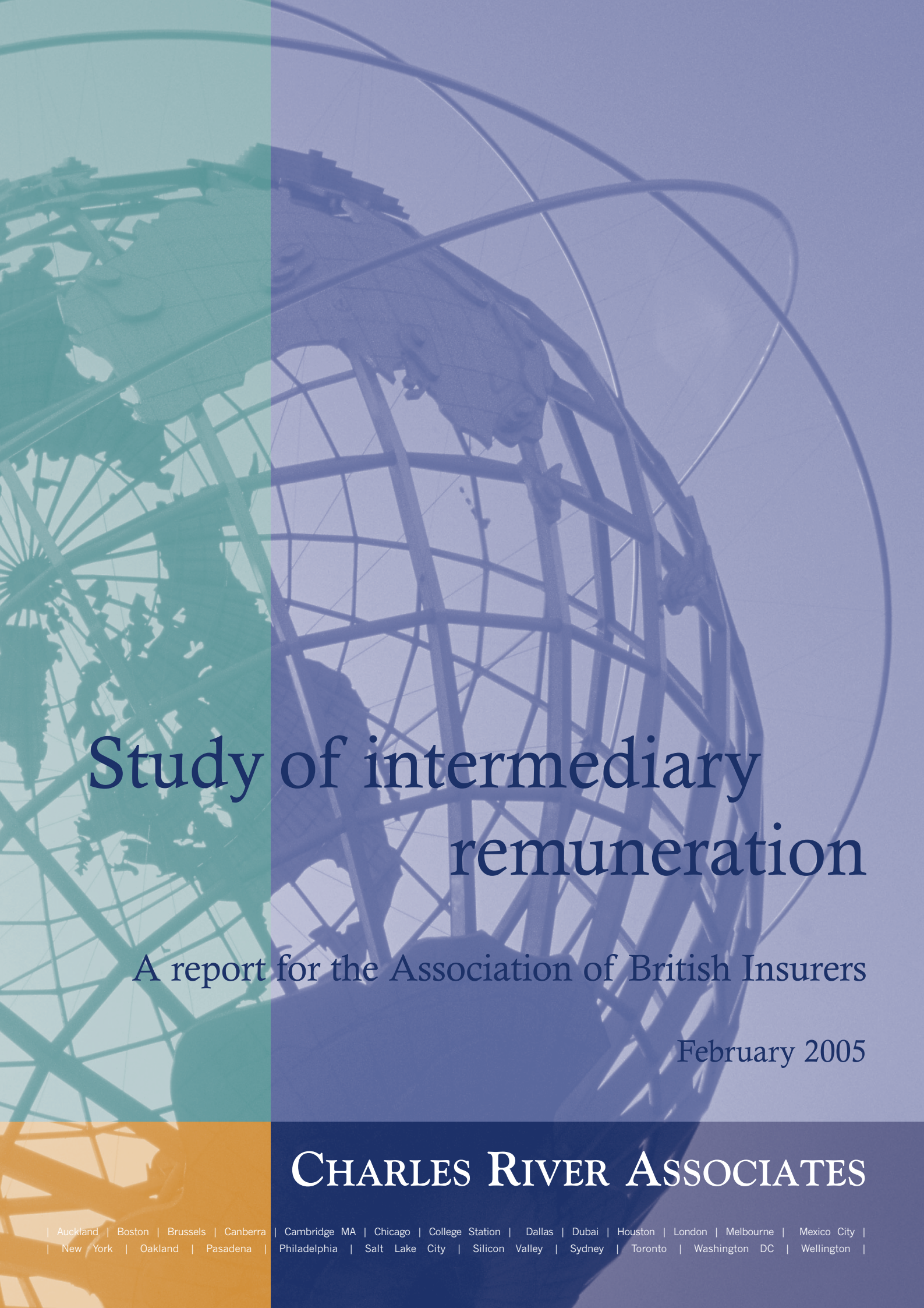


Study of intermediary remuneration

A report for the Association of British Insurers

February 2005

CHARLES RIVER ASSOCIATES

| Auckland | Boston | Brussels | Canberra | Cambridge MA | Chicago | College Station | Dallas | Dubai | Houston | London | Melbourne | Mexico City |
| New York | Oakland | Pasadena | Philadelphia | Salt Lake City | Silicon Valley | Sydney | Toronto | Washington DC | Wellington |

Acknowledgments

During the course of this project we spoke to a wide variety of senior members of the financial services industry. We would like to thank them for their extensive help in the preparation of this report. In particular, we would like to thank those who gave up so much of their time to help us with the provider surveys and the design and assessment of the Mystery Shopping exercise.

We would also like to thank members of the secretariat of the Association of British Insurers.

For further details on this report, please contact:

Tim Wilsdon and Kyla Malcolm
Charles River Associates
1 Undershaft
London EC3A 8EE
Tel: +44 (0) 20 7664 3700

TWilsdon@crai.co.uk

KMalcolm@crai.co.uk

Copyright © 2005. All rights reserved

CHARLES RIVER ASSOCIATES
ECONOMICS, FINANCE & BUSINESS CONSULTING

Contents

Executive summary i
1 Introduction 1
1.1 Criticism of commission based distribution 1
1.2 Scope of the assignment 3
1.3 Structure of the report 5
2 Critical success factors for a better model 6
2.1 CSFs for consumers 8
2.2 CSFs for intermediaries 14
2.3 CSFs for product providers 19
2.4 CSFs for regulators 23
3 Current trends in adviser remuneration 28
3.1 Changing structure of remuneration for advice 29
3.2 Providers and commission 43
3.3 Impact of remuneration on advice 46
3.4 Implications for the market hitting the critical success factors 58
4 Recent regulatory changes 59
4.1 Depolarisation 60
4.2 The menu 70
4.3 Stakeholder products and their sales regime 81
5 New models for remunerating intermediaries 89
5.1 The range of new models for remunerating distribution 89
5.2 Assessment of the new models against the CSFs 92
5.3 Recommendations 108
Annex 1: Range of new business models 110
Annex 2: Comparative markets 127
Annex 3: Provider surveys and econometric methodology 130
Annex 4: Mystery Shopping 134

Tables

Table 1: Comparison of rebates in 2001 and 2004 41
Table 2: Structure of commission 42
Table 3: Recommendation without ISAs in 2001 and 2004 51
Table 4: Average value of initial commission 52
Table 5: Single premium products – size and strength of relationship between commission and market share, by product 55
Table 6: Regular premium products – size and strength of relationship between commission and market share, by product 56
Table 7: Repayment of credit card debt 57
Table 8: Assessment of market trends against CSFs 58
Table 9: Concentration ratios for independent intermediaries 65
Table 10: Assessment of depolarisation against CSF 70
Table 11: Value for money 75

Table 12: Assessment of the menu against CSF 81
Table 13: Assessment of stakeholder products and their sales regime against CSF 88
Table 14: Dimensions of possible models for remunerating intermediaries 91
Table 15: Top level cost benefit analysis for financial advice 107
Table 16: Mystery Shopping scenarios 135

Figures

Figure 1: Critical success factors for consumers 9
Figure 2: Critical success factors for intermediaries 15
Figure 3: Critical success factors for product providers 20
Figure 4: Critical success factors for regulators 24
Figure 5: Proportion of IFAs with some fee based income 30
Figure 6: Average proportion of IFA income that is fee based 30
Figure 7: Share of new business written on a fee basis (as measured by business written on nil commission) for regular premium products 31
Figure 8: Share of new business written on a fee basis (as measured by business written on nil commission) for single premium products 32
Figure 9: The proportion of commission bearing new business written on particular commission terms for single premium products (averaged over the period 1999-2004) 35
Figure 10: Proportion of new business written on initial only terms for unit linked bonds 36
Figure 11: The proportion of commission bearing new business written on particular commission terms for regular premium products 37
Figure 12: Expenditure on commission to acquire business 44
Figure 13: Commission as a percentage of income and of total expenses 44
Figure 14: Comparison of total equity-based investments 47
Figure 15: Pressure to proceed with recommendation 49
Figure 16: Product mix by scenario 51
Figure 17: The relationship between average commission levels after rebates and market share for four single premium products 53
Figure 18: The relationship between average commission levels after rebates and market share for four regular premium products 54
Figure 19: Average commission terms on a regular premium personal pension 82
Figure 20: Average commission terms on a single premium personal pension 83
Figure 21: Average commission structure for regular premium group personal pensions 84
Figure 22: The range of new business models under review 92
Figure 23: Dimensions of remuneration 100
Figure 24: A “simplified” structure 102
Figure 25: The range of new business models under review 110

Executive summary

The remuneration of intermediaries for distributing investment products has been a persistent problem for the reputation of the life industry. Most recently a report by the Treasury Select Committee criticised the nature of remuneration in the saving and investment industry along a number of dimensions arguing:

- Commission based selling leads to an inevitable conflict of interest, as advisers have an incentive to sell products without proper reference to customers' needs as opposed to providing a less sales focused ongoing advice service. Only by moving away from commission based selling can confidence be restored in the industry;

- Greater comparability between fee based and commission based remuneration needs to be included in the menu proposals in order to enable consumers to compare the alternatives they face; and

- Trail commissions are inappropriate if the consumer is not receiving ongoing advice. Only those consumers receiving ongoing advice should be paying trail and they should be offered the opportunity to pay for this through an annual fee.

Against this background, Charles River Associates was commissioned by the ABI in order to assess the extent to which:

- The current remuneration model leads to consumer detriment; and

- Changes to today's model of remuneration could be implemented that would benefit consumers and lead to increased confidence in the long-term insurance industry.

In order to assess these we compare how the current market trends measure up to the critical success factors of different stakeholders, and whether this results in a remuneration system that meets consumer needs. The critical success factors determine what the ideal outcome would look like from the perspective of each of the stakeholders (consumers, intermediaries, product providers and financial regulators).

Market trends

Based on an analysis of how the market is currently working and ongoing market trends there is:

- **No evidence of bias being prevalent across the advice market:** To test whether remuneration structures are working to the consumer's benefit we test whether they lead to biased advice and result in detriment to the consumer. Based on an extensive

Mystery Shopping exercise and econometric evidence from detailed provider information, it was concluded that there was no evidence of a systemic problem of bias.

- **No evidence of bias to over-sell:** Bias to sell would arise if the remuneration of advisers caused them to recommend an investment product purchase (rather than, say, reducing debt, or holding savings in cash) *because* this results in a payment to the adviser (when this is not in the best interest of the consumer). For the scenario tested of a lump sum investment, we find that there is no difference in the recommendations from IFAs working on a fee basis compared to those working on a commission basis and no evidence that tied advisers recommend higher levels of equity investments compared to IFAs. Although commission may act to motivate advisers to find new customers and reward advisers for giving advice, there is no evidence that this encourages them to recommend a higher proportion of equity-based products than advisers working on a fee basis. This is an important new finding in an area not covered by our 2001 research for the FSA and we recommend that this is tested through future Mystery Shopping exercises.

- **No evidence of provider bias on regular premium products:** Provider bias would arise if an adviser recommends a particular provider *because* of the level of remuneration they will receive from that provider (as opposed to recommending the provider that is best for the consumer). There is no statistically significant relationship between commission and market share for regular premium products.

- **Evidence of limited provider bias in single premium products but this has not got worse over the last three years:** There remains a concern regarding the relationship between changes in post rebate commission levels and changes in market share for income drawdown and single premium personal pensions – two out of the five single premium products we tested for the purpose of this study. However, there has been no increase in the degree of provider bias over the last three years.

- **Evidence of limited product bias but this has not got worse over the last three years:** Product bias would arise if an adviser recommends a particular product *because* of the level of remuneration they will receive (rather than because the product is best for the consumer). In 17% of cases ISAs were not recommended where they were appropriate (based on the assessment of an IFA group). However, this was the only product where we found problems and the relatively low prevalence of this was very similar to that found in 2001.

- **Evidence of no relationship between the structure of commission and the consumer's service requirements:** The structure of commission on products was not determined by whether consumers were asking for a long-term relationship with the adviser or a one-off consultation. In addition, we found significant differences in the

structure of commission across products and providers despite products meeting similar consumer requirements. However, without actually observing a particular advice relationship over many years, it is not possible to test whether this results in detriment through consumers failing to receive the services required.

- **Evidence of other issues remaining in a minority of recommendations:** The large majority of recommendations were judged to represent suitable advice according to the IFA group used to assess the Mystery Shopping results. However, we found that in 10% of cases, there were concerns about quality. For instance, some advisers did not recommend repayment of credit card debt (we are not able to compare this to fee based advisers as the debt based scenario was not tested for these advisers). In addition, we found occurrences when key features documents and a personal illustration would only be provided if the consumer agreed to go through with the transaction.

Recent regulatory changes

To determine whether we should be concerned regarding the way the market works today, we need to review how the recent regulatory changes are likely to impact the market and how this measures up against the same set of critical success factors. We find:

- **The long-term impact of depolarisation on remuneration remains unclear, but it can be expected to result in benefits through additional choice and competition:** Depolarisation brings benefits to consumers by increasing the choice of products available from an individual adviser and types of advice from the market. However, depolarisation may increase the potential for problems in terms of how intermediaries are remunerated (e.g. it introduces the potential for bias between internal and external products for multi-ties). In the short-run, there is also evidence that anticipation of multi-ties entering the market is resulting in commissions being bid up. In the long-term, efficiency gains can be expected to arise, but it is unclear when, and to what extent, these will be passed on to consumers through lower charges. Finally, there are legitimate concerns about the role of ongoing advice where providers fall off panels of multi-tied advisers.

- **The menu will significantly reduce the potential for bias arising from the remuneration system:** The menu is likely to have a positive impact on consumers' understanding of the basis of remuneration. In particular, it is likely to reduce the potential for provider and product bias. However, this effect should not be overstated. It will take time for these benefits to arise and the current complexity in the underlying commission structures will make comparisons across menus difficult, resulting in differences in a market average that could be confusing for consumers. Much of the concern among providers, advisers and consumer groups about the effectiveness of the menu arises because the underlying complexity of the market is

hard to capture and to present. The implication is that the menu is the right kind of regulatory response to the concerns about depolarisation, but that it would be more effective in a market with fewer, simpler and more transparent remuneration structures. Unfortunately, the menu creates no incentive to move to such a market.

- **Stakeholder products and the basic advice regime should increase clarity between remuneration structures:** Differentiation between the basic advice regime and the full advice regime will help both markets work effectively. This offers an opportunity for the full advice regime to have a system of remuneration that reflects its higher costs but with pressure on levels being exerted through the menu. New stakeholder products offer the potential for "clear blue water" between the stakeholder range and other products due to the investment restrictions in place and the potential removal of RU64. This is likely to lead to the re-emergence of some initial charges in the non-stakeholder market, appropriately resulting in consumers sharing a portion of the cost of initial advice if they are to lapse early.

We therefore conclude that the problems of perception are greater than the reality - there is no evidence of bias to sell and problems of provider bias will be addressed by the menu. However, issues surrounding product bias and the proliferation of structures with no link to service justify public concern.

Hence if the industry is to regain the trust of its customers and regulators, it must go further in addressing the underlying causes of these concerns.

A new approach

Given the remaining concerns, we looked afresh at the potential range of new models for remuneration, finding 7 groups comprising 23 models that warranted consideration. We examined which of these models were consistent with improving the problems that we identified in the market.

One of the models tested was a fee based model - we concluded that there was no evidence that artificially moving to such a regime, to the exclusion of commission, would lead to benefits since consumers choosing to pay on a fee basis do not receive better advice than those opting for a commission basis. The menu will improve the comparability of the fee and commission based regimes compared with today but this in itself is unlikely to increase the fee based market quickly as most consumers, with the exception of the very wealthy, have a preference for paying for advice only when they purchase a product. There is evidence, however, that although most commission based advisers are happy to operate on a fee basis there are some who are reluctant to do this and seek to persuade consumers to pay by commission. This should be monitored by the industry in any future analysis, and examined by the FSA in its early supervision work once depolarisation and the menu have been implemented.

Executive summary

We support new models of remuneration that clarify the objectives and simplify the structure of commission as they are likely to restore trust in the industry and bring benefits to consumers. There is currently no link between the structure of commission and the type of relationship requested by the consumer, leading to the accusation that providers are competing for intermediaries rather than for consumers. This reflects the fact that commission is performing a number of different roles each of which are legitimate in their own right but in combination lead to confusion over the role of commission. These include:

- Rewarding advisers' "prospecting" activities which, as well as being a distribution service to providers, is the principle means of raising consumers' awareness of the need to address their financial needs and offering them a starting point for doing so. This encouragement and awareness-raising is not only an important source of generic advice, but also important to closing the savings gap;

- Rewarding advisers for the initial cost of undertaking the advice process and fulfilling the transaction. These costs occur predominantly at the start of the advice process but ongoing commission (renewal and trail) is often perceived as deferred initial payment for this service;

- Providing an incentive to encourage high levels of persistency and preventing unnecessary churning of consumers' portfolios; and

- Payment for ongoing services to meet the needs of consumers including the administration of the product, follow-up meeting to discuss the ongoing suitability of the investment, and ongoing surveillance of the market-place.

The Treasury Select Committee has accurately identified that it is difficult for commission to meet all of these objectives simultaneously, as current commission structures confuse rewards for the initial sale and those for ongoing service and advice: That is, if trail commission represents a deferred initial commission (representing payment for services at the beginning of the advice process) it is unreasonable to expect advisers to provide ongoing services or for this payment to be taken away if they do not provide these services. A better model of remuneration would improve clarity over the role of commission at the start of the relationship with the consumer, so that the consumer and the adviser are aware of the purpose of ongoing remuneration.

There needs to be an explicit ongoing charge for the ongoing relationship with the adviser that is transparent to consumers. If the structure of commission or fees is meant to reward intermediaries for providing consumers with an ongoing relationship, this has a number of implications:

- If a consumer wants ongoing provision of advice they should pay more than those who are only interested in one-off advice;

Executive summary

- The amount that consumers are paying for advice on an ongoing basis should be revealed to consumers, and advisers should be incentivised to explain the services they are providing for this on an ongoing basis; and

- If the consumer is dissatisfied with the advice they are getting they should be able to transfer the payment elsewhere or even stop paying for this advice altogether.

Any model of remuneration should be explicit about the payments made for initial advice and also needs to allow the cost of initial advice to be spread over time. Spreading the cost of initial advice over time brings the following advantages:

- The mismatch, between receiving the payment from the consumer through product charges and the time at which the cost of advice is incurred by the adviser, is shared between the provider and the adviser; and

- Advisers are rewarded for persistent business, thus encouraging advisers to recommend good products and reducing the likelihood of excessive churn.

A similar approach could be used in the fee based market. That is, steps could be taken to encourage fees to be paid over time which may also bring advantages. However, the VAT implications of this would need to be examined.

Collectively, providers should take responsibility for consumer friendly remuneration structures. Without a common approach, the structure of commission is likely to be too focused on initial commission and the level of proliferation of commission structures in the market will remain. Although the menu is expected to constrain the level of commission, any individual firm acting alone would nonetheless have an incentive to bring payment forward in time in order to gain market share. This results in an increased incentive to churn consumers, so where there are initial charges this may result in consumer detriment. Hence there may be a need for a degree of coordination to get simple structures that incentivise persistency while allowing competition in levels.

Certain aspects of market behaviour work to the consumer's benefit. In other areas, the current variability serves the interests only of providers and advisers. We believe that standardisation and simplification in these areas – subject to the agreement of the competition authorities – would serve consumers better than the current market. In summary, we propose continued flexibility on:

- The level of initial commission;

- Uplifts to particular advisers; and

- Offering rebates to consumers.

Executive summary

We propose standardisation between providers, whilst allowing appropriate variation between products, on:

- The period over which initial advice is paid for; and
- Ongoing reward structures.

We further propose that two aspects of today's structure should be abolished because these result in complexity and the potential for bias:

- The freedom for advisers to choose their own mix of initial and ongoing payment; and
- The freedom of providers to offer indemnity terms.

Instead, the roles that these aspects were performing should be undertaken by other means.

This would have a dramatic effect on the number of structures in place. It is estimated that the FSA has had to deal with hundreds of different structures during its collection of information for the menu. The proposals in this report would be likely to reduce this number to around a dozen. Designing the best tools to deliver this outcome is a challenge that providers need to tackle in partnership with intermediaries, the FSA and competition authorities.

Simplifying commission structures will substantially improve the effectiveness of the menu. A further benefit of this approach is that simpler remuneration structures could also substantially improve the effectiveness of the menu in constraining product bias. If products have a similar remuneration structure for all advisers this will result in the market average being presented in the same way across the market. It will then be possible to compare the maximum rates of one adviser to those offered by another adviser in any part of the market and allow easier comparison across products meeting similar needs.

We want the menu to work better in all distribution channels. The need to protect consumers from product and provider bias and to empower them to get the advice they want and need goes beyond the IFA channel. Tied advisers are required to reveal "commission equivalent" remuneration on the menu. Our proposals are designed to work within the current framework of regulation and hence would be applicable across all channels.

The focus of our analysis and recommendations has been on saving and investment products. The research did not find any evidence of commission related problems for protection products. If concerns in this area remain it could be investigated more extensively using a Mystery Shopping exercise that focused specifically on the provision of advice for these products. There is, however, no reason why the proposals for saving and investment products should not be extended to cover protection.

We therefore recommend that:

- **There is an explicit charge for ongoing advice that is transparent to consumers and that can be removed should consumers choose not to receive ongoing advice.**
- **On an annual basis, consumers are informed about ongoing payments to their advisers, and the degree to which they can expect ongoing services in return.**
- **Providers agree to transfer the payment for ongoing advice from one adviser to another when requested by consumers, or stop it and reduce overall charges.**
- **A compelling case is presented to the Office of Fair Trading setting out how the benefits of simplified structures of commission will result in increased competition whilst ensuring the gains from competition are passed onto consumers. This offsets any concerns regarding providers coordinating over the structure of commission.**
- **A set of simplified structures are agreed by the industry that would bring benefits to the consumer by increasing the effectiveness of the menu. Differences in structure within products or between products meeting similar customer requirements need to be justified from a consumer perspective.**
- **Providers should determine whether there are particular products that always require ongoing advice and how they will encourage this to be undertaken.**
- **The model should retain the flexibility to spread the cost of initial advice over time. A mechanism that allows fees to be paid over time could also be beneficial.**
- **The result of simplified structures and the encouragement of competition across products is likely to change the timing of remuneration to advisers by, for example, spreading out the payment of commissions that are today paid on an initial or indemnity basis. This may therefore necessitate financing arrangements to facilitate a change from one remuneration regime to another. This finance should not vary depending on the particular provider's product that has been recommended in order to prevent the re-emergence of provider bias.**

Executive summary

The future we envisage is one in which:

- Consumers would see more clearly what their adviser is being paid, and payments would be clearly linked to the services offered;

- Ongoing advice would be paid for either through ongoing commission or regular fees. Consumers would have real power to move their payments for ongoing service from one adviser to another, providing a challenge to advisers to deliver the services they are paid for;

- Paying for initial advice through fees could be structured to allow payment over time, potentially offering consumers a clearer choice between fees and commission. It should be clearer to consumers that choosing not to pay by commission ought to result in lower product charges. There remain formidable obstacles to widespread opting for fees by consumers, but the market could be changed to deliver potentially more attractive choices for consumers;

- The potential for the menu to reduce or eliminate the remaining areas of product bias would be more likely to be realised; and

- Providers would compete for market share in terms of offering the best products for consumers.

This represents a challenging agenda for change for both providers and distributors alike. Significant further work will be needed by the ABI, its member firms and other stakeholders to further define and make the necessary changes over a sustained period. Some may believe that further upheaval is not required at a time when industry dynamics are already changing as a result of regulatory intervention.

However, it is our firm conclusion that the changes currently underway, although valuable, are not sufficient to remove the causes of current consumer concern and uncertainty about the industry's sales practice. Industry-led action now can therefore both accelerate the achievement of the benefits put in place by regulatory reform and make a material contribution to the future commercial health of the long-term savings industry by removing a potent, if overstated, source of distrust. Our proposals do this by putting consumers – their long-term needs and their active choices – right at the heart of the industry's remuneration practice.

Executive summary

1 Introduction

In May 2004, the ABI commissioned Charles River Associates (CRA) to undertake a review of intermediary remuneration. The overall aims of this project are to establish:

- the extent and nature of any substantive negative effects of commission in the long-term savings market on the performance of the market but especially on consumers. This is to provide an evidential basis against which to test some of the perceived problems;

- the likely impact of regulatory and market trends on the way the market performs. Focusing on whether the current changes are likely to be sufficient to correct any identified problems in the market; and

- possible new business models that would better meet the needs of consumers, intermediaries and providers and would allow the industry to establish and maintain a good reputation among consumers, policymakers and media.

This report sets out the evidence we have gathered over the last six months regarding how the market works today and our recommendations over how the model for remunerating distribution could be improved in the future.

In bringing this report together CRA has been grateful for the considerable time invested by regulators, consumer groups, providers and intermediaries to discuss the issues surrounding remuneration. In addition, CRA has relied extensively on data provided by industry participants on commission and remuneration structures.

1.1 Criticism of commission based distribution

To put the report in context, it is important to understand the considerable criticism faced by the industry of the commission based sales regime. There has been considerable concern expressed by Government, financial regulators and consumer associations regarding the problems associated with the current commission regime. Indeed in CP121, concerns with remuneration structures resulted in proposals to fundamentally change the system of the remuneration of independent financial advisers.[1] However, this led to concerns about the risk to the supply of independent financial advice and a subsequent loss of choice. Hence, instead of wholesale change, the independent intermediary sector, through their trade association, has advanced the merits of the menu, which has subsequently been adopted by the FSA.

[1] *Reforming Polarisation: Making the market work for consumers*, CP121, Financial Services Authority, January 2002.

Introduction

Most recently, the review by the Treasury Select Committee into how to restore confidence into the industry expressed a number of concerns including that the current commission based regime has resulted in:

- an excessively expensive and inefficient business model;
- advisers being incentivised to sell inappropriate products to consumers and to bias their advice on particular providers;
- consumers paying for ongoing services but not receiving them; and
- particular problems in the market such as the sale of mortgage endowments.

This is summed up by the quote below from the Chairman of the Treasury Select Committee, John McFall,

> *"I suggest to you that further mis-selling scandals like endowment mortgages are going to continue to dog the financial services industry until action is taken to more closely align consumer interests and the way commissions and fees are charged, stripping out the big, up-front commissions and making fees more closely dependent on performance of products."*[2]

The Treasury Select Committee published its recommendations in July and those focused on remuneration are summarised below:[3]

- "In the Committee's view it seems likely that as long as most of the selling activity in the long-term savings industry is rewarded on a commission basis, many savers may remain suspicious that they are being sold a product for the wrong reasons. Shifting away from the current commission based sales system common in much of the industry is likely to be a key component of any strategy to rebuild consumer confidence in the industry after the long catalogue of mis-selling scandals in recent years."
- "The evidence presented to our inquiry suggests that the retail long-term savings industry gives insufficient weight to the issue of asset allocation and the investment returns it delivers to savers. The fee structure that currently dominates the industry primarily rewards the initial sale. A fee structure containing a stronger linkage to subsequent investment performance would help align more closely the long-term interests of the saver and the industry."
- "Full and open disclosure of fees and commissions in a manner that is readily comprehensible to savers and gives them a balanced view of the various options is a

---

2 *Restoring confidence in long–term savings, Uncorrected transcript of oral evidence,* 2nd December 2003.

3 *Restoring confidence in long–term savings,* House of Commons Treasury Committee, Eighth Report of Session 2003–04.

vital part of delivering an efficient market in financial advice and long-term savings products. The current proposals from the FSA fall short of this goal in several key respects. There should be no suspicion that an adviser might be able to steer a client towards paying commission that might add substantially to the client's advice bill, to the detriment not only of the client but also the more efficient and fairer operators in the advice market. It should be a basic requirement that each client should be given an explicit comparison of the total cost, in cash terms, of buying a product on a fee basis and the total cost on a commission basis over the likely life of the product."

- "For IFAs to receive trail commission whether or not they are providing any real ongoing advice to the client is unacceptable. The persistence of this practice is a clear sign that the market for financial advice is not working in the best interests of consumers. The Committee urges the major product providers, IFAs and the regulator to limit urgently the basis on which trail commissions are paid in the financial services industry and to ensure that such payments only occur when the client is actually receiving the annual advice that such commissions are supposed to fund. Clients opting to pay for financial advice via fees should be given the explicit option of paying an annual fee for any ongoing advice they receive rather than having trail commission paid from their investment."

Our project, which has been welcomed by the Treasury Select Committee, attempts to look into these criticisms, determine the magnitude of the problems the current remuneration system presents and set out how different business models for remunerating financial advice might better meet the Committee's objectives.

1.2 Scope of the assignment

In developing the methodology to complete this assignment we have been conscious to take into account:

- *Current market developments*: The market is currently changing in anticipation of various regulatory developments (depolarisation, the menu and stakeholder products). We have therefore undertaken an extensive interview programme with market participants to allow us to understand what are transitional effects and what are long-term trends.

- *The need to move the debate on*: Previous analysis and recommendations have shifted the debate but problems of both substance and perception remain. Learning from this experience we developed a methodology that: (1) reviewed the type of conditions where remuneration might lead to consumer detriment rather than focusing on particular product market *hotspots*; and (2) looked afresh at how new business

models can meet the divergent interests of the primary stakeholders in a way that best meets the long-term needs of consumers.

Therefore, this assignment is looking at a much wider question regarding any potentially negative effects attributed to current remuneration regimes than previous analysis. Our approach therefore draws on the experience of previous projects but also considerably develops this methodology.

The key components of the methodology were as follows:

- *Interview programme*: We have undertaken interviews to gain the perspectives of different stakeholders. The purpose has been to understand how remuneration affects different types of consumers, providers, and intermediaries.

- *Analysis of market trends*: Although trends in remuneration are often asserted e.g. a move to trail commission or the growth in the fee based market, there is little hard evidence available on the extent of these trends. We have attempted to collect information to identify these trends and allow us to understand what is driving them.

- *Provider survey*: Working with a number of product providers we developed a focused data request to understand the structure of commission and level of new business. This was completed by members of the ABI and has allowed us to examine how the structure of commission is changing and whether the relationship between commission and new business has stayed the same as that found in our work in 2001.[4] Given the commercially sensitive nature of the data provided, CRA has ensured that procedures have been in place to keep the data confidential.

- *Mystery shop*: Working with NOP Mystery Shopping, the ABI and a team of IFAs we developed a Mystery Shopping exercise. Using 250 visits we investigated the potential for product bias, the role of commission in ongoing advice and the bias to (over) sell.[5]

- *Remuneration survey*: To understand remuneration in the tied market, we developed a tied sector survey on current remuneration structures and how these have changed over the last five years. As well as enabling us to comment on the importance of

[4] *The effect of commission based remuneration on financial advice*, Charles River Associates for the Financial Services Authority, December 2001. This was published alongside CP121 and is available on the FSA's website.

[5] Bias to sell would arise if the remuneration of advisers caused them to recommend an investment product purchase (rather than, say, reducing debt or holding savings in cash) *because* this results in a payment to the adviser (when this is not in the best interest of the consumer) i.e. to over-sell investment products compared to what consumers need. Product bias would arise if an adviser recommends a particular product *because* of the level of remuneration they will receive (rather than the product that is best for the consumer).

various different components of remuneration in the tied sector, it was also necessary in order to review the Mystery Shopping in the tied sector effectively.

- *Workshop*: Finally, the degree to which the various models meet the needs of different stakeholders (consumers, intermediaries, providers and regulators) was tested at a workshop with senior members of the industry.

It was also important throughout the study to bear in mind concerns regarding competition issues arising from any potential collective solution to any problems identified. We have therefore been careful to take this into account both throughout the analytical work undertaken and any discussions held about future regimes of remuneration. In addition, satisfying the competition authorities is one of our criteria for assessing new business models. This is discussed in both Chapter 2 and Chapter 5.

1.3 Structure of the report

The rest of this report is structured as follows:

- Chapter 2 sets out the critical success factors for remuneration structures. These have been based both on existing evidence and also on aspects that have emerged from the interview programme with consumer groups, regulators, intermediaries and product providers. It is these critical success factors that we have used to assess the benefits of different models for remunerating advice and funding distribution;

- Chapter 3 provides the evidence on the changes ongoing in the market-place in terms of trends in the nature of remuneration in different channels, how the structure of remuneration varies by product and the evidence regarding the current level of bias resulting from today's remuneration structures;

- Chapter 4 reviews the recent changes in the regulatory regime. In particular, we examine whether these will substantially change the current structure of remuneration and whether such changes meet the objective of designing a customer-orientated remuneration model that meets the critical success factors of the relevant stakeholders;

- Chapter 5 sets out our assessment of whether any of the potential new business we have identified would better meet the objectives, how such a model might come about, and the need for transitional arrangements to introduce this smoothly into the market-place.

2 Critical success factors for a better model

Before considering how current remuneration models are serving today's consumers it is useful to think what a 'good' remuneration system would look like from the perspective of the various stakeholders (consumers, intermediaries, providers and regulators). The components that make a good system are termed critical success factors (CSFs). The overall objective is to find the model that works best from the consumer perspective, i.e. a successful customer-orientated business model. However, a successful customer-orientated model must be consistent with the critical success factors of the other participants – that is product providers must be willing to produce good value products and distributors must be prepared to get these to the final customer.

The current debate has focused on the relative merits of fee based versus commission based remuneration from the consumers' perspective.[6] In particular this has focused on:

- The consumer's willingness to pay fees for advice;
- The degree to which fee based advice removes any incentives for bias; and
- Whether fee based advice would result in a more competitive market for the provision of products and advice.

In this chapter we look afresh at the critical success factors from the viewpoint of each of the stakeholders based on existing survey and interview evidence. This is used later in our analysis to assess whether a broader range of different business models (beyond simply fees and commissions) will work from the consumers' perspective.

In total, 24 interviews were conducted with a combination of consumer representatives, intermediaries, providers and regulators. The analysis of CSFs for stakeholders is a necessary simplification. Within each group of stakeholders there may be different groups with different sets of preferences. For example, although remuneration being conditional on sale is a CSF for many consumers (so that advice is free to those who do not make a purchase), some consumers prefer remuneration to be unconditional as demonstrated by the fact that some of them currently choose to remunerate intermediaries on a fee basis. Similarly, we are generalising for intermediaries and product providers.[7]

Equally, the CSFs for a particular stakeholder may vary depending on the products under consideration. For example, consumers' understanding of the remuneration system may be

[6] See *The effect of commission based remuneration on financial advice*, Charles River Associates for the Financial Services Authority, December 2001, published alongside CP121 as well as CP 166 both of which are available on the FSA's website.

[7] Throughout this section, intermediaries refers to any distributor model that sits between the product and the consumer.

more important from a regulator's perspective if the characteristics of the product are opaque than if the price and other salient features of the product is transparent. Furthermore, the consumer's need for ongoing advice may vary both by the type of product e.g. protection products compared to pensions, but also by the complexity of the product e.g. annuities versus income drawdown.

It is important to recognise, that although we have considered each category of stakeholder separately, this does not mean the CSFs necessarily conflict. Indeed we would expect there to be considerable overlap in some areas since all stakeholders will be seeking a thriving market-place in which to participate.

However, there are clear cases where the various CSFs that are considered to be important for stakeholders come into conflict with one another. In some cases these could be either contradictions or tensions between the CSFs for any one category of stakeholder e.g. consumers may seek both to spread their payment for advice over time but would also prefer not to be locked in to a particular adviser. As well as these potential tensions within a stakeholder group, there may also be contradictions between the CSFs of different stakeholder groups. These trade-offs will need to be taken into account when assessing the various different possible remuneration models under consideration.

