides for a "scheme under which certain disputes may be resolved quickly and with the minimum of formality by an independent person". This statute therefore provides specifically for the Financial Ombudsman Scheme (FOS).

The FOS provides a more efficient route for consumers to seek redress than the court system allows. The consumer's right to compensation under the FOS does not affect any other legal remedy. Hence, there is no requirement for the consumer to use the FOS, and the consumer may choose to sue through the courts instead. However, the consumer cannot be compensated more than once for the same loss.

To use the FOS, the complainant must have been a user of the services of a firm participating in the FOS scheme, and there must have been a culpable act or omission on the part of that firm. In the case of appointed representatives, the principal of the appointed representative (i.e. the product provider in the case of a tied appointed representative, or a network in the case of a network member IFA) is responsible for the acts and omissions of the appointed representative.

Commissions

4.16 The commission system of adviser remuneration is of fundamental significance to the operation of the retail savings market. In particular, commission has an impact upon:

- complexity;
- the functioning of the market in advice;
- the potential for adviser bias; and
- incentives to focus on higher-income consumers.

4.17 Most professional advice – for example, legal, private medical and accounting – is paid for by the consumer directly, typically on the basis of an hourly rate. It is noteworthy that this is not generally the case in the retail savings market.

4.18 There is some evidence that consumers of financial advice feel that fees, as opposed to commissions, are in principle preferable. Consumer research carried out for the FSA[5] found that the majority of respondents had a preference for paying a fee for the services of IFAs, based upon a concern that commission might bias advice.

4.19 However, the same research found that most consumers were not prepared to pay the level of hourly fee that fee-based IFAs are currently charging. The appropriate hourly fee suggested by consumers for IFA services ranged from £10 to £200 per hour, with an average of £70, against the range of fees actually charged of £120 to £250 per hour.[6]

4.20 In particular, respondents felt that advisers merited a lower level of remuneration than, say, doctors, dentists and accountants, for a variety of reasons:

- the level of training and knowledge is seen to be lower than for other professions;
- financial advice is not seen as having the same stringent regulations and requirements as other professions;
- the service of advisers is not seen to be as critical as the services of, say, the medical or legal professions; and
- advisers are seen as salesmen rather then service providers.[7]

4.21 Furthermore, adviser reluctance to offer a fee option to consumers is exacerbated by a misplaced belief in the industry that fees for financial advice always attract VAT, whilst commission does not.

[5] FSA, "Polarisation: Consumer Research – Report of research studies carried out by IFF Research Ltd, ORC International Ltd and NOP Solutions", January 2002.

[6] Interestingly, the same research found that few consumers that had used IFAs actually realised that it might be possible to pay a fee, and felt they had not been given that option.

[7] FSA, "Polarisation Consumer Research – Report of research studies carried out by IFF Research Ltd, ORC International Ltd and NOP Solutions", January 2002.

PAYMENT OF VAT ON IFA FEES

There is a widely held belief in the industry that customers are liable for VAT on fees for financial advice, but not on commissions. This is incorrect. Guidance from HM Customs and Excise states as follows.

To assess the VAT liability of the adviser's service, he should establish first what the consumer is seeking:

1. *advice only; or*
2. *execution only; or*
3. *a mixture of both advice and execution (or is not sure).*

The method of charging for a service, for example by fixed fee or hourly rate, makes no difference to whether or not VAT is charged. It is important to establish what is being supplied to the consumer.

Financial advice is taxable. Therefore, where the adviser gives only financial advice to the consumer, VAT will be due. For example, a client might request a valuation of current pension arrangements. However, the execution of the purchase of many financial services is exempt from VAT, provided that the product is classified as exempt.

In most cases, consumers will approach advisers with the intention of receiving both advice and execution services, and are unsure what product they require. Where that advice directly results in the consumer taking out an exempt product (listed below), **the whole service is exempt from VAT**, the advice being ancillary to an overall execution service. Even if the consumer intended to take out a product listed below but at the last minute changed his mind, the supply may still be exempt, as long as the execution activity was still the predominant part of the service.

Occasionally, the advice given far outweighs the work done to arrange a contract (for example, because a consumer has received a general financial health check, with advice covering a range of financial issues, but then only buys a minor product requiring minimal intermediation). In these circumstances, which would be rare, the execution service is ancillary to the advice, and VAT is due on the whole service. HM Customs and Excise will look carefully at cases where this rule is being misused solely to achieve the best VAT result by misrepresenting the predominant service.

The exemption for execution services depends on what financial or insurance product is eventually taken out. For example, under current policy, exemption applies to the arrangement of mortgages, share investment, loans, credit, bonds, stocks, insurance, pensions provided by insurance companies, and currency.

This would clearly include the products of authorised unit trusts, oeics, investment trust companies and life savings products.

4.22 It is certainly the case that fees are not widely used. The FSA has found that only around 10 per cent of IFA income comes from fees. Fees are almost entirely unknown in the tied sector.

4.23 The traditional market solution to the remuneration of advice has been commission, a form of payment with two key features:

- it is contingent on a sale; and
- it is a payment from a product provider to a distributor, not from a consumer to a distributor in the first instance. (In practice, the consumer is the ultimate source of payment for the advisory services, through the various charges levied upon the investment[8].)

