Oxera

Assessment of the benefits of the FSA suitability letter

A report prepared for Financial Services Authority

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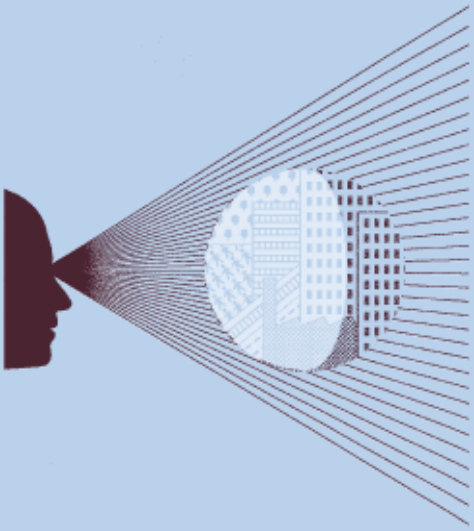

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1 Introduction

1.1 Objectives and remit

Oxera has been commissioned by the FSA to assess the benefits of the requirement for firms to issue a suitability letter when they recommend a product. This requirement is part of the wider set of provisions concerning product suitability contained in the FSA's Conduct of Business Sourcebook (COB) 5.3.14.

This research should be seen in the wider context of the debate on the costs (and benefits) of financial regulation. The cost of regulation study, conducted by Deloitte on behalf of the FSA and the Financial Services Practitioner Panel,[1] estimated the (direct) costs of compliance in three markets in the financial services sector: corporate finance, institutional fund management, and investment and pension advice.[2] These costs are incurred by financial services firms, but economic theory suggests that such costs will ultimately be borne by the users of the financial services—ie, private individuals and companies. The level of these costs should therefore also be considered from a consumer perspective: do the benefits of FSA rules to users of financial services outweigh the direct and indirect costs?

In 2006, the FSA commissioned Oxera to develop a framework for identifying and measuring the benefits of regulation.[3] A best-practice methodology has been developed that will enable the benefits of individual rules or clusters of rules to be analysed and compared with the incremental costs they impose.

This study applies this framework to assess the benefits of the requirement in the FSA COB for firms to issue a suitability letter to their customers upon the sale of particular products. These benefits are considered against the counterfactual of there being no regulatory requirement to provide such a suitability letter.

This report should also be viewed in the context of the time, resources and existing data available to undertake the study. The bulk of the information gathering undertaken for this study was conducted in a limited period between late November 2006 and early January 2007. Therefore, as there are some useful pieces of information that it was not possible to gather, there are limitations in the estimates of the benefits of suitability letters. With significantly more time, some of these gaps could have been filled through additional work (and some may be filled through ongoing work at the FSA, for example on Quality of Advice Process). Where there have been limitations, these are noted in the report and, where possible, the research required to remedy this shortcoming is identified.

1.2 Suitability letter requirement

COB 5.3.14 requires firms to issue a suitability letter, which must:

1) explain why the firm has concluded that the transaction is suitable for the customer, having regard to the personal and financial circumstances of that customer;

[1] Deloitte (2006), 'The Cost of Regulation Study', study commissioned by the FSA and the Financial Services Practitioner Panel, June.

[2] The costs of the administrative burden imposed on the UK financial services industry by the rules in the FSA Handbook were estimated by Real Assurance Risk Management (2006), 'Estimation of FSA Administrative Burdens', June. The costs of the administrative burden form a subset of the compliance costs.

[3] Oxera (2006), 'A Framework for Assessing the Benefits of Regulation', a report prepared for the FSA, June.

2) contain a summary of the main consequences and any possible disadvantages of the transaction.

According to the guidance provided by the FSA, a suitability letter should explain simply and clearly why the recommendation is viewed as suitable, having regard to the customer's personal and financial circumstances, needs and priorities identified through the fact-finding process, and attitude to risk in the area of the need to which the recommendation relates.[4]

Thus, before recommending a designated investment to a private customer, a firm must undertake a fact-finding exercise to ensure that it has sufficient personal and financial information about that customer that is relevant to the services provided by the firm. No specific information requirements are prescribed, but they should, at a minimum, ensure that a customer's needs and priorities can be identified, together with their attitude to risk. There is no requirement for this information to be retained if the customer does not proceed with the recommendation.

A letter is required only if the consumer proceeds with a transaction. The rules specify the latest point at which a letter can be sent. COB 5.3.18R state that, in case of a pension contract or stakeholder pension scheme, where the cancellation rules require notification of the right to cancel, the suitability letter must be issued no later than the fourteenth day after the contract is concluded and in any case, when the transaction is effected or as soon as possible thereafter.

The firms interviewed by Oxera indicated that, in practice, firms provide a suitability letter to their customers after the first meeting with the customer, at the second meeting or after the second meeting. The timing of when consumers receive the suitability letter varies by firms and may also depend on customers' preferences.

Introduced in 2001, the FSA requirement for a suitability letter replaced the previous requirement for a 'reason-why letter' explaining to private customers why a particular product has been recommended.[5]

Firms are obliged to provide a suitability letter for packaged products, which include life policies with an investment element; personal pensions, including stakeholder pension schemes; units or shares in collective investment schemes; and investment trust savings schemes. It is important to note that suitability letters are not required in respect of all investment products, even though the overall suitability obligation applies more widely. Thus, in considering the interaction of the suitability letter and the suitability obligation itself, this report focuses on situations where both requirements apply.

In 2005, the FSA implemented a requirement of the Insurance Mediation Directive that firms should produce a 'Statement of Demands and Needs'. This has similar objectives to a suitability letter: for advised sales, the Demands and Needs Statement requires the intermediary to explain the reasons for their recommendation. This requirement applies to a wider range of insurance products than packaged products.

In October 2006 the FSA consulted on a new COB sourcebook which included revised rules for a 'suitability report' based on a review of the existing suitability letter requirements.

1.3 Methodology and approach

This study applies the framework for assessing the benefits of regulation, as developed by Oxera for the FSA.[6] The framework identifies two steps for an assessment of benefits.

[4] FSA Handbook—COB 5.3.16 and COB 5.3.30.

[5] FSA (2000), 'The Conduct of Business Sourcebook—CP 45a', February.

– *What to measure*—the first step is to identify the potential benefits of the rules concerned in terms of improvements in market outcomes. From the perspective of consumers, there are several broad dimensions of detrimental market outcome that emerge from the combined effect of market failures, risks and incentive misalignment. The potential benefits of regulation can be defined in terms of the extent to which these detrimental outcomes could be mitigated. One such outcome that a suitability letter requirement might address is sub-optimal choice. This would mean that, overall, a requirement to provide a suitability letter would result in a more optimal fit between what consumers buy and what they in fact need or want.

– *How to measure*—the second step is to assess how to measure improvements in market outcomes, which can be done directly and/or indirectly. Direct measurement works best for ex post analysis when it is possible to compare the relevant metric defining a particular outcome before and after the regulation is in place. Where direct measurement of changes in real market outcomes is not possible, benefits can be assessed through simulations of markets operating under the two conditions, or indirectly, by evaluating the impact of changes brought about by the regulation at points between the application of the regulation and the change in the position experienced by the customer. This involves the identification and measurement of proxies at these intermediate stages, which are themselves good and robust indicators of changes in the desired market outcomes.

This study applies these two steps and then attaches, where possible, a monetary value to the benefits of the suitability letter requirement. Where it is not possible to estimate the monetary value of changes, a more qualitative description of the likely benefits is given (see sections 2 and 3).

1.4 Structure of the report

This report is structured as follows.

– Section 2 sets out the approach to measuring the benefits of the suitability letter requirement. It describes the market outcomes that the suitability letter requirement aims to improve and the mechanisms through which these benefits may be delivered.

– Section 3 reports the empirical research conducted by Oxera to assess the benefits of the suitability letter requirement.

– Section 4 concludes.

– Appendices 1 and 2 describe the approach to quantifying the damage caused to consumers of the sale of products that are less suitable[7] and reductions in post-purchase operational costs. Appendix 3 provides further examples of the frequency with which mis-sales would need to occur to cover different levels of cost.

[6] Oxera (2006), 'A Framework for Assessing the Benefits of Regulation', a report prepared for the FSA, June.

[7] References to 'less suitable' products throughout this report should be read as meaning less suitable for the consumer in question, bearing in mind the consumer's needs and circumstances, rather than any suggestion that a product is inherently unsuitable to be sold.

2 Methodology for assessing the benefits of the suitability letter requirement

This section identifies the potential benefits of the suitability letter and the mechanisms through which they may be delivered. This assessment determines the scope of the empirical research described in section 3.

2.1 Counterfactual

The FSA asked Oxera to assume, for the purposes of this study, a situation without the suitability letter requirement as the counterfactual.[8] The FSA also asked Oxera to assume that the Treating Customer Fairly (TCF) principle would not add any substantive conduct of business requirements above and beyond those required by other FSA requirements.

2.2 What to measure—underlying sources of consumer detriment and market outcomes that the rule may be improving

In assessing the benefits of regulation, the first step is to identify the underlying sources of consumer detriment and market outcomes that the suitability letter requirements may be improving. This is the 'what to measure?' question.