For each of the stakeholders we categorise their critical success factors into the following five groups:

- Encouraging cost effectiveness (C): a structure that allows the most cost-effective relationship between market participants e.g. if advisers are best placed to undertake administration then the resulting structure would ensure that they are able to conduct the administration on behalf of providers, resulting in better value products. Similarly, it implies that those models which impose considerable costs on any stakeholder would not be desirable;

- Facilitating fair competition (FC): this involves allowing good providers or intermediaries to make a reasonable rate of return while providing good value to end consumers;

- Reputation (R): any new system of remuneration needs to overcome, and be seen to overcome, the problem of perception that is currently linked to commission based remuneration as well as ensuring that remuneration structures do not lead to future crises of confidence in the sector;

- Incentive alignment (I): for each stakeholder, a model aligns incentives if other stakeholders are also better off. For example, providers will find attractive remuneration systems that incentivise distributors to increase sales as we would expect these to lead to an actual increase in new business and funds under management from which product providers derive their profits; in turn Government

will find them attractive as this may reduce the savings gap, meeting key policy objectives so providers' incentives are aligned with Government and distributors; and

- Simple and transparent (S): given that the demand for advice arises from the asymmetry of information between consumers and providers, we need to take into account the degree to which the remuneration system is understood, particularly by consumers, and whether this is important.

In this chapter we are not considering transition issues and whether these might be of more concern to different stakeholders. These are only of importance if new business models are identified that better meets consumer needs.

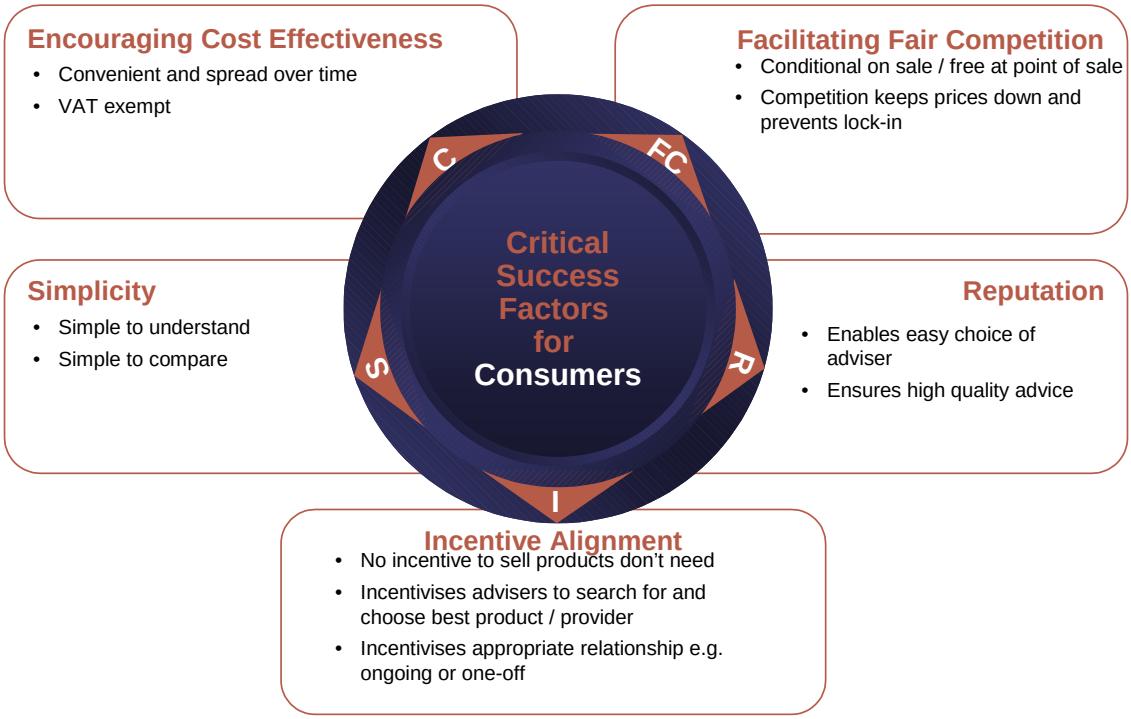
2.1 CSFs for consumers

When considering the CSFs for consumers it is important to distinguish between what they currently believe are the most important factors and what, arguably, they should take into account (even though they may not currently be doing so). Figure 1 below sets out the CSFs that are important given the preferences of *current* consumers.

Many consumers do not fully understand the workings of the intermediary market and do not necessarily understand the implications for them that different incentives have for their intermediaries and providers. Therefore regulators often have a significant role in determining what customers should want from a system of remuneration. What consumers "should" want has therefore been included in the regulator's CSFs later in the chapter.

Critical success factors for a better model

Figure 1: Critical success factors for consumers



Source: CRA based on evidence from consumer surveys and interviews with various stakeholders.

Encouraging cost effectiveness

Convenient and spread over time

Consumers seek remuneration models that are convenient for them and in particular most prefer to pay through the product purchase rather than through a separate charge. A remuneration model should therefore seek to minimise the transaction costs of going through the advice process (hence an option of paying for advice through direct debit could in theory have a similar impact as paying through commission). Consumers may also prefer commission being spread over time as it means the intermediary is at risk if the consumer was to lapse the product - hence the intermediary is incentivised to sell a good product.

VAT exempt

A further issue that is relevant for consumers is that if remuneration is VAT exempt, this would lower the cost of advice. If the customer is only seeking advice and not seeking the execution of the purchase of a product, then VAT will be due. Often, when advice is paid for through fees, rather than offset by commission, it is precisely because the consumer is seeking only financial advice and hence VAT would be due. This has led to a perception that

Critical success factors for a better model

VAT is always due when advice is paid for directly through fees from the consumer and hence that paying through fees is more expensive than paying through commission.[8]

Facilitating fair competition

Conditional on sale

Most consumers appear reluctant to pay the full cost of advice at the point at which advice is given – this may be due to a number of reasons. Firstly, consumers may not understand the value of advice. A fee may represent a high upfront cost in comparison to the value the consumer believes they receive. However, evidence suggests relatively few consumers do not go through with a commission based transaction because they have been made aware of the size of the commission.

Secondly, this may reflect consumers being unwilling to agree to an unconditional payment when the quality of the advice is unknown. This may be entirely rational since when consumers first take out advice they may not be able to assess the quality of the advice. Only after the advice has been given and a product has been recommended do consumers feel comfortable in remunerating advisers.[9]

Therefore, consumers typically prefer remuneration structures that are conditional on sale in order that there would be no requirement of payment if there is no purchase of a product. Indeed there is a substantial body of evidence showing a very low willingness to pay fees:[10]

- IFA Promotion / B-different found that only 11% of consumers were willing to pay fees (with 63% preferring commission and 20% preferring fees with commission offset);[11]
- AMP found that they thought £100 was a fair figure for the total price of advice;[12]
- Swiss Re found that less than 2.5% of consumers were prepared to pay more than £75 and less than 1% were prepared to pay more than £100;[13]

---

8 It should be noted that financial advice is taxable and hence if an adviser only gives financial advice then VAT will be applied. However, the execution of the purchase of financial services is typically exempt from VAT. If advice directly results in the consumer taking out an exempt product then the whole service is exempt. Hence the method of charging for the service makes no difference to whether or not VAT is charged. (Although it should be noted that if commission is used then this is only actually paid when a product is taken out and hence it would be hard to argue that VAT would be due.) For further details see the Sandler Review - *Medium and Long Term Retail Savings in the UK: A Review*, July 2002.

9 It should also be noted that fee based advisers often offer a consultation for no charge at the beginning the relationship.

10 As quoted in *Cost Benefit Analysis of the Defined Payment System and the Price List, for AIFA and IFA Promotion*, Charles River Associates, June 2002.

11 *"If we only knew our sell by date"*, Research for IFA Promotion undertaken by B-different. March 2002. The question was based on a fee of £400.

12 *Depolarising Financial Services: Customer Choice or Customer Confusion?* Research for AMP undertaken by Teamspirit.

Critical success factors for a better model

- Continental Research found that 70% of consumers thought that any fee should be less than £70;[14] and
- The FSA found that consumers were willing to pay an average of around £70 per hour or a total fee of around £130.[15]

Indeed, the following quote is typical of the views of consumers,

"I wouldn't buy anything from this person – they seem to take an awful lot of money and you have to pay for this advice whether you like it or not or whether you buy the product or not."[16]

There are a number of reasons that have been given by consumers regarding the advantages of commissions compared to fees including:

- paying a stranger is a leap of faith and therefore it needs to be conditional on the services being provided;
- fees might put off people who do not know whether they need advice from seeking it in the first place;
- not everyone can afford to pay upfront fees;
- advisers will still have arrangements (e.g. bonuses) with some providers i.e. fees would not necessarily eliminate any biases;
- advisers might not earn enough to encourage them to perform well.[17]

The first of these reasons seems particularly important for new users of financial advice or of a particular financial adviser. In addition, it seems unlikely that the majority of consumers will ever have sufficient information about the quality of advice to be prepared to pay unconditionally for advice at the beginning of an advice relationship.

Further, many consumers are reluctant to pay fees when these are described as hourly rates as they are concerned about the open-ended nature of hourly rates which could lead advisers to take longer over a task than would be necessary.[18]

"It's all a bit non-specific about what fee you'd pay. I get the feeling it will be expensive as it will end up being another £500 for this and that."[19]

---

13 *The Insurance Report 2001*. Swiss Re.
14 Continental Research 2000. Consumer research commissioned by London Economics.
15 *Reforming Polarisation: Making the market work for consumers*, CP121, Financial Services Authority, January 2002.
16 *Polarisation – menu testing research*, Consumer Research 24, Financial Services Authority, February 2004.
17 *Polarisation: Consumer Research*, Financial Services Authority, January 2002.
18 *Polarisation: Consumer Research*, Financial Services Authority, January 2002.
19 *Polarisation – menu testing research*, Consumer Research 24, Financial Services Authority, February 2004.

Critical success factors for a better model

Competition keeps prices down and prevents lock-in

Whilst there is little evidence to suggest that consumers currently base their choice of financial advisers primarily on price, consumers do not want to pay too much for the advice process. Therefore it is reasonable to assume they would prefer remuneration models that encourage competition between advisers and hence keep prices down so that advice is as attainable and affordable as possible.

Although survey evidence shows that consumers do trust their advisers and can remain loyal to their advisers over a long period of time, they also purchase products through a variety of channels and access other forms of financial information. Therefore, it is unlikely that they would favour models which lock them permanently into getting advice from a single source and prevent them from switching to another adviser without incurring severe switching costs.

Reputation

Enables easy choice of adviser

Once established, financial advisers appear to build a strong trust relationship with consumers. However, it is clear that the reputation of advisers is an important factor for consumer in terms of choosing their adviser. For example, consumers will frequently depend on the recommendations of friends and family to choose their adviser (thus relying on others' past experience) or rely on strong brand names of high street providers.

Ensures high-quality advice

Although obvious, consumers are clearly seeking remuneration models that ensure that they receive high-quality advice from intermediaries. It is clear from the survey evidence that this means consumers are not necessarily looking for the cheapest source of financial advice, but rather one that they can trust and that has adequate knowledge and expertise to understand their needs.

Incentive alignment

Intermediaries are aligned with consumers in providing unbiased advice

Consumers seek models which align advisers' incentives with their own need for trust, quality and savings. This covers a range of different aspects including that advisers should not be incentivised to sell consumers products that consumers don't need,

"sometimes they coerce you into buying…"[20]

[20] *Polarisation: Consumer Research*, Financial Services Authority, January 2002.

Critical success factors for a better model

Instead there should be incentives for advisers to both search for, and choose, the most appropriate product and provider for the consumer. This aligns the incentives of the adviser with the consumers' requirements regarding saving. Remuneration models which makes clear that advisers are not incentivised to give biased advice - either across products or providers - are therefore to be preferred by consumers so that there is incentive alignment to develop and maintain trust. However, it should be noted that consumers are somewhat sceptical about whether truly independent advice exists regardless of whether advisers are paid by fees or commissions,

"I'm cynical and don't think there really is such a thing as independent advice. There has got to be a kickback somewhere"[21]

Furthermore, consumers usually see little difference between the impact of bonuses which are paid in tied channels compared to commissions which are usually earned in IFA channels. Indeed, 71% of consumers agree that it is inevitable that any adviser's judgement will be coloured by the commission they receive on products. Nonetheless, 47% of those same consumers also agreed that advisers choose the best products for their customers regardless of the commission they receive.[22]

Intermediaries are aligned with consumers in providing required services

In addition, it is clear that different consumers are looking for different services from their advisers. Some are seeking a solution to a particular problem at that time (the investment of a an inheritance for example), while others are looking for an ongoing relationship with their adviser. It is reasonable to assume that those wanting advice over time would prefer remuneration regimes that incentivise the appropriate behaviour from their adviser. Those who seek one-off advice may, rightly, be concerned about the payment for ongoing relationship that they do not desire (not withstanding the general preference to have advice paid for over time).

Indeed, many consumers find the concept of an open-ended payment over time unusual when there is no evidence of an ongoing service,

"If it (the commission) was just on the first year's premiums that would be OK – it's the fact that you have to keep paying each year."[23]

[21] *Polarisation: Consumer Research*, Financial Services Authority, January 2002.
[22] Consumer views on the IFA market, NOP 2001, available from www.unbiased.co.uk.
[23] *Polarisation – menu testing research*, Consumer Research 24, Financial Services Authority, February 2004.

Critical success factors for a better model

Simple and transparent

Simple to understand

Finally, although surveys do not find consumers demanding ever more information from their advisers (indeed some argue the opposite), when information is provided it needs to be simple and transparent. It is reasonable to assume that consumers would therefore prefer remuneration models that are simple to understand in order to have clarity regarding the form of the relationship between themselves and the intermediary.

Simple to compare

In addition, information in itself does not necessarily help consumers. To make information useful, consumers need to be able to compare it to a reference point. Hence, where information is provided, structures should facilitate easy comparability between products, intermediaries and providers.

2.2 CSFs for intermediaries

At present, intermediaries vary according to a number of different characteristics. Most obviously there are regulatory differences i.e. whether intermediaries are tied advisers or independent advisers. Depolarisation will bring about further differences in terms of the regulatory position and the number of providers on whose products the intermediaries advise.

Within the tied sector, there may be differences between intermediaries:

- from life insurance companies; and
- from banks.

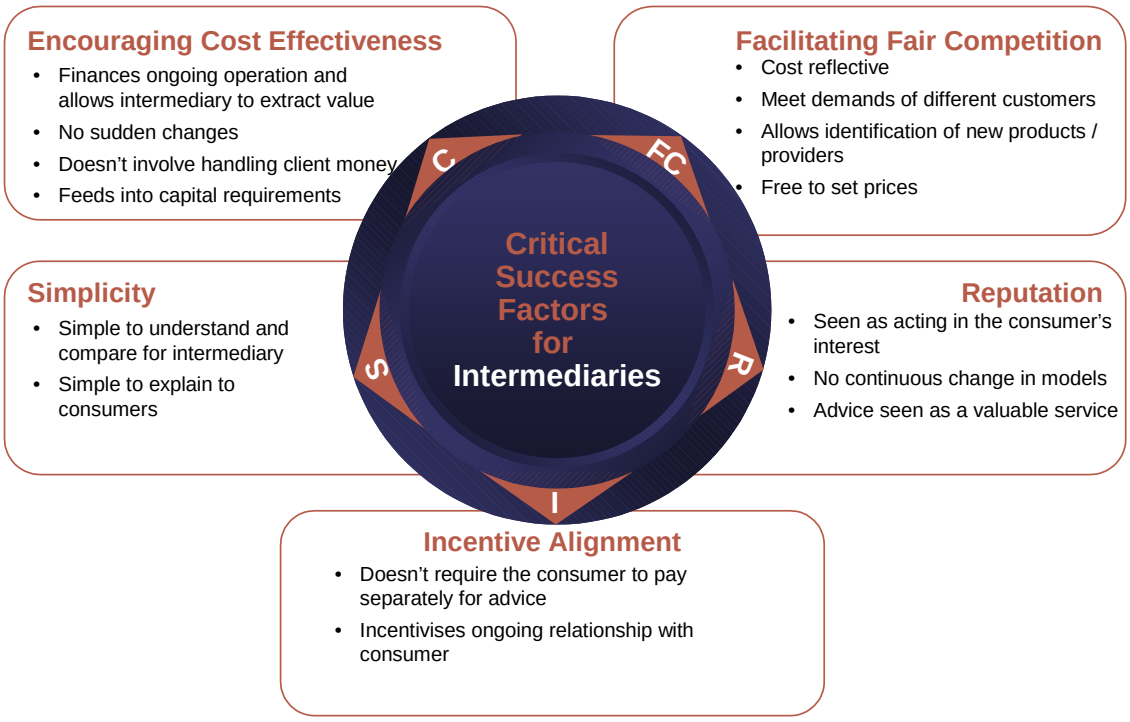
Within the independent sector, there may be differences between intermediaries:

- in networks, national intermediary firms and those who are in neither;
- who focus on the group market and those who focus on the individual market; and
- who focus on some product areas compared to those who focus on others.

Which CSFs apply or which are of most importance are therefore also likely to vary according to the type of intermediary that is being considered.

Critical success factors for a better model

Figure 2: Critical success factors for intermediaries



Source: CRA based on interviews with intermediaries and product providers

Encouraging cost effectiveness

Finances ongoing operation

A priority for many intermediaries is the need to ensure that they can maintain their income and security of cash flow. This is seen as important for maintaining the ongoing operation of the intermediary business.

This results in a variety of preferences over the structure of remuneration:

- Some intermediaries prefer upfront or indemnity commission (as this provides a cheap source of bringing forward commission paid over time), helping to match the costs of providing initial advice with the revenues received;

- Some intermediaries prefer trail commission: (as this introduces more stability into future cashflows and making the business less vulnerable to variation in new business volumes). Trail commission provides greater stability and is a key factor in how intermediaries are valued. Many interviewees indicated that when they were considering whether or not to invest in a particular intermediary business, the degree to which there was a reasonably secure income stream generated by trail commission

would be a crucial factor in the decision making process. Trail commission here acts as a more tangible link to the value of the relationships with the customer base.

Furthermore there is a difference between the incentives offered to individual advisers and those facing the owners of the company. It is likely that the larger the intermediary business, the larger the effect of these differences.

Hence the degree to which advisers care about the ongoing financing of the business and building up value in the business will depend crucially on ownership rights and whether the individual will receive any of the benefits of that value in the future.

Imposes no sudden changes

The majority of independent intermediaries interviewed favoured a system with more ongoing rather than upfront commission because this provided greater stability in the way they were remunerated. That is, one of the success factors for a future remuneration system is that it should not be so far from today's system as to cause sudden shocks to the system. This is partly because this would necessitate explaining these changes to existing consumers who are used to the current remuneration structures as well as potentially incurring significant systems costs.

Interaction with other aspect of the regulatory system

The remuneration system must take into account the other regulatory requirements imposed on the intermediary sector. This was illustrated by two examples:

- Remuneration structures should enable intermediaries to efficiently meet regulatory capital requirements. In particular, if income streams that are provided through remuneration can be counted towards capital requirements these would have a clear advantage.

- A further concern for some intermediaries is that remuneration regimes should avoid the need for intermediaries to handle client money. This would require advisers to be authorised to hold client money which in turn would have implications for the costs of the business, e.g. personal indemnity insurance, capital requirements etc.

Facilitating fair competition

Cost reflective

Intermediaries value remuneration regimes that differentiate between the costs of services provided for different product types or for different providers. In particular, it is important that intermediaries should receive higher remuneration for advising on, or administering the

purchase of, more complex products or with more complex administration compared to products that may take less time or effort on the part of the intermediary. That is, they get a reasonable reward for the activities they undertake.

Meets demands of different customers

A further aspect of remuneration systems for intermediaries is that they should be sufficiently flexible to allow them to offer differentiated propositions to consumers. For example, intermediaries want the flexibility to offer consumers the option of paying for their services through the consumer's preferred method. Similarly, intermediaries may wish to offer rebates for consumers who make large investments or to offer a different structure to those consumers who are willing to pay for ongoing advice.

Enables new products to be identified

In addition, intermediaries value remuneration regimes that reward them for identifying new products and providers, and signal the arrival or presence in the market-place of new innovative products as well as remunerating the effort that may be required to search for new products.

Allows market forces to determine rates

Intermediary businesses are also keen to ensure that they are able to set prices so they can compete in the market. On the tied side this includes the flexibility to use a combination of salary and other remuneration incentives such as bonuses. While on the independent side this includes the ability to set remuneration levels on the basis of commercial factors rather than regulatory obligation. This requires structures that enable intermediary businesses to reach agreements with consumers which meet the requirements of both consumers and intermediaries.

Reputation

Seen as acting in consumer interest

Intermediaries recognise that the reputation of the industry requires all intermediaries to be seen as acting in the consumer interest. There is therefore a desire for remuneration systems that are seen as offering good value for money and encourage high-quality advice. In addition, an important objective is for a system that demonstrates they are acting in the consumer's interest in order to prevent further intrusive regulation. This desire is often expressed as wanting a system that encourages all intermediaries to put consumers first (and hence preserving the reputation of the industry).

Critical success factors for a better model

Within intermediary businesses, the use of the menu (see section 4.2 for more details), which applies to the whole intermediary business, means that the actions of a minority of advisers within a firm could raise the maximum commission that is disclosed, reducing the competitive position of the firm as a whole. Indeed, intermediaries anticipate that pressure will be brought to bear on them in order to improve their offering. This is seen as a favourable attribute of the menu approach.

Prevents continuous change in structures

Further, intermediaries are generally concerned that continuous regulatory intervention damages the reputation of the industry and of intermediaries in particular. Regulatory change is often undertaken in a way that suggests there was something fundamentally amiss with the original system (and hence change itself is seen as often damaging the reputation of the industry). There is therefore a concern that remuneration systems should not be changed in a way that damages the reputation of the industry, but also that changes should be permanent.

Identifies advice as a valuable service

It is also important for intermediaries that advice is seen as a service in itself and one that is valued. Hence, remuneration structures that enable advisers to signal to consumers that they are undertaking a valuable service and in which their services are seen as important, are to be encouraged.

Incentive alignment

Intermediaries are aligned with consumers in combining the cost of advice with the cost of the product

Remuneration regimes that do not require the consumer to pay separately for advice may be favoured by intermediaries for those consumers who do not want to pay a fee. This is important for intermediaries since it reduces the reluctance of consumers to seek advice and avoids entering into difficult discussions regarding paying for it.

In addition, remuneration within product pricing has clear advantages for intermediaries. In particular, since they are VAT exempt consumers pay less money. Further, they avoid the additional cost of invoicing and time recording systems (although some advisers would see this as a vital component of a professional services company).

Intermediaries aligned with consumers in providing ongoing advice

Intermediaries may also be seeking remuneration regimes that incentivise an ongoing relationship with clients as this reduces the cost of prospecting new customers and lowers the cost of repeat sales. They are therefore interested in remuneration systems that encourage

consumers to value an ongoing relationship but also to maintain the relationship with the particular adviser.

Linked to this, all intermediaries interviewed argued that the structure of remuneration should be directly related to the services provided. Therefore it should be clear whether the commission payments are linked to the provision of ongoing advice. It was argued that the majority of good advisers already saw trail commission as a method of funding such advice rather than as representing deferred initial commission.

In addition, given the desire for an ongoing relationship between the consumer and the adviser, there was substantial concern that some providers prevented the transfer of trail commission when the client switched adviser. It is thought that this both reduces the incentive of poor intermediaries to provide high-quality advice and also perpetuates a view that trail commission represents something for nothing. Hence remuneration structures which enable consumers to ensure their chosen advisers are remunerated are strongly preferred.

Simple and transparent

Simple for intermediaries to understand and explain

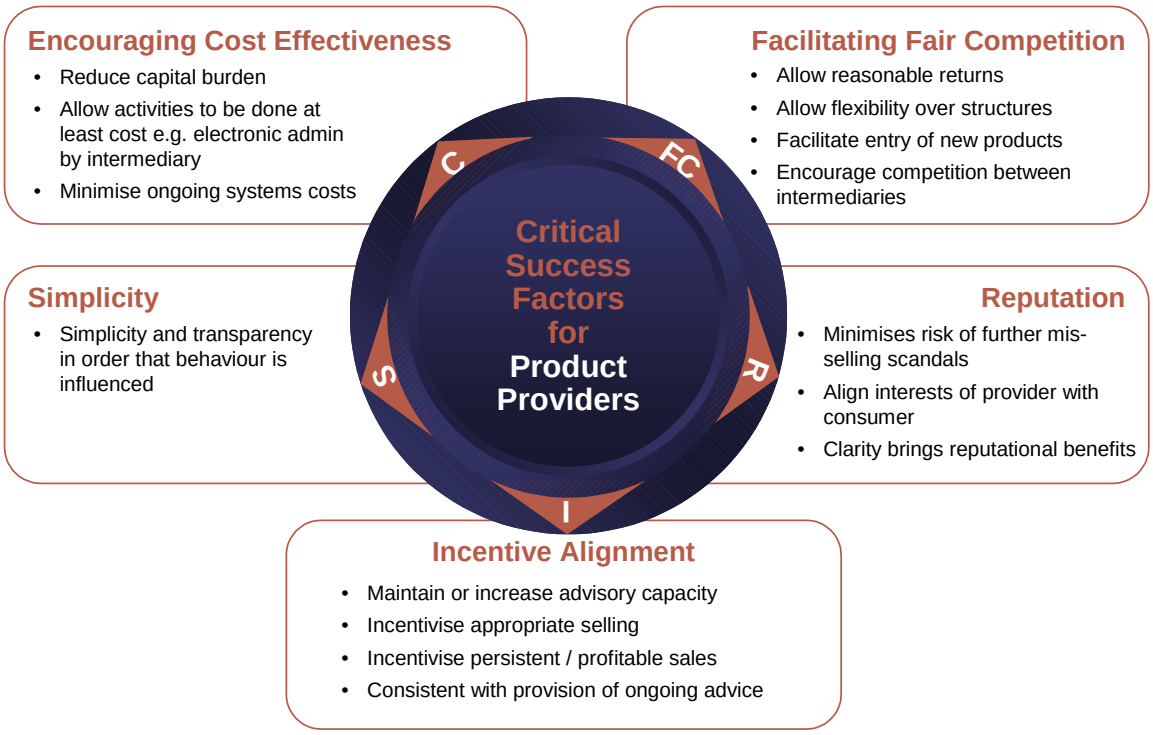
Intermediaries seek remuneration regimes that are simple to understand and to compare. This enables the intermediary to assess their likely income stream and allows transparent communication to the consumer that encourages trust. Finally, regimes that are simple to explain to consumers minimises the time and cost of disclosure.

2.3 CSFs for product providers

Figure 3 below sets out the broad range of CSFs identified through the interview programme with different types of product providers.

Critical success factors for a better model

Figure 3: Critical success factors for product providers



Source: CRA based on interviews with product providers

Encouraging cost effectiveness

Reducing capital strain and spreading financing costs

For a number of providers, there is a preference to reduce the capital burden. Over the recent past there has been a sharp change in the structure and level of charges on some products, without a corresponding change in the structure or level of commission, leaving product providers with higher capital costs for new business. A number of providers believe this is unsustainable in the longer term and new models should consider moving the burden for financing distribution onto other participants who are better able to facilitate this. This may include institutions that are not currently part of today's value chain.

Allows for least cost activities

Providers would like remuneration structures that incentivise intermediaries to deliver products cost effectively. For example, varying remuneration according to the degree of the administrative burden undertaken by the adviser or the technology used for the administration.

Critical success factors for a better model

Minimise ongoing systems costs

Providers are also keen that any remuneration regime should not impose unnecessary systems costs, either with regard to monitoring of remuneration or regarding processing costs. In addition, remuneration models that can overcome difficulties of multiple legacy systems or at least not add to them would be preferred.

Facilitating fair competition

Allows reasonable returns

For providers it is key that the remuneration system allows them to make a reasonable return by greater alignment between the remuneration of advice and product charges. There are concerns that structures of remuneration (or of products) that are misaligned would not lead to a healthy industry in the long-term.

Allow flexibility over structures

Providers would prefer any future remuneration system to retain the flexibility for them to match to their particular product offerings. For example, given the differences in product complexity, case size and the needs to over come consumer inertia, different commission structures may be needed if new products are to be distributed in a competitive market.

Facilitate entry of new products

Providers wish to retain the ability to design remuneration such that new products, or improvements in the quality of products can be signalled to, and identified by, the market. That is, it may be necessary to provide remuneration structures that allow intermediaries to cover the costs of searching out new products and going up learning curves.

Encourage competition between intermediaries

Finally, product providers are keen to ensure that remuneration in the intermediary market facilitates competition such that remuneration levels are reasonable and also to ensure that excessive remuneration is not paid to intermediaries (thereby keeping charges to consumers at a reasonable level whilst allowing product providers to earn a fair return).

Critical success factors for a better model

Reputation

Minimise risk of mis-selling

One of the areas of most concern to product providers is that any new remuneration regime protects the reputation of the overall long-term saving industry both by providing no encouragement to mis-sell and also by incentivising advisers to provide ongoing advice.

This is used to support the case for simpler remuneration systems, where the incentives for providers and advisers are transparent. Others argue that models of remuneration that strengthen the long-term relationship between consumers, advisers and providers will reduce the likelihood of future product crises by ensuring that the expectations of consumers are better aligned with market reality.

Align interests of providers with consumers

Furthermore, preventing conflicts of interest between consumers and providers is seen as an important way to prevent hands-on regulation of the sales process and additional regulatory intervention.

Bring reputational benefits through clarity

In addition, providers are generally in favour of systems which bring clarity to consumers and thereby address reputational concerns. Structures which lead to advice being seen by consumers as a valuable ongoing service are therefore important.

Incentive alignment

Providers aligned with advisers in maintaining distribution capacity

One of the other major concerns for providers was that any future remuneration structure must sustain today's level of advisory capacity. Indeed, structures which allow for distribution capability to increase and for market expansion were clearly to be preferred. Providers clearly recognise that distribution, whether undertaken by themselves or by a third party, needs to be remunerated in order that this activity is actually undertaken. And they further recognise that advisory capacity is required in order that products can be efficiently distributed to consumers.

Providers aligned with advisers in seeking appropriate sales

As well as maintaining the level of distribution in the market today, providers would like to encourage distributors to sell more. A system that rewards distributors for additional sales is therefore seen as attractive from the provider perspective. However, it is important to note

that while additional sales are attractive to providers, there is a recognition that these sales must be suitable.

Providers aligned with advisers in seeking persistent customers

Further, product providers seek remuneration regimes that encourage attractive sales from their perspective. For example, this might mean that the system allows incentives to intermediaries for delivering more persistent consumers and high-value consumers.

Providers aligned with advisers in developing ongoing relationships

Finally, many providers find a remuneration regime attractive that supports the development of sustainable relationships over time. Building customer relationships is seen as a beneficial model for selling further products and hence good for the long-term prospects of the industry.

Simple and transparent

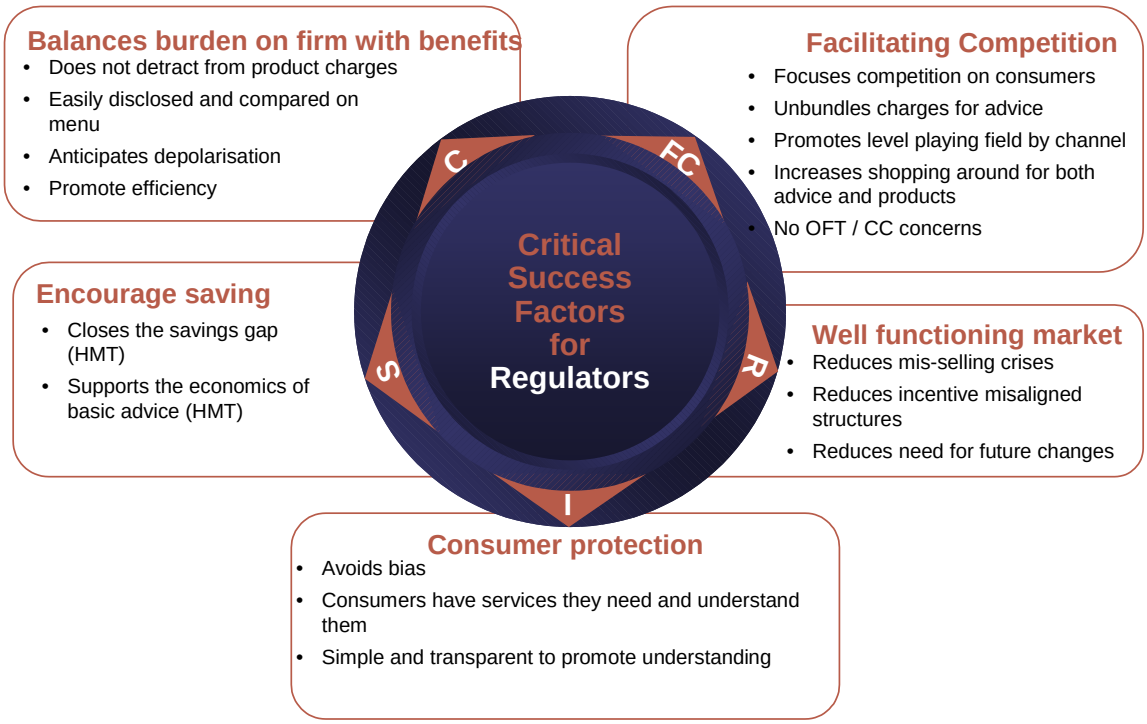
A further CSF for product providers is that remuneration regimes should not become overly complex resulting in any incentive effects being lost due to confusion. There is a concern that some remuneration regimes could have highly desirable characteristics in theory but be so complex that they are not actually understood and therefore do not achieve any of its goals.

2.4 CSFs for regulators

Finally, we need to consider the CSFs from the regulator's perspective. Combining the objectives of the FSA and the Treasury, we end up with a range of CSFs: encourage saving; protect consumers; encourage competition; maintain well functioning financial markets; and minimise the overall cost of regulation by being consistent with other regulatory tools. Given the consumer focus of regulators, it is notable that a number of the CSFs for the FSA and the Treasury will include those factors which are aligned with what consumers *should* want (although as already described in the section on consumers, not all consumers will currently have these preferences).

Critical success factors for a better model

Figure 4: Critical success factors for regulators



Source: CRA based on interviews with product providers, regulators and review of regulatory objectives

Balances burden on firms with benefits of regulation

Similar to the concern of other stakeholders to ensure that remuneration models are cost effective, the FSA has an objective to ensure that the benefits of regulation are balanced against the burden on firms. Hence remuneration models that impose undue costs without clear associated benefits would not be favoured by the FSA.

Does not detract from product charges

Particularly in a world where remuneration is paid for through product charges, it is important that remuneration models do not focus the consumers' attention disproportionately on the remuneration of the intermediary to the detriment of any focus on product charges.

Comparable on menu

Similarly, given the FSA's development of the menu, those models which can easily be disclosed and compared through the proposed structure of the menu will be favoured compared to those models for which such disclosure and comparisons are harder.

Critical success factors for a better model

Anticipates depolarisation

In addition, remuneration models that anticipate the incentives arising from depolarisation (see section 4.1) and hence take into account the changes in regulatory structure that have recently been made, are certainly to be preferred to those models which can only be applied to previously existing types of intermediary i.e. models which are sufficiently flexible to be used across tied, multi-tied and independent channels are to be preferred.[24]

Promotes efficiency

Finally, the FSA and Treasury seek remuneration models that will promote best practice and efficiency in all aspects of the distribution and intermediary value chain.

Facilitates competition

Focuses competition on end-consumers

As with other stakeholders, the Treasury and the FSA are seeking a competitive market-place. At present they have particular concerns that existing remuneration structures focus competition between providers on distribution and intermediaries rather that focusing competition on the end consumers. Regulators seek to encourage providers to design products for consumers rather than advisers.

Unbundles charges for advice

Remuneration that identifies advice as a separate activity with a known cost is seen as attractive in encouraging competition in both the advice and product market.

Increases shopping around

Remuneration models that promote a level playing field across channels and hence increase the amount of shopping around for advice (both within a particular channel and also across channels). Similarly structures which increase shopping around for products are also valued by the regulator.