4.24 In practice, a wide range of variants on the pure commission theme are observable. Some DSFs are remunerated with salaries and bonuses relating to sales levels. And, in the case of many IFA firms, the provider will pay commission to the firm, although individual advisers may receive a salary plus a sales-related bonus. However, the incentives created by such arrangements for the individual adviser are broadly the same as those generated by commission.

4.25 The commercial attractions of this commission-based system are obvious:

- it allows advisers to offer advice and consultation which appears entirely free. This is highly effective in attracting otherwise reluctant consumers;
- yet at the same time it allows advisers to be paid for their services, which consumers would otherwise be unwilling to do, by wrapping up the costs of commission in the product charges; and
- it also creates sharp sales-related incentives for the adviser, which meets the needs of the product providers.

4.26 At the same time, a commission-based system raises a number of serious concerns.

Complexity

4.27 Commission adds significantly to the complexity of the retail savings market. Its structures are complex, with extensive use of confusing terminology. It may take the form of a single initial payment, known as "front-end" commission. This is further divided into "indemnity" and "non-indemnity" commissions:

- "indemnity" commission relates to regular premium business, whereby commission is paid by the product provider on the assumption that the premiums will continue to be received for long enough to recoup the costs of commission from the customer. If the customer stops contributions prematurely, the adviser is obliged to repay commission to the product provider.

[8] A recent exception to this has been the stakeholder pension, for which product regulation has limited the amount of charges that can be deducted from the consumer's premiums. Some providers have therefore funded the costs of commission from other internal resources.

4.28 Alternatively, commission may be a series of annual payments. These are known as "renewal" (for regular premium business) or "trail" (for single premium business) commissions, and their payment may be instead of, or in addition to, "front-end" commissions. "Renewal" commissions may be set at a level percentage of premiums, or may vary, according to some formula, over the life of the policy.

4.29 This complexity has multiple effects:

- it adds to consumer confusion generally;
- it makes it extremely difficult for consumers to understand how much the adviser with whom they are dealing is being paid; and
- it has a significant impact on product provider costs and efficiency, because of the requirements that it places upon providers' IT systems.

Functioning of market for advice

4.30 Commission also contributes to a widespread confusion about the nature of market interactions. Distributors are described as being in the business of providing a series of services to consumers generally referred to collectively as "advice". Yet because of their remuneration arrangements, one might more accurately describe distributors as being paid for delivering sales of the providers' products. In order to be able to deliver these sales, distributors provide consumers with a range of free services (including advice, persuasion and execution assistance). But the consumer, in most cases, neither values nor understands these services properly.

4.31 This prevents the creation of a properly functioning market in the provision of advice. The consumer does not set the price for advice, is broadly unaware of what it is costing, and may not even be aware that he is receiving it. The consumer is not in a position to judge whether or not he is getting value for money. Cost-effective, good quality advice is therefore not directly rewarded.

4.32 This is compounded by the way in which consumers are informed about the adviser's remuneration, which can happen at two points:

- first, when the "terms of business letter" is issued at the start of the process; or
- second, after the adviser has recommended a product to the client (i.e. near the end of the process).

DISCLOSURE OF CHARGES

The FSA's Conduct of Business Rules (Chapter 5) require that, before a firm conducts designated investment business with or for a private customer, the firm must disclose in writing to that private customer the basis or amount of its charges for conducting that business. Before effecting a transaction, independent advisers must disclose to customers any remuneration or commission in connection with the transaction, whilst product providers must disclose any remuneration payable to their employees or agents.

However, in the case of the purchase of a life policy, where a firm provides the customer with a KFD, the requirement to disclose remuneration or commission before a transaction does not apply, provided that the firm discloses to the consumer the actual amount or value of remuneration or commission within five business days of effecting the transaction.

These disclosures should be made in a manner that is clear, fair and not misleading[9], and should normally be made in writing. There is no requirement for commission to be disclosed orally.

4.33 Terms of business letters for some commission-based IFAs describe commission as "paid by the product provider". Whilst this may be legally true, it does not assist the consumer in understanding that, ultimately, he is funding the cost of advice. Such wording clearly creates the impression that this is a sum funded by the provider of the product, at no cost to the consumer.

4.34 The FSA provides guidance on content and wording[10] but, other than stating that cash terms must be used, product providers may use their own descriptions and format, providing they are clear, fair and not misleading. This has not entirely prevented the use of confusing language – some examples of descriptions of charges encountered by the Review include: "commission enhancement factor", "actual commission rate entitlement", and "non-indemnity initial commission payable".

4.35 The timing of commission disclosure at the end of the sales process, and the fact that commission is disclosed within the KFD, also contribute to consumers failing to comprehend how much their adviser is remunerated for distributing a product. The Review has heard from distributors that consumers seldom read more than the front page of a KFD. It is unsurprising, therefore, that FSA research has demonstrated that consumers have a poor understanding of the cost of commission, and the fact that they bear this cost[11].