2.2.1 Market failures, risks and incentives

The markets for retail investment and pension advice are characterised by asymmetric information between the adviser and the consumer. Investment and pension products can be complex and have a high degree of product differentiation. Consumers' needs are also heterogeneous. Identifying the optimal (or suitable) product for a particular consumer is, therefore, potentially complex, and consumers may need to rely on expert advice to be able to choose a suitable product. In addition, the products may exhibit very different future performance from their past performance, or from the performance of similar products. Furthermore, even the relative characteristics of the assets underlying the products may not be generally observable by consumers. Therefore, the level of risk inherent in the underlying assets may not be (easily) assessed by the consumer. The result is that, at the time when the purchase is made, consumers may not be in a position to assess whether the advice they have received is of high quality or whether the products they have been advised to buy are, indeed, suitable for them. Ex post, the *actual* performance of a product is also not necessarily a good indicator of whether, at the time the product was sold, it was suitable.

In addition, there may be a principal–agent problem in the markets for retail investment and pension advice. The interests of the expert agent (the firm) may not necessarily be aligned with the interests of the principal (the retail consumer) because the former may receive differential levels of remuneration from product providers for the sale of different products, where more remuneration is not necessarily correlated with providing a more suitable product. This may give firms an incentive to sell certain products, not necessarily because it is in the interest of the consumer but because it is in the firm's own financial interest (product bias).

[8] In practice, elements of the requirements stem from European Directives and this is consequently a simplifying assumption for the purposes of this study. For example, the effect of certain MiFID requirements being implemented in the FSA Handbook would affect the baseline and counterfactual of this study and previous costs work.

2.2.2 Relevant market outcomes

The information asymmetry, together with the principal–agent problem, may result in a sub-optimal choice of products by consumers as a result of actions (or inactions) of the agent (firm). Consumers may be sold products with higher (or lower) risks than they want to bear or with terms not (or less) suitable to their personal situation. Such products may be recommended by a firm, for example, if they attract a higher commission (product bias). Furthermore, the product may not be tax-efficient—ie, it is not the right product because it does not allow the consumer to take advantage of certain tax benefits. Ensuring that the expert adviser understands enough about the specific position of the customer takes time, and therefore represents a cost to the firm. Products that are less suitable may be recommended by the firm (and purchased by consumers) not as a result of differential rewards to the firm, but as a result of the firm cutting costs, for example, by not making sufficient effort to find out what a particular customer needs. In all these cases, the detriment to consumers arises from them purchasing a product that is unsuitable or less suitable than one they could have realistically expected to have purchased if the agent had been acting in the consumer's best interests.

The measurement of these benefits should therefore focus on the difference between the financial consequences of the product purchased and the financial consequences of the products that the consumer would have chosen had they been advised about, and opted for, a suitable or more suitable product.

A suitability letter requirement may result in a better fit between what consumers buy and what they in fact need. Thus, one of the main dimensions of market outcome that COB 5.3.14 seeks to improve is the optimality of consumer purchase decisions. A suitability letter may affect this market outcome in the following ways.

– *Delivering benefits through the 'consumer mechanism'*—a suitability letter may help consumers to have a better understanding of whether the product they are considering buying, or have preliminarily agreed to buy, is in fact suitable. The requirement to provide a suitability letter may not be unique in addressing this issue—ie, there are other rules that are likely to contribute to a better fit between what consumers buy and what they need, such as the requirement to give suitable advice, and product disclosure and risk warnings. However, the critical factor here is whether, once the customer has received the suitability letter, they change their subsequent behaviour *as a result of receiving the letter*, and change the product they purchase (including buying no product at all).

  As explained in section 1, the FSA rules specify that in the case of a pension contract or stakeholder pension scheme, where the cancellation rules require notification of the right to cancel, the suitability letter must be issued before the cooling-off period ends. This gives consumers the opportunity to change their mind and cancel the purchase.

  In the case of other products, the suitability letter must be issued when the transaction is effected, or as soon as possible thereafter. This means that consumers may not have the opportunity to change their mind and that, under these circumstances, the suitability letter requirement is unlikely to deliver benefits through the consumer mechanism. However, firms interviewed by Oxera indicated that, in practice, firms may issue the suitability letter before the transaction is effected. In these cases, the suitability letter requirement may still deliver benefits through the consumer mechanism.[9]

  In addition to changing the purchase decision, the receipt of a suitability letter by the customer may also change their subsequent behaviour with respect to complaints,

[9] Even if the suitability letter is provided after the cancellation period has expired, if the consumer, on receipt of the letter, is not happy with the recommendation, they have the right to complain to the adviser (under the requirements on firms to have a complaint-handling/dispute resolution procedure that would encompass complaints that the product sold is unsuitable). However, this potential consumer benefit is not explored further in this analysis.

complaints procedures and complaints outcomes. These changes also have the potential to reduce costs to consumers in general (by, for example, reducing the total costs of complaint-handling), or to the specific consumer (by, for example, reducing the time and effort needed to decide whether it is justifiable to launch a complaint).

– *Delivering benefits through the 'firm mechanism'*—the requirement to provide customers with a suitability letter may result in firms making a better assessment of the needs of their customers and/or may increase the probability of resisting any incentives that could result in biased advice. The fact that a firm has to explain in writing why a product is suitable for its customers may provide it with an incentive to comply with the rules on suitability. As a result, the requirement to provide a suitability letter may affect the content of the advice, which in turn changes the product that the customer buys. The outcome is similar to that where the customer takes action upon receipt of a (good) suitability letter—the products bought are more suitable, overall, than would otherwise be the case. However, this arises as a result of a change in the firm's behaviour (eg, because they give better advice), rather than the customer changing their behaviour.

    – There are a number of different causal pathways that link the lack of a suitability letter requirement to a reduction in the suitability of the advice given and product purchased. Apart from the motivation to reduce costs by doing less research, the regulatory requirement to produce a suitability letter may also make it easier for networks of independent financial advisers (IFAs) to maintain the regulatory compliance with suitability requirements of their IFAs. The *regulatory* requirement may make it easier for the centralised supervisors of the network to get individual advisers to provide them with sufficient information to effectively monitor compliance with the suitability requirement. (This mechanism is likely to operate in a similar way to the use made by the FSA of the suitability letter—see below.)[10]

– The requirement to provide a suitability letter may also enable the FSA to assess (more easily) the quality of the firm's appraisal of suitability, and thus more easily monitor the compliance of firms with the suitability requirement in respect of packaged products. In this respect, the requirement for a suitability letter is unique—there is no other rule that results in verifiable evidence (ie, an audit trail) of the way the firm assessed the suitability of a product for a particular consumer. This may increase the probability of being caught by the FSA, thereby reducing the incentives to advise and sell unsuitable products; or, to put it differently, for the same level of monitoring, with a suitability letter the costs of the FSA would be lower and consumers (of financial services in general) would benefit through lower prices.[11]

– A suitability letter may also help the Financial Ombudsman Scheme (FOS) to assess complaints more efficiently or effectively, reducing its complaint-handling costs and incentivising firms to provide good-quality advice in the first place. As with the effect through the impact on the FSA, increasing the effectiveness or efficiency of the FOS could feed through into more suitable products being sold or lower costs being incurred by firms. This, in turn, could lead to lower prices as a result of competition between firms.

[10] Source: FSA internal analysis.

[11] The production of a suitability letter may also help firms (or networks) in their internal compliance functions and reduce the costs of ensuring any given level of compliance with the suitability requirement. (Indeed, a number of the firms interviewed for this research indicated that this was one of the reasons why they would continue with a suitability letter even in the absence of a regulatory requirement.) However, this impact should already have been taken into account by firms when estimating the incremental costs of the suitability letter requirement in the Deloitte study. If firms that would change their behaviour if the suitability letter requirement were dropped maintain their compliance with the suitability requirement, any additional costs incurred as a result of that compliance should be taken into account in calculating the incremental cost savings from dropping the suitability letter requirement. If firms would not compensate, and their compliance with the suitability requirement falls, this effect will manifest itself as a damage to customers (who purchase less suitable products as a result).

The actual benefits (and costs) of the suitability letter across the whole market depend on the extent of compliance by firms—ie, the extent to which they produce a suitability letter. If no suitability letters are produced or if they are of poor quality, the potential benefits of the suitability letter requirement will be more limited.

This means that, in principle, two types of benefit across the whole market could be measured:

– the *actual* benefits, taking into account the possible extent of non-compliance; and
– the *potential* benefits, assuming full compliance.

To the extent that firms do not comply, the costs and benefits may be reduced proportionately. The primary focus of this study is therefore on the benefits to consumers of firms complying with the suitability letter requirement. Where relevant, references are made to the extent of (non-) compliance.

2.3 How to measure: direct and indirect measurement of benefits

The next step in the framework is to consider the ways of measuring changes in market outcomes as a result of the suitability letter requirement. These changes can in principle be measured directly or indirectly.

2.3.1 Direct measurement

The requirement to provide a suitability letter may result in a better fit between what consumers buy and what they in fact need or want. Direct measurement of this type of benefit requires the measurement of the fit between what is sold and what is needed/wanted under the conditions of a requirement to provide such a letter and under conditions where such a requirement is absent. Having measured the difference in fit, it would be necessary to calculate the financial damage suffered by customers as a result of the change in products purchased.