Promotes level playing field by channel

In addition, structures which promote a fair comparison between the method of remuneration i.e. fees compared to commission, are also useful as there is a perception that consumers do not understand the relative cost advantage of one compared to the other.

[24] The terms multi-tie and limited range adviser are used interchangeably in the report.

Critical success factors for a better model

Does not incur competition concerns

An additional aspect of remuneration models is that they should avoid concerns from the competition authorities i.e. from the OFT or Competition Commission, and be seen to be structures that facilitate a competitive market for consumers. In particular, any collective agreements would need to be seen as bringing efficiency gains for consumers without increasing the potential for anti-competitive or collusive activity.

Maintain well functioning financial market

Reduces mis-selling crises

The regulator is also concerned about the reputation of the industry and would favour remuneration models that prevent future problems of product crises and mis-selling scandals. Clearly it is in the interest of the FSA to prevent problems and to be seen as an effective regulator.

Reduces incentive mis-aligned structures

Linked to this, it seems likely that remuneration structures which have fewer potential problems of incentive misalignment would be favoured e.g. if either the use of salaries or of fees was thought to have none of the concern of alternative remuneration structures then a move towards these would be seen as beneficial.

Reduces need for change

To this end, it also seems to be the case that models which reduce the need for future changes in regulation would be beneficial as there is a recognition that regulations must be allowed to work rather than facing frequent change.

Consumer protection

The FSA's consumer protection remit is similar to the preferences of other stakeholders for remuneration models which both align incentives across the value chain and also are simple and transparent for consumers to understand.

Avoids bias

Remuneration models which align incentives of intermediaries with consumers would reduce any potential bias. This means ensuring that the model does not bias the recommendation on either different product types or on different providers or indeed that models do not provide incentives to sell products that are unsuitable for consumers.

Critical success factors for a better model

Consumers have services they need and understand the services they receive

Remuneration models that clearly deliver to consumers those services which they seek with transparent charges are to be valued. This may also include a preference for such services to be made available for a range of different consumers and not simply for those with large investments. Furthermore, it is also important that consumers actually understand the services that they are receiving. In many cases delivering desired services will include advisers being incentivised to provide a long-term service, but at the very least remuneration models should encourage a discussion around what services are offered in order that consumers can identify which services they require. Hence models in which ongoing remuneration and ongoing services are clearly matched such that consumer expectations of both level of service and cost of advice can be clarified.

Simple and transparent to promote understanding

Simple and transparent models are of importance to regulators since simple models are more likely to be understood by consumers. Not only does this ensure that consumers have a better understanding of the various incentives facing their intermediary and so increase the level of trust between consumer and intermediary, but it would also help consumers to impose competitive restraint on the level of remuneration.

Encourage saving

Closes the savings gap

One of the concerns of the Treasury is that the savings gap should be reduced such that consumers take more responsibility for their needs in retirement. Hence they would favour remuneration models that ensure that sales of savings and investments are sufficient to meet these needs. In addition, some stakeholders are concerned about the possible macro-economic effects of a decline in the size of the saving market regarding the impact on financial markets generally and its impact on capital flows and the associated performance of the whole economy.

Supports the economics of basic advice

Further, the Treasury, through the Sandler review, has designed a range of products in the stakeholder suite which need only basic advice.[25] They are likely to wish to see models of remuneration which are consistent with this sales regime and facilitate the distribution of these products to those consumers for whom they are suitable.

[25] *Medium and Long Term Retail Savings in the UK: A Review*, July 2002.

3 Current trends in adviser remuneration

Even before the recent changes to the regulatory regime have their full effect we would expect the market to continue to evolve due to competitive pressure, innovation and the changing demand of consumers. In this chapter we review the way the market is currently working and how it has changed over the last five years, with the objective of understanding what is driving these changes, whether they are likely to continue and whether the resulting market-place better meets the CSFs set out in the previous chapter. Below we investigate:

- The changing structure of remuneration for advice - in a dynamic market-place structures of remuneration are changing over time and this section examines whether different structures or types of remuneration are becoming more prevalent, what is driving these trends and whether they are likely to continue;

- The importance of different remuneration structures from the provider perspective - covering the relationship between the structure of commission, the structure of charges and the size of commission in industry margins; and

- How remuneration impacts the advice that consumers are given - this section draws primarily on the results of the provider survey and the Mystery Shopping exercise to establish whether the current remuneration structures in both the tied and independent channels are driving any kind of bias in the recommendations made. The section covers whether there is any evidence of: a bias to sell; product bias; and provider bias, and how this compares to the situation when this was last considered in 2001.

The main results of the section are that, based on an analysis of how the market is currently working and ongoing market trends, there is:

- No evidence of bias being prevalent across the advice market;

- No evidence of bias to sell i.e. to over-sell investment products compared to what consumers need;

- No evidence of provider bias on regular premium products;

- Evidence of limited provider bias in single premium products but this has not got worse over the last three years;

- Evidence of limited product bias but this has not got worse over the last three years;

- Evidence of no relationship between the structure of commission and the consumer's service requirements; and

- Evidence of other issues remaining in a minority of recommendations.

The methodology for this section, particularly relating to the assessment of product and provider bias, replicates that of the report undertaken by Charles River Associates for the Financial Services Authority in 2001.[26] For that reason we do not discuss the methodological issues in detail in this report. Differences in methodology are discussed in the annexes to this report.

3.1 Changing structure of remuneration for advice

Below we look at the basis on which advice is currently remunerated in the independent and tied channels. We then consider how this varies by product and consumer.

3.1.1 IMPORTANCE OF DIFFERENT FORMS OF REMUNERATION

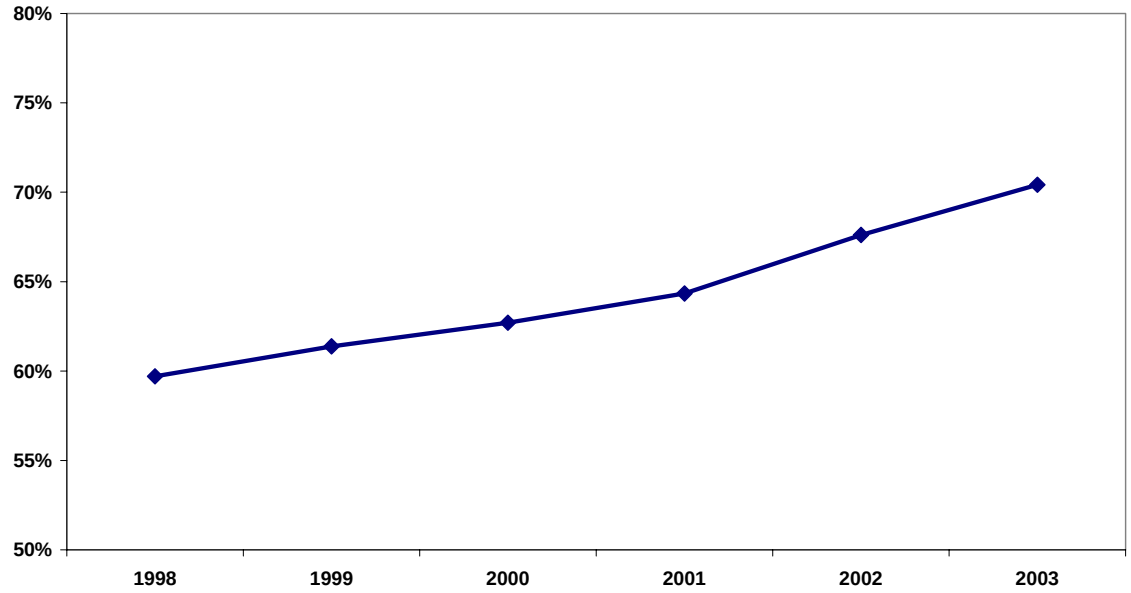
IFAs

Figure 5 below provides details on the proportion of IFAs who have any fee based income. It is clear from the chart that a higher proportion of IFAs had fee based income in 2003 compared to 1998, with the proportion increasing from 60% to 70% over the last five years.

[26] *The effect of commission based remuneration on financial advice*, Charles River Associates for the Financial Services Authority, December 2001. This was published alongside CP121 and is available on the FSA's website.

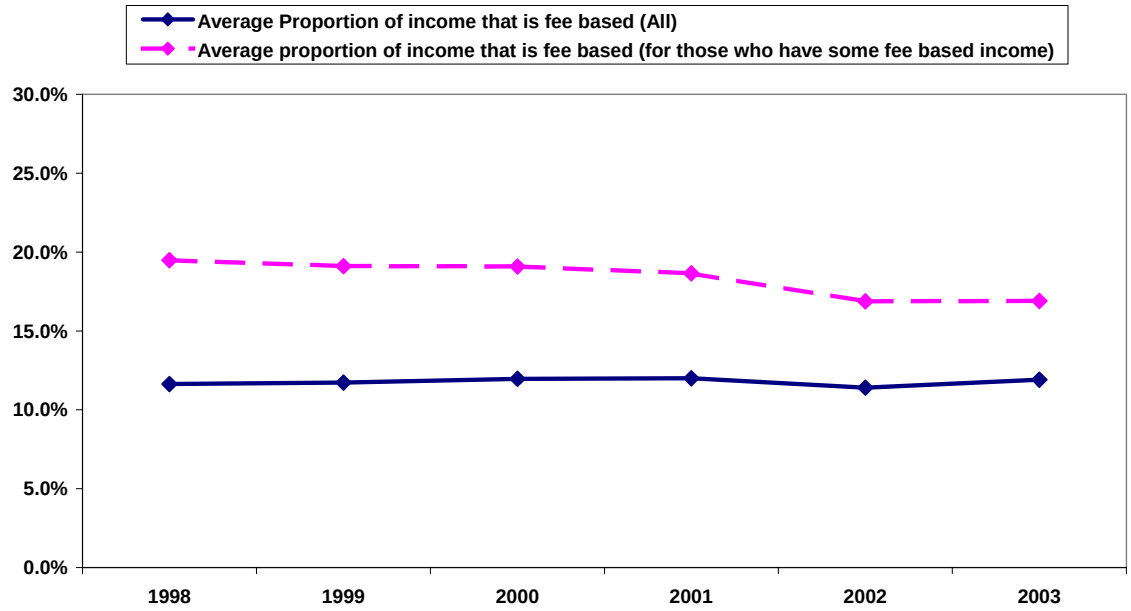
Current trends in adviser remuneration

Figure 5: Proportion of IFAs with some fee based income



Source: CRA analysis of MATRIX IFA Data

Figure 6: Average proportion of IFA income that is fee based



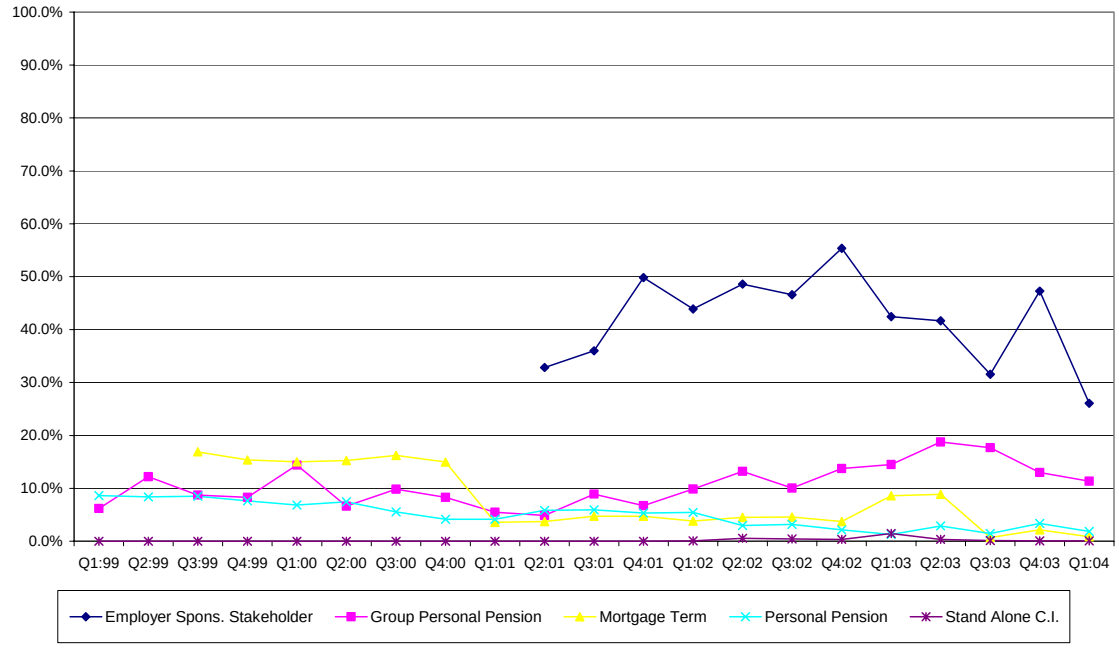
Source: CRA analysis of MATRIX IFA Data

Current trends in adviser remuneration

However, although the proportion of IFAs who use fees is increasing, it is worth noting that the average proportion of turnover that fees account for has actually remained relatively constant over the same time period – at around 12% of income. The seeming contradiction can be explained because the increased proportion of those advisers having some fee based income is offset by a small but gradual decline in the average proportion of income that is fee based for those that have some fee based income (falling from around 19% to 17%), as is seen in Figure 6 above.

It is clear from the information on fee based advice that the great majority of remuneration in the IFA sector comes through commissions rather than through fees. Examining the range of products covered in our provider survey also supports the evidence that there has not been any significant increase in the level of business written on a fee basis (as measured by the business written on nil commission terms).

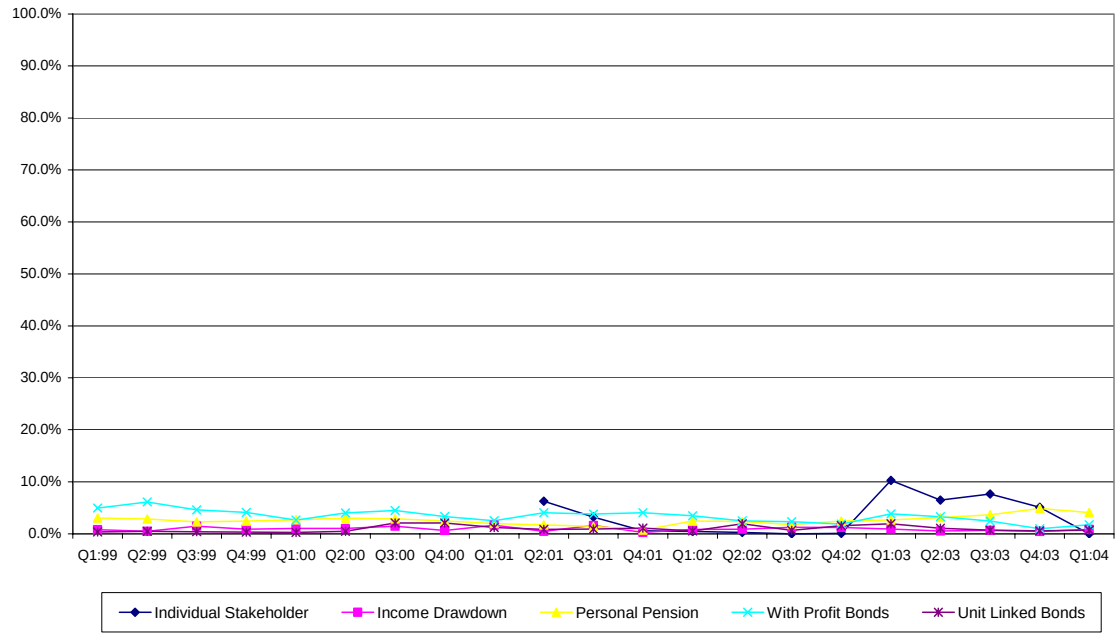
Figure 7: Share of new business written on a fee basis (as measured by business written on nil commission) for regular premium products



Source: CRA analysis

In fact, as can be seen from Figure 7, we have seen a decline in the share of new business written on nil commission terms in mortgage term and individual personal pensions, although we have seen an increase for group personal pensions in the last three years. The results for the employer-sponsored stakeholder market are indicative that fee based business is greater in this market segment; however, the low number of responses by providers in this category means that this is estimated with significant uncertainty.

Figure 8: Share of new business written on a fee basis (as measured by business written on nil commission) for single premium products



Source: CRA analysis

In the single premium categories there is a lower level of new business written on a fee basis and again there is little evidence to support any increase in fee based remuneration. Again the stakeholder result is based on relatively few providers and little weight should be placed on the variation observed.

In addition to the evidence on fees and commissions it is also worth noting that even where the IFA company is being paid by commission, it is possible that the individual adviser is paid by salary. On the IFA side, it is thought that those advisers who are part of nationals and regionals are more likely to have a higher proportion of their remuneration coming through salary than those who are network members. However it is not possible to get accurate data to support this assertion.

Tied advisers

If we turn to the tied channel, there are differences between advisers for whom salary represents a significant proportion of remuneration and those for whom remuneration is entirely driven by sales-related factors.

Current trends in adviser remuneration

The great majority of bank staff have some element of salary, although this is less the case with the tied sales forces for insurance companies. Indeed within the banks, well over half of remuneration is paid in the form of salaries. The average tied adviser would typically have about 70% of their remuneration paid through salary, with some banking staff having a considerably greater proportion than this. Further, there is some evidence from our survey that this proportion has grown slightly over time. However, it should be noted that salary levels may be determined in part by previous performance in which the previous level of sales may be a determining factor.

With advisers who are tied to insurance companies, the degree to which salary forms a component of remuneration depends on the structure of the relationship between the insurance company and the adviser i.e. whether they employ their advisers or operate a franchise system.

Considering the tied side as a whole, it seems likely that since banks have become more prevalent in this sector and many insurance companies have reduced or closed their direct sales forces, the proportion of remuneration represented by salary has increased for the average tied adviser.

As part of the tied provider survey, discussions were held regarding the use of qualitative measures as a factor determining bonuses. Although the exact means of how such factors fed into bonuses varies considerably across the various tied providers, all those contacted indicated that quality factors did have an important impact and these factors were thought likely to become more important in the future.

It was clear that there were a number of different ways in which these factors fed into remuneration. For some, the failure to meet minimum standards, particularly relating to compliance, led to retraining, or potentially the loss of a job for serious compliance breaches, or alternatively it led to a failure to qualify for any bonus if it related to less essential issues. For others, it was clear that performance regarding qualitative factors could act to reduce or increase the bonus available to individual advisers.

Typical factors that fed into remuneration included:

- links to persistency;
- fact finds completed to a high level;
- completeness of the data provided;
- compliant nature of the sale; and
- no unnecessary churning of business.

Additional factors that also fed into bonuses in some companies included factors such as the degree to which advisers assisted other members of the company and were seen as team players as well as other traits which were seen as beneficial from a managerial perspective.

3.1.2 DIFFERENT STRUCTURES FOR DIFFERENT PRODUCTS[27]

The degree to which remuneration varies across products differs between the type of adviser and indeed between the type of institution under consideration.

IFA channel

Looking at commission earning products, we can examine the proportion of new business written under different distribution structures. In the provider survey, we investigated:

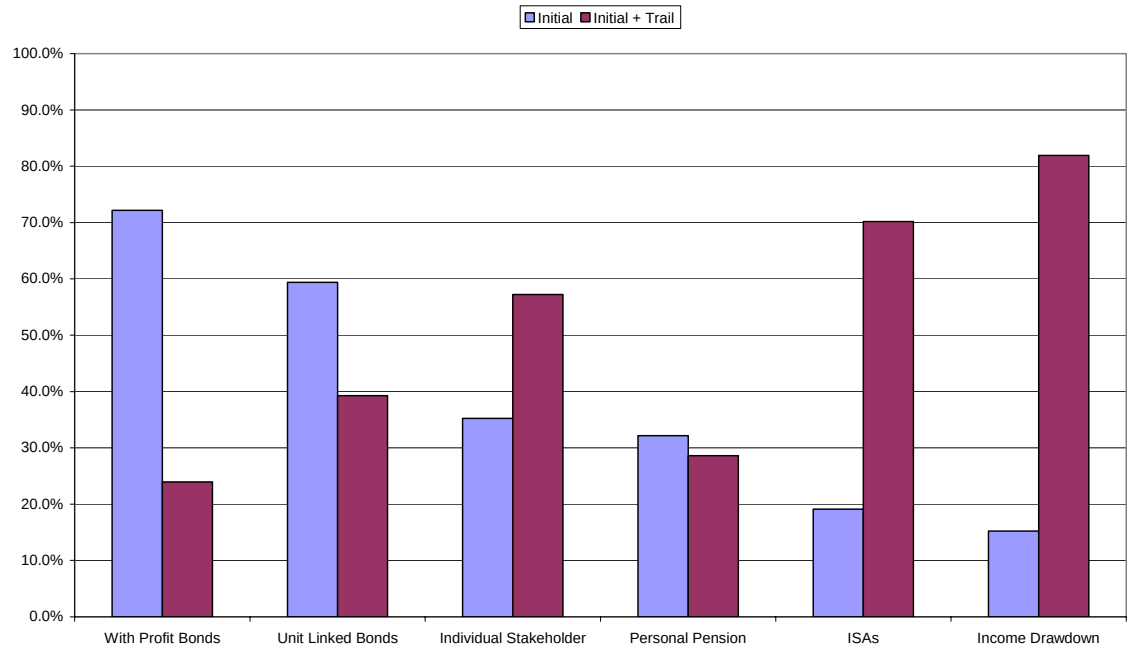
- the proportion of single premium business written on initial only terms versus initial plus trail; and
- the proportion of regular premium business written on initial plus renewal terms versus initial plus fund based trail commission.

We find there are substantial differences between products.

[27] Commission can take a number of different structures. Initial commission is commission paid to the adviser in the initial period and can take two forms: non-indemnity commission which is not subject to any clawback and is paid on an "as earned" basis as the premium is received; and indemnity commission, this is paid upfront but is then subject to clawback by the provider should the consumer lapse. Clawback is where the adviser has to return some of the commission they received because the consumer has lapsed the product soon after it was taken out. Indemnity commission is calculated as the initial commission discounted back. Renewal commission is payable after the initial period and rewards the intermediary for persistent business of regular premium business. Trail commission performs a similar function to renewal commission for single premium business.

Current trends in adviser remuneration

Figure 9: The proportion of commission bearing new business written on particular commission terms for single premium products (averaged over the period 1999-2004)[28]



Source: CRA analysis

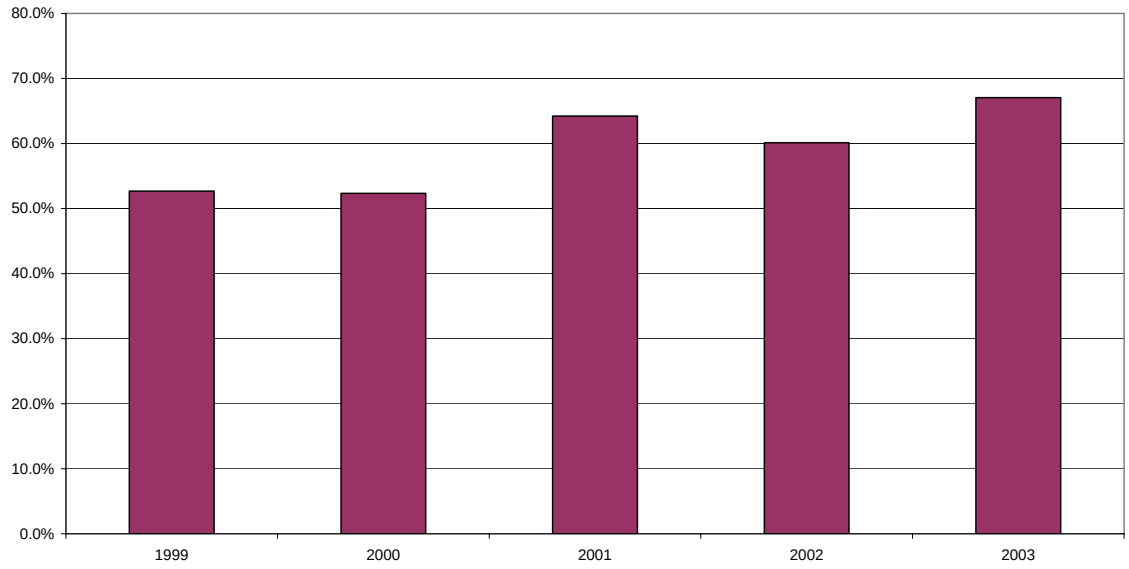
As shown in Figure 9, the structure of commission varies from with-profits bonds that have 70% of their new business written on initial only terms, to income drawdown products that have over 80% of new business written on initial plus fund based trail.

Over time we find that, with the exception of personal pensions, all the products under examination saw an increase in the proportion of business written on an initial-only basis over the five-year period. This is illustrated by the example of unit linked bonds in Figure 10 below.

[28] Note that these figures do not sum to 100% as they exclude new business written on nil commission terms and that written on fund based only terms.

Current trends in adviser remuneration

Figure 10: Proportion of new business written on initial only terms for unit linked bonds

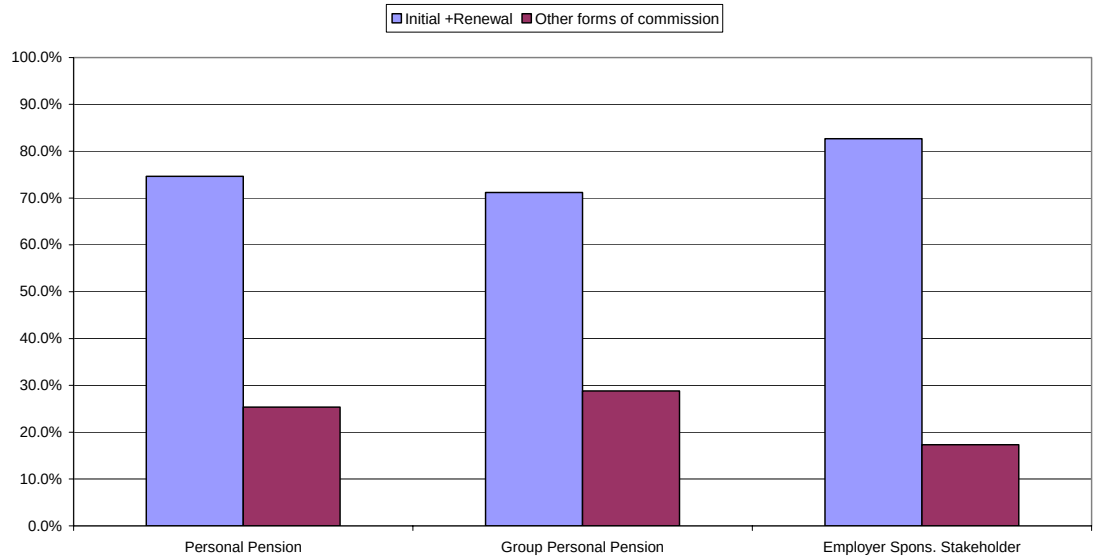


Source: CRA analysis

In contrast to the general trend of an increase in the proportion of new business written on initial-only terms, personal pensions saw an initial decline but this has grown back to the level observed in 1999. There is too short a time-series on individual stakeholder pensions to draw any strong conclusions.

For regular premium products, the protection products (mortgage term, standalone critical illness and term assurance) are written on an initial plus renewal basis and are not included in Figure 11.

Figure 11: The proportion of commission bearing new business written on particular commission terms for regular premium products



Source: CRA analysis

Looking at the proportion of commission bearing regular premium pension products we find there is little variation between personal pensions, group personal pensions and employer-sponsored pensions regarding the proportion written on traditional commission (initial plus renewal terms).

However, this obscures a significant trend that has seen the proportion of new business written on initial plus fund based commission or level terms rise since the introduction of stakeholder pensions for personal and group personal pensions.

Tied channel

Information from tied advisers reveals that there is a significant difference in remuneration structures between banks and insurance companies.

In particular, the great majority of the banks who participated in our tied adviser survey had remuneration structures that gave the same remuneration for products that could be classified as investment products. That is, advisers would typically receive the same reward whether they advised ISAs, unit trusts, unit linked bonds, guaranteed equity bonds or (where applicable) with-profit bonds. Similarly, advisers typically received the same reward whether they advised personal pensions or stakeholder pensions (although in some cases this could be a different value to that received on investments). This was not the case for protection products where there was more variation in rates observed. Product providers indicated that

this was because the products serve different needs and hence have different costs of advice for the adviser. Thus it is clear that for the banks, within the categories of investments and pensions, there is limited potential for product bias at the adviser level.

The insurance companies who have tied advisers follow a different model to the banks. The primary reason for this is that these companies are often using a franchise model and their advisers are generally seen as being in the same "adviser market" as IFAs from the perspective of providers and hence the providers offer similar, if not identical, structures and levels of commission as those they offer to IFAs. Particularly with those companies that operate a franchise system, there are concerns expressed that the Registered Individual (RI) has considerable freedom to switch to a different provider or move to being an IFA if their current provider alters commission shapes or levels to a significant degree.

Hence tied advisers who advise on the products of some of the insurance companies do face different incentives across products in the investment category including, but not limited to, differences between unit trusts and unit linked bonds.

Innovative forms of remuneration

Through the interview programme with different product providers and intermediaries we investigated whether innovative methods of remuneration had been used over the last five years and their implications.

Accelerated fund based commission

Some providers have chosen to encourage the take-up of fund based commission (whilst reducing their levels of commission overall) by offering intermediaries the opportunity to receive a greater proportion of their fund based commission upfront through "accelerating" the payment. These models, it is argued, have the advantage of allowing upfront commission to cover initial costs, allowing the potential for higher levels of commission, whilst adding long-term value to the business.

In these models the expected fund based commission is calculated over a period of time (for example ten years) by using an expected growth in the fund and possibly growth in premiums over ten years and then paying the resulting expected fund based commission at the start of the period. The actual fund based commission that would have been earned over time is set off against this upfront instalment. Once this is paid off, the adviser will again receive conventional fund based remuneration; if the commission payments are lower than expected – due to lower investment returns – the payback period is longer than the ten years. There are a number of differences between providers regarding the exact terms of the commission structures e.g. the degree to which commission will be clawed back. From an economic perspective this implies:

Current trends in adviser remuneration

- A loan for intermediaries where the interest rate depends on the difference between fund based commission rate with, and without, the accelerator;[29]

- A trade-off between security of timing of income upfront versus uncertain cash flow from fund based commission (although clawback remains); and

- Uncertainty has moved to the timing of the recommencement of fund based commission.

This form of commission offers the opportunity to move advisers onto fund based commission (thus increasing the embedded value of the adviser business) while providing them with initial commission. However, in doing this the structure of commission has been made more complex and comparison across structures more difficult. The current picture regarding the success of these products is mixed, with some providers gaining share, whilst others have found intermediaries wedded to traditional indemnity commission.

Factoring

A number of providers have introduced factoring schemes allowing them to move the cost of commission financing away from the life office balance sheet onto that of a commercial bank balance sheet. It was argued by some providers that changes to life office accounting standards will make commission financing less attractive to life offices.

Trading off initial commission versus trail commission

A variety of providers offer intermediaries a choice of commission structures within any given product. In particular, there is often a choice between structures with higher initial commission and lower ongoing commission and those with lower initial commission but higher ongoing commission e.g. offering intermediaries the choice of 6% upfront and no trail or 4% upfront and 0.5% trail, or a range between the two.

The choice depends entirely on the intermediary and is seen as changing the timing of payment rather than the level of remuneration. From an economic perspective this has a number of characteristics:

- A movement from initial commission to fund based trail commission means the intermediary is subject to the risk of investment performance; and

[29] For example, accelerated commission must always be more valuable than the level of implicit fund based commission used to calculated the upfront payment. That is, it is better for the intermediary to have £100 today rather than £10 each year for the next ten years. The alternative is for the intermediary to accept a higher level of fund based commission but have to wait for the returns over time.

Current trends in adviser remuneration

- A movement from initial commission to trail commission means the intermediary is subject to greater persistency risk, but providers are subject to less risk (although indemnity commission with clawback may also lead the intermediary to face persistency risk).

Although a number of providers offer such a choice of commission structures, there is considerable variation between providers as to the degree to which it has been taken up. Some providers claim that up to 50% of advisers choose to trade-off initial commission for greater trail commission, whilst other providers see the great majority of advisers as choosing to stick to initial focused commission structures.

Wraps

Wraps are offerings which combine different underlying products into one overall package. They could include the ability to exploit any product-specific tax advantages and facilitate switching between different types of products as well as consolidating information about the overall package.

The potential development of wraps, in which a variety of products of different structures are captured within one package, is an area that brings particular implications for remuneration structures, especially since they could combine products that currently have very different remuneration structures.

At present the majority of offerings which would currently be classified as wraps in the UK have commission structures that are based on the underlying products rather than at the overall wrap level. There are limited examples of offerings where pricing and commission structures are designed at the overall wrap level, although these are thought to be more common in locations such as Australia where wraps themselves are more popular.

Fund of funds products are similar to wraps in that they consolidate information and allow for easy switching. The main difference between fund of funds and wraps is that only unit trusts underlie the former whereas the latter also allow for insurance based products to sit alongside unit trusts. The main benefits from a fund of funds are the cost advantages for advisers, the smaller amount of paperwork and the ease and low cost of switching. From the provider's perspective, it is clear that there is a lower chance of switching away from the fund of fund provider even when there is switching of the underlying funds.

The structure of remuneration for fund of funds products has been seen to be broadly identical to that for unit trusts with the most common commission structure being 3% initial commission with 0.5% fund based trail commission. It seems therefore that the extra functionality for both consumer and adviser in a fund of funds compared to a unit trust is paid for partly by the lower cost of administration, as well as the ability of the fund of funds provider to exploit economies of scale from the fund managers and pass on lower prices to consumers.

The expectation is that other wrap products would follow the structure of commission that is already observed on fund of funds. It is also expected that wraps could facilitate a more transparent structure for remunerating advice. In particular, it is thought that wraps will be able to separate the charges for the product and the charges for the commission in a straightforward way enabling the latter to be agreed between consumer and adviser. However, it should be noted that while wraps may facilitate this transparency, they are thought unlikely to be at the forefront of developing and driving this transparency – in part because consumers are currently thought to be unwilling to move to such transparency for wraps alone.

3.1.3 DIFFERENT STRUCTURES FOR DIFFERENT CONSUMER NEEDS

The remuneration structure used to reward advisers could vary by consumer. This could reflect the demand for different structures (fee versus commission), the product advised but also whether the individual negotiates or is offered a superior deal (usually in the form of a rebate) or whether the type of relationship requested by the consumer affects the structure of remuneration.

Rebates

In the IFA channel, some advisers will offer rebates on commission for the benefit of their consumer. Typically this will lead to either an increased premium being invested in the product (increased allocation) or to lower charges being imposed.

A small number of IFAs did indeed offer Mystery Shoppers a rebate of commission, although the percentage overall was lower compared to a similar exercise 3 years ago.

Table 1: Comparison of rebates in 2001 and 2004[30]

	Proportion of shops in which a rebate was offered	
	2001	**2004**
Commission based IFAs	22%	16%

Source: CRA calculations based on NOP Mystery Shopping 2001, 2004

For those shops in which rebates were offered, the resulting average initial commission was brought down from £1,260 to £840. Hence the average value of rebates in 2004 was found to be £420 or around 33% of the total initial commission.

[30] The Mystery Shopping exercise is based on 167 fully documented shops and sample sizes of individual scenarios and can be found in Annex 4.

In those shops in which rebates were not offered, the average initial commission was £705 and hence those shops where rebates were offered still receive commission rates of around £135 more than those shops in which rebates were not offered.

The relationship between consumer and adviser

The Mystery Shopping also provides evidence on the link between trail commission and ongoing services. In the Mystery Shopping, some shoppers went to advisers seeking an ongoing relationship with them whereas others were looking only for one-off advice. It can be seen in Table 2 below that there was no difference in the structure of commission that advisers received between these different scenarios.