4.36 The industry has often argued that the practice of "commission rebating" shows that there is effective competition for advice. This is the practice whereby advisers arrange for part of their commission received to be paid back to the consumer. Data on regular premium personal pensions business show that rebating is now more common, with 63 per cent of new business weighted by volume of business being charged full commission in 2000

[9] Conduct of Business 2.1.3R.
[10] Conduct of Business 5.7.5R.
[11] FSA, "Polarisation: Consumer Research - Report of research studies carried out by IFF Research Ltd, ORC International Ltd and NOP Solutions", January 2002.
[12] Personal Investment Authority (PIA) Disclosure Survey, conducted January 2001.

(1999: 80 per cent)[12]. It is believed that low charges on stakeholder pensions have led to advisers offering commission rebates on other, non-stakeholder pensions products in recent years.

4.37 More generally, product providers estimate that between 20 and 30 per cent of transactions on non-pensions life fund investment and savings products involve some degree of commission rebating, although what proportion of the commission is rebated is unclear. Furthermore, this estimate includes fee-based business (which accounts for some 10 per cent of IFA revenues) and execution-only transactions. While this would indicate a reasonable level of consumer awareness of the availability of rebates, it is not sufficiently compelling to counteract the anecdotal and survey evidence that pricing pressures in the commission-remunerated advice market are limited.

4.38 In an ideal world, financial advisers would compete intensely against each other on the basis of the value for money that each was delivering to customers – specifically, the quality of advice relative to its cost. In this way, the best advisers would prosper at the expense of the worst. In an industry in which consumers are unusually reliant upon the advice of intermediaries, a well-functioning market for advice is particularly desirable. The reliance upon remuneration via commission, coupled with poor consumer understanding of the true costs of advice provision, mean that today's reality is a long way from the ideal.

Consumer detriment

4.39 The focus of public policy concern to date on commission has been largely upon the potential for provider and product bias created by the commission system. Prima facie, the fact that different providers remunerate advisers at different rates for selling different products creates the concern that this will lead to consumer detriment through the sale.

4.40 IFA firms argue that this is mitigated through the use of the product panel system. This refers to the creation of a panel of preferred products by the firm's in-house research department, or by third party suppliers of independent information. The panel process is generally rigorous, taking into consideration such factors as service standards and product design. The FSA believes it is best practice that commission should not form part of the panel criteria.

4.41 However, the Review is not persuaded that, in practice, commission bias is overcome by the panel system. Larger IFAs refer to commission negotiation as the second stage in the panel selection process, and product providers described commission levels to the Review as "part of the product mix". It appears that should other aspects of the product not be satisfactory (one provider, for example, cited poor investment returns), increasing commission levels can often enable a provider to remain on a panel. This would suggest the commercial interests of the distributor can take priority over the financial interests of consumers.

4.42 The Review was also frequently told that market norms around commission levels have developed, particularly in the with-profits market, to which product providers have to conform if their products are to be sold. When one provider raises commission levels in order to gain sales volume advantage, the remainder tend to follow. Product providers confirmed to the Review that changing commission levels in the with-profits market resulted in correlated changes in sales volumes. The result, therefore, is upward pressure on commissions.

4.43 Research carried out for the FSA[13] as part of the depolarisation review confirmed the existence of both product and provider bias in certain areas:

- time series data found both product and provider bias in with-profits bonds; and
- a mystery shopping exercise found that around 15 per cent of consumers were recommended a product which was considered unsuitable by an independent panel and had higher commission levels.

4.44 The depolarisation review concluded that commission bias is causing consumer detriment in the region of £140 million a year. As this is based only on those cases where the researchers found significant bias, it was considered by the depolarisation review that this figure is likely to be an under-estimate.

Focus on higher-income consumers

4.45 There is inevitably an important element of fixed cost in the process of one-to-one interaction. Yet with present commission practices, income to the adviser is directly related to the size of the sums invested. Wealthier customers are therefore inherently more profitable and hence more attractive to advisers. This means that the market has a natural tendency to target the more affluent. Chapter 5 discusses the impact of regulation on distributors' costs in more detail, and the consequences for access to advice for the mass market generally.

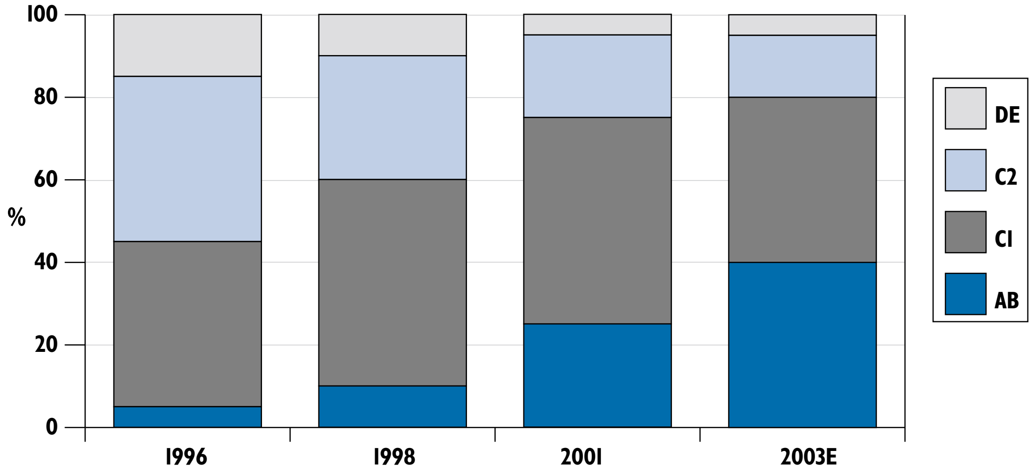
4.46 This tendency towards the more affluent is increasing due to:

- downward pressure on pensions commission levels because of the introduction of stakeholder pensions, which are price-capped. With lower levels of commission, the need to focus on higher-income consumers is more acute; and
- rising costs of distribution (set out in Chapter 5), which have a similar effect.