A necessary (but not sufficient) condition for benefits to arise is a change in the product purchased by those individual consumers. Such an outcome can, at least in theory, be measured by observing real markets when a suitability letter requirement is either introduced or removed. It can also be measured by simulating market sales under the two conditions.[12] In practice, undertaking such analyses is problematic for any requirement such as this one which was introduced some time ago and for which baseline data, even if it had been collected, would be hard to interpret given all the other changes in the market in that time which may result in a better fit between what consumers buy and what they need, making it difficult to measure the unique effect of the suitability letter.

2.3.2 Indirect measurement

The indirect route requires the full set of mechanisms (or chain of causal links) through which the rule may deliver benefits to be identified. From the analysis set out in section 2.2, the following mechanisms can be identified that will lead to a changed outcome for consumers as a result of the requirement to provide a suitability letter:

[12] An example of such a controlled experiment can be seen in a recent study undertaken by the US Federal Trade Commission (FTC) on how disclosure of broker compensation in the mortgage sector affects consumer understanding of loan costs and consumer choice of loans. The FTC study examined the effect of disclosure within a controlled experiment. Approximately 500 recent mortgage customers were shown cost information about two hypothetical mortgage loans and asked a series of questions. Respondents were randomly divided into different groups, which were then provided with different amounts of information about broker compensation. Comparison of the understanding of loan costs and loan decisions taken by respondents in the different groups provided an estimate of the effect of the disclosure. Lacko, J.M. and Papparlardo, J.K. (2004), 'The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment', Federal Trade Commission Bureau of Economics Staff Report, February.

– the consumer changes their purchase decision;
– the firm changes the advice offered;
– subsequent transaction costs incurred by consumers, firms and/or regulators change.

These are explored below.

Consumer changes purchase decision

For a suitability letter to have a positive impact on the fit between what consumers buy and what they need as a result of consumer actions, a number of conditions need to hold. In particular:

– the suitability letter needs to be a good reflection of the consumer's needs;
– the consumer reads and understands the content of the suitability letter;
– the information provided on alternative options allows the consumer to conclude that a more suitable product is available than the one recommended;
– as a result, the consumer changes their purchase decision;[13]
– this change results in a more optimal purchase in terms of product (and/or quantity).[14]

Firm changes the advice offered

The requirement to send a suitability letter may also improve the sales process prior to the sending of the letter (eg, by giving firms incentives to take more care in assessing suitability), provided that:

– the sales interaction prior to the sending of the letter changes;
– as a result, consumers are provided with better advice;
– the consumer's ultimate choice of product provider and product is more optimal.

Firms are only likely to improve the quality of advice if they have incentives to do so. Such incentives can arise from the following:

– compliance with the suitability letter requirement means that the marginal effort required to comply with other elements of the suitability requirement as well is low, so the (marginal) cost of giving good advice falls;

– the suitability letter requirement increases the probability of being caught with respect to the suitability requirement, so compliance with the suitability requirement increases. This can arise through a number of routes, because:

  – the evidence contained in the suitability letter itself makes monitoring compliance with the suitability requirement easier;

  – compliance with the suitability letter requirement is easier to monitor than directly monitoring suitability, and there is a correlation between compliance with the suitability letter requirement and compliance with the suitability requirement;

  – the requirement to provide a suitability letter to the customer makes it easier for that customer to monitor the adviser in terms of the information that is deemed to be relevant by the adviser, that the information about the customer is correctly recorded, and that the reasoning between the facts of the case and the advice is logical and makes sense to the customer.

[13] This is more likely to occur if the suitability letter is given to the customer before the purchase contract is irrevocably concluded.
[14] There is a possible further indirect route for *future* benefits if the receipt of a poor suitability letter results in the consumer changing adviser (to a better adviser) for any future purchases.

Under the first two mechanisms, the use made of the suitability letter by the FSA in carrying out its compliance and enforcement function, and by the FOS in assessing complaints, will have an impact on the changes in market outcomes experienced by consumers. In theory, the more the FSA and FOS use the suitability letter for its evidential value and as an indicator of compliance with the suitability requirement, the more likely it will be that the absence of the suitability letter will result in a negative impact on the degree of compliance with the suitability requirement, and hence the suitability of the product sold. This may occur either through direct scrutiny of the letters by supervisors or by supervision taking account of how a firm's own systems and controls monitor compliance with the requirements to assess the quality of advice provided. In addition, firms' internal compliance functions may be easier to apply if they can rely on the regulatory requirement to provide a suitability letter to ensure that individual advisers provide their supervisory functions with accurate records of what has been advised and why.

Under the third mechanism the requirement to give the letter to the customer means that the information recorded by the firm about the customer is more likely to be factually correct. In addition, the requirement to set out the reasons for the particular advice given may in itself make the firm improve the level of the research it carries out on both the customer needs and requirements and the research on the products available to best meet these needs. This can arise either because the firm is concerned about the customer's reaction to an illogical letter or because the (reliable) information on the customer, combined with the knowledge that the FSA will have on products, means that it will be easier for the FSA to spot advice that is unsuitable or less suitable. Hence, the advice given prior to the handing over of the suitability letter is changed as a result of this requirement.

Subsequent transaction costs incurred by consumers, firms and/or regulators change

The requirement to send a suitability letter provides an audit trail that may have a positive impact on the redress (and enforcement) process in terms of lowering transaction costs, provided that:

– the suitability letter has evidential value and is used as such by the party responsible for dispute resolution (or supervisors);

– the facts contained in the suitability letter would be more difficult, more expensive, or more time-consuming to establish independently through other means;[15]

– the suitability letter is a fair reflection of the information given to, and by, the consumer during the sales process.

2.3.3 Interaction with other rules and FSA supervision

The description of the mechanisms through which the suitability letter requirement may deliver benefits indicates that this requirement exhibits interaction with other rules—in particular, the suitability requirement itself—and with FSA supervision.

Interaction with the suitability requirement—in theory, if firms conduct a suitability assessment (in line with the FSA rules on suitability), the costs of putting this in a letter would most likely be low. However, in practice, the suitability letter requirement may give some firms that would not necessarily fully comply with the suitability requirement an incentive to do so. This would result in higher costs being attributed to complying with the suitability letter requirement that in fact arise from adherence to the underlying suitability requirement. In

[15] The suitability letter may also improve the usefulness of other documentation, if they were still available (for example, the fact-find). The impact of the suitability letter in this area needs to take account of its effect on the total evidence available in any subsequent dispute.

other words, the suitability letter requirement should be seen in the context of the suitability requirement.

This also means that the costs incurred by firms in complying with the suitability letter requirement already give an indication of the benefits of this requirement. Relatively high costs may indicate that the letter is leading to firms spending more time on establishing the needs and requirements of customers and/or researching the product range available in more depth. Where this is happening the suitability letter requirement is (indirectly) leading to a higher quality of advice being provided than would otherwise be the case.

Interaction with supervision—there is also interaction with the way firms are supervised by the FSA. The extent to which the suitability letter requirement gives firms an incentive to comply with the suitability criteria depends on the extent to which the FSA uses the suitability letter in its supervisory process, either through direct scrutiny or through assessment of firms' own monitoring of the quality of advice. The more weight is attached to suitability letters in supervision, the more likely it is that firms will get caught, and the more they will do to comply with the suitability criteria. In other words, the benefits of the suitability letter requirements may, at least to some extent, depend on the effectiveness of FSA Supervision and Enforcement, and the extent to which suitability letters are used by the FOS in assessing complaints.

2.4 Focus of Oxera's empirical research

There are various types of analysis that could be undertaken for direct and/or indirect measurement of the benefits of the suitability letter requirement. This section describes the focus of Oxera's empirical research, given the time constraint and data availability.

2.4.1 Direct measurement

As discussed above, the improvement in market outcome as a result of the suitability letter could, at least in theory, be measured directly by observing real markets when a suitability letter requirement is either introduced or removed. It could also be measured by simulating market sales under the two conditions. Furthermore, it would require an estimate of the financial damage suffered by customers as a result of the change in products purchased.

Data on the market outcomes for the UK that spans the introduction of the suitability letter requirement (or something similar) is not available.[16] However, it might be possible to conduct market simulation studies to measure the impact of the suitability letter through the consumer route and it might also be possible to partially simulate the firm route. Such simulations would, however, be complex and it was not practical to attempt to carry these out within the time frame of this research. As a result, no direct measurement of the impact of a suitability letter requirement on the product purchased was attempted for this study.

Direct measurement of the benefits would also require calculation of the damage caused to consumers of products that are less suitable. A methodology for calculating this was developed, which is described in Appendix 1.

For the potential benefits that have been identified in the areas of transaction and complaint costs, direct measurement of transaction costs would be necessary, again using a real or simulated setting. For the same reasons of the lack of any before-and-after data, and the complexity of setting up simulated outcomes, direct measurement of these benefit types was not possible for this report.

[16] The suitability letter requirement (or something similar) was introduced a number of years ago and the information on market outcomes prior to this introduction do not seem to have been recorded (at least not in a useable form). It was agreed with the FSA that the probability of being able to find such data was low, and as a result this method was not attempted.