Table 2: Structure of commission

Scenario	Proportion of shops with trail commission
One-off	48%
Ongoing relationship	47%

Source: CRA calculations based on NOP Mystery Shopping

Although this evidence does not necessarily imply that consumers do not receive the service they are seeking, it does mean that there is no incentive to ensure that the appropriate services are provided. Further, it does not distinguish the cost of advice between those who seek one-off advice and those seeking an ongoing relationship.

The Mystery Shopping focused on whether the structure of commission at the point of sale is related to the type of relationship. However, it is also useful to consider the degree to which consumers use the ability to move trail or whether providers prevent them from doing this.

Although trail commission must be disclosed at the point of sale, (and indeed it will also be disclosed on the menu), evidence seems to suggest that after the point of sale the value of trail commission is rarely revealed to consumers on an ongoing basis. Hence consumers are often unaware about the level of commission that is being paid to advisers on a regular basis.

Advisers, on the other hand, are clearly more aware about the use of trail commission. There is evidence that when consumers switch advisers, the new adviser will seek permission from the consumer to switch the stream of trail commission to them and away from the previous adviser. The ability to switch trail commission, and indeed the fear that consumers may do this, should be acting as a constraint on adviser behaviour and, in particular, that advisers should be seeking to offer high-quality ongoing service to match the trail commission that they receive.

However, given that consumers are not always aware of trail commission, not all of them know that they could constrain adviser behaviour. For those who do understand trail

commission it is extremely difficult for them to impose a constraint on adviser behaviour except through the threat of moving to a different adviser. Indeed there seems to be little that the consumer can do in the case where they believe they are not receiving ongoing service or do not wish to receive such service.

Furthermore, there is evidence in the market-place that not all providers allow trail commission to be switched to the new adviser. It seems that preventing this from occurring means that consumers lose all ability to impose constraints on their adviser's behaviour except through switching out of the product which they may not wish to do.

3.2 Providers and commission

To understand the importance of remuneration for product providers, we need to consider the relationship between the revenues they receive (through product charges) and the cost of distribution and the relative importance of commission in terms of providers' cost structures.

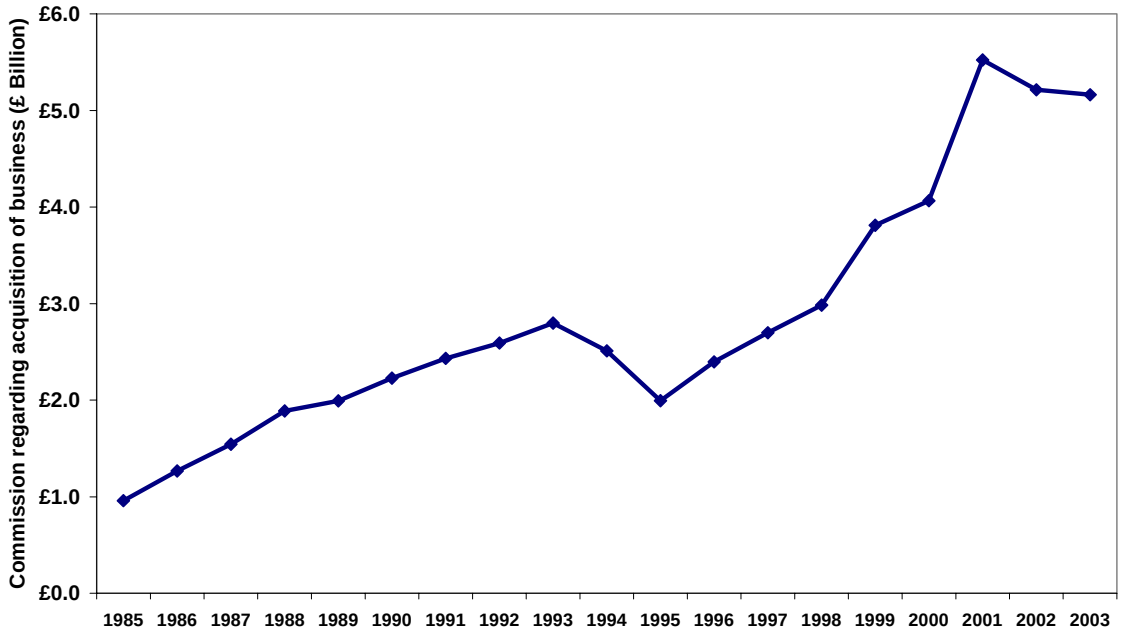
3.2.1 COMMISSION IN INDUSTRY MARGIN

In this section, we examine the importance of commission in the life and pensions arena. Margin figures in the life and pensions industry are not straightforward to understand due to the upfront cost of acquiring business compared to the ongoing revenues that accrue. This often means that acquiring new business can be seen as driving short-term losses even though it may add to the long-term value of the business. In particular, profit (or loss) figures for the industry have considerable variation in them, making a comparison of commission to profit difficult to interpret. Hence, below we focus on the value of commission and how it compares to the level of premiums.

Figure 12 below shows the cost of commission by the life industry in the acquisition of new business. It is clear from this figure that the value of commission has increased five-fold over an 18 year period.

Current trends in adviser remuneration

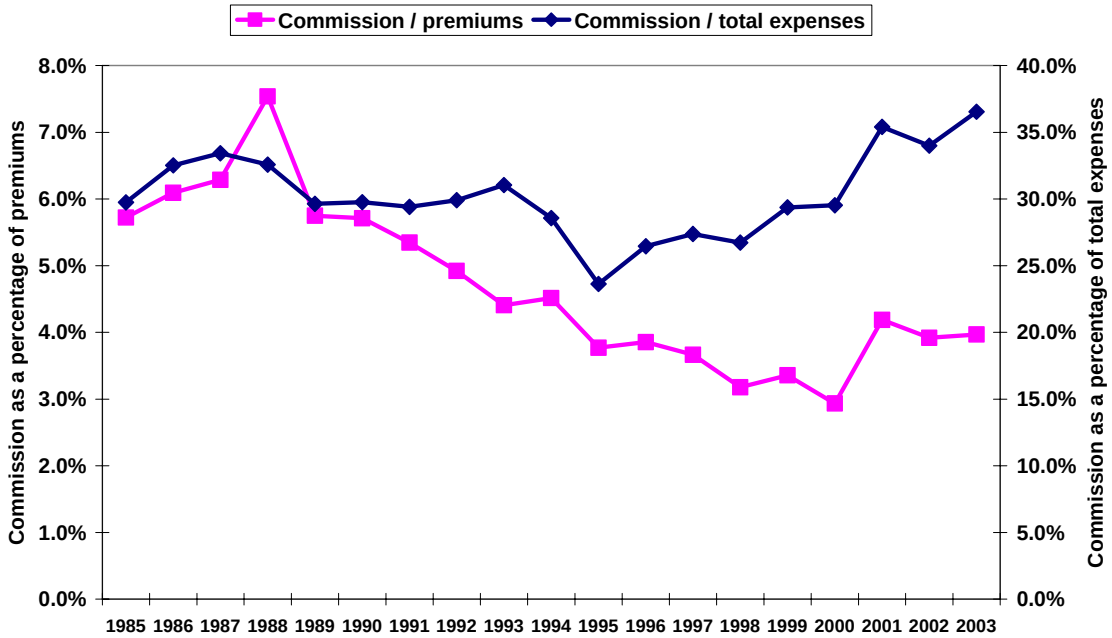
Figure 12: Expenditure on commission to acquire business



Source: CRA calculations based on SynThesys Life 2003

However, the increasing value of commission payments must be set in the context of the value of business that is being written. Figure 13 below compares the commission used in the acquisition of business to the value of premiums.

Figure 13: Commission as a percentage of income and of total expenses



Source: CRA calculations based on SynThesys Life 2003

It is clear from the chart that commission has been falling as a percentage of premiums from a peak of 7.5% in 1988 to a low of 2.9% in 2000. However, the last few years have seen a reversal of this trend as commission has increased to 4% of premiums. The main cause of this has been stagnant premiums while commission jumped by 20% in 2001 as was seen in Figure 12. When considering commission in comparison to other expenses, it has remained a broadly constant proportion over the period.

It is important therefore to see the concerns regarding commission in the context of commission relative to premiums falling over the last fifteen years, suggesting that any detriment driven by commission may fall in importance over time. (Although the last few years have seen a halt to this steady decline, commission rates as a proportion of premiums are still well below their level in the late 1980s.)

A further development in the market is the advent of "realistic reporting" which is forcing life and pension companies to take a more detailed look at the underlying finances of the various products that they offer. Although it might be expected that well-run companies would already have a detailed understanding of the contribution made by various products, realistic reporting requirements may bring into view facts that were not previously understood by managers regarding some of their offerings. If this leads to the identification of products which are not thought to be profitable given current levels of remuneration to advisers, this could lead companies to reassess the product, the remuneration offered or to look at other ways to improve the profitability of products.

3.2.2 RELATIONSHIP BETWEEN COMMISSION AND CHARGES

Using information from the Mystery Shopping exercise also allows us to examine the relationship between commission and charges. The main consideration is to see whether the products with high initial commission also have high charges and hence whether the high commissions are being passed straight through to consumers.

In order to compare charges, we use the Reduction in Yield (RIY) figures which companies disclose in the key features documents and on personal illustrations. The RIY is a measure of the level of charges. A high RIY indicates that charges are higher than a low RIY.

We compared the RIY on products after ten years.[31] In particular, we compared the RIY on unit linked bonds and that on ISAs. We found that there was no evidence that products on which there is high initial commission paid (unit linked bonds) have a higher reduction in

[31] Although information on the transfer value is also disclosed at the five-year mark, it is not always converted into a reduction in yield which was more commonly disclosed at the ten-year mark. Hence we have chosen to compare information at the ten-year mark, even though a comparison at five years would have been more appropriate for the scenario under investigation in the Mystery Shopping exercise.

yield than those on which there is a lower initial commission paid (ISAs) if the product is held for ten years.[32] This is consistent with the evidence found in our work for the FSA in 2001.[33]

3.3 Impact of remuneration on advice

This section considers whether the way advisers are paid is related to the advice offered.

3.3.1 BIAS TO SELL

There were a number of different tests that were undertaken to assess whether there is a bias to sell, including:

- comparison of fee based versus commission based IFAs in terms of amount invested; and
- pressure to buy analysis based on the Mystery Shopping.

Comparison of total equity investments

One of the key tests for the Mystery Shopping exercise was to undertake shops on a fee basis. To our knowledge this has never been attempted in a systematic way before. Partly this was in order to address the accusation often thrown at the industry that commission based advisers are biased to sell investment products, whereas fee based advisers, since they will be paid regardless of whether consumers purchase a product, are not. Hence, it is often argued that there would be less detriment occurring if the market moved toward fee based remuneration.

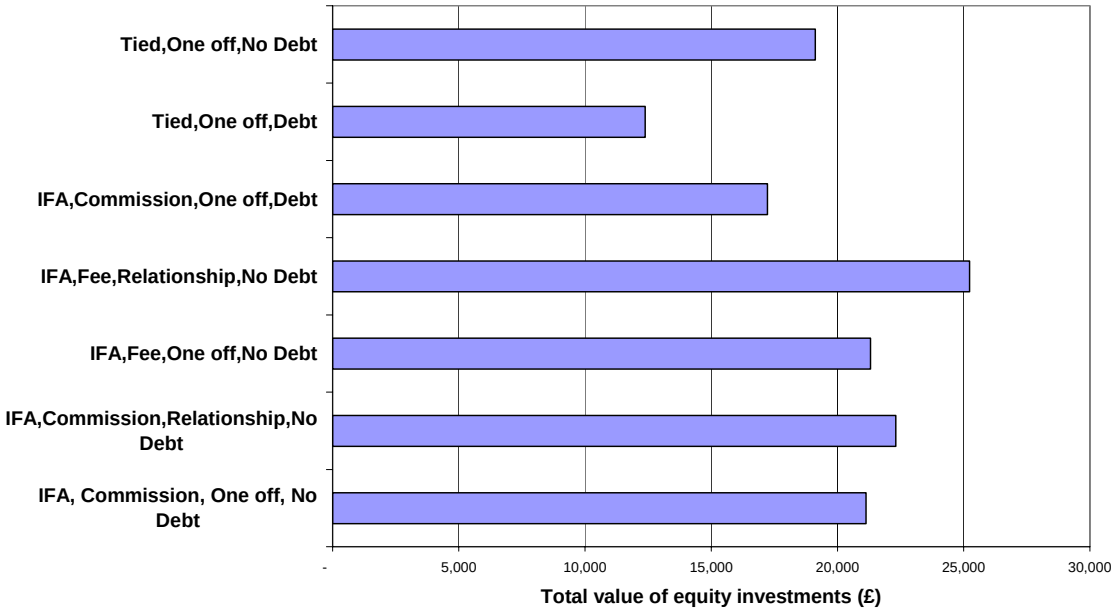
We therefore examine the total value of investments that were recommended for investment in equity-based, and commission bearing, investments across all the scenarios and the results of this can be seen in Figure 14 below.

[32] However, this does not allow for tax differences that the IFA group saw as a key characteristic to recommend ISAs.

[33] *The effect of commission based remuneration on financial advice*, Charles River Associates for the Financial Services Authority, December 2001. This was published alongside CP121 and is available on the FSA's website.

Current trends in adviser remuneration

Figure 14: Comparison of total equity-based investments[34]



Source: CRA calculations based on NOP Mystery Shopping

As expected the total value of equity investments is noticeably lower in the debt scenarios than in the no debt scenarios – since the majority of advisers did recommend that shoppers repay debt.

It is also notable that tied advisers typically recommended lower average equity investments than did IFAs. This may well reflect the fact that tied advisers have a substantial proportion of their remuneration paid through salaries, although it should be noted that retention of jobs and future career development will also typically be partly determined by sales and hence they nonetheless retain an incentive to sell products. Alternatively, it could reflect internal procedures in which recommendations for maintaining emergency savings are greater than many IFAs will use as a rule of thumb.

However, contrary to the accusations often facing the industry, commission based advisers do not in fact tend to recommend a greater level of investments into equity than do fee based advisers. In fact, the average level of investments recommended are higher for advisers operating on a fee basis than those on a commission basis although there is no statistically significant difference in these numbers.

[34] It should be noted that Guaranteed Equity Bonds have been included within the definition of equity investments even though they are often legally structured as deposit accounts with uncertain returns. Given that there is a risk involved in terms of the return that will be made, the lock in period typically associated with them and the similarity of commission structures, it seemed appropriate to include them within this description.

We conclude from this that there is no evidence of a bias to sell by advisers working on a commission basis compared to those working on a fee basis. However, this may raise the question of whether advisers operating on a fee basis face a bias to sell despite the fact that they will receive fees irrespective of whether the consumers purchases a product. The view of the IFA group who assessed the Mystery Shopping was that in the great majority of recommendations given by advisers operating on both a fee and commission basis were reasonable given the consumer's needs.[35]

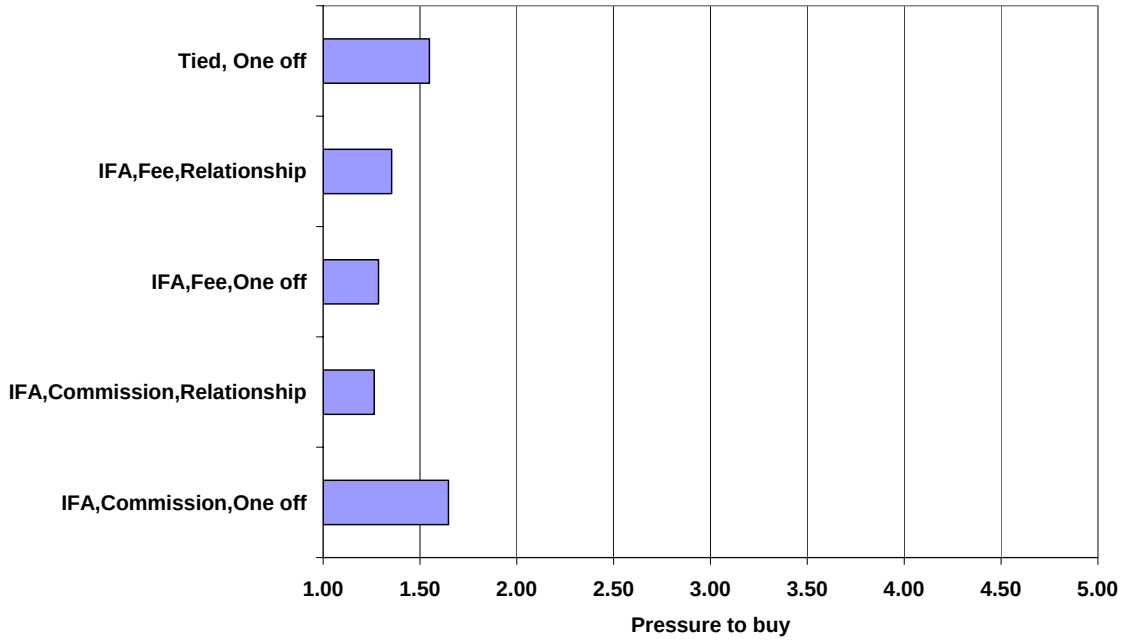
There are also small differences observed between the relationship and one-off advice scenarios in which those shoppers seeking ongoing relationships are recommended a greater level of equity investments from both IFAs operating on a commission basis and those operating on a fee basis. It is possible that this recommendation occurs because of the potential ongoing relationship, as IFAs will recognise that they are more likely to be asked to monitor the investments on an ongoing basis.

Pressure to proceed with recommendation

As part of the analysis, shoppers were asked whether they felt under pressure to proceed with the recommendation of the adviser. They were asked to rate this on a scale of 1 to 5 in which 1 represented "Under no pressure at all". It is important to recognise that the shoppers are not typical customers of financial advisers in that they knew when undertaking the visit that they would not be pursuing the recommendation. Nonetheless their views are useful in establishing whether there is considered to be a "hard sell" environment.

[35] The IFA group was not shown information that distinguished the results from the fee based scenarios from those in the commission based scenarios but rather saw combined information.

Figure 15: Pressure to proceed with recommendation



Source: CRA calculations based on NOP Mystery Shopping

It is clear from Figure 15 above that shoppers generally did not feel under pressure to proceed with the recommendations of advisers, and many shoppers indicated that advisers had suggested that they take time to consider the recommendations. Indeed, in less than 3% of all shops did shoppers rank the pressure as 4 and no shopper ranked it as a 5.

3.3.2 PRODUCT BIAS

There are a number of different issues examined when considering whether there is any evidence of product bias from the Mystery Shopping:

- Is the product mix different across scenarios?
- Do advisers recommend ISAs?
- Are these results linked to different levels of initial commission?
- Do high commission paying products represent poor advice for the consumer (assessed using guidance from the IFA group)?
- Do high commission products results in high charges?

Product mix

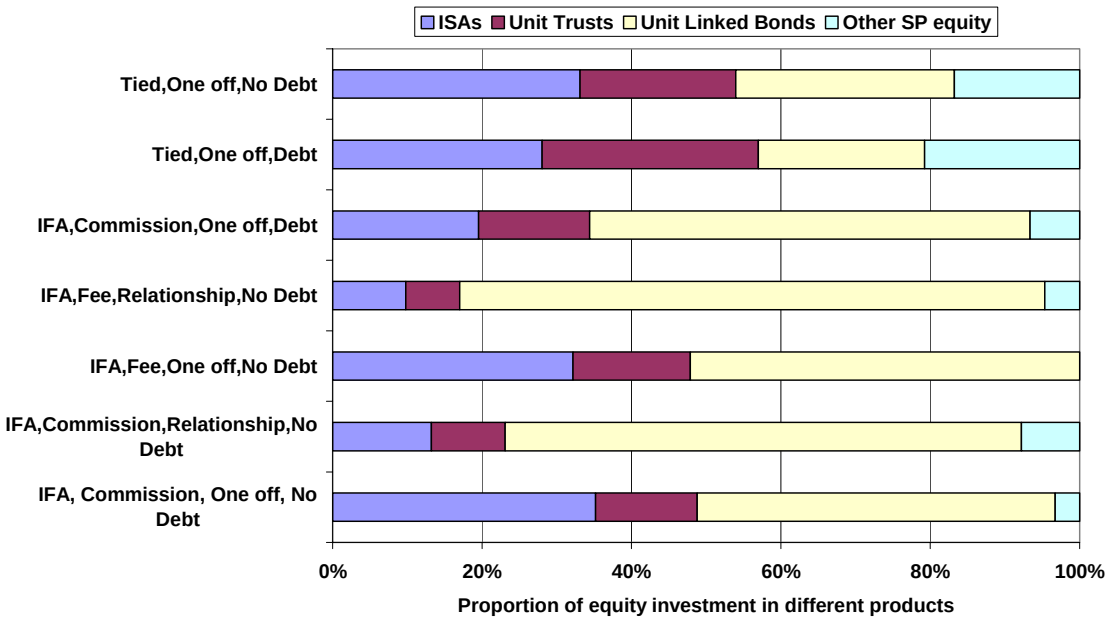
One factor for consideration is the overall split of different types of products that are recommended between the various different scenarios.

A range of single premium products were recommended including:

- ISAs;
- Unit trusts;
- Unit linked bonds;
- With profit bonds;
- Guaranteed Equity bonds; and
- Discretionary portfolio management.

In general, it was not thought by the IFA group that any of these recommendations would be seen as unsuitable, although they were surprised by the recommendation of discretionary portfolio management, arguing that the portfolio was not really large enough to require such a service. However, since this was only recommended in one instance it is not examined further. The chart below compares the product mix of recommendations and combines the with profit bonds, guaranteed equity bonds and discretionary portfolio management into the "other single premium" category.

Figure 16: Product mix by scenario



Source: CRA calculations based on NOP Mystery Shopping

It can be seen from Figure 16 that the average recommendation appears much more balanced across the tied channel compared to the IFA channel. Furthermore, the scenarios in which shoppers were seeking ongoing relationships have a noticeably larger proportion in unit linked bonds than those seeking one-off advice.

Was an ISA recommended?

In all scenarios, the IFA group indicated that there would be no reason to not recommend an ISA to the shopper. Although they have recently been reduced, tax benefits still remain on ISAs implying that there are advantages to consumers from having ISAs rather than using other investments.

Compared to a similar exercise undertaken by CRA in 2001, these results are broadly similar as can be seen in Table 3 below.

Table 3: Recommendation without ISAs in 2001 and 2004

	Proportion of shops in which no ISA was recommended	
	2001	**2004**
Commission based IFAs	24%	20%
Tied advisers	11%	12%

Source: CRA calculations based on NOP Mystery Shopping 2001, 2004

For the purposes of this study, the major concern is whether the failure to recommend ISAs is linked to the value of initial commission and Table 4 below is quite striking in that regard and shows that advisers who did not recommend ISAs received over 50% higher initial commission than those advisers who did recommend ISAs.

Table 4: Average value of initial commission

Scenario	Average initial commission
ISA recommended	£460
ISA not recommended	£700

Source: CRA calculations based on NOP Mystery Shopping

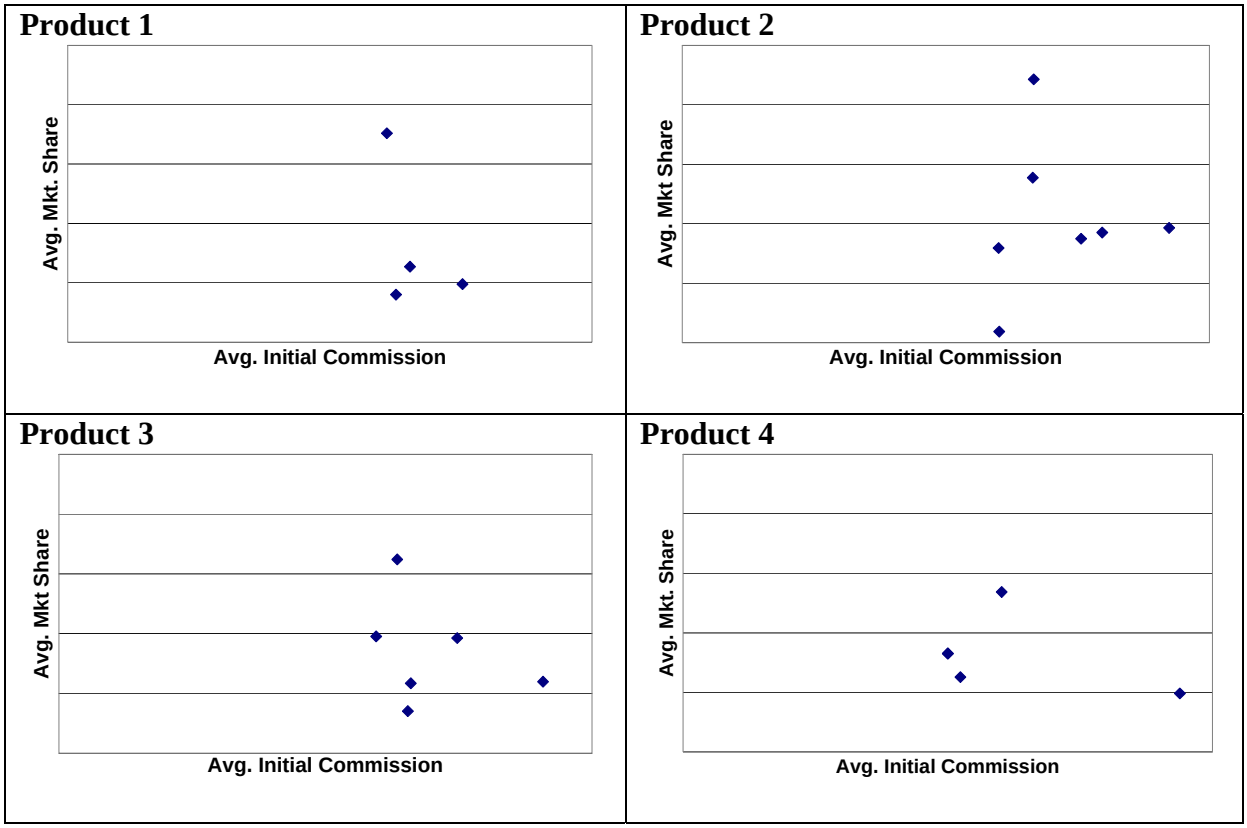
3.3.3 PROVIDER BIAS

Drawing on results from the Provider Survey we can examine whether there is any evidence of provider bias in terms of the average level of commission and the providers' position in the market, or whether changes in commission over the last five years have resulted in a corresponding change in their market share.

Comparison of average rates

Due to commercial sensitivity we cannot show detailed results by product on the relationship between average commission paid and the average market share, although we can present results across products for single premium and regular premium products. These are shown in Figure 17 and Figure 18 below.

Figure 17: The relationship between average commission levels after rebates and market share for four single premium products[36]

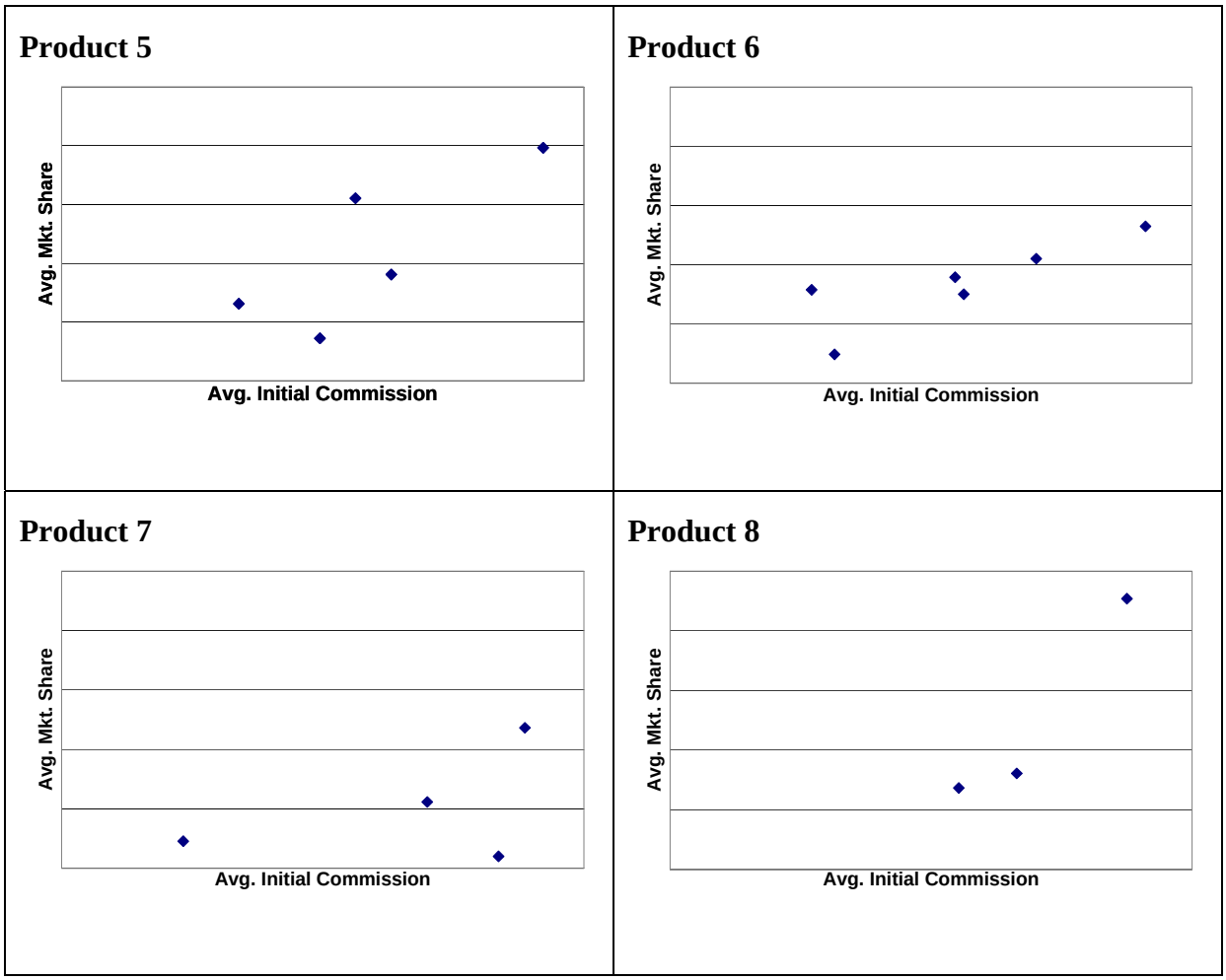


Source: CRA analysis

Econometric analysis of this data shows that for single premium products there is no relationship between the average level of commission and the share of new business volume.

[36] In order to preserve the confidentiality of data we do not disclose the names of products nor the scale on either the market share or average initial commission.

Figure 18: The relationship between average commission levels after rebates and market share for four regular premium products



Source: CRA analysis

For regular premium products, a different pattern emerges where there would appear to be an upward relationship between the average rate of commission and the share of new business in each of the markets under investigation. However, to test for provider bias it is appropriate to look at whether changes in commission terms have resulted in changes in market share. This is because it has to be recognised that the average level of commission may be related to new business volumes for a range of factors:

- Advantage of scale – large providers may benefit from economies of scale which they share with distributors in the form of higher commissions; and

- Distribution of returns between provider and advisers – providers with higher market shares may offer higher commissions whilst holding the product terms the same for different intermediaries. This may reflect a high-volume low-margin operation, whilst other providers choose a high-margin low-volume operation.

Changes in commission and market share

To try to determine whether changes in commission leads to changes in the choice by advisers to the detriment of consumers, we look at the relationship between market share and the relative rate of commission for a particular provider to the average in the market. If there is provider bias we would expect to find a statistically significant positive relationship between changes in commission and changes in market share. For more details on the econometric specification and methodology see Annex 3.

Table 5: Single premium products – size and strength of relationship between commission and market share, by product

Product category	The % points change in market share for a 1% change in commission
Personal pension	1.4%
Income drawdown	0.5%
Individual stakeholder	Statistically insignificant
Unit linked	Statistically insignificant
With-profits bonds	Statistically insignificant

Source: CRA analysis

The results for the single premium products under examination are set out in Table 5 above. We found the relationship between changes in commission and changes in market share to be statistically significant at the 10% level for both personal pensions and income drawdown. Results for other products were not statistically significant.

The interpretation of the results in Table 5 above is that an increase in commission by 1% would increase market share by 1.4% in the personal pension single premium market and by 0.5% in the income drawdown market respectively. For example, in the personal pension single premium market, if commission increased from say 5% to 5.5% (a 10% increase in commission), this would lead to an increase in market share from say 20% to 34% (a 14% point increase). Such large increases in market share are not typically observed in the market-place because increases in commission rates by one provider are rarely undertaken in isolation but rather face competitive responses by other providers and hence the impact of one provider increasing their commission rates while all other providers keep their rates constant is never observed in practice.

This is consistent with the results from our analysis in 2001, where we found three single premium products where there was a positive statistically significant relationship. Perhaps surprisingly, the products where we have identified a problem do not overlap with those in the earlier study, which found distribution bonds, with-profits bonds and pension annuity to have evidence of commission bias. As with our analysis in 2001, this is a problem we

associate with single premium products rather than something we attribute to particular products.[37]

For regular premium products we tested whether, on average, changes in the initial commission resulted in changes in the market share of particular products. As we found in the analysis undertaken for the FSA in 2001, we did not find a statistically significant positive relationship between commission and new business market share.

Table 6: Regular premium products – size and strength of relationship between commission and market share, by product

Product category	The % points change in market share for a 1% change in commission
Group personal pensions	Statistically insignificant
Personal pensions	Statistically insignificant
Term assurance	Statistically insignificant
Mortgage assurance	Statistically insignificant
Stand-alone critical illness	Statistically insignificant

Source: CRA analysis

Therefore, we conclude that the provider bias in the regular premium products remains of little concern but this analysis supports the previous analysis that there is a more significant problem with single premium products.

3.3.4 OTHER ISSUES INDENTIFIED

There were a number of other issues identified in the Mystery Shopping exercise that give cause for concern although they do not directly influence the assessment of different models of remuneration.

Debt scenarios

In two of the scenarios (one in the tied channel and one in the commission based IFA channel) shoppers said that they had credit card debts totalling £6,500; if asked, they were instructed to say that they had incurred these debts through a one-off event such as a house redecoration / kitchen refurbishment. It is clear that the best advice that they should be given is to repay debts and the IFA group indicated that anything other than this recommendation would be bad advice. They also indicated that advisers who told consumers to transfer balances to credit cards with 0% introductory rates should not be seen as a recommendation to repay the debt.

[37] This therefore does not suggest that problems identified with particular products in 2001 have been solved.

Current trends in adviser remuneration

Looking at the recommendations of the advisers, at first sight it appeared as though 22% of shops in the commission based IFA channel were not advised to repay credit debt along with 15% of those in the tied channel. However, in two of the shops, shoppers were recommended to transfer balances to cards with a 0% interest rate which does at least reduce repayment in the short-term. In a further three shops, shoppers were recommended to have emergency savings of a greater value than the credit card debt. This would leave only six shops of concern representing 11% of the IFA scenario and 9% of the tied scenario.

Table 7: Repayment of credit card debt[38]

Scenario	Proportion of shops in which credit card debt was not recommended for repayment
Commission based IFAs	11%
Tied	9%

Source: CRA calculations based on NOP Mystery Shopping

The evidence in Table 7 above shows that there is a problem across both tied and IFA channels regarding debts that are not being recommended for repayment.

Whether advisers operate on a fee basis

The reluctance of some of the advisers in the Mystery Shopping to operate on a fee basis, confirms earlier evidence from 2002 in which a survey of consumers found that some consumers who had tried to pay a fee had been encouraged not to do so by the advisers who typically argued that this was because it would be cheaper for the consumer to work on a commission basis. Furthermore, consumers thought that if they were to pay by fee then the first consultation should be free in order for trust between consumer and adviser to be established.[39]

Hence it could well be the case that advisers who persuaded Mystery Shoppers to operate on a commission basis were doing so in order to generate trust going forward for what they would perceive to be a positive ongoing relationship. Indeed, this was seen to be more common in those shops in which assessors were seeking an ongoing relationship compared to those in which assessors were seeking one-off advice, although sample sizes are quite small and hence it is difficult to draw strong conclusions from this observation.