[13] Charles River Associates Ltd, "Polarisation: research into the effect of commission based remuneration on advice", January 2002.

4.47 Recent research conducted by an IFA network supports these observations. As shown in Figure 4.1, AB consumers accounted for 23 per cent of the customer base of this network in 2001 (c.f. 4 per cent in 1996), with this figure projected to rise to 40 per cent by 2003.

Figure 4.1: Socio-economic breakdown of consumers purchasing through IFAs



Source: Berkeley Independent Advisers Limited.

Recent trends in commission structures

4.48. Accurate information on commission levels is extremely difficult to obtain: not only is it of considerable commercial sensitivity, but practices such as rebating mean that raw data usually require modification if they are not to be misleading.

4.49 Such evidence as the Review has been able to gather suggests that two trends are at work:

- a fall in commissions for pensions products; and
- a rise in commissions for certain types of bonds, in particular with-profits, unit-linked and distribution bonds.

4.50 Returns to the Personal Investment Authority (PIA) demonstrated that rebating of commission on pensions products has increased substantially: the percentage of new regular premium personal pensions business written through IFAs (weighted by volume of business) where full commission was charged reduced from 80 per cent in 1999 to 63 per cent in 2000[14]. It is generally accepted that the main cause of this is the introduction of price-capped stakeholder pensions. Other data show that commission offered by product providers has also reduced in recent years. Between 1995 and 1998, commission offered on a 25 year Personal Pension Plan (unweighted) stood between 64 per cent and 67 per cent of the first year's premiums. In 1999, this fell to 56 per cent, and in 2000 to 40 per cent.

[14] PIA Disclosure Survey, conducted January 2001.

4.51 The rise in commissions for investment bonds is less well documented, but it is an assertion which the Review heard on numerous occasions in discussions with both distributors and product providers. It was suggested that commissions for these products had risen by between 10 and 20 per cent over the last five years.

4.52 The likelihood is that this reported rise in commissions reflects, at least in part, the exercise of market power by distributors seeking to compensate for the fall in income from pensions commissions. This is consistent with a picture of the distribution market in which customer pressure on the price and quality of advice is weak.

Changes in the structure of distribution

4.53 This section considers the series of changes seen over the last decade in the structure of distribution:

- the decline of DSFs;
- a corresponding growth in the importance of the IFA channel;
- the appearance and rapid growth of IFA networks;
- the appearance of funds supermarkets; and
- growth in execution-only business.

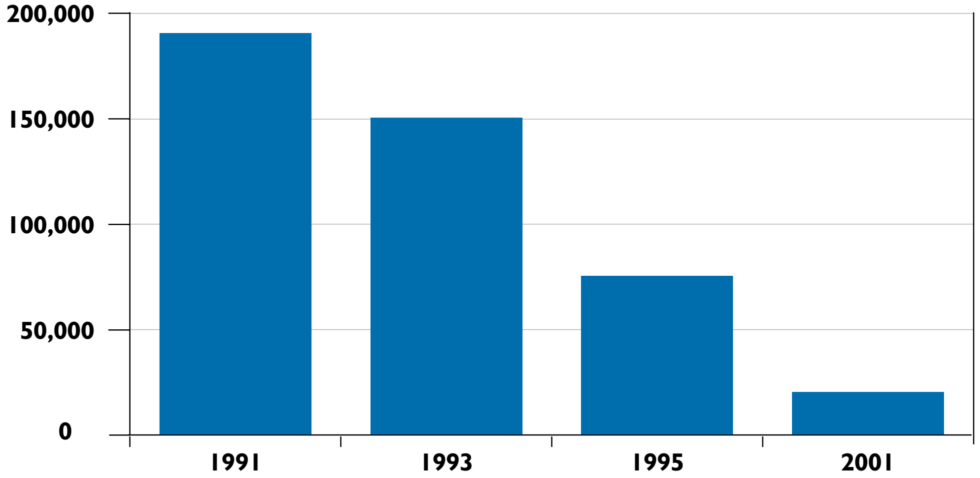
4.54 These changes have arisen as a result of several factors:

- greatly increased regulatory pressure on distribution, which has put particular demands on DSFs;
- partly as a consequence, an increasing shift towards higher-value transactions with wealthier consumers, whom IFAs are better placed to reach because of their wider product range;
- with the growing market opportunity available to the fragmented IFA sector, the emergence of networks, seeking economies of scale in the absence of outright mergers of IFA firms;
- internet technology driving the appearance of funds supermarkets, which in turn has fuelled the growth of execution-only business; and
- execution-only business as a market response to the practice of bundling advice with sales, enabling consumers who do not want advice to access products more cheaply.