2.4.2 Indirect measurement: consumer changes purchase decision

A (good) suitability letter may help consumers to make better decisions if they read, understand and act on the letter.

There is some limited evidence on whether people read and understand suitability letters, but there is no evidence on the extent to which consumers act on them.[17] Research commissioned by the FSA concluded on the basis of face-to-face and telephone interviews with consumers that consumers considered the suitability letter useful.[18] However, only consumers who had actually read the letter were interviewed—the research report also indicates that it was difficult to find consumers who had read the letter and that many had no recollection of having received a suitability letter. This suggests that the benefits of the suitability letter to consumers in terms of changing their purchase decisions to a more suitable product subsequent to receiving the letter may be limited.

Some useful information about the extent to which firms produce suitability letters and their quality can be found in recent thematic work carried out by the FSA on the Quality of Advice Process. Rather than focusing on the outcome of the advice process (ie, whether the advice provided was suitable), the Quality of Advice Process work focused on the aspects of giving advice that are critical to achieving this outcome.[19] In total, 100 financial advice firms were visited (50 by the FSA and 50 separate mystery shops, conducted by an independent research agency). The sample ranged from very small firms with two advisers to large national firms. During the FSA's visits, 528 transactions were reviewed, although not all involved a suitability letter.

Where a suitability letter was required, more than half of the firms sampled provided what the FSA regarded as a poor standard of letter to their customers, or no letter at all. Suitability letters issued to customers were often insufficient in terms of providing the customer with a tailored, clear and concise record, highlighting the key points and risks associated with the recommendation made. Risk warnings were often inadequate and did not provide the customer with a balanced view of the product. Over half of the firms did not explain any potential limitations and risks as a result of the advice provided being limited.

The problems identified with the production and content of suitability letters, combined with the limited evidence that consumers actually change their purchases as a result of the receipt of the letter, suggests that the benefits to consumers from this mechanism (ie, in changing purchasing decisions) in the current market place may be limited. This may depend on the extent to which even imperfect letters are an improvement on no letter at all. Further research could be undertaken to test this tentative conclusion and to seek to establish whether this mechanism would be more effective if, for example, the quality of suitability letters improved and if compliance with the requirement increased.[20] However, with the agreement of the FSA, it was decided not to undertake any further research on the use of suitability letters by consumers in shaping their final purchase decisions because—

[17] As discussed in section 2.2.2, in assessing the benefits delivered through the consumer mechanism, it should be taken into account that, in the case of a pension contract or stakeholder pension scheme, firms are only required to issue the suitability letter before the cooling-off period ends, and, in the case of other products, may issue the suitability letter when the transaction is effected or as soon as possible thereafter. In other words, consumers purchasing products other than pensions may not have the opportunity to cancel their purchase after receiving the suitability letter.

[18] Reflexions Communication Research (2002), ''Suitability Letter' and Fact Find Process—A Draft Research Report Prepared for: Financial Services Authority', November.

[19] FSA (2006), 'Quality of Advice Process in Firms Offering Financial Advice—Considerations for Treating Customers Fairly', July.

[20] A survey could be undertaken of consumers who have recently gone through the sales process, asking them, for example, at what point in the process they received the letter, whether they recall its content, and whether they changed their purchase decisions as a result of the information contained therein. Similarly, consumers' use of, or capability of understanding, the suitability letter could be established in a simulated sales process. Further information on the use of the letter in the sales process could be obtained by surveying firms' views on the importance of the letter in influencing consumer decisions, or by conducting mystery-shopping exercises to establish how advisers' purchase recommendations are influenced by the letter. Expert analysis of actual consumer decisions or a sample of suitability letters provided by firms to consumers could be carried out to provide an independent evaluation of the suitability of consumer decisions or the quality of the suitability assessment carried out by firms and the way it is disclosed to consumers.

particularly given the timing provisions in the rules—this was not one of the primary mechanisms through which the FSA expected the requirements to deliver benefits (confirmed by the policy review undertaken to inform the October 2006 consultation).[21] It was therefore agreed with the FSA that it would be more useful to focus this current research on the way the suitability letter requirements might lower the cost of seeking redress or might change firms' behaviour.

2.4.3 Indirect measurement: firms change the advice offered

There are various types of analysis that could be undertaken to measure the extent to which the suitability letter changes the advice offered by firms.

For example, given the current extent of firms' non-compliance with the suitability letter requirement, it would be possible to compare the quality of advice provided by a representative sample of firms not producing suitability letters or suitability letters of poor quality with that provided by firms producing good-quality suitability letters. A difference in the quality of advice would give an indication of the correlation between the production of (good) suitability letters and the provision of good quality of advice. Such an analysis would require identification of firms that comply with the suitability letter requirement and those that do not.

As discussed in section 2.3.3, the costs incurred by firms in complying with the suitability letter requirement already provide an indication of the interaction between the suitability letter requirement and the suitability requirement. Where firms have identified relatively high incremental costs of the suitability letter requirement, this is likely to indicate that, in the absence of the requirement, they would reduce the time spent on ensuring suitability, as well as changing the output in the letter itself (or not producing a letter at all).

According to the Deloitte study, this mechanism is seen as contributing to the incremental costs identified by the study.[22] Relatively high costs attributed to the suitability letter may indicate an improvement in the quality of advice. It would therefore be useful to understand why certain firms in the sample of the Cost of Regulation Study provide relatively high estimates of the costs of producing suitability letters.

While the conclusion of the Cost of Regulation Study is that the median incremental cost of the suitability letter requirement is 0.41% of total costs, the majority of firms interviewed by Deloitte would continue to produce a suitability letter (or something very similar) if the requirement were removed. Thus, if there is an impact on the products bought by consumers, this is likely to be through the mechanism whereby firms change their behaviour outside the pure letter production process, leading to different advice and different products being bought. Therefore, the apparent key to understanding the delivery of benefits through this mechanism is to ascertain what, precisely, firms would do differently in the absence of the suitability letter requirement in those areas that would affect their compliance with the suitability requirement.

To understand how firms would be likely to change their behaviour if the suitability letter requirement were removed, interviews were conducted with 14 firms to obtain a better understanding of the process they have in place to ensure that their advisers provide suitable products, and the role of the suitability letter in this process. These firms ranged in size, used different business operating models and differed in the extent to which they sold particular products, including those not covered by the suitability letter, such as mortgages. Included in this sample were four firms that would be considered large.[23]

[21] FSA (2006), 'Reforming Conduct of Business Regulation', CP06/19, October.

[22] Deloitte (2006), 'The Cost of Regulation Study', study commissioned by the FSA and the Financial Services Practitioner Panel, June, p. 52.

[23] The objective of this research was not to seek to reproduce a whole market sample that underpins the Deloitte estimate of total costs, but to seek to establish what types of behavioural change were being reported in the Deloitte study (information that

In addition, interviews were conducted with FSA supervisors and the Enforcement team, the FOS, and industry experts to gain a better understanding of the mechanisms that might lie behind any benefits arising from the suitability letter in either the compliance function with respect to suitability, or dispute-handling and complaint resolution where a suitability letter could have a significant role in these after the sales processes. Where possible, existing research on these issues has also been taken into account.

There were three limitations in this approach. In the time available, it was not possible to conduct interviews with a large representative sample of firms. In particular, it would have been helpful to speak to a large number of firms reporting high costs of suitability letters. This might have enabled identification of the relevant behavioural changes, which could then be mapped onto the likely changes in products bought. A cheaper alternative—re-interviewing firms that had already reported their costs in the Cost of Regulation Study—proved not to be feasible due to confidentiality constraints. It has therefore not been possible to obtain direct information on the behavioural changes underlying the results reported in the Cost of Regulation Study. For similar reasons, it has also not been possible to obtain access to the firms visited by the FSA for its work on the Quality of Advice Process.

Oxera also considered the extent to which the introduction of regulation of sales in general insurance could be used as a benchmark to identify the impact of the suitability letter requirement. Since January 2005, the FSA has been required to regulate insurance and mortgage intermediaries, and therefore FSA regulation of insurance sales was introduced at the same time. An element of the insurance conduct of business suitability requirements is that an insurance intermediary must provide a customer with a Statement of Demands and Needs, which has similar objectives to a suitability letter. Where the intermediary is making a personal recommendation, the statement must explain the reasons for personally recommending the contract in question, as well as setting out the customer's demands and needs.

The FSA supervisors interviewed by Oxera noted that there had been a significant reduction in sales of income protection and critical illness policies, for example. However, it was not possible to identify the extent to which this is attributable to the Demands and Needs Statement compared with other factors (eg, the FSA's thematic work on Quality of Advice and the OFT investigation into payment protection insurance).[24] Furthermore, a large proportion of insurance products are sold on a non-advice basis. A Statement of Demands and Needs is still required for non-advised sales but the intermediary is not required to demonstrate in the statement that a suitable recommendation has been given.

was not available in sufficient detail in that study). By understanding what behaviour was actually changing, this could then be mapped onto the likely impact on the quality of advice given, which is the mechanism being investigated in this part of the research. As a result, the sample of firms used here was not chosen to be necessarily representative of the industry.

[24] FSA (2006), 'Quality of Advice Process in Firms Offering Financial Advice—Considerations for Treating Customers Fairly', July. OFT (2006), 'Payment protection insurance—Report on the Market Study and Proposed Decision to Make a Market Investigation Reference, October.