Whether advisers provide necessary documentation

A further issue that was raised in a number of shops was that personal illustrations and key features documents were not provided despite assessors requesting such information. Instead,

[38] Note that credit card debt was not tested with fee based IFAs.
[39] *Polarisation: Consumer Research*, Financial Services Authority, January 2002.

some advisers indicated that such documentation would only be provided if the consumer agreed to go through with the transaction.

3.4 Implications for the market hitting the critical success factors

In this chapter we have set out how the structure of remuneration has changed over the last five years. Based on these market trends, we can compare the current system of remuneration against the CSFs discussed in the previous chapter.

Table 8: Assessment of market trends against CSFs

Stakeholder	Positive impact on CSF	Negative impact on CSF
Consumers	No evidence that the current system leads to consumers being recommended products that they do not need. Given their preference for conditionality, and that there is no evidence that operating on a fee basis leads to better recommendations for consumers than operating on a commission basis, consumer CSFs seem to be met in this regard.	No evidence that advisers are incentivised to provide the appropriate level of ongoing service since the prevalence of trail commission does not currently vary according to whether consumers seek ongoing advice.
Intermediaries	No need to move away from a structure of conditional remuneration. This meets the intermediaries' CSF for not requiring consumers to pay separately for ongoing advice.	To the extent that intermediaries want to move their revenue onto a more stable footing through an increase in trail based commission, the five years have not represented a significant move forward. This may reflect the bear market reducing the returns to fund based remuneration putting an increasing strain on IFA commission levels.
Providers	Array of structures maintains flexibility for providers.	Complexity and unclear remuneration systems mean that the industry's reputation is still at risk and mis-selling scandals could still result. Appropriate provision of ongoing advice is not incentivised.
Regulators	Evidence on bias to sell suggests that the current structure of the commission market versus the fee based market is not a cause of concern.	Consumer detriment has not been resolved over the last five years and there are still issues of product and provider bias that need to resolved. Although some innovative structures may align interest of industry with Government agenda, there is an increasing complexity in the structure of remuneration.

Source: CRA

4 Recent regulatory changes

In the last chapter we considered how the remuneration of financial advice has been changing and attempted to anticipate whether these changes alone will improve the way the advice market is working.

In this chapter we distinguish between ongoing market developments and changes that are coming about due to recent or imminent regulatory change. The UK financial advisory market has been subject to a number of substantial regulatory changes over the last fifteen years; however, the last few months have seen some of the most significant to date. Below, we review what these changes are expected to do, what will determine the impact they have on the market and how the market will perform against the critical success factors identified in Chapter 2. We find:

- **The long-term impact of depolarisation on remuneration remains unclear, but it can be expected to result in benefits through additional choice and competition:** depolarisation may increase the potential for problems in terms of how intermediaries are remunerated and introduce concerns about the role of ongoing advice. In the short-run, there is also evidence that anticipation of multi-ties entering the market is resulting in commissions being bid up. In the long-term, efficiency gains can be expected to arise, but it is unclear when, and to what extent, these will be passed on to consumers through lower charges.

- **The menu will significantly reduce the potential for bias arising from the remuneration system:** The menu is likely to reduce the potential for provider and product bias. However, it will take time for these benefits to arise and the complexity in the underlying commission structures will make comparisons across menus difficult, resulting in differences in a market average that could be confusing for consumers. Much of the concern about the effectiveness of the menu arises because the underlying complexity of the market is hard to capture and present. It would be more effective in a market with fewer, simpler and more transparent remuneration structures.

- **Stakeholder products and the basic advice regime should increase clarity between remuneration structures:** Differentiation between the basic advice regime and the full advice regime will help both markets work effectively. New stakeholder products offer the potential for "clear blue water" between the stakeholder range and other products. This is likely to lead to the re-emergence of some initial charges in the non-stakeholder market, appropriately resulting in consumers sharing a portion of the cost of initial advice if they are to lapse early.

It is important to note that we examine these changes sequentially and hence, in section 4.1, we consider the impact of depolarisation on its own without considering any impact from the menu, which we consider in section 4.2.

4.1 Depolarisation

The polarisation regime, applying to packaged investment products since 1988, has recently been changed.[40] The regime imposed a division of financial advisers between independent financial advisers who advise on products from across the market and tied advisers representing one company. These restrictions have been removed allowing more options regarding adviser status and distribution methods. In particular, advisers are now able to advise on a limited range of providers rather than having to advise either on the whole market or only one provider.[41]

The FSA's depolarisation reforms have a number of implications:

- Firms that wish to continue to hold themselves out as "independent" are able to do so provided they continue to advise from across the market for packaged investment products and offer their customers the option to pay by fee.

- It introduces the concept of range and scope into the regulatory framework:

    - The scope of a firm's advice to a particular customer can be one of three types: i) the whole market (or a sector of the whole market); ii) from a limited number of product providers; or iii) from a single product provider.

    - The range represents "a list, or selection, of packaged products. Every firm that advises a private customer about packaged products will be required to provide advice based on a particular range of products. (This will not, however, prevent firms from making a recommendation outside their range or ranges, in certain circumstances.)"[42]

    - Advisers need to disclose the scope of their advice and need to provide suitable advice within the range of products offered to the customer. It is possible for an intermediary company to have more than one range. It is also

[40] Packaged investment products are life assurance, personal and stakeholder pensions, endowments, collective investment schemes, investment trust savings schemes and ISAs (where life assurance and collective schemes are components).

[41] *Reforming Polarisation: Removing the barriers to choice*, CP166, Financial Services Authority, January 2003.

[42] *Reforming Polarisation: Removing the barriers to choice*, CP166, Financial Services Authority, January 2003.

possible to increase the range offered to the customer and advise on products beyond the company's range.

- The so-called "better-than-best" rule has been abolished allowing providers to make investment in intermediaries without this reducing the intermediary's ability to advise on provider's products in the same way as in the past.

The main FSA objective from depolarisation is to increase the options for consumers and hence, it is hoped, increase the amount of competition occurring in the market. It is therefore important to consider the impact that these significant structural changes will have on the remuneration of different types of financial advisers (including both current and future models). In this section, we consider the:

- Impact on the market for independent advice;
- Likely structure of multi-tie distributors (full service, gap fill and panel based);
- Prospect for the development of intermediary brands and likelihood of consolidation;
- Provision of ongoing advice under multi-tie distributors;
- Impact on both the level and structure of remuneration for advisers; and
- Impact on the identified CSFs.

4.1.1 THE MARKET FOR INDEPENDENT ADVICE

In order for advisers to present themselves as independent in the depolarised environment they will have to offer to work on a fee basis. This could potentially change the market for independent advice quite considerably, for example:

- Consumers who were not previously offered a fee basis could choose to pay for advice in this way; and

- Advisers who are not willing, or able, to work on a fee basis could choose to become multi-tied in order to remain commission-only agents.

In addition, existing IFAs who do not wish to offer to work on a fee basis may remain advising across the whole market but will not be able to describe themselves as "independent".

It is not, in our view, likely that this will have significant impact on the amount of advice paid for on a fee versus a commission basis. There is relatively clear evidence from consumer surveys that even if offered a fee basis, consumers will choose to pay for advice under a commission basis (as explained in section 2.1). Therefore from the demand-side this is only likely to have a limited impact.

Equally, the great majority of advisers are believed to be willing to work on a fee basis, although it is clear that not all do in practice.

It may be that some IFAs would prefer not to work on a fee basis because of the need for time recording systems which are not worth the fixed cost of implementation if only a small number of consumers prefer a fee basis. However, even if advisers have to offer a fee basis they will be free to persuade their clients to work on a commission basis. Indeed, evidence from the Mystery Shopping found that 20% of advisers in the fee based scenario persuaded shoppers to work on a commission basis rather than a fee basis despite assessors being briefed to work on a fee basis. Therefore it seems unlikely that this, in itself, will lead many advisers to change their status.

4.1.2 THE STRUCTURE OF MULTI-TIES

The major change forthcoming in the industry that needs to be considered is the development of new business models that have not been feasible in the past, notably the development of limited range advisers and the introduction of other providers' products into hitherto tied channels. The impact of these on remuneration will depend on the type of models that are likely to develop. At the time of writing, negotiations are ongoing between product providers and intermediaries, therefore we can only speculate on how the models will develop and whether they will be successful.

There are a number of different possibilities for how these new models of distribution will develop and how they will be structured. The possibilities include intermediaries who:

- have ties with a small number of full service providers;
- have a single provider for each product but distribute the products of different companies (this is known in the market-place as "gap filling" when a tied provider brings in the product of other companies or "best of breed" when undertaken by an independently authorised intermediary); and
- are tied to a small number of providers for each product but the group of companies varies for different products, which is known as the panel strategy.

Businesses from both the current tied channel and from the current IFA channel are in the process of developing multi-tied propositions. In the IFA channel, the expectation is that a number of IFA businesses are likely to set up multi-tied arms to their businesses alongside the existing IFA channel while others will move completely towards a multi-tied business.

In the tied channel, some businesses seem to be considering bringing in specific products into a multi-tied range, whilst others are considering using panels for products.

As this report is being written, the number of advisers that choose to remain independent versus those who choose to go multi-tie is uncertain. However, it is clear that there are

significant enhancements to commission being offered for advisers who choose to join multi-ties. Nonetheless, there are a number of important factors that still need to be resolved:

- Will providers be free to offer different products (including different charging structures) across different distribution channels? Although this seems likely to attract regulatory scrutiny, it will be very difficult to determine whether products are designed specifically with the customers of multi-ties in mind and hence hard for this to be prevented.

- How will commission be set for internal versus external products? This introduces a new potential for bias, between manufactured and imported products. For one provider interviewed as part of the research, who has traditionally used a tied distribution channel, there is an expectation that the manufacturing and the distribution side of the business will be separated in order to prevent accusations of this kind.

- The focus on what remuneration the company earns versus what the adviser receives. This is not a new problem. Currently with IFA networks, the Registered Individual (RI) will receive a proportion of the total commission and the network will also receive a proportion. Potentially both are important for the consumer as the remuneration to the network may influence whether the product appears on the panel, whilst the remuneration to the RI may influence the advice provided by the adviser.

Although all of the models described earlier do seem to be under development, it is difficult to draw strong conclusions from deals currently being undertaken in the market-place. There are examples where:

- Providers have added to their product offerings to become full service providers to particular intermediaries suggesting that they believe that the full service provider model will dominate; and

- There are other deals where full service providers have only agreed to provide one part of the range – protection products – although they may later compete to be part of the pension and investment panels.

There are a number of different factors involved in determining which of these models are more likely to be seen in practice:

- Intermediaries who have no brand recognition by consumers are more likely to depend on the branding of the providers on whom they advise. It seems plausible that in order to advertise that they have ties to providers that they will need to be tied across the whole range of products. Hence those intermediaries with no brand recognition are more likely to take the full service approach. Conversely, if the

intermediary has a strong consumer brand they may not want to advertise a close tie with providers and hence may choose the product panel approach.

- It will vary depending on the product focus of the adviser. For example, those advisers who specialise in particular product areas are likely to require a wider range of options in those areas. By contrast they may be willing to have a lower number of providers for those products in which they advise on less frequently.

- Small multi-ties will have narrower panels reflecting the administration cost of negotiating with many providers.

In addition, the structure of the panel is likely to vary across different product categories. For example, typically there are smaller panels on protection products than there are on pension products. Mainly it is thought that this is because the potential detriment from making a poor selection of the provider is lower on protection products than on pensions. This is partly because there is less variation in protection products, whereas for pension products the long-term financial strength of the company is of greater concern. Intermediaries are therefore thought to be more wary about the consequences of limiting choices here.

Economies in searching the market

The variety of different ways of structuring the multi-tie proposition is likely to have an impact on the costs of distribution. In particular, it seems likely that the fewer providers that are used, the lower will be the costs of transacting with these providers. Technologies are likely to be put in place to facilitate trade with a small number of providers.

However, it should be stressed that these cost reductions are likely to accrue only to those businesses which were previously IFAs since it is only those businesses that are seeing a reduction in the number of providers with whom they are having to trade. For the tied channel, moving to multi-ties would involve increasing the number of providers with whom transactions are made and hence could be expected to increase the costs of distribution.

Models where there is product specific gap filling could have reasonably similar cost implications compared to tied advisers. However, this will depend on the number of products where additional providers are brought in and also on the total number of providers and any required changes to technology or processes.

It should also be noted, when considering the whole advice process, that while a change in the number of providers does reduce search and research costs, it does not have any impact on those aspects of the process connected to the know-your-customer requirements. For example, conducting the fact find and ensuring that suitability requirements regarding the best product to be recommended are tasks that must be fulfilled and the cost of these tasks is not impacted by the number of providers that could be recommended.

Despite this caution, it should be expected that multi-tied advisers would be able to reduce their costs compared to whole of market IFAs (although they arguably have a reduction in the service available due to the reduced number of providers that they could advise on). If there are significant cost reductions, it is possible that this will result in lower commission, as these cost savings could be passed on to consumers. Conversely where tied advisers move to a multi-tie there will potentially be an increase in the service due to the additional choice. Similarly, having full service propositions may involve a smaller number of providers in total compared to product specific panels with the former potentially having cost advantages and the latter likely to have more specialists.

4.1.3 INCREASED BARGAINING POWER OF INTERMEDIARIES

A clear trend in the market-place in advance of depolarisation was the increased consolidation of the intermediary sector. This could reflect both the desire to increase bargaining power by intermediaries in anticipation of depolarisation, or an inevitable industry reorganisation due to a fall in adviser returns. There is also evidence of increased power of networks as compared to RIs.

The development of intermediary brands

The development of intermediary brands has mainly been focused on the IFA channel, although other brands that are expected to involve multi-ties are also becoming more visible. Linked to this is the consolidation that has been occurring in distribution which is also adding to the strength of intermediary brands.

In the majority of product markets it is thought that the increased consolidation and branding is leading intermediaries to be in a position where they can exert greater pressure over providers. Indeed, Table 9 below shows the importance of the larger distributors in the independent intermediary market.

Table 9: Concentration ratios for independent intermediaries[43]

Number of firms in concentration ratio	Concentration ratio
Top three	22%
Top five	28%
Top ten	39%

Source: Matrix IFA data and CRA calculations

[43] These concentration ratios are based on a sample of IFAs in the Matrix IFA dataset. Where IFAs are regulated through networks the turnover of the IFA has been included with the turnover from the network head. Furthermore, these calculations are conducted on the basis of the turnover information provided through Matrix. In addition, since information is available both on network heads and also on network members, it is assumed that there is no double counting between these two sources.

However, what is important may be the relative strength of providers and intermediaries in the product market rather than in the market as a whole. Hence it was argued that in the annuity market, there is already an equilibrium with a small number of intermediaries advising on the annuities of a small number of providers resulting in a market in which there is more balanced bargaining power.

The main evidence of the increasing power of distributors were the various deals and agreements that have been considered recently, especially regarding the multi-tie channel. It is believed that many of the negotiations that were pursued were taking the form of providers offering significant sums of money to secure places on panels. The FSA has expressed concern about this regarding the implications of any inducement on intermediary behaviour. In particular, they are keen to ensure that payments to intermediaries are adequately captured and disclosed appropriately.[44]

Increase in the power of the networks compared to RIs

A further issue is that the change to the polarisation rules will increase the power of the networks at the expense of individual advisers. Under multi-ties with limited providers, it is possible for the network to have significantly more power over the provider selection, i.e. it will not be possible for advisers to choose providers not on the panel (as is currently possible for IFAs operating in networks with panels). The increase in power over advisers may well reveal itself through an increase in the share of remuneration kept by the network in comparison to that given to advisers.

In addition, although it will still be possible for the intermediary to change from one multi-tie network or national to another, this may become more difficult. For example, if an intermediary wishes to change multi-tie, it will be more difficult to take their customers with them if the multi-tie to whom they go does not have the same range of providers as the multi-tie which they are leaving. This is in contrast to the position for IFAs who are more easily able to move to a different IFA network or company with their clients.

In the short-term it seems clear that the impact of increased bargaining power of intermediaries is that much of the focus of providers' efforts regarding distribution is on securing a position in the multi-tie and hence competition for the intermediary is taking precedent over competition for customers.

Given this pressure and the recognition that distributors are needed by providers, it seems clear that the pressure on remuneration and commission levels is building rather than declining. However, this should not be taken as evidence that consumers are suffering from this process. It is perfectly conceivable that this process is simply shifting the margins in the business from product providers to intermediaries and that overall prices (of both products and advice) will remain the same for consumers. Nonetheless the overall impact will

crucially depend upon the success of the menu and the degree to which competitive forces can be brought to bear in the advice market between consumers and intermediaries.

In addition to the pressure on commission based remuneration, there is also evidence of an increased pressure on other forms of remuneration such as demands by intermediaries for training allowances and the sponsoring of conferences. This is consistent with an argument that even if the menu constrains commission structures, alternative forms of incentive may be substituted.

4.1.4 THE PROVISION OF ONGOING ADVICE IN MULTI-TIES

One of the areas of most concern that has been highlighted during the research is the implication for ongoing advice from the development of multi-ties in which the providers in the tie may change after a period of time. The common presumption is that contracts for multi-ties will be written for approximately 3-5 years duration. However, concern has been expressed by interviewees representing all the different stakeholders, that this could lead to difficulties if a particular provider does not remain a part of the multi-tie after this period.

The first main concern is that if a provider drops out of the tie then the consumer would not receive any ongoing advice on the product because whilst the adviser can offer "servicing" they can not advise on a provider who is no longer part of the multi-tie. Potentially this could lead to consumers going without advice – a particularly important concern with products such as income drawdown where ongoing advice is seen as essential and where switching of providers may be much more difficult once the product has been taken out.

The second concern is that advisers would "churn" the consumers who have products with providers who are no longer part of the multi-tie. In some cases there may be good logic in doing this, for example, if there was a need to increase contributions on a pension product, advisers would only be able to recommend that the top-up be made with a provider who is part of the current multi-tie and then there would need to be a consideration of whether the whole policy should be moved. However, with other products, it may be less clear that there is a need or that the consumer benefits from the policy being moved to another provider. If this becomes prevalent this is likely to impact on the structure of the commission terms, for example, the focus of commission may match the length of tenure of the multi-tie.

[44] Financial Times, 24th June 2004.

4.1.5 THE IMPACT ON REMUNERATION

Little evidence of a change in structure

Despite the various observations regarding the pressure on commissions in the developing multi-tie channel, it seems that this did not have an impact on the structure of commission negotiated in anticipation of the introduction of multi-ties.

Even though there are agreements being made involving payments of fixed fees in order to secure positioning on panels, this does not appear to have impacted the remuneration structures. On a product basis, both intermediaries and providers seem in agreement that the structure of commission in the multi-tie channel is being based on that already observed in the IFA channel.

Remuneration depends on level of exclusivity

Although there are a range of models being developed in the multi-tie arena, it seems clear that those manufacturers who have exclusivity in a product would be expected to make higher contributions to the intermediary business than those manufacturers who are one of a large number of providers for a particular product.

Remuneration depends on brand awareness

Thus the short-term expectation is that depolarisation will increase commission to advisers as providers seek to retain their positioning with intermediaries that are growing in importance. However, it is difficult to know the degree to which this can be continued and the importance of consumers' brand awareness in the market. It is expected that advising on providers who have strong brand recognition is likely to be easier for intermediaries than advising on providers that consumers have never heard of and hence this may temper the ability of intermediaries to unduly exert their bargaining power with the larger brands. For the smaller provider companies or for new entrants, however, there is a concern that they will face foreclosure in these arrangements and that getting access to distribution may become more difficult.

Potential pressure on the use of trail commission

As explained above in section 4.1.4 there is a concern about ongoing advice where providers leave a multi-tie panel. In the tied channel, if an adviser leaves the intermediary business, they would no longer receive trail commission. It seems highly likely that if either adviser or provider leave in the multi-tie context that this would also be the case.

Hence, this may place pressure on intermediaries when considering the structure of commission available to them given that it imposes increased uncertainty regarding the likely receipt of trail commission. While at present this may be uncertain due to consumer behaviour, it now has the added uncertainty of the ending of contracts between the intermediary business and the product provider.

In theory there is the potential for a countervailing pressure moving intermediaries towards trail commission. In particular, one of the main issues that is often used as the reason for intermediaries not moving to trail commission is that this would have cash flow implications. However, as discussed above, there are considerable sums of money that seem to be available to intermediary businesses in the short-term in order to ensure providers are present on panels. There is therefore a clear opportunity for this money to be used to finance a potential change in the cash flow position of intermediaries. However, in practice this is not thought likely to occur as it is believed that the money will be used in other parts of the business, or indeed will leave the business to the benefit of either network owners or the individual RIs.

Increase in non-commission based remuneration

An additional factor that is being observed in the market-place is that there has been a trend to increase the level of training and other support services by providers for intermediaries. It seems likely that these aspects will continue if intermediaries retain strong bargaining power.

4.1.6 ASSESSMENT OF DEPOLARISATION AGAINST CSFS

Although depolarisation will impact many different aspects of competition in the advice market which are likely to bring benefits, here we focus only on the expected impact on remuneration.

At present it seems unlikely that depolarisation and the move to multi-ties will lead to lower costs of distribution in a way that will impact prices to consumers. Instead it seems likely that distributors will gain at the expense of providers as the former are able to exploit increased bargaining power.

The high-level impact on the various CSFs for remuneration models of the stakeholders is set out in Table 10 below:

Recent regulatory changes

Table 10: Assessment of depolarisation against CSF

Stakeholder	Positive impact on CSF	Negative impact on CSF
Consumers		Potential for a reduction in both the clarity of expectations over advice and ongoing advice, particularly related to providers who leave multi-tie propositions
Intermediaries	Likely increase in the ability to cover the cost of services from either an increase in remuneration or a fall in the cost of providing services	May become harder to identify new products or providers in a multi-tie context compared to IFAs, although easier compared to tied providers, may be harder to explain the advice proposition to consumers if there is a risk that they may no longer be able to advise on products they previously recommended
Providers		Potential for increased capital strain, increased competition over intermediaries rather than between intermediaries
Regulators		Likely focus of competition amongst providers on intermediaries in the short-term rather than on consumers, possible concern over long-term provision of advice to consumers

Source: CRA

4.2 The menu

One of the major regulatory developments that will be faced by the industry over the next year is the introduction of the menu or fee and commission statement that coincides with depolarisation. The menu (which will actually be called "A guide to the cost of our services" and be branded as "Key Facts") was created as an alternative to the Defined Payment System first proposed by the FSA in CP121 and was adopted by the FSA as an integral part of the depolarisation process in CP166.

The menu attempts to tackle some of the identified and perceived problems with remuneration structures head on. The main FSA objectives from the menu are:

- "reducing the potential for commission bias (including mitigating the perceived risk that depolarisation may lead to firms migrating to those product providers prepared to pay the most commission);
- facilitating shopping around by consumers; and

- exerting a pro-competitive force on commission levels, and through them, on charges."[45]

The overall objective is to increase consumer empowerment and thus increase pressure regarding the way the intermediary is remunerated.

To understand the impact of the menu we need to consider carefully how it will be implemented and the implications this has for market participants. This was tested through our interview programme alongside research conducted into the menu. The key characteristics of the menu are that:

- It will be provided early in the advice process: the menu will be given to consumers at the same time as the initial disclosure document (IDD) and terms of business;[46]
- It will provide comparative information by product category (set out as a standard template by the FSA) regarding the likely cost of advice for consumers by product type;
- It will display the maximum commission rate that advisers will charge (after rebates) on particular product groupings and will also contain a market average rate for comparison;
- It will be applied to all channels i.e. independent, tied and limited provider advisers. All providers owning 50% or more distribution, will have to include the value of benefits and services they offer to the representative in order to reflect the full cost of distribution;
- The cost of advice will be presented in terms of common commission structures used by the intermediary; and
- If commission rates change (upwards) the intermediary will need to notify their consumers.

In calculating the market average, the FSA has collected data from product providers regarding the commission rates that they pay in the IFA channel and equivalent information regarding the cost of sales in the tied channel.

The menu is intended to fit to the business model currently employed by different intermediaries. In displaying information, advisers will have the choice of the structure on which to compare information and will be expected to display the information in terms of the structure that they typically use. For example, some advisers may mostly work on only initial commission for certain products and thus they will be able to present their maximum commission in this structure. However, they will need to calculate the maximum rate they

---

45 *Reforming Polarisation: A menu for being open with consumers*, CP04/3, Financial Services Authority, February 2004.

46 The existing system for the disclosure of the cost of advice, introduced in 1994, requires disclosure in cash terms of commission received by IFA firms and remunerations (which the FSA proposes to rename "commission equivalent") by non-IFA firms but this occurred at the end of the advice process.

receive across all structures (using a Net Present Value (NPV) calculation) and then convert this into an initial structure. This will be compared to a market average calculated using the same structure (but normalised on the value of trail).

For example, if an adviser sells insurance bonds on two different structures, one with a high initial commission and one with lower initial commission but with some trail commission, these are then converted using an NPV calculation to establish the maximum level of commission charged. It may be the case that on an NPV basis the higher commission rate is that which includes the trail commission. However, if most of the IFA's business is done on the initial only structure, they will then have to convert the maximum rate based on trail commission into an initial only structure. This would then be compared to the market average.

It has been noted that this means that consumers going to different advisers who use different structures will not only observe maximum rates which are hard to compare but will also observe market averages that have different structures and hence consumers may be confused about the different information that they are receiving. This will make it hard to compare whether one adviser is further from the average than another adviser (and potentially confuse consumers by having an apparently different market average). For example, they could be confronted with the following choices on a personal pension single premium pension:

- Initial only: 65% of payments in the first twelve months compared to a market average of 50%;

- Initial plus renewal: 45% of payments in first twelve months with a trail of 2.5% compared to a market average of 36% initial and 2.5 % trail.

Nonetheless, it is clear that in both cases the consumer will be able to compare the adviser's rate to that of the market even if it is harder to compare one adviser with another. Disclosing a cash value for commission on the basis of a fixed level of premium will provide another means by which consumers will be able to compare advisers. However, while this may be beneficial, it will be dependent on the term of the product, which for many products may vary between advisers. In addition, it is likely to lead to mixed messages coming from the combination of the market average and the cash cost. If a smaller number of structures results in these two messages being more consistent, this would make comparability more effective.

For structures that combine initial commission and trail commission, the FSA has indicated that the market average in the menu will be one that displays the same trail commission as the trail commission in the adviser's maximum rate and then calculates the appropriate initial commission. In this way, the market averages are likely to focus more attention on the differences in initial commission.

Recent regulatory changes

In this section, we consider the impact of the menu by examining a number of different aspects including:

- Overall impact of the menu;
- Impact on products;
- Impact on adviser choice;
- The role of infomediaries; and
- Assessment versus the CSFs.

4.2.1 OVERALL IMPACT OF THE MENU

The overall view from the industry is to approach the menu with what could be termed as "limited optimism", although the exact view varies according to different institutions.

No institution has indicated that the introduction of the menu will itself be a damaging development in the market. While at first this may not appear to be a reason to encourage the menu, given the context of its development as an alternative to the Defined Payment System, which could have effectively shifted large sections of the IFA market to operating only on a fee basis or out of business because of the reluctance of consumers to pay fees, the menu has nonetheless been seen as a good development.[47]

Impact of the market average

An area where the menu is thought likely to have the greatest impact is on those advisers who currently charge above the market average. Interviews with representatives of consumers suggested that the presence of the market average was likely to encourage consumers to attempt to negotiate with advisers regarding the rate that they would charge. This was also supported by the consumer testing undertaken by the FSA which found that having the market average is likely to lead to people shopping around and also to seeking to negotiate with their adviser,

"The market average could encourage me to ask them to explain why they are more expensive and to assure me that I'm not being ripped off."[48]

[47] It has also been noted as a good example of the industry and the regulator interacting to develop better regulation with praise for the regulator for a change in policy in the light of evidence and arguments in favour of the menu.

[48] *Polarisation – menu testing research*, Consumer Research 24, Research prepared for the Financial Services Authority by IFF Research Ltd and NOP Research Group.

However, there is a suspicion that only those advisers charging substantially above the market average would face a competitive restraint since again the FSA's consumer research found that,

"I don't know if having the average market comparator would make me shop around, because I'm intrinsically lazy. If it was slightly above or below, I probably wouldn't bother."[49]

In this way, publishing the market rate, may reduce excessive commission rates but could lead to advisers clustering around the market rate. Although the greatest pressure is likely to be faced by those charging the highest rates, this is likely to slowly feed through to the market average as those charging above the average are forced either to reduce their rates or to accept lower levels of business.

One concern expressed by some is that the menu may constrain the level of commission in such a way that advisers are not able to differentiate themselves in terms of the services they offer and that this could reduce the variety of advisory offerings on the market. However, consumer representatives argue that in the advice market, as with other markets, consumers recognise that the cheapest price is not always the best thing to look for and assessing quality and value are also important (although it is recognised that these are harder to assess in financial advice, particularly at the start of a relationship). Hence it is thought that those advisory businesses that offer additional services and receive additional remuneration will not be unduly constrained in explaining and demonstrating the value of their services (although there has been concern regarding the space on the menu allocated to explaining these services).

It is also important to consider the impact of the menu on those who are currently pricing below the market rate. Some have argued that if consumers are only concerned that they are getting a fair deal, and they judge this purely through comparison with the market rate, then the incentive to charge below the market rate may be reduced and hence we could actually observe an increase in commissions from those currently being paid below the average. However, it seems unlikely that this would be the case since it should be questioned why these advisers are charging their current rates if they could already increase them without any damage to their business.

Impact on choice of remuneration –fees v commission

One of the conditions of the menu is that advisers will have to present the rates at which they are willing to work on a fee basis. Although consideration was given to making this comparable with the commission disclosure, i.e. an estimate for the cost of advising on a particular product, it was decided that this need only set out the types of fee based

[49] *Polarisation – menu testing research*, Consumer Research 24, Research prepared for the Financial Services Authority by IFF Research Ltd and NOP Research Group.

arrangement.[50] So for example, this could include a series of hourly rates according to the qualification of the adviser or staff to which they relate. There will be some flexibility for firms to set out their normal charging basis, whether hourly rates, flat fees or any other model. The FSA also decided against having a market average fee level on the basis that the models used in the fee arena vary too much to make this useful and geographical variation makes this meaningless.

It is unclear what the impact of having fees displayed on the menu will be. It has been noted by some interviewees that the menu actually made some consumers less likely to use the fee option because the amounts involved were considered to be high. However, if this is the case, then these consumers would not have chosen to follow the fee route in the absence of the menu either as they would also have chosen to pay through commissions when the information on fees was revealed anyway.

However, although consumers will be informed as to what the cost of fee based advice will be because of the menu, they are often reluctant to pay fees and do not necessarily value working on a fee basis more than on a commission basis. A useful way to test this is to look at the evidence from the Mystery Shopping exercise. Although the shoppers are not representative consumers, they are able to observe a range of recommendations for the same scenario from both commission and fee based IFAs as well as tied advisers. In this, shoppers were asked to consider whether, given the value of commission disclosed or the fee paid, they thought that the advice recommended represented value for money. It is striking from Table 11 below that commission based IFAs were seen as offering value for money in more cases than other types of advisers.

Table 11: Value for money

Scenario	Proportion of shops not thought to be value for money
Commission based IFA	14%
Fee based IFA	42%
Tied	30%

Source: CRA calculations based on NOP Mystery Shopping

It is likely that this partly reflects the fact that commission based IFAs receive their commission through the product charges (and shoppers did not have to pay this) whereas fee based IFAs had to be paid through a separate cheque. As no purchase was made, this cheque did actually have to be paid by the shoppers.

However, given that 42% of fee based shops were not seen to represent value for money, this throws considerable doubt on the likelihood of the fee based market growing significantly in

[50] It is theoretically possible to make fees directly comparable with commission by each product having a specific fee structure if a product is purchased. However, as fees are unconditional on sale this approach is not practical.

the light of depolarisation. Furthermore, it may also support the reason that most consumers start relationships with IFAs on a commission basis and later move to a fee basis once advisers have had the opportunity to demonstrate their value, which is hard to judge on the basis of one or two meetings and one piece of advice.

4.2.2 IMPACT ON PRODUCTS

Comparison across products

One of the advantages of the menu is that consumers will be able to observe the different commission levels and structures across different product categories. This should encourage them to question advisers regarding the recommendations of products where there seem to be substantial differences in the commission.

A potential weakness of the menu is that it will result in too much focus on products specified on the basis of their legal and product structure rather than on the basis of the consumer needs that they meet i.e. the menu is focused on supply-side substitution rather than demand-side substitution which is surprising for a document aimed at improving the functioning of the market from the demand-side. This seems in contradiction to the definition of the product groups in the FSA menu consultation: "a product group is a collection of mass market investment products of a similar nature or that fulfil a similar objective, sold to private customers".

At present there are different views as to the impact of the menu on differences in remuneration between products. For example, the menu may prompt consumers to question why they are being sold a product with higher upfront commission compared to a different product category which has much lower upfront commission but is instead remunerated on a trail basis. This could potentially lead to consumers questioning the basis and reason for which trail commission is paid on products and whether they should expect ongoing services for the ongoing payments.

Indeed, collective investments and investment bonds are seen as two separate categories (albeit within the same wider group of investments) even though they both meet medium-term investment needs. It may be the case that having products differentiated on the menu may mean that consumers do not understand that different products can meet the same needs. Hence if products are in different groupings, it may be less likely that the commission structure from one product will constrain another.

An alternative option would be to merge both collective investments and investment bonds into the same category and display commission rates and structures for the two products combined. Indeed it could well be the case that a test of whether or not the menu has been successful is whether convergence in unit linked bonds and unit trusts is observed, especially

in terms of the structure of commission, but also in terms of the level. In particular, there seems no apparent reason, other than history, as to why commission levels on the two products take fundamentally different shapes when the products serve broadly the same investment needs for consumers.

A further observation is that, arguably, if advisers are recommending that a product be switched from one provider to another, there seems less justification for a high initial commission to be paid than if the adviser is recommending that a new product with new flows of money should be taken out because the latter has additional costs in terms of persuading the consumer as to the importance of following their recommendation. Since the menu applies across the business, it may be difficult for intermediaries to signal that they would take less initial commission in these circumstances as a matter of course.

Furthermore, the issue of products being specified on a supply-side structural basis may also have implications for the development of wrap accounts and whether remuneration can be priced at an overall package level.

Competition with products outside the menu

The scope of the menu is something that is seen as contentious as it needs to balance coverage of products with the complexity of the document.

Many providers have concerns that the menu may impact competition between products that are on the menu and those that are not. For example, there has been considerable concern expressed that commission rates on protection products (which are not on the menu) are likely to rise to substitute for a lower level of commission on saving and investment products (which are on the menu). Equally, guaranteed equity products, that some would argue compete directly with with-profit bonds, will not be in the menu whilst with-profit bonds will be.

However, one of the most significant areas of concern for providers and intermediaries is that the menu was a simple idea that has been made unnecessarily complex. This is both in terms of the document itself, regarding the large number of different categories that are presented, and also in terms of the whole sales process since the menu will be provided alongside a raft of other documents. Indeed, the FSA's consumer research bares this out,

"…some found them 'too daunting'. They were put off by the sheer size and complexity of the tables and all the figures."[51]

Hence many stakeholders believe that the menu should be limited to mass-market products and that more specialised products should always be kept off the menu in order to ensure that

[51] *Polarisation – menu testing research*, Consumer Research 24, Research prepared for the Financial Services Authority by IFF Research Ltd and NOP Research Group.

the document is not overwhelming. For example, it is argued that long-term care products and possibly income drawdown are too specialised for such a document.

Furthermore, at the same time as consumers receive the menu they will be given the IDD setting out the status on which the adviser is working and the range of products on which they can advise and the adviser's terms of business. There is therefore a fear that the menu will be lost in the array of information that is provided and hence that consumers will not pay due attention to it.