Decline of DSFs

4.55 Since 1991, it is estimated that the number of registered individuals in DSFs has reduced from 190,000 to around 20,000. Some caution does need to be applied in interpreting these figures as in the early years companies registered many employees who did not provide advice to consumers and have since been deregistered. Nonetheless the number of advisers operating in DSFs has reduced dramatically over the last ten years.

Figure 4.2: Life office company representatives



Source: Cazalet Financial Consulting, Life 2001.

4.56 The decline reflects a series of decisions by many life companies either to reduce substantially their reliance on DSFs, or to exit the channel altogether. This has been driven by three key weaknesses of the channel:

- failure to appeal to higher-income customers;
- high turnover of staff; and
- high compliance costs.

4.57 It is difficult for DSFs (or indeed any tied adviser) to target successfully the more profitable higher-income customer segment, with its more complex and demanding requirements. In a polarised regime DSFs have a more limited product range.

4.58 This has contributed to a separate problem: the high turnover of DSF staff. It has been common practice for an individual wishing to become a financial adviser to start with a large DSF employer in order to get the necessary training, and then to become an IFA and gain the opportunity to pursue wealthier and more profitable customers. Annual staff turnover rates of 100 per cent were not unheard of in DSFs in the early 1990s. This resulted in ongoing recruitment and training costs, and a continuing low skills level – which perpetuated the poor competitiveness of the DSF channel.

4.59 Perhaps most importantly, compliance costs have become considerably higher for DSFs than for IFAs:

- in a typical large IFA firm, perhaps one-third of sales are checked by the compliance departments; for some DSFs, 100 per cent of cases are checked; and
- a study for the ABI[15] argued that supervision costs for DSFs at £6,400 per adviser per year were 40 per cent higher than for IFAs.

[15] Oliver, Wyman & Company, "The future regulation of UK savings & investment: Targeting the savings gap", September 2001.

4.60 This reflects a number of factors:

- DSFs have historically had a higher incidence of mis-selling cases, partly because of their lower skill levels and greater focus on lower-income groups. They therefore attracted greater levels of regulatory attention, creating in turn a more interventionist compliance culture within their firms; and
- legal responsibility for DSF mis-selling lies with the provider. Many providers, particularly those active in other financial services businesses, are keen to protect their brand from the resulting reputational risk and are willing to incur additional compliance costs. IFAs are not under the same constraint and, in any event, have less resource to expend in this way.

Importance of IFAs and networks

4.61 Since many life companies took the decision to disband their DSFs, they have increasingly focused on the IFA sector. In 2000, IFAs accounted for 55 per cent of sales of life products by value. IFAs are also an important channel for the unit trust industry, generating between 45 and 50 per cent of sales in the unit trust and oeic market[16].

4.62 The dominance of IFAs, as measured by value of sales, should not be misunderstood. IFA sales of life products are only 20 per cent of the market by volume, reflecting their focus on wealthier individuals. When coupled with data showing falling penetration of pensions products, this has led to concerns that lower-income consumers are effectively being disenfranchised by the shift away from DSFs. This is one of the concerns behind the FSA's proposals for depolarisation.

4.63 Nonetheless, a shift to IFAs also means a move to a more fragmented distribution system. 37 per cent of IFA firms have a single registered individual, and the average number of registered individuals in a firm has been estimated to be 3.7[17]. This has important implications for the industry's capitalisation and ability to invest in technology.

4.64 IFAs have sought to remedy this through the use of networks. In the late 1980s, IFA networks formed to provide smaller IFA firms with compliance and administration services. These included DBS (now part of Misys Financial Services Division) and Tenet Group. Memberships of these two networks alone stand at 8,500, or more than 30 per cent of active independent advisers who were formerly PIA registered. It is estimated that around half of all IFA registered individuals are now network members. Many of the former DSF sales staff who have become IFAs have chosen to do so via membership of a network, in order to satisfy the FSA's training and competency requirements. It is believed that, whilst in the last 10 years, the number of registered individuals has remained broadly the same, the number of firms has reduced by over half, as networks and national firms have become more prominent. The top 25 IFA firms now account for 71 per cent of the IFA market[18].

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[16] FSA Consultation Paper (CP) 121, "Reforming Polarisation: Making the Market Work for Consumers", January 2002.
[17] B&W Deloitte.
[18] CGEY, "UK Mutual Funds - The Way Forward", 2001.

4.65 More recently, networks have also sought to develop technology solutions, in an effort to increase the productivity of their members. It is recognized that technology has the potential to streamline the processing of policy applications, speeding up the "back office" tasks, and allowing IFAs to spend more time in face-to-face sales activity. Additionally, technology allows "non-compliant" policy applications to be automatically halted, thus reducing the burden on the compliance department and the time taken to correct application forms.