3 Quantification of the benefits of the suitability letter requirement

This section reports the empirical research undertaken by Oxera to measure the benefits of the suitability letter requirement and in particular the extent to which the suitability letter changes the advice offered by firms. Furthermore, it measures the potential reduction in transaction costs incurred by consumers, firms and/or regulators—the requirement to send a suitability letter provides an audit trail that may have a positive impact on the redress (and enforcement) process in terms of lowering transaction costs.

There are still significant uncertainties surrounding both the measures of the *incremental* costs of the suitability letter for the total market, and the total incremental benefits for the whole market. In particular, there is uncertain or conflicting information about the proportion of *transactions* where the removal of the suitability letter requirement would result in a significant change in the behaviour of the firm. The Deloitte Cost of Regulation Study reports that more than half of the firms in the sample would not change their behaviour significantly and would not make significant savings from the abolition of this rule, notwithstanding the reported result that the median incremental cost of the suitability letter requirement makes this requirement one of the most expensive to comply with.[25] FSA research suggests that many firms are failing to comply fully with the existing suitability letter requirement, but the incidence of this type of problem by transaction does not seem to be recorded.[26] Where a firm would not significantly change its behaviour, it is therefore not clear whether this results in firms continuing to meet the requirements of the (old) rule, or continuing *not* to meet the requirements of the (old) rule (because they do not meet the requirement now).

Given the quality of the information available, there are problems in trying to match a global measure of costs against a global measure of benefits. Rather than attempt this directly, a different general approach has been adopted by analysing the benefits that would arise where firms would change their behaviour in the presence (or absence) of a suitability letter requirement.

It is therefore useful to understand what might lie behind the motivation of at least some firms to continue with the production of a suitability letter (or something very similar). For these firms, the incremental *costs* of the requirement are low or non-existent, but also the incremental *benefits* of the requirement are low or non-existent. This is set out in section 3.1 below.

For those firms that would change their behaviour, both the savings to them and the potential damage to customers may be more significant. By analysing this group of firms in isolation, it is possible to obtain some idea of how significant the incremental benefits of the suitability letter would have to be to consumers and others in order to outweigh the incremental costs incurred by this type of firm. This analysis is set out in sections 3.2 and 3.3 below, covering the benefits that could arise from products being purchased by consumers being more suitable, and the reduction in post-sales transaction costs incurred by firms, customers and others involved in dispute resolution respectively.

[25] Deloitte (2006), 'The Cost of Regulation Study', study commissioned by the FSA and the Financial Services Practitioner Panel, June, pp. 48 and 52.
[26] FSA (2006), 'Quality of Advice Process in Firms Offering Financial Advice—Considerations for Treating Customers Fairly', July, p. 16.

3.1 What would firms do in the absence of the suitability letter requirement?

For firms that would continue to produce a suitability letter, or something very similar, it is unlikely that the requirement itself results in significant benefits—technically speaking, the factual and the counterfactual would be the same. Since the firms would not change their behaviour significantly, there are also few, if any, costs arising from the regulation requiring the suitability letter. In other words, for those firms, both the benefits and costs of the suitability letter requirement would be small.

For firms that would change their behaviour significantly, there will be both potential cost savings to them if the rule were removed, and potential costs (in terms of damage as a result of mis-selling) to consumers arising from that change in behaviour. (These costs are the mirror of the benefits that consumers get from the application of the rule.)

3.1.1 Deloitte's Cost of Regulation Study

The Cost of Regulation Study indicated that the incremental costs of the requirement to provide a suitability letter were relatively high, with this requirement being the most expensive cost to firms after the cost of managing their relationship with the FSA (including payment of fees to the FSA). In calculating the incremental cost, Deloitte measured the median cost, expressed as a percentage of the firm's total costs, for those firms operating in the investment and pension advice business. The Deloitte study also presents the *average* total costs (in terms of time per letter—1.4 hours) reported by firms for the production of the suitability letter, and the average proportion of these costs that firms think are incremental to the regulatory requirement (30%).[27]

In addition to these reported results, the Cost of Regulation Study also indicates that a majority of firms sampled would not change their behaviour significantly if the suitability letter requirement were removed.[28] Around 8–9 of the 32 firms reporting would continue to produce the letters more or less as now (no savings would accrue to them if the rule were removed), while around the same number again would continue to do most of what they do now, but would scale back their activities in this area.[29]

3.1.2 Real Assurance study on administrative burden

After the Cost of Regulation Study was completed, the FSA published further research on the cost of the administrative burden on firms.[30] In this research, which covered the production of suitability letters, all the firms surveyed (six in total) indicated that they would continue to provide suitability letters (or something very similar) even if the regulatory requirement were removed; thus, the incremental costs were estimated to be nil.

3.1.3 FSA work on the Quality of Advice Process

The current degree of compliance with the suitability letter requirement may give an indication of what firms would do in the absence of the requirement. Firms that currently do not produce a suitability letter are unlikely to produce one in the absence of a regulatory requirement. Firms that produce a suitability letter of poor quality may also be less likely to produce one in the absence of a requirement. As described in section 2, there is some evidence that the current suitability requirement is quite often not fully complied with. To the extent that it is not complied with at all, there are no costs or benefits for firms or customers

[27] Deloitte (2006), 'The Cost of Regulation Study', study commissioned by the FSA and the Financial Services Practitioner Panel, June, p. 52.
[28] Ibid, p. 52.
[29] Ibid, p. 53.
[30] Real Assurance Risk Management (2006), 'Estimation of FSA Administrative Burdens', June.

arising from removing the requirement. If the form of the requirement is complied with—ie, a document is provided to the customer—but its content does not actually explain why the product recommended/chosen is suitable, it is unlikely that the letter provides significant benefits, but may still incur some (process) costs for the firms.

3.1.4 Oxera research

The interviews carried out by Oxera indicate that, in particular, the larger and medium-sized firms in the sample would continue to provide suitability letters, or something very similar, if the regulatory requirement were removed. There are a number of reasons for this.

– Firms generally consider suitability letters useful for compliance purposes. The letters are used by internal compliance officers to monitor the compliance of their advisers and sales force with FSA suitability requirements. Typically in larger and medium-sized firms, a sample of suitability letters is reviewed on a regular basis, and issues with the advice provided are discussed with the member of staff concerned, with the aim of improving the quality of the advice. Larger firms also reported other mechanisms to ensure the quality of advice, including monitoring the mix of products sold over time and mystery-shopping exercises.

– Firms tend to consider it important to confirm their advice in writing, since this may enable them to establish a clearer defence for the advice provided in cases where customers file a complaint. The letter provides evidence of the reasons why a certain product was recommended to the customer, and shows that the customer was made aware of the risks associated with the product. It provides a snapshot recording of the understanding of both the client and adviser at the time of purchase, and forms a reference for future complaint cases.

– Not producing a suitability letter would not necessarily result in avoidance of significant costs. Although firms indicated that when the suitability letter requirement was introduced they incurred significant costs in putting systems in place that enabled them to produce the letters, these costs were incurred many years ago and are now considered sunk.

In the long term, some of the larger and medium-sized firms might change the systems they currently have in place to monitor compliance of their advisers and sales force. Such a change may or may not include the removal of the suitability letter. In other words, it cannot be ruled out that, in the long term, larger and medium-sized firms might stop producing suitability letters in the absence of a specific requirement. One firm indicated that it would be unlikely to continue to collect information on affordability (ie, whether a customer can afford a particular investment, having regard to the customer's current level of income and expenditure and any likely future changes). If firms reduce the quality and amount of relevant information they collect on clients, it is possible that the quality of advice could be affected. Not collecting information on affordability could affect the suitability of a recommendation where this information would be relevant, and could thus result in non-compliance with the suitability requirement.

Some of the firms interviewed indicated that, while they would continue to produce a suitability letter, they would take an opportunity to review its format and (to a lesser extent) its content. One firm noted that the impetus for some of the text in its suitability letter was from a risk-adverse compliance perspective, ensuring that standard paragraphs were included in the letter. One firm thought that the letter would become simpler in content and more customer-friendly in order to increase the propensity for customers to read and understand it.[31]

[31] Such comments from firms are consistent with the FSA's proposed simplification of the requirement in NEWCOB as the 'suitability report'. See draft section 10.4 in Annex 6 to the FSA's CP06/19, 'Reforming Conduct of Business Regulation', October 2006.

The research found that there are smaller firms that would continue to produce suitability letters if the requirement were removed.[32] However, there are also indications that some smaller firms would stop producing suitability letters. Some of them consider these letters unnecessary since they have long-term relationships with most of their clients or consider it simply too costly to produce the letters.

In the absence of a specific requirement, new firms entering the market may decide not to produce suitability letters. No further information on this was obtained.