Whilst the concerns of complexity do need to be taken seriously, a further consideration is that the menu could have a constraint on innovation and on the success of new product development. For example, if consumers are reluctant to take up products that are outside the menu because they believe that those products on the menu have received additional regulatory approval, then this will make them naturally resistant to new products which do not fit into existing product categories. Achieving a separate category would incur regulatory cost and time delays (although the wider the original categories, the less likely the need for this). Similarly, if products do fit into existing categories but offer additional functionality and impose additional costs on advisers, then the increase in remuneration for any given category would need to be signalled to consumers. This imposes a cost of reproducing the menu and hence also increases the time to market of new products. Given the breadth of these categories the costs are likely to be low.

4.2.3 IMPACT ON ADVISER CHOICE

Competitive pressure from new customers

It is expected that existing customers will not change their behaviour dramatically when they see the menu since these customers have strong existing relationships with their financial advisers and are believed to be unlikely to change adviser unless there are already concerns regarding the level of service being received. The exception to this being that should the adviser be revealed as being noticeably expensive, existing customers may seek to change adviser.

However it is possible that new customers will be alerted to the cost of advice in a way that they previously were not and this could lead the maximum cost of advice to be one of the factors that is used in deciding upon which new financial adviser to use. If this is the case, the distance between the maximum rate and the average rate may become an important dimension of competition and rates may be forced down.

To some degree this will depend on the practical accessibility of the menu during the search process. If advisers choose to make the menu available remotely, this will lower the cost and hence increase the chance of comparing between advisers.

Nonetheless, it is likely that the impact of the menu will grow over time as more customers receive them and use them as one of the factors in deciding which adviser to use. It is also therefore likely to have a bigger effect for new intermediaries that are building up their set of client relationships compared to well-established intermediaries.

Concerns on equivalence

The use of the menu applies across all of the channels that are on offer in the new depolarised world i.e. single ties, limited range advisers and whole of market advisers. However, each of these channels brings its own challenges regarding the appropriate cost information that needs to be taken into account when estimating the cost of advice.

There remains considerable concern amongst institutions at the moment that applying the menu across channels will bring about the perception that some channels are more expensive than others when this may be due to calculations of costs rather than the reality. There is therefore a worry that the different levels of the average cost of advice between channels may lead to switching between channels on the basis of the revealed cost without a recognition of the different services available between channels.

Furthermore, there are concerns that focussing the consumers' attention on commission payments may distract their attention from product charges and features. This is of particular concern in the tied channel where it is argued that it is product charges and features that are what should be compared between different providers rather than the cost of advice. This is especially the case since the consumer will not be in a position to negotiate with the adviser regarding the cost of advice, as the majority of the cost elements are outside of the control of the individual adviser.

Impact on within company variation

The requirements for the menu are set at company rather than adviser level. That is, all advisers working for the same company will have the same menu that they must display. In the tied sector, where the remuneration to advisers is much more centralised already, this is likely to have a limited effect. However, in the multi-tied and IFA sector, given that the menu will display the maximum rate that will be charged, this is likely to bring an influence across advisers that was not previously there.

As the menu is based at the company level this is also likely to place a constraint on some advisers. In particular, individual advisers may be concerned if the whole company looks expensive because of the actions of one adviser that charged a customer a particularly high rate of commission which pushes up the maximum level of commission. In this way, it seems that advisers are likely to come under pressure from their colleagues regarding the commission rates they charge so as not to appear overly expensive.

Recent regulatory changes

4.2.4 THE ROLE OF "INFOMEDIARIES"

A further area of importance is that of the role of the financial press. In particular it is thought that the media will play a role in enforcing competition in the market with those institutions with high figures displayed on the menu forced to reduce costs through "naming and shaming". This pressure is thought to be more likely to have an impact on the tied channel due to consumers knowing the brands more in this channel.

In the multi-tie channel, this effect is likely to be dependent on the degree to which major financial brands operate under fixed multi-tie models across their entire range and in which all the brands that are in the multi-tie are well known. For example, it could easily be envisaged that the names of the providers in the multi-tie would also be revealed and linked to the maximum rates paid.

For businesses that offer different channels, this also brings the potential for the media to compare the cost of advice depending on which of the channels the consumer uses. Hence this is likely to lead businesses to clearly define the proposition that they offer in different channels in order to justify the different cost of advice that is disclosed.

In the IFA sector and the limited range advisers where the range may vary according to the product, there are currently fewer brands that are recognised by consumers and hence it is thought to be less likely that the press will focus their attention in these areas. However, this will depend on the degree to which intermediary brands are built up and how observable are large networks or nationals to both press and consumer.

4.2.5 ASSESSMENT OF THE MENU AGAINST CSFS

The outcome of the menu is still controversial although overall none of the stakeholders believed that it would be damaging and most believe it will be positive with its effect growing over time. There are nonetheless some stakeholders who believe that it will have little effect as it will be buried in the other information provided to consumers. Our assessment is that it will have a significant impact but that this will take some time to materialise.

The high-level impact on the various CSFs for remuneration models of the stakeholders is set out in Table 12 below.

Recent regulatory changes

Table 12: Assessment of the menu against CSF

Stakeholder	Positive impact on CSF	Negative impact on CSF
Consumers	Positive impact on the expectations of advice and the associated costs, it will retain the ability to have remuneration conditional on sale, and it will ease comparison between advisers and across channels and increase consumer's bargaining power	Weaker effect given the relative complexity, although it will be significantly better than having no information upfront in the advice process
Intermediaries	The menu allows the continuation for advisers of accepting remuneration paid for through product charges and hence advisers do not have to have a separate cheque for advice and they remain free to set prices	May not be straightforward to explain to consumers although it will give intermediaries the opportunity to explain the value of the advice service they offer. It is likely to impose a constraint on prices which will impact expensive advisers who do not offer good value for money, but should not prevent fair competition
Providers	Should facilitate competition between advisers and hence be of benefit to providers as it lowers the cost of advice, making their products cheaper for consumers	Potentially makes sharing costs with advisers more difficult and potentially distorts competition between products favouring some providers
Regulators	Should lead to some increase in shopping around, improved consumer understanding of advice and its costs, increased transparency in the cost of advice and promote a level playing field between different channels	May lead to a focus on adviser remuneration at the expense of focussing on product charges

Source: CRA

4.3 Stakeholder products and their sales regime

To understand the impact of the proposed Sandler regime on remuneration it is useful to consider how the existing stakeholder pension impacted the structure and level of remuneration. The stakeholder pension was launched in April 2001; however, the effect of stakeholder on charges was felt on the market much earlier due to an update in the rules by the FSA, which anticipated the introduction of stakeholder pensions. RU64 set out that advisers needed to make sure that consumers were not "materially disadvantaged" by being advised a particular product in comparison to a stakeholder pension.[52] However, the dramatic effect on commission is only seen immediately before the introduction of stakeholder pensions in 2001. The decline in charges has led to provider capital strain and shifted the risk of lapsing the product onto the provider rather than the consumer. Although this was somewhat mitigated by the decline in commission, given that commissions are still declining

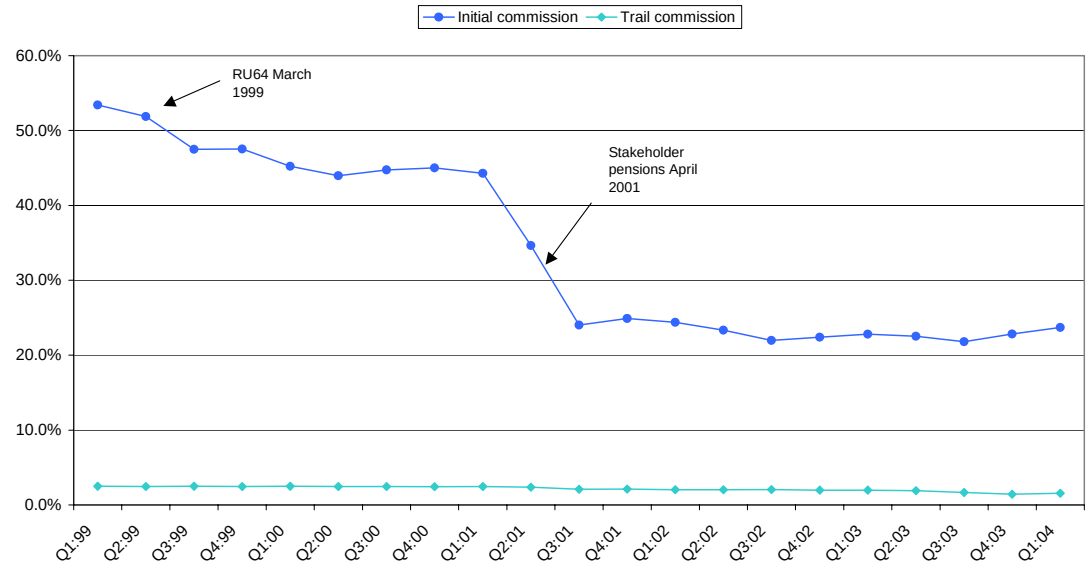
[52] Regulatory Update 64 (RU64), PIA.

(as evidenced by recent announcements by major providers), the problem of capital strain remains.

It is interesting to note that the advent of the stakeholder pension was to impact the level of commission rather than the structure of commission in the individual market. For example, the average rate of commission on stakeholder pensions has fallen dramatically compared to that previously paid on personal pensions. Further, average rates of commission on regular premium non-stakeholder pensions have fallen to half the level seen five years ago and it is thought that this is primarily due to the impact of stakeholder pensions. Although the decline in initial commission has resulted in a flattening of commission, on the whole commission has maintained a front end loaded basis and not moved to level loaded (although some providers have switched their focus onto fund based trail commission).

As can be seen by a comparison of Figure 19 and Figure 20 below, the impact of stakeholder had a much more pronounced effect on the regular premium pension market compared to the single premium market.

Figure 19: Average commission terms on a regular premium personal pension



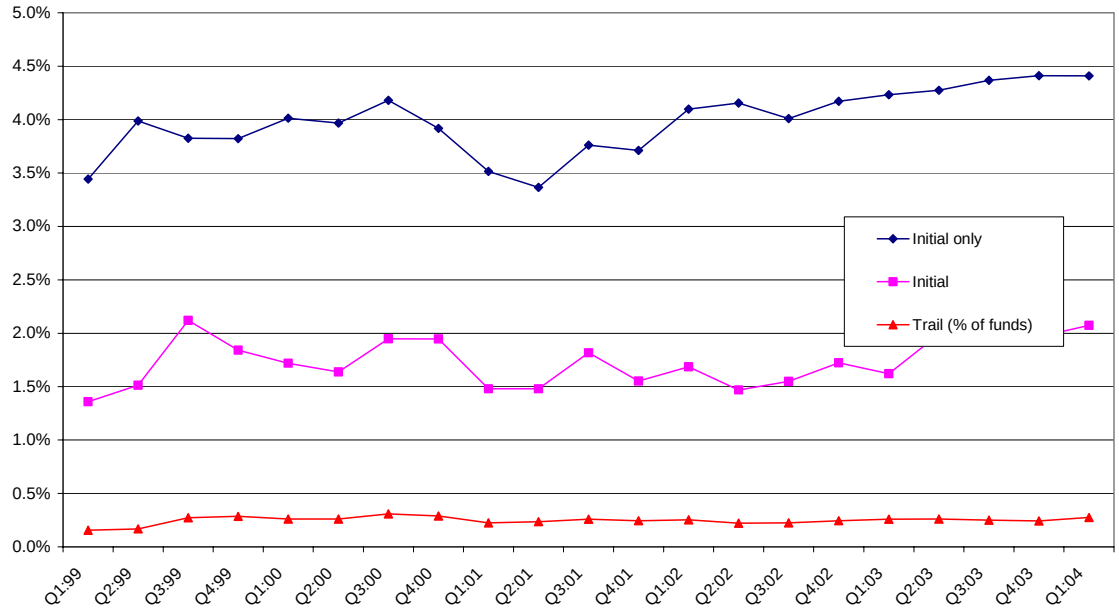
Source: CRA analysis based on the provider survey

It is clear from Figure 19 above that the level of initial commission fell dramatically around the introduction of stakeholder pensions in the second quarter of 2001. In comparison, the level of commission on single premium personal pensions, shown in Figure 20 below, fell following the introduction of stakeholder pensions but only by about 10-15%. Further, the commission level of regular premium has remained at the lower level, whilst we have seen

Recent regulatory changes

single premium commission rise back to and beyond those seen in the two years prior to the introduction of stakeholder pensions.

Figure 20: Average commission terms on a single premium personal pension



Source: CRA analysis based on the provider survey

Since average commissions have fallen on regular premiums, but remained stable on single premiums for personal pensions, this is consistent with advice focusing on the provision of either single premiums or regular premiums with larger case sizes.

The reduced initial commission on regular premium stakeholder pensions has led some to argue that RU64 led to a greater mismatch between the timing of the efforts of the advisers and the remuneration they receive than had previously occurred. Hence, there has been an increasing importance of trail commission used as deferred initial commission than would have been the case in the absence of RU64.

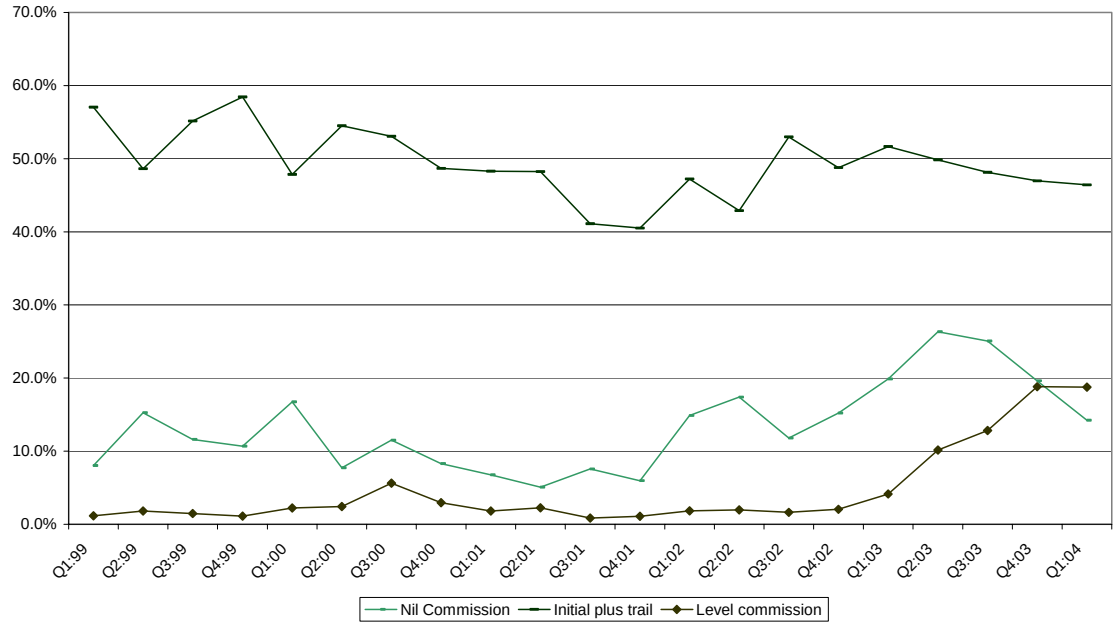
It is thought that stakeholder pensions have not resulted in a simplification of commission arrangements. Indeed, the need to incorporate significant flexibility into the new pension massively increased the costs of its introduction. For example, one interviewee indicated that for a manufacturer distributing only through the tied distribution channel with a single remuneration model, the development of stakeholder took four man-months to build and develop. This was contrasted to the eighty man-years it was thought to have taken some of the large providers who used a multitude of different commission, product and rebate structures.

Recent regulatory changes

In the personal pension market, stakeholder pensions do not appear to have had a big impact on the amount of business written on a fee basis. We have seen the amount of business on single premium business remain around 4-5% although there appears to have been an upward trend over the last year. For regular premium business, it would appear that the amount of new business written on nil terms fell from 10% prior to stakeholder to only 3-4% today.

There was however an increase in the proportion of group pension business that was sold on a fee basis. Indeed, there are increasing restrictions by many providers on the size and quality of group schemes that will yield commission.

Figure 21: Average commission structure for regular premium group personal pensions



Source: CRA analysis based on the provider survey

In the group market, stakeholder pensions have also led to increased negotiation over the level of commission. It is thought to be fairly common for advisers to search across providers on the basis of the annual management charge available for customers and then to establish what commission can be given at this rate.

As stakeholder pensions have no exit penalties, switching does not impose a cost on consumers. For this reason, advisers may feel it legitimate to churn the business as they gain from commission if they transfer an individual or a group compared to when policies remain with existing providers. To the extent that this imposes a cost on providers through excess switching, this represents one of the biggest tensions of operating under a mono-charging price regime.

Recent regulatory changes

One of the most controversial impacts of stakeholder pensions has been the "contagion" effect. That is, RU64 and the regulatory link between the stakeholder and non-stakeholder markets meant that the development of stakeholder products not only led to an impact on remuneration for stakeholder products, but also impacted the remuneration on non-stakeholder pension products.

Although a significant impact on the level of remuneration has been observed, the evidence suggests that remuneration has not yet reached an equilibrium. Different providers were seen to adjust their commission structures at different points in time with some providers acting shortly after the introduction of the stakeholder regime and others following later. Indeed, the realignment has continued with providers recently reducing their commission structure further still on group pensions, suggesting this is still not in equilibrium.

Recently, we appear to have seen developments in the non-stakeholder pension markets, with a number of providers offering niche pension products charging above the 1% cap and with more conventional charging structures. Some argue that although this does not mean the market is returning to pre-stakeholder levels of charges and commission, this does reflect a structure that allows both the provider and the adviser to cover initial costs.

4.3.1 THE STAKEHOLDER PRODUCT RANGE AND THE BASIC SALES REGIME

The new stakeholder regime, suggested by the Sandler review in 2002, is substantially different from the original stakeholder pension product, in particular:

- The range will be extended to include a cash saving product, a medium-term saving product and a smoothed saving products, all of which will be subject to a price cap;
- The requirements of the advice regime will be reduced, with the basic sales regime allowing lesser trained advisers to guide consumers through the process; and
- For the new stakeholder pension, there will be an increase in the maximum level of charges to 1.5% AMC for the first ten years, then returning to 1% AMC.

In this section we consider whether this will lead to:

- commission going up to reflect the increased price cap or whether this will lead to a greater margin for providers;
- a change in the structure of commission for stakeholder products, such as a return to more front-end-loaded commission to match the higher charges earlier in the life of the product; and

- an impact on the structure of remuneration outside of the stakeholder regime, either in the remuneration that can be received in the full advice channel or in the level of remuneration on other, non-stakeholder, products.

The impact of the increased price cap

In trying to understand whether the increased price cap will impact on the remuneration of advisers we first need to determine whether providers will increase their charges from 1% to 1.5% in the early years of the product.

It is interesting to note that in some parts of the market - individuals with significant funds under management and parts of the group market - competition has driven charges significantly lower than 1% already. It would appear surprising if the price in these segments of the market were to increase when the price cap is lifted since it is not the price cap that is keeping prices where they currently are today. We would therefore not expect remuneration to change in these segments.

However, in the majority of the individual market and for smaller groups schemes, prices of 1% AMC seem prevalent and hence the price cap appears to be binding. It therefore seems likely that we should expect that charges will rise when the cap rises.

Having identified that prices are likely to rise in some parts of the market, it should then be considered how this increased charge will be split between providers and intermediaries.

As has already been noted above, remuneration to IFAs in the stakeholder market does not yet appear to be in equilibrium as is seen from the observation that providers are still reducing commission rates paid on stakeholder pensions. This supports the view of many market participants that providers have been subsidising the sale of stakeholder pensions in the last few years.

Hence, it is likely that a proportion of the increase in charges will be retained by providers in order to return to an equilibrium level of commission being paid given the charges available. Given the advent of the simplified sales process, however, the cost of advice is expected to fall and hence this should lead to additional funds available for either provider or intermediary.

The general view from interviewees was that although the increase in the price cap to 1.5% was to be welcomed, it still represented a tough constraint for the market and most doubted that remuneration to advisers would increase much in the light of the higher charges. Furthermore, some providers remain concerned that the basic advice regime will provide insufficient consumer protection and hence that they will need to cover the costs of full advice within the 1.5% price cap in order to prevent future concerns regarding mis-selling.

Recent regulatory changes

In the tied channel, where many people think that stakeholder products are most likely to be seen in great numbers, typically remuneration is equal between stakeholder and non-stakeholder pensions at present and it seems unlikely that this will change in the light of the increased cap since the equality of remuneration seems to be undertaken for reasons of eliminating product bias.

Remuneration under the basic advice regime

Although the overall level of remuneration is not expected to increase considerably for stakeholder products, it may nonetheless be the case that the structure of commission changes. Given the increased charges available to providers in the early years of the product, there may be scope for some providers to increase the amount of initial commission compared to trail commission without imposing undue capital strain.

The "reason why not" and the relationship between stakeholder and non-stakeholder products

There is considerable ongoing debate about whether the new stakeholder range will operate in isolation from consumers wishing to go through the full advice regime. This will depend on whether full advice intermediaries will need to take into account the stakeholder range when advising a customer. There are a number of reasons to believe that the stakeholder and the non-stakeholder market will operate independently from an economic perspective:

- It currently appears unlikely that there will be a RU64 condition on the new stakeholder range. However, there is ongoing debate regarding whether advisers will need to explain to the consumer the reason why they have not been advised a stakeholder product.

- The difference between the stakeholder and non-stakeholder products is significantly wider than it was under the existing stakeholder pension. Stakeholder investment products will be risk controlled through a limit of the amount of equity investment in the medium-term products or lifestyle switching in the pension product. For consumers wanting more investment choices it will be relatively straightforward for the intermediary to justify going beyond the stakeholder range. In the past it was thought that RU64 imposed high regulatory risk to advising non-stakeholder pensions, but given the greater distinction between the stakeholder and non-stakeholder markets, the regulatory concern is thought to be much lower.

- There will need to be formal separation between advisers working under different regimes. It appears that it will not be possible for an adviser to change during the advice process from using the basic advice regime to the full advice regime or vice versa. Therefore once the adviser has started under the full advice process there is a recognition that he is undertaking a more costly activity.

It therefore seems likely that the constraints imposed by the stakeholder range will only indirectly constrain the traditional full advice model. We would therefore expect the structure of charges and remuneration to reflect a greater front-end load basis in the non-stakeholder market than in the stakeholder market. Although a return to very high upfront charging products is unlikely, allowing some additional upfront pricing could enable commission structures to match the advice needs of consumers more easily.

4.3.2 ASSESSMENT OF STAKEHOLDER PRODUCTS AND THEIR SALES REGIME AGAINST CSFS

The high-level impact on the various CSFs for remuneration models of the stakeholders is set out in Table 13 below.

Table 13: Assessment of stakeholder products and their sales regime against CSF

Stakeholder	Positive impact on CSF	Negative impact on CSF
Consumers	Matches demand for advice with provision for a wider range of consumers	May lead to higher commission in the non-stakeholder market, higher prices of new stakeholder products
Intermediaries	Lower cost of advice in basic advice regime, cost reflective to serve different consumers in different ways	Potential for contagion to extend to other product markets where stakeholder products exist and hence may reduce ability to cover costs, concern regarding suitability under the basic advice regime
Providers	Increased price cap and basic advice regime lead to higher returns and reduce capital burden, maintains advisory capacity	Potential for contagion to extend to other product markets where stakeholder products exist and hence may constrain product margin on a wider range of products, concern regarding suitability under the basic advice regime
Regulators	Increased likelihood of stakeholder sales, reduces regulatory cost of sales	

Source: CRA

5 New models for remunerating intermediaries

Based on the analysis in Chapter 3 and Chapter 4 our assessment is that the perception of problems in the financial advice market is worse than the reality. Problems in the remuneration system are not prevalent. In particular, there is no evidence of a bias to sell, and evidence of provider bias is likely to be substantially addressed by the introduction of the menu and the corresponding increase in transparency.

However, material problems remain with the way remuneration is working today. While these problems have not got substantially worse over the last three years, there is no strong evidence that they have improved either and evidence does not suggest that trends in the market alone or the recent regulatory changes will resolve these problems.

In particular, issues surrounding product bias remain along with a proliferation of commission structures with no clear link to service, which add complexity and do not help positive incentives. A new approach or model of remuneration that addresses these issues would clearly be beneficial in terms of consumer welfare, in addition to addressing the problems of perception.

Therefore it is important to consider whether there are other models of remuneration that would better meet the CSFs set out in Chapter 2. In this chapter we consider:

- the range of alternative models regarding how distribution is remunerated;
- whether any of these models better meet the CSFs than the model today and in particular address the problems resulting in consumer detriment; and
- the next steps needed to determine whether the cost of implementing such a model would be justified by any resulting benefits.

5.1 The range of new models for remunerating distribution

In order to examine whether there are models that could better meet the needs of consumers, it is important to consider a wide range of possible models. Indeed, members of the ABI were keen to ensure that as wide a range of models as possible was placed under consideration. This includes both those models that are similar to today's model and also more extreme examples. We have categorised these as being evolutionary or revolutionary change compared to today, where:

- *Evolutionary* means only an incremental change from today's system of remuneration. This is often indicated by examples already existing of market participants operating under such models even though these are not market wide; and where

- *Revolutionary* means a fundamental change as activities are undertaken by different parties compared to today or where there is a totally different remuneration model.

The first step therefore is to develop the full spectrum of models for consideration. In order to do this, we examined the various services that are being undertaken and need remunerating and thereby establish the possible components of a new model for remuneration. We identified that the most important characteristics that distinguish between new remuneration models are:

- The collection of activities that are being remunerated;
- Who ultimately pays for the remuneration;
- The timing of the remuneration payments;
- Whether the payment or timing of remuneration is facilitated and by whom;
- Whether payment is conditional and what the conditions are;
- What determines the value of the remuneration i.e. over what characteristics it varies;
- The level of aggregation at which the remuneration is paid; and
- Which market participants must create the new model.

The various dimensions are summarised in Table 14 and these are explained in some detail in the annex to this report. This analysis was based on decomposing the elements of the current remuneration arrangements and examining recent innovative changes. In addition, we worked with the ABI to understand the implications of how comparable markets and the remuneration of investment products works in other international jurisdictions. The analysis of remuneration in the legal and estate agents markets was very important in thinking through how remuneration affects the incentives of different types of adviser to meet the needs of the end consumer. In the annex to this report, we set out in detail the lessons from these comparative markets and the implications we can learn from the attempts by other countries to change the structure of remuneration.

Table 14: Dimensions of possible models for remunerating intermediaries

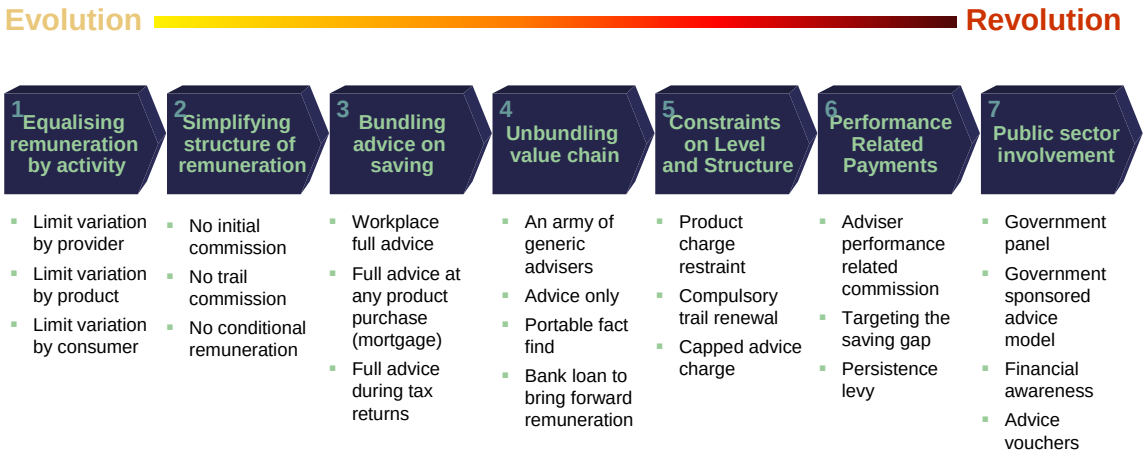
Dimension	Options
Activities intermediary is remunerated for	Fact find
	Generic advice
	Specific advice
	Sales / persuasion
	Administration
	Post sale service / ongoing advice
Who pays the remuneration	Consumer
	Employers / employer trade unions
	Inherited estates
	Government
Timing of remuneration	Initial / upfront
	Level loaded / ongoing
	Back-end loaded
	Limited by timing and structure of product charges
Who facilitates any difference in the timing of the remuneration and the timing of the payment	Individual product provider
	Collective providers
	Industry levy
	Banks
	Government
	Networks
Conditionality	Whether there is a purchase
	Continued contributions and persistency
	Investment performance
	Term
Variability	Variation by individual customer (rebates)
	Variation by provider
	Variation by product
Level of aggregation on which remuneration is based	Individual product
	Customer
	Group
	Adviser
Created by	Individual provider
	Collective action
	Intermediaries
	Regulator

Source: CRA

New models for remunerating intermediaries

By considering the different permutations of these characteristics we have developed 23 new models of remuneration which have been categorised into seven groups. Although this is not an exhaustive list of every conceivable model that could be identified, it does represent the range of models that may be useful for some parts of the distribution of saving and investment products. These groups and the models underlying them are set out in Figure 22 below.

Figure 22: The range of new business models under review



Source: CRA

Further details of these models can be found in the annex.

5.2 Assessment of the new models against the CSFs

In order to examine whether any of these models offers an attractive model for the long-term future of the saving industry we have left transition issues to one side i.e. we consider whether there are attractive new business models that can be identified, but do not yet consider the practicality of moving to these models from where we are today.

5.2.1 RULED OUT ON FIRST PRINCIPLES

The first step of the assessment is to identify whether some models can be ruled out from first principles. In particular we filtered the models using two rules:

- Application of business logic; and
- Hard regulatory constraints.

There are some models that simply do not work from an economic perspective. For example, if the Government were to determine a panel of providers for each product (as they suggested for the Child Trust Fund), we can rule out models which leave commission to market forces. In such a model, advisers would provide consumers with recommendations as to the products that they should take out, but not the choice of provider which would be up to the consumer. Hence there would be no incentive for providers to offer any commission on these products since they would be confident of receiving a fair share of the product market anyway. Thus if left to the market, commissions would fall to zero and no-one would advise on this product. In this model therefore commission rates would need to be agreed by Government for each product in order to ensure that advisers were remunerated (or consumers would need to operate only on a fee basis). Failure to do this would lead to a loss of adviser capacity.

Hence, this range of models would not lead to a market where providers have an incentive to bring products to the market and intermediaries have an incentive to distribute and advise on them. However attractive these may hypothetically be from a consumer perspective, these models do not represent a meaningful way forward and hence we have discarded them.

Regarding the regulatory constraints, there are some models that could not arise because of competition concerns. For example, if collective action led to a situation where all providers agreed not to vary the level of commission for a particular product, similar to the Maximum Commission Agreement, then this would be seen as price fixing and hence can be ruled out as being anti-competitive (as it was by the OFT). That is, these models would be seen to advantage providers at the expense of intermediaries or consumers. We have discarded models that would not be possible for these reasons. For example, from Figure 22, this would prevent providers from developing some of the models in the first group: "limit variation by provider" and "limit variation by product".

By contrast, if an intermediary business imposed a condition of having no variation across providers (and we already see this in the market-place today) then this would be an acceptable outcome.

5.2.2 ASSESSED ACCORDING TO WHETHER THE MODELS ADDRESS THE IDENTIFIED PROBLEMS

The second element in the assessment is to consider whether the proposed models actually help to address the problems that have been identified. There is nothing to be gained from moving away from one model and towards another model that does not actually tackle the problems of the first. It is therefore useful to set out the remaining problems and the implications for choosing between the models.

No bias to sell

Commission based models has been heavily criticised by the Treasury Select Committee (TSC) and therefore it was important to test whether it might be attractive to encourage models of remuneration that were not conditional on sales, that is, encouraging the fee based sector.

The evidence presented in this report does not support this proposal. Firstly, there is no evidence that this would reduce problems in the market. The evidence reported in Chapter 3 shows that there is no evidence that advisers working under a commission basis were more likely to recommend commission generating investments than these working on a fee basis. In fact, we actually found that the average level of investments was higher for advisers working on a fee basis. Therefore, if the concern is regarding the "bias to sell", there is no evidence that moving to a fee based system would be beneficial (and further there would be costs and risks of doing so).

Secondly, a large increase in the fee based market, with remuneration that is unconditional on sales, is inconsistent with market realities. In particular, it is clear from the evidence in Chapter 2 that consumers do not like fees and are unwilling to pay them. That is, the amount that consumers are willing to pay as a fee for financial advice is much less than what it would actually cost to pay for advice through fees. Based on evidence from consumer surveys, consumers would not purchase advice from advisers operating on a fee basis given the current rates of fees. Hence a wholesale move towards fees would lead to a dramatic decline in the advice market with a corresponding reduction in the number of consumers purchasing products and making long-term savings provision.

Finally, it is important to note that remuneration structures evolve with customer relationships. Most consumers operating on a fee relationship started on a commission basis and over time moved onto a fee basis. This observation is consistent with a desire by both advisers and consumers to build up trust in the relationship. From the consumer perspective, this is entirely rational since consumers are unable to judge the quality of their advisers at the outset. Similarly, from the adviser perspective, this is thought to be a way of signalling that advice will initially be free unless the consumer thinks it is worth following.

There does not, on the basis of our analysis, seem particular merit in artificially expanding the fee based sector. Hence from Figure 22, we would not wish to move the whole advisory market to operating on an unconditional basis. This does not, however, imply that fee based advisers are not providing a very valuable service to consumers who prefer to transact on this basis, nor that more cannot be done to deliver fee options to consumers.

Further, the menu will improve the comparability of the fee and commission based regimes. However, this in itself is unlikely to increase the fee based market quickly since consumers have a preference for paying on a conditional basis. However, during the Mystery Shopping research undertaken for this project, we discovered evidence that although most commission

based advisers are happy to operate on a fee basis there are some who are reluctant to do this and seek to persuade consumers to pay by commission. This should be monitored by the FSA in the depolarised world to ensure the remuneration structure reflects the preferences of the consumer rather than their adviser.

Limited provider and product bias

The analysis of the market and regulatory trends found that there was evidence of limited product bias, in particular in the advice on ISAs. Although the menu will make comparison between products more transparent, the different commission structures will make apparently similar products difficult to compare. Models that increase the ability to compare the remuneration the adviser receives for different products that meet the same consumer need are likely to be beneficial.

In terms of provider bias, the menu tackles this much more directly through the use of a market average. Considering our range of models in Figure 22, this suggests that it is unnecessary to force all intermediaries to offer models that "limit variation by providers" since concerns of provider bias will mainly be addressed through the menu.

However, different advisers will be able to present the market average on a different basis, using different structures of commission. This will therefore make the comparison of menus offered by different advisers problematic. Therefore, although the menu is likely to greatly reduce the potential for provider bias, remuneration models that simplify comparison across the market may have significant consumer benefits. Hence we have looked for models that address these concerns.

No relationship between structure of commission and consumers' service requirements

There is currently no link between the structure of commission and the type of relationship requested by the consumer, leading to the accusation that providers are competing for intermediaries rather than for consumers. This reflects the fact that commission is performing a number of different roles each of which are legitimate in their own right but in combination lead to confusion over the role of commission. These include:

- Rewarding advisers' "prospecting" activities which as well as being a distribution service to providers is the principal means of raising consumers' awareness of the need to address their financial needs and offering them a starting point for doing so. This encouragement and awareness-raising is not only an important source of generic advice, but also important to closing the savings gap;

- Rewarding advisers for the initial cost of undertaking the advice process and fulfilling the transaction. These costs occur predominantly at the start of the advice

process but ongoing commission (renewal and trail) is often perceived as deferred initial payment for this service;

- Providing an incentive to encourage high levels of persistency and preventing unnecessary churning of consumers' portfolios; and

- Payment for ongoing services to meet the needs of consumers including the administration of the product, follow-up meetings to discuss the ongoing suitability of the investment and ongoing surveillance of the market-place.