4.66 However, progress has been hampered by a number of factors:

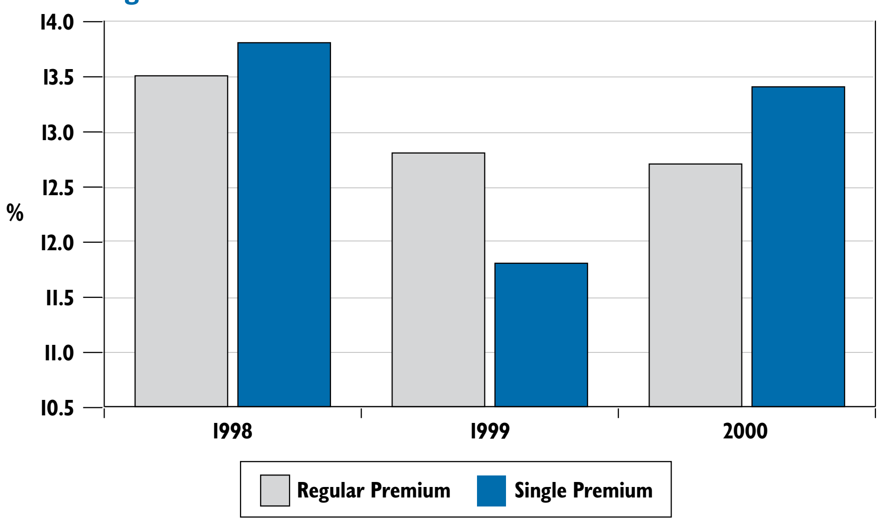
- IFA firms typically lack capital, because of their size;
- the large number of firms makes coordinating common IT standards very difficult;
- developing technology solutions also cannot be done without close involvement from providers, which multiplies the co-ordination difficulties; and
- the plethora of legacy systems within providers supporting products which are no longer actively sold has also proved a barrier.

BANCASSURANCE

The emergence of bancassurers as the dominant players in the retail savings market has often been predicted, on the premise that a banking operation provides a client base and "warm leads" for the marketing of regulated products. The operation can become a "one stop shop" for all of the financial needs of its customer base. As banking customers display considerable inertia in moving bank accounts, a long-term relationship can develop, to be exploited by cross-selling regulated products.

In reality, this dominance has failed to materialise. The numbers of registered individuals in the bancassurance arena has been relatively stable over the last 10 years. The bancassurance share of the market actually declined between 1995 and 1999, although has since stabilised (in terms of premium value rather than numbers of transactions), at around 13 per cent (Figure 4.3).

Figure 4.3: Bancassurance share of new individual business



Source: Cazalet Financial Consulting, Life 2001.

This compares unfavourably with other European markets. For example, in France, commercial banks have 24 per cent and mutual banks 37 per cent share of the market. In Germany, banks take an even greater share of the market, with a 74 per cent total share[19].

Various reasons have been given for the failure of bancassurance to develop a greater presence in the UK:

- there have been cultural inhibitors: retail banking staff have been reluctant to pass on leads to the regulated sales entity within the bank, which can be regarded as a competitor for the business of the customer;
- retail banking staff have historically been targeted with quotas of leads, regardless of their quality. Hence, many leads were of poor quality (low persistency, no identifiable need, affordability issues, etc);
- banks sought initially to manufacture products as well as distribute them, and have found it difficult to generate sufficient volumes to make this activity cost-effective; and
- the banks to some extent have suffered from competition from IFAs for their target market of the "mass affluent".

Looking forward, it is widely argued that bancassurers are now likely to develop a much stronger position in the market. A recent shift in their emphasis away from manufacturing towards simply being distributors should make them more cost-effective. Also, many commentators argue that they would be beneficiaries of depolarisation, if the limitation on the range of products they can presently offer is removed.

Funds supermarkets

4.67 The growth of funds supermarkets illustrates the potential for technology to drive efficiency improvements in the industry. These are distribution platforms that offer a wide range of retail investment products, primarily unit trusts and oeics, from a number of different providers, together with administration to benefit both the intermediary and investor. They are essentially web-based. The Review welcomes this development, with its potential to improve efficiency through automation.

4.68 Among the leading players are FundsNetwork, set up by the US fund manager Fidelity Investments, Cofunds (M&G, Jupiter, Threadneedle & Gartmore), Skandia and Egg. FundsNetwork, focusing only on investment funds, and Egg, which as part of an online bank offers a wide range of retail financial services, illustrate the range of different offerings.

4.69 It should also be noted that not all funds supermarkets operate in the same way. For instance, FundsNetwork provides a complete online service to direct investors. Conversely, Cofunds does not deal directly with the public and emphasises the benefits it can bring to the intermediary, including convenience in execution of investments and the provision of all valuation and other back office services at no cost.

[19] Arthur Andersen.

4.70 It is estimated that approximately 50 per cent of IFAs have formed a relationship with either FundsNetwork, Cofunds or Skandia. In August 2001, seven months after launch, Cofunds estimated that they had achieved market shares of 6.3 per cent of IFA Individual Savings Account (ISA) sales and 5.8 per cent of Personal Equity Plan (PEP) transfers.[20]

4.71 Funds supermarkets derive their income from fees negotiated with fund managers for the distribution and administration of their funds. The service is normally free for both intermediaries and investors. The revenue stream is usually agreed as a share of the initial load plus a percentage of the annual management charge.