3.1.5 Concluding remarks

From the published results of the Deloitte Cost of Regulation Study and FSA work on the Quality of Advice Process, it is not possible to establish whether there is any systematic distribution of the reaction to a possible removal of the suitability letter requirement. Discussions with firms and supervisors for this study indicate that, for large firms, internal processes use the suitability letter as part of compliance procedures, and they would be likely to continue this practice even if not required to do so. These discussions also indicate that for some small and very small firms, there appears to be less explicit integration of the suitability letter with the internal compliance system. If this is reflected in the results obtained by Deloitte, it is possible that, in terms of sales volumes, few sales of packaged products would be made without a suitability letter if the regulatory requirement were removed.[33]

For these reasons it is difficult to establish a robust global figure for the global *incremental* costs of the suitability letter requirement. However, it is possible to analyse the benefits in relation to costs for two different types of firm: one where very little, if anything, changes if the requirement is removed; and the other where there are changes in both the costs of compliance and the potential costs to consumers as a result of the changed behaviour of the firm.

For the group of firms that would continue to produce a suitability letter, or something very similar, it is unlikely that the requirement itself results in significant benefits—technically speaking, the factual and the counterfactual would be the same. However, as the firms would not change their behaviour significantly, there are also few, if any, costs arising from the regulation *requiring* the suitability letter.[34,35]

However, for the group of firms that would change their behaviour significantly, there will be both costs savings to them if the rule were removed, and potential costs to consumers arising from that change in behaviour. The costs and benefits balance can be measured only for those firms (and their consumers) that would change their behaviour. If the assumption is made that, for the firms that would not significantly change their behaviour, both incremental costs and incremental benefits are zero, and if, for the firms that would change their behaviour, the benefits of the rule outweigh the costs, the rule will deliver a net positive outcome overall, irrespective of the proportion of the market represented by these firms.

As a result of the uncertainty surrounding firms' propensity to change behaviour described above, the cost–benefit balance will primarily be estimated at the level of the individual firm that would significantly change its behaviour. The focus of the analysis is therefore on measuring the impact of specific changes in behaviour on a transaction basis.

[32] The FSA's Quality of Advice Process also found that there were 'many examples of good practice, particularly in the smaller firms' (July 2006).

[33] The Deloitte study provides information by firm and the results are not weighted by size. Therefore, if there is a systematic bias in the behaviour such that small firms are more likely to change their behaviour, the proportion of firms changing their behaviour will be higher than the proportion of *transactions* to which the changed behaviour applies.

[34] More strictly defined, there are unlikely to be any significant cost savings for firms if the rule were removed. If the rule were imposed on an industry that was already producing something similar to a suitability letter, firms might incur transitional costs as they change their systems to meet the exact regulatory requirements.

[35] For these companies the private benefits of the suitability letter are likely to outweigh the private costs and hence their decision to continue with the letter. This outcome should hold, even if other firms do not produce the suitability letter.

3.2 The firm mechanism: potential reduction in the sale of products that are less suitable

For firms that would stop producing suitability letters (in the absence of a specific requirement) and/or potentially reduce their compliance with the suitability requirement, a regulatory requirement to produce a suitability letter may deliver significant benefits to consumers if it results in a better fit between the product(s) they are advised to buy and their needs/wants. The suitability letter requirement will result in incremental benefits to consumers if it gives firms additional incentives to comply in full with the FSA rules on suitability. The extent to which this may occur depends on a number of factors, discussed below.

3.2.1 What are the incentives for mis-selling?

As explained in section 2, the potential benefits of the suitability letter depend on the extent to which advisers would recommend products that are less suitable or unsuitable in the absence of a suitability letter requirement. This in turn depends on the incentives firms may have to sell unsuitable, or less suitable, products (ie, to mis-sell).

There may be two reasons why mis-selling of products occurs:

– providing good-quality advice requires time, and results in costs to the financial adviser. To reduce costs, the adviser may spend less time on evaluating the customer's needs or searching for the product that best satisfies those needs, and this may affect the quality of advice, potentially resulting in mis-selling;

– there may be a product or provider bias. For advisers remunerated through commissions paid by product providers for a given level of total payment by the customer, the adviser may receive significantly different income depending on the product sold and/or the specific provider of that product. Advisers may, therefore, give preference to products with relatively high commission over those with low commission, or they may sell products in circumstances where the consumer would be better served by not buying (eg, because they have significant debt or already have a product meeting the need identified). This may also result in the sale of products that are less suitable or unsuitable for the particular consumer.

There is only very limited evidence on the extent of mis-selling currently in the market. There is data from the FSA and FOS on the number of mis-selling cases that have been detected and addressed. However, there are no precise estimates of the number of mis-selling cases that are not detected.

3.2.2 Can a suitability letter be used to identify mis-selling?

Firms, supervisors and industry experts confirmed that the suitability letter can be used to identify cases of mis-selling and selling of products that are less suitable. It can provide sufficient information to enable a supervisor or internal compliance officer to assess whether the advice may or may not have been appropriate. However, in most cases, more information would have to be gathered to reach a final judgement on the suitability of a specific product for a specific customer—for example, from the fact-find. For many customers there is not a mechanistic relationship between their requirements and the best product. Judgements are required, and different advisers could legitimately recommend a number of different products, all of which would be suitable.

However, notwithstanding the potential complexity of identifying the full set of suitable products for a particular customer, a suitability letter that contains the types of information required by the rule would, for many cases, be a relatively easy way to identify where products that were less suitable or unsuitable had been sold.

The extent to which suitability letters can be used *in practice* to detect cases of mis-selling depends on whether firms produce suitability letters (ie, comply with the suitability letter requirement) and the quality of these letters. Furthermore, even if a suitability letter is produced and is of reasonable quality, there are some limits to its usage. For example, it is possible to cover up some forms of mis-selling in a suitability letter. A letter may indicate that a certain high-risk product was recommended because the customer had indicated that they were not risk-adverse. However, it cannot be assessed, just by looking at the suitability letter, whether the financial adviser's interpretation of the customer's appetite for risk was, indeed, correct. However, for those characteristics that are customer-specific, the requirement that the letter has to be given to the customer is likely to increase the probability that this information is reasonably accurate. In the absence of the suitability letter requirement, but still in the presence of a suitability requirement, the firm could more easily give the appearance to the FSA of meeting the latter by recording incorrect information on the customer's characteristics (eg, in the fact-find). The FSA would need to check back with specific customers to decide whether a particular product was, in fact, suitable—a much more time-consuming and expensive activity than reading documents held by the firm. With a suitability letter requirement, the firm faces the possibility that the consumer will raise issues with the FSA if it systematically misrepresents the consumers' characteristics in order to justify the sale of products that either give it high remuneration or it chooses without researching the market (ie, reducing the firm's search costs), or both.

3.2.3 What is the effect of suitability letters on FSA supervision?

Both FSA supervisors and the internal compliance function of large firms indicated that they attach significant benefit to the existence of a suitability letter in enabling them more easily to monitor and assess compliance with the suitability requirement. As already indicated, one of the reasons given by firms for why they would continue to produce a suitability letter (or something similar) even if the requirement were removed is the advantage to the firm for internal monitoring purposes.

From the FSA's perspective, the loss of the suitability letter (or similar) would increase the difficulty of supervisors and enforcement when monitoring the performance of firms or investigating issues of mis-selling. This increase in difficulty would come with a cost that would ultimately be borne by consumers. There are two forms in which this cost could arise:

– the FSA could compensate for the increased difficulty by using more resources to restore the same level of supervision or enforcement (in which case, the FSA would be more expensive to run);

– the effective level of supervision and enforcement could decline, which in turn could be expected to increase the levels of non-compliance with regulatory requirements (ie, a deterioration in market outcomes for consumers, assuming that the current level of supervision is reasonably efficient).

The FSA was asked to estimate the additional costs that its supervisory and enforcement functions would incur in the absence of a suitability letter (but under an implicit assumption that the basic information upon which a suitability recommendation could be made would remain available, and be equally reliable).[36] Subject to some considerable uncertainty, the minimum additional resources required to maintain the same level of supervision and enforcement in the *complete* absence of suitability letters is set out in Table 3.1 for the two parts of the FSA that could make this estimation. A more detailed description of the method

[36] Because the suitability letter is provided to customers, there is a check on its accuracy at the time it is produced. It would be a high-risk strategy to mis-describe the characteristics of the customer. In the absence of the suitability letter being provided to customers, it may be easier for the firm to record incorrect characteristics of the customer to justify whatever product was sold. Recreating the true characteristics of the customer after the event to enable the FSA to assess the compliance with the suitability requirement could be very difficult when contemporaneous records cannot be relied upon.

used to calculate this benefit to the FSA is provided in Appendix 2, together with an explanation of the assumptions and costs, and the issues involved.

Table 3.1 Estimated additional costs assuming no letter produced, 2005/06 (£m)

	Total costs (£m)	Share of costs where suitability letter affects work (%)	Increase in time spent on these activities (%)	Estimated increase in cost (£m)[1]
Small Firm Division	10.5	10	~33	0.4
Enforcement Division	14.2[2]	100	~10–30	2–4
Total				**2–4**
		Average FSA savings per letter produced		£1–£2

Note: [1] The figures in this column have been individually rounded to one significant figure to reflect the uncertainty of the calculation. See Appendix 2 for more detailed figures. [2] Refers to internal costs.
Source: Oxera calculations based on data and percentage estimates from the FSA. See Appendix 2 for more details.