The Treasury Select Committee has accurately identified that it is difficult for commission to meet all of these objectives simultaneously, as they confuse rewards for the initial sale and those for ongoing service and advice. That is, if trail commission represents a deferred initial commission (representing payment for services at the beginning of the advice process) it is unreasonable to expect advisers to provide ongoing services or for this payment to be taken away if they do not provide these services. Equally, those consumers who are not looking for a long-term relationship with their advisers, should expect to pay less than consumers who are.

A better model of remuneration is likely to improve clarity over the role of commission at the start of the relationship with the consumer, so that the consumer and the adviser are aware of the purpose of ongoing remuneration. In particular, from Figure 22, this suggests that a model which includes some element of "compulsory trail renewal" would be beneficial.

5.2.3 A NEW APPROACH

The new approach that best meets the objectives set out above has three elements:

- An explicit ongoing advice charge;

- The cost of initial advice spread over time; and

- Simplification of structures of commission.

Explicit ongoing advice charge

If the structure of commission or fees is meant to reward intermediaries for providing consumers with an ongoing relationship, this has a number of implications:

- If a consumer wants ongoing provision of advice they should pay more for it than those who are only interested in one-off advice;

- The amount that consumers are paying for advice on an ongoing basis should be revealed, and advisers should be incentivised to explain the services they are providing for this on an ongoing basis; and

- If the consumer is dissatisfied with the advice they are getting they should be able to transfer payment elsewhere or even stop paying for this advice altogether (and receive lower product charges).

By introducing an explicit charge for ongoing advice we would address the current confusion between advisers, in which some advisers claim that trail commission reflects the reward for the initial advice and some believe this is a reward for ongoing services. More importantly, this will empower consumers to pay for the services they want, understand what services they receive in return and be able to reward advisers when these services are provided to their satisfaction. This should help consumers to understand the choices that they face and to at least be involved in the decision regarding whether to pay for them. This should improve the quality of ongoing services provided to consumers and mean that advisers spend the appropriate amount of time undertaking these activities (rather than seeing these services only as marketing for future consumer purchases). Such an ongoing advice charge would be likely to require providers to help to facilitate it, potentially also involving improvements in ongoing services given to advisers by providers.

Finally, this provides an opportunity for the industry to defuse a potential problem of perception arising in the future. As the size of trail commission grows over time, there will be increasing concern about the services received for these payments. Clarification of the role of ongoing payment will prevent this from occurring.

There therefore appears a strong argument that there needs to be an explicit ongoing charge for the ongoing relationship with the adviser that is transparent to consumers.

Cost of initial advice spread over time

Equally, any model of remuneration should be explicit about the charges or commission paid for initial advice. There is also a good argument that the cost of initial advice ought to be spread over time.

Spreading the cost of initial advice over time brings advantages:

- To empower consumers, low surrender values and high initial charges have been discouraged by regulatory action. The motivation for this was to prevent excessive charges and to enable consumers to avoid punitive surrender costs and being locked-in to poor-value products. This has resulted in consumers paying for advice over time and the risk for whether consumers do actually pay for advice moving onto product providers. If the payment of commission is spread over time, the risk due to

the mismatch (between receiving the payment from the consumer through product charges and the time at which the cost of advice is incurred by the adviser) can be shared between the provider and the adviser (indeed commission clawback is partly designed to facilitate this sharing of risks); and

- Spreading the payment of commission over time provides a reward for advisers for persistent business, thus encouraging advisers to recommend good products and reducing the likelihood of excessive churn.

If the payment for advice occurs conditionally on the sale of the product, an attractive model of remuneration will therefore result in the payment for initial advice being spread over time.

Indeed, a similar approach could be used in the fee based market. That is, steps could be taken to encourage fees to be paid over time which may also bring advantages. This would allow a better comparison between fees and commission. It would also allow consumers who prefer unconditional remuneration but who cannot currently afford to pay the whole fee upfront to instead pay a regular fee over time. If advisers are willing to receive remuneration over time when operating on a commission basis, it is unclear why they would not also be willing to receive remuneration over time when operating on a fee basis. Indeed they could offer to receive fees structured in a similar way to commission. However, there is little to prevent fee based advisers offering this service today; therefore, although this is likely to have a positive impact, the benefits are likely to be small. One possible reason for this service not having developed is the VAT implications of such an approach since fee based advice that is not connected to the sale of a product incurs VAT.

Spreading the cost of advice over time clearly brings substantial benefits to consumers as much of the risk sharing has been moved onto advisers and providers with consumers facing limited risks in paying for initial advice despite receiving that initial advice. However, the relaxation of RU64 requirements and the development of the stakeholder range of products is likely to lead to a separation of markets between products with the basic advice regime and those facing the full advice regime. This offers an opportunity for the full advice regime to have a system of remuneration that is more cost reflective with pressure on levels being maintained through the menu. This is likely to lead to the re-emergence of some initial charges in the non-stakeholder market, appropriately resulting in consumers sharing a portion of the cost of initial advice if they are to lapse early.

Simplification of structures of commission

Without a common approach, the structure of commission is likely to be too focused on initial commission and the proliferation of commission structures in the market will remain.

Although the menu is expected to constrain the level of commission, any individual firm acting alone would nonetheless have an incentive to bring payment forward in time in order

to gain market share or offer attractive financing terms (through indemnity arrangements with better interest rates or more favourable clawback conditions). This results in either an incentive for advisers to churn consumers (so where there are initial charges this may result in consumer detriment) or in choosing the provider offering the most favourable financing arrangements.[53]

It is self evident from the data provided for the provider survey that there are a large array of commission structures currently on the market. There is little evidence that the market alone will determine focal points of competition e.g. around structures with the same initial period or same structure of ongoing payments. Indeed, providers appear to be aiming to differentiate themselves by offering innovative commission arrangements to advisers. Indeed, the justification for different commission terms is often defended in terms of the needs of the intermediary not the needs of the consumer.

There is therefore a strong argument that, collectively, providers should lead the industry towards consumer friendly remuneration structures. A degree of coordination will be required to get simple structures that incentivise persistency while allowing competition in levels. Without coordination, it will always be in the interests of a single provider to offer terms that focus commission on earlier payments.

Simplifying commission structures will substantially improve the effectiveness of the menu. If products have a similar remuneration structure for all advisers this will result in the market average being presented in the same way across the market. This will mean that the market average will be the same if a consumer compares menus from two different advisers and that it will be easier for the financial press to inform consumers about the market rate, thus removing the potential for considerable confusion.

It will then be possible to compare the maximum rates of one adviser to those offered by another adviser and allow easier comparison across products meeting similar needs. So for example, it will be more straightforward to compare the commission rates on different long-term saving products - increasing transparency and competition.

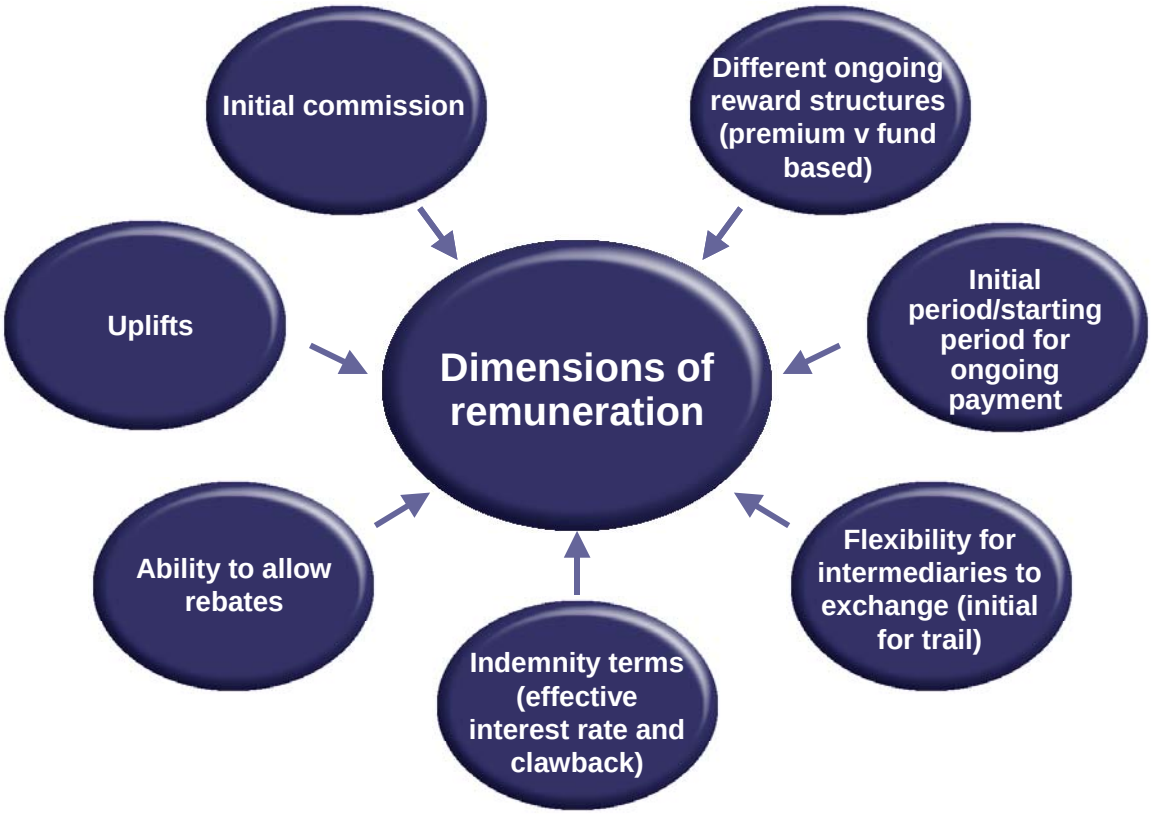
It is also clear that consumers may be unaware when a product they are advised to take out requires ongoing advice – this is very clearly illustrated by the example of income drawdown. In these cases, providers should only distribute products to consumers where appropriate ongoing advice is being provided.

However, although simplification is easy to talk about in abstract terms, it is useful to flesh out what a simplified structure would look like in practice. Looking at the current structures of remuneration (illustrated in Figure 23 below), these can be grouped into factors determining the level of commission and whether this is taken by the adviser or returned to

[53] Even if the consumer does not face initial charges, costs imposed by too high a level of switching across all consumers will need to be recovered from consumers, resulting in higher charges.

the consumer (rebates), factors determining the period over which this is paid and factors that allow advisers to change the timing of when they receive this payment.

Figure 23: Dimensions of remuneration



Source: CRA

Some elements of the current remuneration system are fundamental to incentivising and rewarding advice. These include:

- The level of commission - although in an efficient market we would expect the level of commission to converge around a market rate where a similar service is being provided, firms should be able to compete by offering higher levels of commission, reflecting the efficiency of the distribution channel. The advisers can then determine the degree to which these are passed onto the consumer;

- Uplifts (variation between intermediaries) - higher levels of commission can result from scale efficiencies or sharing of costs between intermediaries and providers. We therefore expect to see different levels of commission between advisers in a market that is working effectively; and

New models for remunerating intermediaries

- Rebates (variation across consumers) - where consumers are investing different amounts and where advice contains fixed costs elements, we expect to see the proportional cost of advice vary and for this to result in rebates to some consumers.

Other elements are required for an effective commission structure but it is difficult to justify the current level of differentiation from the consumer perspective:

- Ongoing reward structures – why do some consumers of the same product make ongoing payments based on premiums and others pay for this in terms of investment performance?

- Initial period – why do different products meeting the same consumer needs have different initial periods?

The question regarding whether ongoing commission should be related to performance is a difficult one. Performance related commission structures bring the advantage to consumers that the rewards of advisers are aligned with the returns to consumers. However, the danger is that this leads to products being chosen to reflect the risk preferences of the adviser rather than the consumer and that the rewards for advice can become completely unaligned to the cost of providing it. It is also likely to be the case that the need for performance related commission will vary by product.

Unless there are justifications for these different structures from a consumer perspective, these should be simplified. Any role that these structures fulfil should be undertaken through other means that do not complicate the structure of remuneration.

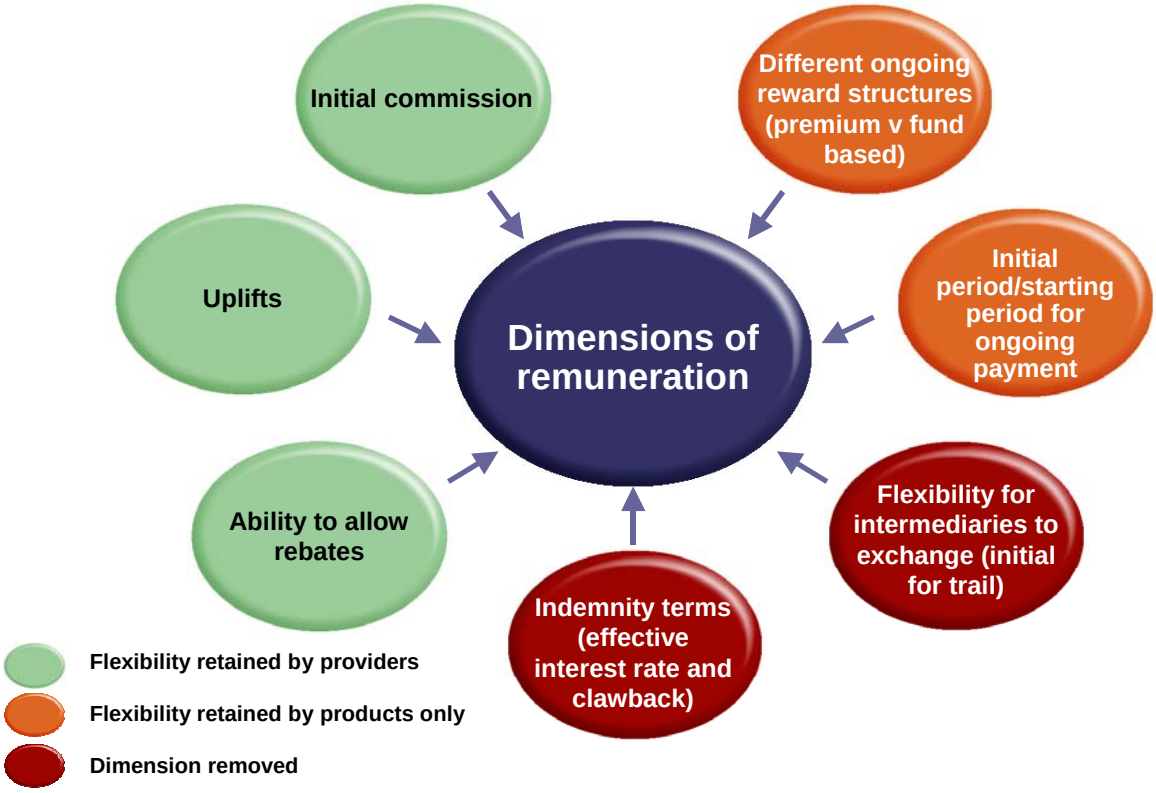
However, some elements cannot currently be justified from a consumer perspective at all. These should be undertaken through other means entirely, for example:

- Flexibility for intermediaries to trade off initial commission for ongoing payments. It is very unclear that this reflects the preferences of the consumer; and

- Indemnity commission similarly appears to meet the financing needs of the intermediary and is unrelated to the needs of the end consumer.

Therefore, returning to the structure of commission we would propose keeping the essential characteristics of the remuneration structure, standardising some elements and excluding others that complicate the relationship between the consumer and the adviser. These are set out in Figure 24 below.

Figure 24: A "simplified" structure



Source: CRA

Hence we would suggest that flexibility be retained regarding the level of initial commission, uplifts and the ability to allow rebates. However, while variation on different ongoing reward structures and on the initial period may be necessary across products, it is not clear that there are any benefits to consumers from this varying across providers. Further, there seem to be very limited benefits indeed from variation resulting from the flexibility available to intermediaries to trade initial commission for trail commission or for providers to offer indemnity terms, both of which bring complexity and a potential way for provider bias to reappear in a non-transparent manner.

Further, this suggests that there should be very good reasons justifying the need for more than one structure of remuneration for any given product category. For example, this could mean that for pensions there may be a case for three different structures. One would cover personal pensions. A second would cover stakeholder pensions where the impact of price caps may both justify and require a different structure of commission compared to personal pensions which do not face price caps. A third structure would be likely to be required for group pensions which, due to the different cost structures involved and the different needs in terms of retaining existing employees and gaining new joiners, may require a different structure again.

This would have a dramatic effect on the number of structures in place. It is estimated that the FSA has had to deal with hundreds of different structures during its collection of information for the menu. The proposals in this report would be likely to reduce this number to around a dozen.

We want the menu to work better in all distribution channels. The need to protect consumers from product and provider bias and to empower them to get the advice they want and need goes beyond the IFA channel. The FSA will require tied advisers to reveal "commission equivalent" remuneration on the menu. Our proposals are designed to work within the current framework of regulation and hence would be applicable across all channels.

The focus of our analysis and recommendations has been on saving and investment products. The research did not find any evidence of commission related problems for protection products. If concerns in this area remain it could be investigated more extensively using a Mystery Shopping exercise that focused specifically on the provision of advice for these products. There is, however, no reason why the proposals for saving and investment products should not be extended to cover protection.

5.2.4 TESTING THE APPROACH

There are two particular hurdles that the new approach will need to overcome.

Firstly, the approach outlined above requires coordination between providers if it is to simplify the proposition to consumers with the corresponding benefits this would bring. This will require guidance from the competition authorities. This is required before any specification of a "simplified" commission structure can be set out in more detail.

Secondly, although the approach requires relatively little change in current regulation, the approach should be subjected to the same test (i.e. cost benefit analysis) to determine whether this will result in consumer benefits in excess of any costs.

In both cases, our analysis suggests the approach is robust to these tests but more detailed work should be undertaken to verify these conclusions.

Competition concerns

If members of the ABI are to take forward the proposals in this report, it is clear that this will require coordination over structures of commission. This will be aimed at simplifying commission structures for consumers and would lead to the exclusion of certain aspects of flexibility of commission that are seen in the current market. As stated above, it is clear that such coordination would require the agreement of competition authorities before any detailed discussions of the meaning of the coordination of structures could be undertaken.

New models for remunerating intermediaries

Competition authorities such as the OFT would need to be convinced that advantages from coordinating on structures would outweigh any potential anti-competitive effects from such agreements.

The over-arching concern that the OFT are likely to have is whether consumers would actually benefit from these arrangements. In the light of this, the potential anti-competitive effects that the OFT might be concerned about include:

- Whether having prescribed structures of commission would facilitate collusion on levels of commission;
- Whether today's advisers would be disadvantaged with structures agreed by providers compared to in today's market-place and the impact this would have on the provision of advice to consumers;
- Whether tomorrow's advisers will find it harder to enter the market due to the removal of indemnity commission;
- Whether there is actually a need for these arrangements or whether a similar end can be met by different (non-coordinated) means; and
- Whether any transitional financing arrangements are required and the degree to which these would benefit advisers as opposed to providers and how consumers would therefore be affected.

However, agreements between horizontal competitors are allowed where there are clear efficiency gains that can be demonstrated and where anti-competitive effects are limited.

There are clear efficiency gains for consumers including:

- Consumers understanding what they are paying for and what they are getting for it and hence leading to better advice for them. For example, those seeking ongoing advice will receive it and pay for it, whereas those who do not require ongoing advice will neither receive it nor pay for it;
- Prescribed structures could be more simple for consumers to understand hence enhancing competition between advisers for consumers as well as increasing the ability of consumers to negotiate over the cost of advice;
- Increasing the ability of consumers to compare the cost of advice paid for through commission for products that meet the same needs; and
- Increased effectiveness of the menu which: improves consumers' understanding of what they are receiving and paying for; increases the ability of consumers to negotiate over the cost of advice; and increases the ability of consumers to compare the cost of advice. Hence this will increase consumers' ability to shop around.

Furthermore, it seems as though coordination on structures is necessary for these benefits to arise as the evidence suggests that there are current problems of bias in the market which will not be resolved by regulatory change, and indeed regulatory change may encourage

additional problems in the future. In addition, simplification of structure *per se* does not imply any change in the total remuneration available to advisers. Although the level and timing of remuneration may differ compared to today for different products, the extent to which this occurs will depend on the actual proposals for simplified structures on a product by product basis (these can only be determined once there is agreement in principle that coordination is justified).

Removing indemnity commission leads to a concern regarding barriers to entry into the advice market. New advisers will require capital or financing to sustain their business until they receive payment for their services. Our proposals suggest that financing is made independent of product choice. This does not prevent the participation of product providers (with the corresponding advantages this brings), but means that any financing must be offered to all intermediaries independent of whether they are advising the provider's products. Arguably, this would increase the options open to intermediaries for financing and make this independent of the particular product that is being advised. Clearly this unbundling should enhance competition for the financing of intermediaries.

In addition, anti-competitive effects are limited because:

- Simplification would be occurring on the structure and not on the level of commission and hence providers remain free to set the level of commission that they desire;

- Even if consumers find it difficult to compare commission structures, providers are already able to identify and compare commission structures across their competitors. Indeed data providers already offer such information to IFAs. Thus simplifying structures would not make this significantly easier for providers and hence it could not be argued that this approach would make collusion more likely.

However, there may remain a concern that the actual process of discussing structures of commission may lead to a discussion of levels of commission. In order to prevent the perception of any such wrong-doing, it may be appropriate to have representatives of the FSA or OFT involved in the discussion of the simplification of structures.

Designing the best tools to deliver this outcome is a challenge that providers need to tackle in partnership with intermediaries, the FSA and competition authorities.

A top-level cost benefit analysis

When considering changes to regulation, the FSA is required to undertake a cost benefit analysis (CBA) to establish whether the benefits of the new regulation outweigh any costs that new regulation might bring. These CBAs must take into account the effect of the change in regulation on:

New models for remunerating intermediaries

- Direct costs;
- Compliance costs;
- Quantity of products sold;
- Quality of products sold;
- Variety of products sold; and
- Efficiency of competition.

To determine the scale of benefits the new approach would bring to consumers would require a detailed CBA taking into account the cost of the changes this will require providers and intermediaries to make. Table 15 below presents a top-level CBA which follows a similar approach to that of the FSA in CP121. Looking at the benefits from a qualitative perspective there is very good reason to believe the CBA would be positive.

Table 15: Top level cost benefit analysis for financial advice[54]

Potential consumer benefits	Detail	Quantification
Quantity of products sold	*Possible increase in provision of ongoing advice as consumers are able to hold intermediaries to account*	** Positive
Quality and variety of products sold	*Reduction in product bias due to increased effectiveness of the menu*	Positive ~ £45 million (50% of product bias remaining from the analysis of detriment resulting from previous analysis of commission bias)
	Require ongoing advice for particular products	Positive (e.g. income drawdown and contracting out)
	The advice offered better meets the demand of consumers	** Positive
Efficiency of competition	*Reduced focus on commission structure, greater transparency leads to greater competition and benefits being passed onto consumers*	** Positive
	Increased pressure on commission levels due to lower cost of shopping around	* Positive
Potential consumer costs	**Detail**	**Quantification**
Direct costs	*No change in menu or monitoring by the FSA*	Minimal, indeed this could significantly lower the cost of the menu data analysis
Compliance costs	*One-off: Changes in system to use simplified structures* *Ongoing: Structures need to be agreed and updated at intervals* *Commission statement setting out ongoing payment for advice*	Needs to be estimated. Whether provider or intermediary provides statement determined through CBA
Quantity of products sold	*Separate ongoing service charge is not accepted by consumers reducing the demand for ongoing advice and subsequent product purchases*	Needs to be estimated
Quality of and variety of products sold	*Reduction in variety of commission structures stifles relationship between advisers and providers*	Minimal, depends on simplification but little customer focused justification for this dimension of competition
Efficiency of competition	*Simpler structures facilitates coordination between providers to the detriment of consumers*	Approval by Competition Commission / ongoing surveillance required proxy for cost
	Removal of indemnity commission may increase the barriers to entry to become intermediaries where other forms of financing are not available	Depends on transition arrangements

Source: CRA

[54] It should be noted that in this table the "product" relates to financial advice rather than to financial services products. Asterisks indicate the likely benefits with more asterisks meaning higher benefits.

To take the CBA further, we would need to specify the "simplified" structures in detail, to determine the impact this would have on the systems and processes of today's providers and advisers. This will also allow us to determine the extent of the change in the cashflows for particular kinds of advisers and the resulting need for transitional finance. None of this can be in the absence of agreement by competition authorities regarding the acceptability of coordination on structures.

In addition, the way that the charge for ongoing advice is presented to the consumer needs to be carefully tested through piloting with consumers.

5.3 Recommendations

We recommend the following changes to the current system of remuneration:

1. There is an explicit charge for ongoing service and advice that is transparent to consumers and that can be removed should consumers choose not to continue with the relationship with their adviser. This should be distinct from the payment for initial advice.

2. On an annual basis, consumers are informed about ongoing payments to their advisers, and the degree to which they can expect ongoing services in return. This statement could be added to existing documentation provided each year to the consumer by the provider or consolidated in a statement by the customer's adviser. The most effective means of doing this should be determined by estimation of compliance costs in the CBA.

3. Providers agree to transfer this ongoing payment between advisers when requested by consumers. Although apparently only a relatively small problem at the moment, there are a number of cases where providers have refused to transfer ongoing commission to the adviser chosen by the consumer to undertake these services. Clarity over the distinction between the spread of initial commission and payment for ongoing relationship should mean there is no justification for not transferring remuneration for ongoing service.

4. A compelling case is presented to the Office of Fair Trading setting out how the benefits of simplified structures of commission will result in increased competition whilst ensuring the gains from competition are passed onto consumers. This offsets any concerns regarding providers coordinating over the structure of commission. This should build on the case set out above.

5. A set of simplified structures are agreed by the industry that would bring benefits to the consumer by increasing the effectiveness of the menu. Differences in structure within products or between products meeting similar customer requirements need to

be justified from a consumer perspective. In practice, simplified structures should allow flexibility over the level of commission but constrain the timing of payments. We have therefore suggested that simplification is likely to standardise the initial period for each product or cluster of products, as well as standardising the structure by which initial is spread over time (premium or fund based). We do not see the justification for indemnity commission and flexibility over the way initial commission is spread as elements that work to the benefit of consumer. We therefore propose that these are excluded from the structure of commission.

6. Providers should determine whether there are particular products that always require ongoing advice and how they will encourage this to be undertaken or whether products only need ongoing information provided by the provider. For example, it should not be necessary in the future that the FSA is required to step in to determine that a product such as income drawdown requires an ongoing relationship between the adviser and the consumer.

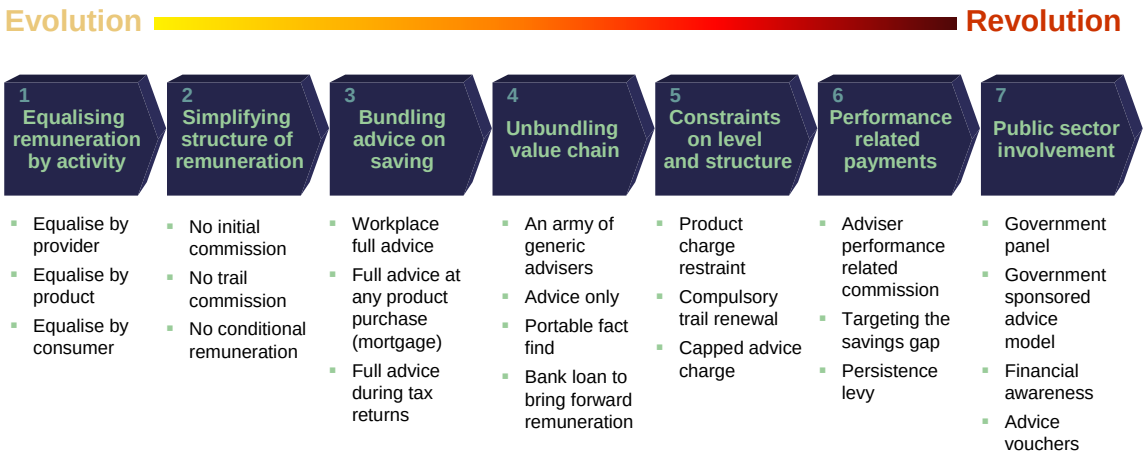
7. To share risk between advisers and providers and provide the appropriate incentives the model should retain the ability to spread the cost of initial advice over time. A mechanism that allows fees to be paid over time could also be beneficial as this would both allow consumers who have a preference for fee based advice but cannot afford the upfront payment to conduct business on this basis and improve comparability between commission based and fee based systems.

8. The result of simplified structures and the encouragement of competition across products is likely to change the timing of remuneration to advisers by, for example, spreading out the payment of commissions that are today paid on an initial or indemnity basis. This may therefore necessitate financing arrangements to facilitate a change from one remuneration regime to another. The requirements for this will depend on the degree to which "simplified" remuneration structures spread commission payment over time relative to today (which can only be determined once coordination has been passed by the competition authorities). Given the structure of the market, it is very likely that this will result in remuneration structures that increase the relative amount of commission that is spread over time resulting in an increased need by intermediaries for financing arrangements. This finance should be separate from the remuneration structure. There are a number of ways finance could be provided, varying from providers offering loans independent of whether they offered the product and industry wide loans schemes (possibly using securitisation at the industry level). However, the key component of these is that finance does not vary depending on whether the particular provider's product that has been recommended – this is in order to prevent the re-emergence of provider bias.

Annex 1: Range of new business models

Using the dimensions set out in section 5.1 we can construct a wide range of new business models. Below we categorise these models into seven groups, where the groups are made up of models that broadly meet the same critical success factors.

Figure 25: The range of new business models under review



Source: CRA

This covers a range of models from those that we would categorise as evolutionary to those that would represent a revolutionary change compared to today, where:

- *Evolutionary* means only an incremental change from today's system of remuneration. This is often indicated by there already existing examples of market participants operating under these models but that they are not market wide; and

- *Revolutionary* means a fundamental change as activities are undertaken by different parties or there is a totally different remuneration structure.

The various different business models discussed do not need to work across the whole market-place. Indeed, were some of these models to be the only model this would have serious damaging consequences for the whole industry. Hence models should be assessed as to whether they might work for a part of the market, for example for particular types of consumer. It will then be necessary to consider whether there are combinations of models that together could meet more of the needs of all the consumers and other stakeholders.

Similarly it is important to recognise that some of these business models may be suited to certain products and not to others due to the underlying characteristics of the products such as whether an ongoing relationship between the consumer and the adviser is likely to be required. For example, annuities once purchased can not be changed and hence an ongoing relationship is not required, whereas income drawdown may require the adviser to monitor

the product and give continual advice over a period of some years – hence the structure of remuneration that may be suitable for one product may not be suitable for another.

Below we describe each of these groups of models and undertake a high level review of how they meet the critical success factors of the different stakeholders (set out in Chapter 2).

GROUP 1: EQUALISING REMUNERATION BY ACTIVITY

This group of business models restricts the amount of variation that would be allowed within the remuneration structure. There are at least three types of variation where we could imagine imposing restrictions:

- variation in the level of remuneration paid depending on the particular product provider;[55]
- variation in remuneration by the type of product; and
- variation in remuneration by type of customer or case size.

This does not introduce models that are impossible under the current regime (and indeed all of these models have been tried in the UK life and pensions market) and therefore we would categorise this as a more evolutionary set of models. These models could apply to the independent, limited provider distributors or tied sector.

High-level assessment of Group 1 by critical success factors:

- Product providers: this reduces flexibility for providers to remunerate distributors depending on the activities they undertake and to share efficiency saving with distributors, but it may enhance the industry reputation and, depending on which variation is ruled out and by whom, may encourage competition amongst intermediaries and therefore keep costs low.
- Intermediaries: limits ability to cover differential costs between product/provider or customers, but may increase perception of working in consumer interest, retains conditionality on sales and allows customers to pay through a single payment and hence minimises customer restraint.
- Consumers: reduces potential for intermediary to base their recommendations on remuneration and therefore increases alignment with consumer interests, increases transparency and ability to compare advisers; for example, if variation by consumer

[55] Note this has similarities to the unbundled cost of distribution suggested in the Sandler report, where the level of remuneration did not vary by provider.

type is ruled out then consumers would more easily be able to compare the actual remuneration they would face across advisers. However, may result in big cross-subsidies across consumers perhaps resulting in sub-optimal decisions.

- Regulators: easily integrated into menu and may reduce potential for bias but does not deal with concerns regarding initial commission. It increases transparency but possible competition concerns depending on how it is implemented.

Turning to each of these models in more detail:

Equalise remuneration by provider

Currently we observe different levels of commission and different structures of commission for different providers of the same product. In this business model there would be a restriction in place such that whatever provider an adviser chose they would receive the same level of commission (and the same structure of that commission). This would be intended to prevent any potential or perceived provider bias.

This type of model could only come about due to the choice of intermediaries themselves (by negotiating with product providers or only choosing providers offering the same level of commission) or by the actions of the regulator such that the commission set on the menu was the level transacted at (and any additional commission was rebated directly to the consumer). It is unlikely that collective action or action by a group of providers (which would resemble the maximum commission agreement) would be possible under Competition regulations. However, although providers would not be able to coordinate on levels of remuneration, they could potentially agree on the *structure* of remuneration for a particular product.

Equalise remuneration by product

Historically, commission levels have varied significantly by product both in terms of their level relative to premiums (with lower premium products such as protection having a higher rate of commission, although this may result in a similar monetary value) and in terms of structure; for example, unit linked bonds have higher initial commission and are less likely to pay trail commission than unit trust products that have a lower level of initial commission and a higher level of trail commission (although, again, this may result in the same value of remuneration over the life of the product).

An alternative business model would have the same level of commission paid independent of the product advised. This could take a number of forms, for example, it could be the same percentage of premium or a fixed monetary amount. Combining product groups on the menu could bring this about. Given the difference in the amount invested, it may be necessary to have a number of product groupings.

This model could be brought about by intermediaries themselves or the regulator but it is again unlikely that this could be negotiated by a group of providers or collective action (for the reasons given above). However, although providers would not be able to coordinate on levels of remuneration by product, they could potentially agree on the structure of remuneration.

Equalise remuneration by consumer or case size

Finally, the third type of variation that could be restricted is the ability to charge different consumers a different commission when advising them for the same product and the same level of investment. The market currently works by offering consumers a rebate on the commission paid. That is, consumers making a larger investment are often offered a rebate that can be invested into the product. This, it is argued, reflects the fixed cost in giving advice and the competitiveness of the market.

A rule excluding the possibility of rebates would mean that similar consumers paid the same amount. If some consumers are more sophisticated than others or willing to undertake more search activity this might increase pressure on the level of commission in the rest of the market i.e. the marginal consumer can act to bring about lower commission levels for all consumers.

This type of new business model could be undertaken by advisers today or enforced by regulators. However, it is unlikely that this would be possible in terms of collective action. Further, there will be concern regarding the impact of such a rule on competition because the relatively poor negotiating position of consumers means that the marginal consumer is unable to exert a sufficiently large pressure on commissions to benefit the whole market. Hence rebates are used as evidence that the market is working and the competition authorities are keen to encourage consumers to negotiate for a better deal. It therefore seems very unlikely that a model of this kind, in which rebating is prevented, would be beneficial.

GROUP 2: SIMPLIFYING THE STRUCTURE OF REMUNERATION

In these models we remove certain elements of the structure of remuneration that are causing particular concern. These elements could include:

- No longer allowing an initial commission paid at the point of sale;[56]
- No longer allowing trail commission after the sales process has been completed; or
- No longer allowing any remuneration that is conditional on sale.[57]

[56] This would exclude initial and indemnity commission from being paid at the point at which the product was purchased.