4.72 There is also a strong link between the development of this channel and the growth in execution-only business.

Non-advised sales

4.73 Execution-only sales are those which, in regulatory terms, have no advice accompanying them. When making execution-only sales, firms are not permitted to discuss the product's suitability or the customer's circumstances. When buying without advice, the consumer forfeits several rights, including:

- the right to complain if the product is unsuitable;
- the right to compensation if the product is unsuitable; and
- except in the case of life insurance and personal pensions, the right to cancel the product during a cooling-off period.

4.74 Available figures show that only 5 per cent of life and pensions business is sold on an execution-only basis. The figure for unit trusts/oeics is somewhat higher, at 20 per cent, reflecting the generally higher levels of financial sophistication within unit trust/oeic consumers who, as a result, are more confident making purchases in this way. The value of non-advised unit trust/oeic business has grown considerably in recent years, assisted by the development of on-line funds supermarkets.

4.75 Execution-only transactions may be delivered through call centres[21], with consumers responding initially to advertisements or mailshots. They may also be made via the internet. Generally, product providers use call centres to offer simple products, as these have to be easily explained and understood over the telephone, and followed up with very simple literature. The complexity of certain life products, therefore, makes this form of distribution unsuitable.

4.76 However, IFAs also increasingly offer execution-only business. In particular, a number, including some who are web-based, have developed "discount broking" businesses, which rebate a sizeable portion of their commission

[20] www.cofunds.com.

[21] Although not all call centre business is execution-only. The call centre staff may well include advisers who are qualified to provide regulated advice (i.e., have achieved the Chartered Insurance Institute's Financial Planning Certificate Paper 3, or equivalent).

either directly to the customer or back into the product. Indeed, some online services are regulated IFAs who conduct largely execution-only business. Funds supermarkets form an important part of the business model of these distributors. Since the figures stated for execution-only business do not capture these transactions, it is likely that the market shares cited in paragraph 4.74 understate the true extent of execution-only business.

4.77 Execution-only sales through discount brokers are typically cheaper than buying directly from the provider, reflecting the fact that the discount brokers have economies of scale in dealing with the providers which an individual consumer lacks.

4.78 However, further examination of the direct purchase route reveals a striking anomaly in the retail savings market. A consumer purchase direct from a provider generally attracts the same level of charges as when the product is purchased from an IFA. This is despite the fact that the charges are designed to cover the costs of commission, which in the case of the direct purchase, are not incurred by providers. Indeed, to the extent that the IFA may rebate a portion of the commission, it can actually be cheaper to purchase "retail" (through an IFA) than "wholesale" (direct from the provider).

4.79 The Review has learned that product providers operate in this way because IFAs are generally reluctant to sell products that consumers can buy more cheaply elsewhere. In part, this may reflect a concern amongst IFAs that they will be sanctioned for advising clients to buy a product when they are aware that the same product can be bought more cheaply directly from the provider.

4.80 This anomaly reflects the distorting effects of bundling the costs of advice in with the pricing of the product. In reality, it should be entirely proper for a product sold through an IFA to be more expensive than one bought directly, as the former includes the cost of advice. That this is not, in general, the case points to a market failing arising from the opacity of pricing.

Polarisation review

4.81 Polarisation is one of the key drivers of the structure of distribution. In March 2001, the FSA concluded its first stage in reviewing polarisation, and implemented two changes to the existing regime:

- removal of direct offer[22] advertising from the scope of polarisation rules; and
- the opportunity for product providers to "adopt" stakeholder pension products from other sources and to sell them through their distribution channel.[23]

[22] Conduct of Business Rules, 3.9 – Direct Offer Financial Promotions

[23] The Financial Services (Conduct of Business) (Modification of Polarisation) Rules 2001, Rule Book Amendments and Additions Release 216, March 2001.

CP121

4.82 In January 2002, the FSA issued Consultation Paper (CP) 121, "Reforming Polarisation: Making the Market Work for Consumers". In this paper, several "market failings" were identified:

- competition in the industry centres on providers' abilities to secure IFA distribution through use of the commission system. Differentials in commission levels can result in IFAs recommending unsuitable products. This misalignment between adviser incentives and the consumer's financial objectives can, therefore, result in consumer detriment;

- consumers generally fail to shop around for advice and hence do not make cost comparisons, whilst consumers in the lower socio-economic groups are less likely to access advice at all. Where they do seek advice, lower socio-economic groups tend to use tied channels, where product choice is limited. The FSA concluded that the polarisation regime had, therefore, not delivered good value for many middle-market consumers;

- consumers in lower income groups, who could be acquiring investment products, are unable to access advice within the current regulatory framework. They therefore risk making inadequate provision for their financial future and, in particular, for retirement; and

- the bundling together of the cost of advice and the cost of the product prevents consumers gaining a proper understanding of the role of advice and its cost.

4.83 The core proposals outlined by CP121 are as follows:

- polarisation should be abolished and new enhanced disclosures should be introduced;

- 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. Thus the term independence would be redefined[24];

- limits on product provider investment in IFA firms that currently trigger the "better than best"[25] rule should be abolished. Independent firms should disclose to consumers any stake a product provider has in the firm or in connected firms; and

[24] On CP121's proposal IFAs would not be able to continue to use the word "independent" if they dealt with any clients only on the basis of commission remuneration for packaged products. If an adviser wanted to use the title "independent", he would have to enter into a defined payment agreement with all his customers at next contact with them and before any chargeable work was undertaken.