Given the uncertainty of the proportion of transactions that would actually have no suitability letter (or something very similar) if the requirement were removed and, therefore, the difficulty of calculating the actual additional costs that the FSA would need to incur as a result of the removal of the suitability letter requirement, the last row in Table 3.1 expresses the additional cost to the FSA in terms of the cost per letter produced, using the estimated total of around 2.1m letters produced annually (see Table 3.4 below).[37] Although the savings to the FSA per case will be much higher than this, most letters never get examined by the FSA. The average savings per letter do, however, give an indication of the additional costs the FSA would face on average if one letter were not created. This can be compared with the average incremental costs of the production of that one letter.

Other parts of the FSA (see Appendix 2 for details) also use suitability letters. Although they find the letter useful, they were unable to estimate the additional costs they would incur if they did not have these letters. In addition, within the Small Firm and Enforcement Divisions, there was some doubt that the additional resources would completely restore the quality of supervision and enforcement. Therefore, the estimate of this benefit of the suitability letter to the FSA is conservative. The importance of the suitability letter in the enforcement process is highlighted by the case study provided by the FSA (see Box 3.1). In particular, the FSA expressed some concerns that the implicit assumption that the quality of the basic information would remain the same in the absence of the suitability letter was unrealistic. In the absence of the suitability letter, the information about the customer may be unreliable, which would significantly increase the difficulty of making a suitability assessment from the remaining information on the customer's record and would be very expensive to verify. There would be a clear risk that where the customer characteristic information was incorrect or missing, the information would appear to justify the product sold, rather than be an accurate reflection of the customer's circumstances. In this case, the quality and effectiveness of the supervision process and, therefore the subsequent compliance with the suitability requirement, would be likely to be significantly compromised.

[37] Real Assurance Risk Management (2006), 'Estimation of FSA Administrative Burdens', June, p. 55.

Box 3.1 The benefits of suitability letters

Case study
In 2006, a firm was fined £182,000 for systemic failings in its sales process for pension unlocking, which resulted from advisers not taking reasonable steps to ensure that recommendations were suitable for their customers. Pensions unlocking is a process whereby individuals aged 50 and over can take some, or all, of their pension in the form of a lump sum and/or income before they retire. It is a high-risk activity that is only suitable for a very limited number of people.

The FSA made two visits to the firm. On each occasion, serious concerns were raised regarding the firm's systems and controls and sales procedures. Suitability letters produced by the firm were one of the key factors that allowed the FSA to identify that the firm was neither collecting sufficient information about customers' attitude to risk, nor giving customers adequate advice about the alternatives to pension unlocking.

The letters were found not to be clear and fair to customers, and specific criticisms focused on the following points:

– they were insufficiently personalised. For example, they included a standardised risk statement which was not tailored to individual customers;

– they were misleading in that where the firm recommended not to proceed, the amount that could be raised was still shown, giving mixed signals to customers.

The letters were produced by an administrator and not checked by an adviser before being sent.

In this case, suitability letters were a valuable indicator for the FSA's Supervision and Enforcement Divisions that a firm had inadequate systems and controls, which were considered to be associated with a heightened risk that recommendations would be unsuitable. In addition, the inadequacy of suitability letters was one of the failings identified by the FSA as indicating that the firm was unable to demonstrate that its recommendations were suitable. This case does not illustrate the suitability letter requirement improving the suitability of advice at the stage when advice is given, but does indicate how it can assist at the supervision and enforcement stage. The fine was significant. The Final Notice notes that, in the original Skilled Persons review, around 10% of cases that could be assessed, sales were unsuitable and at a later review found no evidence of unsuitable sales in more recent sales.[1]

Note: [1] For further details, see the final notice at http://www.fsa.gov.uk/pubs/final/Braemar.pdf.

As a result, if the reliability of the information recorded about customers were compromised, either the additional costs to the FSA of compensating for this would be much higher than indicated in Table 3.1 above, or the quality of supervision and enforcement would decline significantly, the effects of which are explored in more detail in section 3.2.5 below.

3.2.4 Post-purchase transaction costs

In addition to the mechanism by which the production of the suitability letter might increase compliance with the suitability requirement as set out above, the suitability letter may reduce the transaction costs incurred by the parties in the case of a subsequent dispute between the customer and the firm.

The discussions with firms undertaken for this research confirmed that one of the significant reasons for firms continuing with a suitability letter (or something similar), even if the regulatory requirement were removed, is the use of the letter in subsequent dispute resolutions. The letter is seen as providing good evidence that the firm was recommending suitable products at the time when the sale was made and on the information available about the customer. From the firm's perspective, the letter has the potential to reduce its transaction costs in any subsequent dispute. If the letter is, indeed, an accurate reflection of the events and information available at the time of the purchase, the reduction in transaction costs for firms is also a benefit to consumers. This is the case even if the firm chooses not to continue with the suitability letter in the absence of a requirement.

Again, there are two main mechanisms through which these benefits can arise:

– a reduction in the incurred transaction costs in disputes that still arise, notwithstanding the existence of the suitability letter;

– a reduction in the number of transactions that are subsequently disputed at all.[38]

With respect to the first mechanism, information was sought from the FOS to establish whether it considered the contents of, or the existence of, the suitability letter as providing it with information for dispute resolution purposes, and the impact on its activities of not having such information.

The FOS indicated that the majority of investment complaints involve suitability. On this basis, a high proportion of the costs of the FOS are potentially relevant to this quantification.[39] The FOS was not, however, able to estimate directly by how much costs would increase if the suitability letter were not produced, but did indicate that both the cost per case, as well as the total number of cases, would be likely to increase if firms stopped producing the suitability letter. The FOS considers that the letter is important evidence for it in evaluating cases and is often the only contemporaneous record of the advice given.[40]

Overall, the costs of running the FOS in 2005 were around £46m,[41] and around 110,000 new cases were dealt with. This suggests that, on average, each new case costs the FOS around £420. In the absence of the FOS being able to estimate the level of cost savings that arise as a result of the presence of a suitability letter, a modest assumption of a 10% saving would save around £4.5m per annum, or around £42 per case. If the savings were similar to those estimated by the FSA for supervisory purposes—in the order of 30%—the total saving would be more like £13m in total and £130 per case.[42]

Not all transactions lead to a dispute involving the FOS, and not all disputes concern products with a suitability letter. Assuming that 50% of the FOS's caseload is related to these products (ie, around 50,000 new cases per annum) and that 2.1m suitability letters are written per year, around 2.5% of all suitability letters would be used by the FOS.[43] Under these circumstances, the savings per letter written would be in the order of £1 (10% savings) and £3 (30% savings). Erring on the side of caution, the estimate of £1 saving per suitability letter has been adopted in Table 3.2 below.

To the extent that the suitability letter prevents disputes arising at all, the savings (ie, the benefits to consumers) are more significant. Again, in the absence of empirical data, using a modest assumption of a 10% reduction in the number of disputes (ie, around 11,000

[38] Where the presence of the suitability letter stops unjustifiable disputes from being launched, there is an unambiguous benefit to consumers. However, if the presence of the suitability letter stopped justifiable complaints, this would have two opposing impacts. For the consumer with the justifiable complaint, this is clearly a negative outcome, but for other consumers there is a reduction in the total transaction costs that, collectively, they have to bear. In this case, an assumption has been made that the presence of a suitability letter does not hinder justifiable complaints.

[39] In the year to March 31st 2005, the FOS dealt with 110,963 new complaint cases, of which 69,737 related to mortgage endowments and 19,251 were other investment-related. Total FOS expenditure (including financing charges and depreciation) for the same period was £45.8m. Source: FOS (2005), 'Annual Review: Report and Financial Statements', June.

[40] FOS communication to the FSA, October 13th 2006.

[41] In the year to March 31st 2005, the FOS dealt with 110,963 new complaint cases, of which 69,737 related to mortgage endowments and 19,251 were other investment-related. Total FOS expenditure (including financing charges and depreciation) for the same period was £45.8m. Source: FOS (2005), 'Annual Review: Report and Financial Statements', June. See also http://www.fos.org.uk/publications/ar06/ar06-what-complaints-about.htm#1.

[42] Figures have been rounded to two significant figures to reflect the uncertainty in the calculations.

[43] The figure that is required is the proportion of the 2.1m suitability letters being written *now* that will feature in complaints made to the FOS in the *future*. The current caseload of the FOS is heavily weighted to endowment mortgages that were sold in the past. If the total caseload drops in the future, the proportion of transactions that lead to FOS investigation from the current set of transactions would also be expected to fall, and hence the proportion of suitability letters that would feature in an FOS investigation would also fall. Using 50% of the current caseload as the base for the analysis is Oxera's best estimate of the future incidence of complaints relating to products covered by the suitability letter requirement.

disputes) would save the FOS an additional £4.5m. Using the same assumptions as above, another benefit of around £1 per letter would arise.

In addition to the cost savings indicated by the FOS, the same impact could be expected for both firms and consumers. Indeed, as already indicated, for those firms that would continue with the suitability letter, the potential future cost savings from the existence of the letter represent a significant factor in the decision to continue.