Annex 1: Range of new business models

In some product markets today, we can find providers who only offer initial commission (without the option to have trail) and who only offer trail commission with no initial, and we also find intermediaries who only work on a fee basis. So again, we would categorise this as an evolutionary business model rather than revolutionary. These business models could be applied to the full range of distribution models.

High-level assessment of Group 2 by critical success factors:

- Product providers: polar impact on timing of remuneration payments (and hence on capital burden and the risk they are exposed to). A focus on initial would worsen the capital burden (and place all of the persistency risk on the provider), whilst a move to trail would clearly lessen this burden (pushing it onto the intermediary). Changing the structure of remuneration would increase the incentives to sell (potentially increasing the risk that they incentivise churn) or to focus on selling persistent business (but perhaps at the expense of encouraging prospecting).

- Intermediaries: increases the clarity of incentives towards either sales activity or focus on encouraging persistency. However, results in a removal of flexibility to serve different consumers in different ways. Potentially inconsistent with consumer preferences (as consumers may not want the adviser to be paid upfront but to be rewarded for advising a good product), reducing demand for intermediary services.

- Consumers: simpler and more transparent remuneration structure but extremes may not be consistent with the variety of preferences consumers currently display. Evidence (see section 2.1) suggests consumers are not in favour of unconditional remuneration. This still does not allow consumers to incentivise ongoing relationship as payment is not conditional on ongoing performance of intermediary.

- Regulators: removes one dimension of remuneration which might cause bias and assists comparisons of costs. However, potential to have large unintended consequences if change structure of remuneration to one that is not wanted by consumers, or needed by intermediaries. Depends on how market evolves, i.e. whether this leads to a reduction in intermediary capacity or alternative sources of financing.

Turning to each of these models in more detail:

No longer allowing an initial commission paid at the point of sale

In this model, remuneration would need to be level loaded, that is it could be expressed as a percentage of the premium or the fund but could not paid as an initial payment. Equally,

[57] This is clearly similar to the proposals in CP121 regarding the defined payment system.

product providers would not be able to lend to intermediaries, i.e. indemnity commission, to bring forward remuneration. The intention would be to reduce the focus of intermediaries away from selling. This would result in significant change in cashflows and put the majority of the persistency risk on to the intermediary rather than the consumer or provider. Although this results in payments over time, they remain unconditional on the performance of the adviser, and therefore provide only a weak incentive to provide an ongoing service (unless the flow of payments can be removed altogether). This does, however, increase the incentive to sell persistent products and reduce the incentive to churn consumers.

No longer allowing trail commission after the sales process has been completed

In this case, the model would only allow remuneration to cover the initial sales process. As the main costs of advice are upfront, this would limit remuneration to a similar upfront structure. It would be possible to base remuneration on activities undertaken by the adviser but there would be no automatic payments based on the persistency of the product. This would seek to better link remuneration with the current activities of the adviser including prospecting for new clients. This would clearly have the opposite effect to the previous business model - it would focus advisers on making the next sale, and reduce the risk to advisers associated with the persistency of the product, although put greater pressure on the cash flow of providers, especially on stakeholder products.

No longer allowing any remuneration that is conditional on sale

By removing conditionality as a characteristic of remuneration this would seek to remove any bias associated with selling the product. As the remuneration is independent of sale, it cannot be directly related to a particular product or provider, as it will be paid even if no transaction occurs. The evidence on how the market is currently working and the preferences of consumers does not support this as a useful model to take forward. This is discussed in section 2.1.

GROUP 3: BUNDLING ADVICE ON SAVING AND INVESTMENT PRODUCTS

The idea behind Group 3 is that the provision of advice on saving and investment products would be simpler (and potentially cheaper) if it was bundled with a product consumers currently seek out and purchase. This could bring the advantage of lower costs to advisers from finding new clients and hence more advice could be provided. In these cases, when consumers are making an active decision to purchase another product, they are provided with an assessment of all their needs (a fact find) and general advice. There are a range of services with which the provision of advice could be bundled, including:

- Mortgages, which are often classified as bought not sold, in contrast to the typical view of life and pensions products;

Annex 1: Range of new business models

- Pensions taken out through employers; or

- Tax services during the annual tax return.

Clearly there is nothing stopping advisers taking this opportunity today. However, given customer preferences and regulatory costs, we currently observe intermediaries frequently giving limited advice on only one particular product type. Therefore to make it compulsory to offer general advice would be a significant change and hence more revolutionary.

High-level assessment of Group 3 by critical success factors:

- Product providers: increases costs for intermediaries and providers when making other product sales (and could reduce sales of primary product), but could increase overall sales for the industry. May be a very inefficient method (since if it was effective we would expect to see it encouraged by today's providers).

- Intermediaries: gives significant advantage to particular types of advisers over others and may lead to inefficient cross-subsidisation across products. This may increase the cost of providing advice, making it uneconomic to provide altogether.

- Consumer: may see this as increasing the cost of purchasing primary purchase without giving them any choice (resulting in a reduction in demand for these products). They may not see bundled adviser as providing high-quality advice on other products.

- Regulator: could be worried that it would reduce shopping around for products (as consumers buy mortgage at one provider, and then get advice that they need a pension, they may then buy this at the same provider regardless of their quality). Alternatively, this may lead to too little attention on saving and investment products (since they are likely to be less significant compared to the purchase of a mortgage, which is the primary reason for using the intermediary) but may improve consumers long-term provision.

Turning to each of these models in more detail:

Full advice at any product purchase

In this model, when any customer seeks the purchase of any financial product, intermediaries would be required to undertake a full fact-find process in order to establish whether the consumer has any other financial needs. Again this would require regulatory intervention in order to impose the requirement for the full advice process rather than the limited fact find that is possible today. The idea is to free-ride on the product where consumers are making an active choice, for example, mortgages, thus reducing the cost of prospecting and the cost of collecting information on the consumer. However, the market has moved to limited fact finds

to reduce the cost of advice, if this was an efficient way to increase demand, we would expect the market to be doing it.

Workplace full advice

Currently, advice in the workplace can focus on particular product areas to reduce the cost of giving advice. In this business model, employees would receive a complete financial review when they were considering whether to join the company pension scheme. Employers would be unable to simply provide access to pensions, but rather would need to fund the whole financial advice process. This would take regulatory action to impose such a constraint. Given the difficulty in providing advice in the workplace, the priority being given to pensions and the efforts to reduce the advice costs, it seems very unlikely that this presents a model that should be taken forward.

Full advice at tax review

A more extreme model would have a full review of finances taking place at the annual tax review. For example, accountants assisting with the annual tax return process would be obliged to undertake a review of the consumers' financial needs and provide them with a fact find to use at a later point in the year. Alternatively, the Inland Revenue itself could include additional questions regarding financial circumstances and then respond to consumers regarding their particular needs e.g. through including a fact find in the tax return and then giving generic advice. However, since self-assessment forms are typically only completed by higher rate taxpayers it seems unlikely that the Government should incur significant costs purely for the benefit of these individuals.

GROUP 4: UNBUNDLING ACTIVITIES IN THE VALUE CHAIN

Currently, advisers often provide a full range of activities from general advice to administering the product purchase and providing ongoing administration and market surveillance. These are often remunerated on the same basis. There is a range of new business models where we break up the value chain into particular activities. This means that different stakeholders can undertake these activities and each activity can be remunerated in a different manner. There are many models that could potentially be included in this group, some of the most interesting are:

- Generic advice models: in these models generic advice (such as the identification of needs and persuading consumers to save) are undertaken by one type of stakeholder whilst specific advice is undertaken by another type;

- Advice only: advisers would only be able to give advice on product and provider but would not be able to assist with the purchase or administration of product;

Annex 1: Range of new business models

- Portable fact find: advisers would be able to collect information but this would be portable to other advisers, lowering the cost of repeating the advice process and shopping around; or

- Separate financing function: the lending function that providers undertake by offering indemnity commission could be taken over by other stakeholders such as banks.

Currently, the majority of the market bundles these activities together. There are some exceptions e.g. discount brokers focus on administration rather than advice. We would therefore characterise this as moving towards the more revolutionary end of the business model spectrum since there are few examples of where this is in use today.

High-level assessment of Group 4 by critical success factors:

- Product providers: introduction of bank financing would clearly reduce the capital burden currently falling on providers and increase transparency over the relationship they have with advisers. The attractiveness of the other proposals depends on overall impact on sales. They may lead to a more complicated sales process or lower conversion rates where there is uncertainty regarding who has the relationship with the consumer and therefore who to market to.

- Intermediaries: complicates role of intermediaries with implication for efficiency and liability. May complicate provision of ongoing services as a number of agents have relationship to final consumer.

- Consumer: may lead to additional transactions costs as the consumer needs to use different stakeholders to get to the point of product purchase. This reduces convenience although it may increase transparency as to what the consumer is paying for.

- Regulator: increases transparency and ability of consumer to switch between advisers but at substantial cost to efficiency.

Turning to each of these models in more detail:

An army of generic advisers

One possibility is that some of the most significant upfront costs of the advice process – such a prospecting new customers, providing generic advice and persuasion - are undertaken by a group of advisers financed collectively by the industry. This would reduce the upfront costs and hence reduce the need for high level of initial commission. There is an open question as to how this would be funded by the industry. There are concerns that the persuasion activity will not lead to any sales unless quickly followed up by an intermediary who can help the consumer with the transaction. However, if the generic advisers become too close to the sale,

this may lose some of the advantages of unbundling the value chain in this way. Indeed, this would need to be carefully thought through if all providers are to have equal incentive to contribute to such a scheme. This model has potential for lowering the overall cost of advice by using less qualified individuals to undertake the generic advice and potential efficiency gains by additional specialisation through the separation of activities.

Advice only

In this model advisers would only be able to give advice on the appropriate product and provider, they would not be able to purchase the product for the consumer and hence they would not benefit directly from the provider. To undertake the administration and purchase of the product the consumer would need to go to a different institution, such as a discount broker, who equally would not be able to provide advice. This would be very similar to the current situation with medical services where consumers go to GPs for advice and, if necessary, receive a prescription which they then take to a pharmacy in order to purchase the appropriate product.

The advice-only adviser would not be able to be remunerated by commission based sales via the product provider but could potentially still be remunerated conditionally on a purchase being made. This would significantly raise the costs, in terms of convenience, for consumers. That it doesn't happen today to any great extent, when consumers have every incentive to receive advice "free" from advisers who operate on a commission basis and go elsewhere to purchase the product on cheaper terms, suggests that this is not an attractive model.

Portable fact find

In this model, fact finds are designed by the regulator such that they can be taken from one adviser to another, thereby reducing the transaction cost of going to different intermediaries. This could be seen as being similar to the optician market in which the results of the eye test are given to the consumer who can then choose to go to a different optician to purchase the glasses (or can choose to purchase at the same location). Indeed, it would need to be mandatory for intermediaries to accept a fact find that has been completed by others (or that has been completed only by the consumer). The liability issues are not straightforward and would therefore need to be thought through with care and regulation would be likely to be required to overcome this concern.[58] This would reduce flexibility and commoditise the advice process. Intermediaries argue that it is important to have the flexibility to structure the fact find and investigate particular issue first hand. Given the importance placed on the relationship between the consumer and the adviser, this is unlikely to have significant impact on the level of shopping around.

[58] This proposal was included in the FSA's proposal in CP166.

Annex 1: Range of new business models

Bank loan to bring forward remuneration

Currently, indemnity commission is a form of lending by product providers to intermediaries. This function could be undertaken by banks or other institutions. Alternatively, product providers could make loans independent of whether the product chosen was one of theirs. As in any other business, the intermediary will have an income stream that they will be able to borrow against. We would expect stakeholders to be willing to lend to advisers on the basis of this income stream at some commercial rate. This is clearly likely to vary by the type of intermediary and the relationship with the bank. Arguably, product providers have better understanding of intermediaries because they are constantly monitoring and communicating with them. Given the concern regarding whether the structure and timing of commission introduce the potential for bias, unbundling the role of remuneration and lending may be beneficial. In addition, unbundling the financing role may reduce the perception of bias and the general suspicion regarding the relationships between IFAs and providers that lead consumers to be wary of entering the advice process.

GROUP 5: CONSTRAINING THE STRUCTURE OR LEVEL OF COMMISSION

In these models, instead of restrictions on the components of commission or variation of remuneration, these impose constraints on the amount of remuneration and its relationship to the product being purchased and the advice being provided to the consumer. The idea being that market forces alone are insufficient to constrain the amount spent on remuneration. This could take a number of forms:

- Commission can only be paid out of the charges of the product;
- Ongoing commission is only paid once consumers have approved the level of services received; or
- An overall level of remuneration that can be charged for advice is set by the Government – similar to the price cap on the purchase of the product.

Although this might be a relatively small change in the structure of the relationship between consumers and distributors, this could fundamentally change this relationship so we categorise this at the revolutionary end of the spectrum.

High-level assessment of Group 5 by critical success factors:

- Product providers: these models could lower the burden on providers by lowering remuneration and changing the structure, but there is a significant danger that they would reduce the market for distribution if the price is set too low and would significantly reduce the flexibility of advisers. They could increase the incentives to provide an ongoing relationship but perhaps at the expense of the incentive to sell.

Annex 1: Range of new business models

- Intermediaries: this may lead to a greater understanding of the relationship between consumer and adviser but could make it significantly more difficult to cover today's cost of intermediation (either because of the level or timing of charges).

- Consumer: this would be simpler and more transparent for consumers, this could lead to a greater understanding of the cost of advice. If the consumer has the choice over whether to continue with the adviser's services over time, and knows how much they cost and what they should be expecting, this could improve services provided to consumers.

- Regulator: by encouraging a long-term relationship between the consumer and the intermediary this could increase the provision of ongoing advice possibly reducing the probability of products failing to meet consumers' expectations, potentially averting problems such as were seen with mortgage endowments. However, there is a risk that this leads to a significant reduction in intermediary services.

Turning to each of these models in more detail:

Product charge restraint

With this model, the structure and level of commission is constrained such that at no point can the remuneration to intermediaries be greater than the revenue earned by providers through the product charges. In many ways this could be seen as similar to the restrictions for Riester pensions in Germany where the cost of distribution must be spread across five years. With the current pressure on charges to be spread over the life of the product, this is likely to substantially change the structure of commission. Providers are not currently able to coordinate on this and thus it may require intervention by the regulator or agreement from competition authorities. Although, this might increase transparency to the ultimate consumer, for some products this would result in a dramatic change in the timing of payments for intermediaries or change in the structure of charges.

Compulsory trail renewal

This model is one in which intermediaries would need to inform their customers on an annual basis of the level of remuneration that they received from providers over the previous year. Consumers would then need to agree to the intermediary continuing to receive this payment in the following period. Should consumers choose not to allow their intermediary to continue to receive the ongoing remuneration, then product providers would be able to offer them lower product charges in order to reflect the fact that intermediaries would not be receiving any further payments or switch this payment to another intermediary. The idea is to encourage intermediaries to maintain a good relationship with the consumer or face losing trail commission. This provides incentives for the intermediary to provide ongoing services

over time and gives the consumer choice regarding whether they want these services at all or whether they want someone else to provide them.

Capped advice charge

With this model there would be a Government imposed constraint regarding the cost of advice, in much the same way as the stakeholder range of products have caps on the cost of the product or legal advice has a prescribed cost for particular services. The Government would indicate the appropriate cost of advice, which could be specified either in terms of an hourly rate, or more likely, the total cost of providing advice. Given that we have a price cap at the product level for stakeholder products and the menu is designed to encourage competition on commission rates in the rest of the market, it seems very unlikely that a model setting the price of intermediary services would be beneficial since it would be bringing additional regulation to an area that has considerable regulation focused on prices already.

GROUP 6: PERFORMANCE PAYMENTS RELATING TO THE QUALITY OF THE ADVICE

The idea behind these models is to increase the incentives for advisers to give good advice by further aligning their remuneration with the result of the advice they give. These models have remuneration payments linked to the quality of advice given by the intermediary as revealed either through the subsequent actions of consumers or through the actual returns to consumers. There are a number of ways this could be done:

- Linking remuneration more closely to the returns on the products purchased;
- Linking remuneration directly to an independent measure of success such as closing the saving gap; or
- Linking remuneration more closely to the persistence of the product.

As this is fundamentally changing the relationship between advisers and their consumers we categorise this as a revolutionary new business model.

High-level assessment of Group 6 by critical success factors:

- Product providers: linking remuneration to the long-term performance of the advice could reduce sales effort in favour of ongoing advice, which could increase or reduce sales in the medium-term, although it could increase persistency leading to higher profits on the products that are sold.
- Intermediaries: closer alignment to the long-term consequences of the advice will lead to financing problems in the short-term. It would closely align advisers to the consumer which should enhance their reputation as well as reducing the incentive to

churn consumers in the short-term, since the rewards from doing so would be smaller than today.

- Consumer: it would make the cost of advice less transparent and in particular mean that the overall costs may be unknown at the time of purchase but would more closely align distribution and consumer interests. It could lead to consumers being locked into particular advisers however.

- Regulator: by linking the remuneration of the adviser more closely to the advice, this should incentivise higher quality advice and encourage a longer term relationship between consumers and intermediaries.

Turning to each of these models in more detail:

Adviser performance related commission

In this model, the remuneration of advisers could be linked to the performance of the investment. This could involve going further than simply using fund based trail commission to remunerate the intermediaries (as is already sometimes the case today) and instead linking remuneration to the relative performance of funds. Hence, where intermediaries recommended an actively managed investment instead of some form of tracker the returns on this would be compared to the returns had a tracker been recommended. Where the actively managed investment under-performs the appropriate index, intermediary remuneration would be proportionately reduced to reflect the poor relative performance. There is a significant danger with linking the returns to the adviser and consumer. In particular, the advice may be focused on the risk preferences of the adviser rather than the consumer. Incorporating more complex methods to align the adviser's incentive are likely to significantly increase complexity.

Saving gap

In this case, the remuneration of the adviser would depend not on what they sold but on whether they met an independent assessment of the individual's needs. So, for example, if we could set out a simple methodology for what an individual should be saving, the intermediary could then be remunerated depending on how close the consumer's provision got to this level. It is clearly not straightforward to identify the saving gap for a particular individual and indeed, if it was, there would be no need for individualised advice. Hence this approach runs the risk of applying a one-size-fits-all model to a process that by its very nature is designed to deal with bespoke requirements. In addition, it is difficult to determine who would pay for this advice as the consumer may have a different assessment of what they should be saving.

Annex 1: Range of new business models

Persistence levy

The persistency levy model is one in which the remuneration to intermediaries depends more heavily on the degree of persistence of the customer. This would involve back-end loaded charges which would vary according to the length of time that consumers retain the product and hence intermediaries remuneration would be similarly linked to these factors. Hence consumers who left early would face higher charges than those who are more persistent. This would ensure that the cost of initial advice is always recovered from the individual who imposes the cost. However, this puts all the risk for persistency back onto the consumer.

Given the Government's continuing desire to limit the structure of product charges such that there are low switching costs, it seems unlikely that this model will be politically acceptable.

However, it is possible that a model which recognises that consumers switch products for a variety of reasons and applies different charges depending on whether the consumer lapsed entirely or simply changed providers, could be beneficial. Indeed, there is an argument that some of the risk of persistency should fall on consumers if we are to see a market that works effectively. In particular, a model of this kind could be attractive in the group market.

GROUP 7: PUBLIC SECTOR INVOLVEMENT IN THE VALUE CHAIN

These models primarily relate to the Government taking the responsibility for particular activities within the intermediation process. As with any public sector involvement we would need to determine that there is a strong case for Government intervention and that changing the incentives on private sector participants could not meet the same ends. Examples include:

- Government panels for particular products;
- Financial awareness;
- Government sponsored general advice provision; or
- Advice vouchers reducing the cost of advice to the consumer directly.

Although on the face of it these models appear revolutionary, some examples have been debated over the last couple of years. For example, the Treasury considered limiting the providers of the child trust fund to a Government selected panel. There is now a generally accepted position that the Government needs to do more on consumer education and awareness.

High-level assessment of Group 7 by critical success factors:

Annex 1: Range of new business models

- Product providers: could be damaging for those providers who are not approved by Government or currently undertake these activities.

- Intermediaries: may reduce the time with the consumer and the need to persuade, hence reduce costs. However, this will implicitly set the market price for advice services, with the dangers this brings.

- Consumer: may (or may not) enhance trust in the advice process due to Government backing, although costs may be higher through regulatory intervention than market disciplines.
- Regulator: should reduce product crises, but could be a concern that consumers would not understand any risks involved with the product because of the Government involvement.

Turning to each of these models in more detail:

Government panel

In this model the primary constraint is that the providers for various different product categories would be pre-selected by the Government to be on the panel of approved product providers and no other provider would be able to offer that particular product for a period of time. Intermediaries would conduct the majority of the activities, from identifying the financial needs and to giving generic advice as to the appropriate product. However, consumers would be responsible for choosing the product provider although the intermediary would then administer the purchase of the product (some of the implications of this model are discussed in Chapter 5).

Financial awareness

In this model, the Government undertakes a financial awareness campaign in which they stress the importance of taking out financial products and making savings and investments. In this way the Government undertakes some of the persuasion requirements in the distribution channel. Although, this would lower the cost of persuasion and therefore potentially reduce the cost of advice, this does not directly address the information asymmetry between the consumer and the adviser regarding specific product needs i.e. if the Government campaign focused on the need to save, the consumers may still need to rely on the adviser to understand the vehicle in which they should save.

A Government sponsored advice model

In this model the Government would sponsor the provision of generic advice and motivation through a body such as the citizens advice bureaux. This would be funded through general

taxation and provide advice free at the point of use or for a nominal fee. The sales would need to be administered by another organisation, for example, they could refer consumers to independent financial advisers, limited provider advisers or tied advisers depending on the consumer preferences. This model has been suggested in the past, pilots using the Citizens Advice Bureaux have been undertaken and the model is currently under examination by the FSA.

Advice vouchers

In these models, consumers would be given vouchers with which they could purchase financial advice from any intermediary that they choose. Vouchers would be supplied by the Government and would be of sufficient value to ensure that the needs of those with low to medium income would be met. These could be targeted to particular consumers and could be used for advice focusing on different products. Consumers with additional requirements would have to supplement the cost of advice from their own resources. This could be beneficial for setting a market-wide price of advice and removing the potential for bias. However, this leaves the Government with the difficulty of determining the value of advice. In addition, the consequences in terms of increasing Government expenditure make this model unlikely to be attractive.

Annex 2: Comparative markets

At the same time that we conducted analysis on the long-term savings market in the UK, the ABI considered the extent to which lessons could be learnt from other markets. These other markets covered both other sectors in the UK and also financial services markets internationally. This annex draws out some of the highlights from the ABI research and indicates how they led to the development of some of the new business models that were explained in the previous chapter.

UK MARKETS

The estate agent market demonstrates some of the difficulties in considering what remuneration should be taken into account when examining the functioning of the market. For example, individual estate agents may often be able to trade-off between salary and the proportion of the commission earned that they receive e.g. some individuals may choose to receive no salary and 0.5% commission, where others choose a moderate salary and 0.25% commission, yet in both cases the estate agency may always receive 1% commission from the consumer. This serves to highlight the difficulty of analysing markets when the amount paid by the consumer may not reflect the incentives faced by the individual intermediary.

In addition, it is clear that although estate agents appear to work for the buyer of a property and undertake certain activities for buyers such as identifying appropriate properties for them, their incentives are actually aligned to those of the seller. Hence it is useful when examining a new business model to consider whether this leads to incentives being structured along the needs of the seller or the buyer of financial services. In the distribution of long-term savings products, it may be useful to move more towards models in which advisers are incentivised along the needs of consumers rather than providers, so for example, moving towards having the payment for ongoing advice linked to the requirements of the consumer may be of benefit. We include a model with compulsory trail renewal to capture this.

The legal market provides a very interesting example for comparison especially with regards to fees. Most legal services (with the notable exception of conveyancing) are paid for through the use of hourly fees. This could suggest that a similar model in which advisers are paid through hourly fees could be of benefit in the adviser market. Indeed such a model is already available in the adviser market but we have also considered whether the use of this model could be extended.

However, there are notable observations in the legal market that may lead us to consider whether the extension of the fees across the whole market would be of benefit. In particular, the legal market has seen the development of contingent fees e.g. “no win, no fee”. This method of remuneration was not allowable in the past, but now that it is possible, it is noteworthy that some consumers (and lawyers) are opting to use it rather that just using

hourly fees. In turn this suggests that the contingent nature of fees may be something that is of value to consumers and their lawyers in the legal market and hence may also be something that is valued in the advice market.

In addition to the development of contingent remuneration in legal services, it is also worth noting that legal aid exists in which the Government subsidises or pays for legal services for those who are unable to pay for this themselves. This leads to a direct analogy with the financial advice market in which the Government could subsidise or pay for advisory services for those who are unable to pay for this themselves. A Government sponsored advice model is therefore considered in our range of new business models as are the use of vouchers.

Additional constraints that are put on this model can include regulating both the hourly fee and the total fee that can be charged for certain services. A model in which there is a capped advice charge is also considered in our new business models.

INTERNATIONAL MARKETS

The ABI went on to examine a number of international case studies where different methods of structuring the remuneration of financial advice have been used. We draw the following lessons from these studies:

- Australia: in this case, the financial regulator has chosen to focus on detailed disclosure of the cost of intermediary services and product charges. Although sharing many of the features of the UK disclosure regime, this appears to makes a clearer distinction between costs at the beginning of the relationship between the consumer and the adviser and ongoing costs (and services that should be expected). Although too early to judge the degree to which consumers have been able to use this information and the market discipline that has resulted, this models illustrates the degree other regulators believe information on the structure of fees, commission and charges can be usefully disclosed. This information fed directly into the models focusing on unbundling the remuneration of financial advice.

- Germany: for Government sponsored Riester products, the costs of distribution must be spread evenly over the first five years of the product, thus limiting the degree to which a consumer lapsing early faces the entire cost of distribution and reducing consumer lock-in. This model is potentially interesting, as it incentivises the provision of persistent products and shares the risk between providers and consumers. However, the disappointing take-up of Riester products illustrate the difficulty of structuring charges independently of the market. Indeed, it is argued that intermediaries have found it attractive to focus on other products available on the market without this restriction.

Annex 2: Comparative markets

- Sweden: there have been recent moves to *collectively* move to a model which unbundles the cost of advice when going through brokers for general insurance products. Consumers will directly pay brokers for their services. It is argued that this increases transparency, reduces the potential for bias and improves competition. Based on the lessons from this model, we considered unbundling the cost of advice from the product charges altogether and the conditions under which collective action may be required to move the market onto a different form of competition.

- United States: the US has a complex range of distributors and therefore is an interesting analogue to the depolarised UK market. The US illustrates a number of different models. For example, individual life assurance companies have standardised the commission terms across consumers using a schedule setting out how the commission arrangements vary by size of premium. At the same time, commission rebates are effectively ruled out due to anti-discrimination legislation. This relates quite closely to our model ruling out variation across consumers. In general, however, the US market illustrates a model where the structure of remuneration is left to the market. Based on anecdotal evidence, this market has not been able to overcome the problems of perception associated with commission. This therefore supports the need for action to make commission based remuneration systems work (and be seen to work) effectively.

Annex 3: Provider surveys and econometric methodology

There were two provider surveys undertaken for the purpose of this research. The first focused on the IFA channel and the second on the tied channel.

PROVIDER SURVEY OF THE IFA CHANNEL

The aim of the IFA provider survey was to collect data on the level and structure of commission across a variety of products. The data was a vital component of our assessment of how the market is currently working, the impact of regulatory and market trends and provided key background to help us think about future remuneration models.

In particular, the survey was designed to test a number of hypotheses:

- Does the relationship between commission and new business vary by type of product?
- Does the structure of commission influence new business volumes?
- Do trends in commission structure depend on the type of product?
- Are changes in commission structures linked to product charges?

We collected quarterly data on commission levels associated with the IFA business over the last 5 years. This was compared to new business data reported in the ABI's MSE data (provided for the purpose of this project) to investigate the relationship between commission and new business.

Coverage of the survey

To see if the type of product was an important determinant of the relationship between commission and new business volumes we chose to focus on 13 key product markets. These vary in terms of whether they are:

- Single premium (7) or regular premium (6);
- Group (2) or individual focused (11);
- Bundled with the sale of other products (1) or unbundled (12);

- Life (10) or protection (3).[59]

We extended the survey in a number of directions compared to that used in 2001 for the FSA. In particular:

- We asked for data on the different structures of commission used and the share of business sold using each of these commission structures. One of the purposes was to understand whether there had been a trend to trail commission.

- We were interested in investigating the relationship between the commission structure and the structure of charges. We therefore asked for information on the level and shape of charges over the five-year period.

This data request was sent to 16 providers where their market share was above 5% in a particular product market in one-quarter of the five-year period.

Minimising the effort to comply with the data request

Historical data on commissions is not commonly used within financial services companies so we thought carefully about the information we needed and consulted a number of product providers regarding how to minimise the resources required to respond to the request, in particular:

- We were aware of the request made by the FSA for commission and new business data that will be used in creating the Fee and Commission statement ("menu"). To reduce the resources required for this data request, we tried where possible to be consistent with the FSA structure.
- During a similar request for data in 2000, we discovered that differences in provider systems meant that different providers found different pieces of the request problematic. This resulted in many conversations about the nature of the data and reasonable approximations. Learning from this experience meant we could be flexible in how firms responded to the survey without losing the integrity of the data.

Econometric methodology

In order to model the relationship between market share and changes in commission we again used a panel econometric methodology.[60] This allows for systematic differences between providers, accounting for differences in brand strength, reputation etc.

[59] The results for ten products, five single premium and five regular premium are reported in Chapter 3. There was insufficient market coverage to complete the analysis for guaranteed equity products, equity ISAs or employer-sponsored stakeholder pensions.

[60] The methodology used in this analysis is largely consistent with that used by CRA to examine commission bias for the FSA in 2001. The justification for this approach is set out in considerable detail in that report.

Annex 3: Provider surveys and econometric methodology

To account for differences there are two rival methodologies, a fixed effects approach and a random effects approach.[61] After testing the model specification we decided to use fixed effects models. These are the results set out in Chapter 3 of the main report.

The results are generated from a fixed effects model of the relationship between market share of those providers providing data and the natural logarithm of the initial commission and the natural logarithm of average initial commission across the market. We included a number of dummy variables to take into account the entry and exit of particular providers.

The only products for which we identified a statistically significant relationship between changes in commission and changes in market share were single premium personal pensions and income drawdown:

- The result for single premium personal pensions is based on 134 observations from 7 providers and is significant at the 5% level; and

- The result for income drawdown is based on 81 observations from 5 providers and is significant at the 10% level.

Finally, we attempted to test whether charges were an important determinant of market shares. Unfortunately, the data collected on charges was insufficient and too sporadic to be analysed meaningfully.

PROVIDER SURVEY OF THE TIED CHANNEL

The aim of the tied provider survey was to collect data on the level and structure of remuneration offered by the tied channel. This data was essential both to understanding how the tied channel remunerates advisers and how this has changed over time, but also to enable the results of the Mystery Shopping to be interpreted and understood.

Coverage of the survey

In total seven providers completed the survey, giving a good coverage of the tied providers in the market-place and including both insurance companies and banks.

It included information on:

- The number of advisers, how this has changed over the past five years and an understanding of the relationship between the provider and adviser e.g. employed / franchised;

[61] The fixed effect approach allows for differences using a group-specific constant term in the regression model. The random effects approach specifies a group-specific disturbance.

Annex 3: Provider surveys and econometric methodology

- The proportion of remuneration based on different components including: salary; overall sales; and product specific sales; and

- How product based remuneration varies across products.

This information was particularly used to consider whether any differences in product based remuneration led to bias in the recommendations of tied advisers.

Annex 4: Mystery Shopping

The Mystery Shopping exercise was designed and tested with a number of IFAs who have provided significant input into the design of the scenarios, as well as with the ABI and NOP World Mystery Shopping who conducted the fieldwork.

The basic scenario is one of a lump sum inheritance of £28,000 with the assessor seeking financial advice regarding the best use of this money. In order both to ensure we have consistency and also in order to be able to test whether or not advice is suitable advice we specified considerable information regarding various personal and financial characteristics.

These financial characteristics include being a basic rate taxpayer, having a bank account, a repayment mortgage with more money to pay off than the lump sum investment and at least ten years still to run on the mortgage. Life insurance and sickness cover are both provided by the employer at specified levels and the assessors also have a pension provided by the company to which both the employer and employee contribute. They were specifically informed that they did not have an ISA.

The objective that the assessors had was to invest the money for long-term growth with a willingness to invest for five years, but a possible need to access the money sooner "just in case". Furthermore, the assessor was willing to take a bit of a risk with the money.

Assessors were tasked with obtaining a clear recommendation from advisers with evidence provided through the personal illustration and key features document and, if possible, a "reasons why" letter.

NOP World Mystery Shopping was commissioned to undertake 250 shops in total. However, as is common in such complex exercises, results are not available for all shops undertaken. There are a variety of reasons for this including that the adviser does not provide any advice; that the adviser would only work on a fee basis and not a commission basis for a commission scenario. In other cases it is because the adviser does not provide a personal illustration or key features document. Clearly this latter observation is of concern and has been discussed in the main report. The need for fully documented advice in which there are clear recommendations reduced the sample size to 167 excluding repeat observations in which an adviser provided alternative options for the use of the money (typically through recommending different providers for the same product). This compares well with similar analysis undertaken for the FSA in 2001 where, coincidentally, 250 shops produced 167 documented results, although this included repeat observations since the recommendation of providers was also examined through the Mystery Shopping exercise in the work for the FSA.

In order to have a reasonable sample size it was necessary to limit the number of different types of scenarios in the testing and hence to prioritise the types of comparisons that we

wished to make according to some of the main areas of criticism that have been faced by the industry. There were four different characteristics of advisers and scenarios over which there was variation, providing seven different scenarios in total. These are shown in Table 16 below.

Table 16: Mystery Shopping scenarios

Adviser	Payment	Relationship	Debt	Sample size
IFA	Commission	One-off	No debt	16
IFA	Commission	Relationship	No debt	19
IFA	Fee	One-off	No debt	7
IFA	Fee	Relationship	No debt	17
IFA	Commission	One-off	Debt	35
Tied		One-off	Debt	36
Tied		One-off	No debt	37

Source: CRA based on NOP Mystery Shopping

For the first time in a systematic way, we sent assessors to fee based advisers in order that the bias to sell between fee and commission based advisers could be tested.

We also tested the extent to which advisers recommend the repayment of debt as a priority. In debt scenarios, assessors were given £6,500 of debt on two credit cards. They were instructed to inform advisers that the debt had been run up through a one-off purchase such as a kitchen refurbishment. If asked, they were instructed to say that they were concerned about the repayments.

We also tested to see whether there is a difference in the remuneration structures used based on the assessors' desire for ongoing advice as opposed to seeking one-off advice with no intention to return to the adviser in the future.

In order to ensure that there is as much consistency as possible across scenarios, assessors performed multiple scenarios.

ANTITRUST

BUSINESS STRATEGY

CHEMICALS

COMPETITION POLICY

DAMAGES

ENERGY & ENVIRONMENT

FINANCE

FINANCIAL SERVICES

HEALTHCARE

LITIGATION SUPPORT

MEDIA

MERGERS

METALS

PHARMACEUTICALS

TELECOMMUNICATIONS

TRANSPORTATION

Charles River Associates Limited

1 Undershaft
London EC3A 8EE
United Kingdom
Tel +44 (0)20 7664 3700
Fax +44 (0)20 7664 3998
www.crai.co.uk

Rue de l'Abbaye 2
B-1000 Brussels
Belgium
Tel +32 (0)2 627 1400
Fax +32 (0)2 627 1444
www.crai.be

Charles River Associates Incorporated

Corporate Headquarters
John Hancock Tower, T-33
200 Clarendon Street
Boston, MA 02116
United States
Tel +1 617 425 3000
Fax +1 617 425 3132
www.crai.com