[25] Conduct of Business 5.3.9R and 5.3.10R: an IFA must not recommend a product from a "connected provider", unless it would be more suitable than another generally available product. A "connected provider" has a direct or indirect holding which represents 10 per cent or more of the capital or voting power of the IFA, or has a direct or indirect holding in the undertaking which makes it possible to exercise a significant influence over its management.

- steps should be taken to streamline the advice process and construct a "buyer's guide" to make consumers better informed and more confident in choosing an adviser.

4.84 Further to these core proposals, the FSA also put forward for discussion the following measures:

- a two-tiered system of advisers, with the lower tier of less qualified advisers, advising on only a limited range of lower risk products; and
- proposals for the unbundling of the cost of advice or marketing from the cost of the product.

4.85 The aim of these proposals is a regime that will be less restrictive of competition than polarisation, without eroding consumer protection.

4.86 Remuneration via a defined payment system is designed to eliminate commission bias. If IFAs are unable to negotiate their remuneration arrangements with product providers, an incentive to sell inappropriate or unsuitable products is removed. Also, if the correct advice is "do nothing", the adviser will still be remunerated, and therefore not incentivised to sell an unsuitable product.

4.87 Enhanced disclosure, and in particular the unbundling of the costs of advice from product charges, is intended to make customers more aware that they are paying their financial adviser for his services, thus increasing their sensitivity to the value being delivered.

4.88 The proposal for a lower tier of adviser and a streamlined sales process is aimed at increasing provision for the mass market, by reducing the cost of distribution to this segment.

The Review's assessment of CP121

4.89 The Review agrees with the analysis of the market in CP121 and welcomes the thrust of CP121's proposals. It believes that the proposal to remove polarisation and associated restrictions such as "better than best" is appropriate, as the distinction distorts competition and does not appear to provide particularly effective protection for consumers. Depolarisation will help improve the range of products open to consumers and should also lead to improvements in distribution efficiency by enabling greater investment in distributors.

4.90 At the same time, the Review believes there are residual areas of concern. In seeking to create a new definition of "independence" that addresses the concerns about commission bias, a tradeoff must clearly be made. The closer the definition is to a requirement to be fee-based, the more effectively these concerns will have been addressed. However research suggests that in practice consumers are unwilling to pay the necessary level of fees for financial advice. So if the definition of independence is too strict, there is a danger that independent status would become unattractive to all but a tiny minority of IFAs. This would leave most consumers to continue to be advised by commission-remunerated advisers, with all the concerns that this generates.

4.91 The Review is concerned that the concept of a "defined payment system", while having much to recommend it, is likely to be too restrictive. It believes that an alternative is needed which seeks to address the unsatisfactory aspects of the present system of remuneration, but in a more flexible way. A recommendation along these lines is set out in Chapter 10.

4.92 The proposed "lower tier of adviser", who would operate in a restricted product regime, is intended to reach segments of the market that are currently economically unattractive. Reducing the training and competency requirements on these advisers should certainly reduce distribution costs to a degree. However, the Review does not believe that it will be practical to reduce the costs of the sales process in any significant way, consistent with retaining the duties to provide suitable advice and to "know one's customer" as presently set out in the Conduct of Business rules. If the lower tier adviser is limited in what he can say to persuade consumers that a product is suitable for their needs, he is unlikely to be successful in persuading consumers of the need to save at all.

4.93 The Review's thoughts on CP121's proposals are presented in more detail in Chapter 10, which deals with recommendations. The Review's objective is to create a clearer economic relationship between an independent adviser and his client, in preference to the present state of affairs, in which the adviser's principal economic connection is with the product provider. It is also concerned to dispel the current opacity as to who is paying for what services, and how much, by creating a market which ensures that consumers understand that advice has a value for which they should pay a price.

Summary

4.94 Although execution-only business is growing in importance, the bulk of sales of retail savings products continue to be through commission-remunerated advisers. This approach, while an understandable and in many ways highly effective response to the difficulties of selling retail savings products to most consumers, raises a number of concerns. In particular, bundling of advice with product, which is an integral part of the commission system, prevents the development of a proper market in advice, in which consumers can assess the price and quality of the service they receive. Presently, consumers cannot affect, and in many cases are not even aware of, the price of the advice they are indirectly but ultimately funding. This is a serious market imperfection.

4.95 The continuing importance of advised sales, against a background of consumer weakness, clearly has very important implications for the competitive focus of providers. Competition among providers necessarily has emphasis primarily on securing distribution rather than on providing the end consumer with simple products which represent good value.

4.96 Distributors also have strong commercial incentives to focus on higher-income consumers. This clearly has implications for efforts to increase savings levels in lower-income groups.

4.97 This is not to say that forces promoting greater efficiency and customer focus are entirely absent: the rise of networks, discount brokers and funds supermarkets are examples of market developments driven by efficiency considerations. But even these show the distorting effects of the current system of remuneration. For example, one factor driving the growth of discount brokers seems to have been the reluctance of product providers to offer products directly to the public on an execution-only basis at prices effectively net of commission.

4.98 The nature of distribution has also been one of the major drivers of significant regulatory interventions in the long-term retail savings industry. These are considered in the following chapter.