Consumers may also benefit from the suitability letter if it enables them to take a more realistic view of whether they have grounds for complaint. This mechanism can work by both reducing the probability of consumers embarking on disputes that they will not succeed in, and in providing consumers with robust evidence about the sales process, thereby reducing their perceived risk of an unfavourable outcome, which may increase the probability of actually taking up a complaint where they will succeed. The benefit of the letter to the consumer when in a dispute with a firm is unlikely to be less than the benefit arising to the FOS, so savings of around £2 per letter are likely to arise. It is not known how many consumers would not pursue a justified complaint because of the absence of the suitability letter, so a benefit from this source is not estimated.

Within the research limitations for this project, information was not collected from firms on their estimated cost savings in dispute resolution as a result of the existence of suitability letters. In theory, firms should have taken this into account when estimating the incremental costs of compliance with the suitability letter requirement, but it is unclear whether this was actually the case. If these benefits have not been captured (through a reduction in the incremental cost savings estimate), it seems unlikely that their cost savings would be less than the cost savings to the FOS (in the order of £2 per letter).

Table 3.2 estimates the cost savings from the impact on the costs of the FSA's supervisory and enforcement functions and from the post-transaction costs of the FOS, consumers and firms (if not already captured in the Deloitte study). It does not capture any consumer benefit that arises because the suitability letter increases the number of justifiable complaints made.

Table 3.2 Broad estimated of the average cost savings per suitability letter produced, excluding the impact of any change in the products actually sold

Cost elements	
Increased FSA costs (supervision and enforcement) per letter	£1–£2
Increased other FSA costs per letter (see text)	£0–£1
Increased costs to the FOS—dispute resolution/more disputes	£2
Increased costs to firms in dispute (if not already included in the cost reduction estimates reported in the Deloitte study)	£0–£2
Increased costs to consumers in dispute	£2
Total cost savings (benefits)	**~£8**

Source: Oxera calculations and estimations.

The savings indicated in Table 3.2 are insufficient to cover the likely costs of the suitability letter for those firms that would cease to produce such a letter. On this basis, the requirement to produce a suitability letter would also need to reduce the sale of products that are less suitable if the benefits of the requirement are to outweigh the costs from the mechanisms identified.

3.2.5 What is the effect of suitability letters on the quality of supervision?

If firms did stop providing suitability letters (or something very similar), there is no guarantee that the FSA would have access to additional resources to compensate for the extra time required to undertake the same level of regulatory activities. In particular, this would be the case where the effect of the lack of a suitability letter was to compromise the reliability of the recorded information about individual customers. Under these circumstances, the result would be less supervision and less enforcement. Assuming that the current level of supervision and enforcement is reasonably efficient, this would translate into higher levels of the sale of products that are less suitable.

Two main pathways leading to higher levels of the sale of products that are less suitable can be identified.

– Firms that are failing on the suitability requirement will, on average, take longer to come to the attention of the FSA, and will therefore have more time to sell a greater number of products that are less suitable before remedial action is implemented. In extremis, this problem may not come to the attention of the FSA at all, because the information on the files indicates that suitable products are being sold, while the reality is different.

– The impact of the first effect may be to increase the profit to the firm from selling products that are less suitable. This, in turn, increases the likelihood of some firms adopting a strategy of failing to comply (partly or fully) with the suitability requirement.

The second outcome is not necessarily linear, but may have step-like effects if the strategy of failing to comply with the suitability requirement suddenly becomes profitable for the generality of firms, once the probability of being caught by the FSA drops below a certain threshold.

Larger firms are visited by FSA supervisors on a regular basis. For these firms, suitability letters are one of the indicators used by supervisors to identify developments which may indicate that products are being mis-sold—when larger firms are visited by the FSA supervisors concerning their sales processes, a sample of suitability letters are normally reviewed. Another important indicator is the mix of products sold over time. Significant changes in this mix over time or across firms might indicate that there is a product bias that could contribute to mis-selling.

Smaller firms are not visited by the FSA on a regular basis. They may be visited when the FSA conducts a thematic review—for example, when the FSA launches an investigation into a particular product or aspect of regulation and compliance, or where a specific piece of intelligence indicates that a problem may be occurring at the firm. A recent thematic review in which samples of suitability letters were reviewed was the Quality of Advice Process review referred to above. Detailed examinations of suitability letters would encourage firms to adopt and maintain adequate controls for their sales process.

The way in which smaller firms are monitored by FSA supervisors can to some extent be compared with the way in which internal compliance officers of larger firms monitor the compliance of their advisers and sales force. Compliance officers use a number of techniques. As with FSA supervisors, they monitor the mix of products sold over time, monitor the level of complaints, review samples of suitability letters, and may, for example, undertake mystery-shopping exercises to evaluate the quality of advice in practice.

With the data available for this research, it has not been possible to estimate the impact of the reduction in supervision and enforcement activity on the quantity of products sold that are less suitable. A number of critical characteristics of the current market outcome appear to be unknown at present, including the current incidence of purchasing less suitable products and the impact of the supervision process on the suitability match between products sold and customer needs.

If the additional resources restored the FSA's supervisory and enforcement functions fully, and this were the *only* factor that affected the level of compliance with the suitability requirement, the maximum benefit of the suitability letter requirement through this mechanism would be the cost savings made by the FSA. However, if, in addition, the removal of the suitability letter requirement were to change firms' compliance with the suitability requirement—notwithstanding the fact that the probability of being caught remains the same—additional benefits would flow from the suitability letter requirement since it would independently change the compliance with the suitability requirement. If the probability of being caught by the FSA for failing to meet the suitability requirement were to fall, there would be an additional impact on consumers. Those firms currently selling unsuitable products would continue for longer before they were caught, and the incentives to sell unsuitable (or less suitable) products would increase for firms (and/or individual advisers) because of the reduced probability of being caught within any given time frame (or at all).

Notwithstanding the lack of data that will allow an estimate of either the independent decrease in compliance with the suitability requirement, or the impact of the reduction in the quality or quantity of supervision and enforcement, it is possible to estimate the increase in the sales of less suitable products that would be necessary to compensate for the additional costs of providing the suitability letter. This is set out below for the more common types of product that are currently subject to the suitability letter requirement, and for a number of cases where the firm (adviser) has an incentive to sell less suitable or unsuitable products.

The analysis below is conducted by reference to pairs of products: the more suitable and the less suitable. This reflects the outcome of the process: a less suitable product was bought, although a more suitable product was available. However, it does not really represent the process itself, where the advice is not between two, predetermined, products. In the actual sales process there will be a range—possibly a wide range—of products that could be sold to the customer. To meet the suitability requirement, the adviser will need to match the product to the customer The more research the adviser undertakes on both the customer needs and the market, the closer the advice is likely to be to the best product available (for that consumer). Thus in the sales process itself there is more of a continuum, rather than a binary choice. In general, the greater the effort, the better the outcome. Where the cost savings, as reported in the Deloitte study, relate to research costs, smaller savings are likely to equate with smaller changes in the suitability of the product (and hence less damage to consumers). Larger savings are likely to equate with, on average, greater damage. However, without being able to measure the graduated impact of reducing research effort, only the simpler pair-wise analysis can be easily undertaken.

3.2.6 Change in market outcomes required for the benefits to equal the costs of the suitability letter

It is possible to quantify the change in market outcomes (eg, sales of products) that would be required from the production of a suitability letter in order to make the benefits of these changed market outcomes equal to the cost of the associated number of suitability letters. This requires the identification of 'pairs' of financial products, with one product representing what a particular consumer purchases when no suitability letter is present, and the other the product purchased by the consumer, given their specific circumstances, when a suitability letter is produced.[44] As the suitability letter requirement covers many different financial products, a large number of pairings is possible.

In addition, for those firms that would change their behaviour, both the dimensions and extent of that behaviour change are uncertain, and will vary from firm to firm. Thus, there are many possible outcomes when a specific transaction is carried out under a suitability letter

[44] The most suitable product can depend on the customer, so the objective is to calculate the damage when the less suitable product is bought by a customer for whom it is the less suitable product.

requirement (ie, as is the case now) and when the requirement is removed (ie, the counterfactual).

To make this analysis tractable, Oxera asked firms and other industry participants to identify possible pairings of products. In addition, where clear financial incentives can be identified for advisers to distort their advice, stylised pairings have been developed. These pairings include the following, which have been used to demonstrate the extent of the change in market outcome that would be required. The first product in the pair is bought when a suitability letter is present (in other words, is it the more suitable product), while the second, less suitable product, is bought when the suitability letter is not produced.

– The same product with lower/higher commission rates paid to the adviser.
– The same product with lower/higher management fees paid to the investment manager.
– Failure to exploit a tax advantage with respect to the amount invested.
– Failure to exploit a tax advantage with respect to the income generated from the investment.
– Reducing debt versus investing in an equity ISA.
– Investing via a unit trust versus investing in an investment bond.
– Investing in a cash ISA versus investing in an equity ISA.
– Investing in bonds versus investing in equities (within a packaged product).

To compare the impact of the costs and benefits of the suitability letter requirement on a per-transaction basis, the appropriate cost needs to be estimated. The Deloitte study reports on the median incremental cost for its sample. For the purposes of the current analysis, the appropriate cost is the average incremental cost saved for those firms that would change their behaviour. It has not been possible to derive this figure directly from the Deloitte study. What can be derived is the average incremental cost for the sample in terms of adviser time: 0.42 of an hour.[45] The Real Assurance report estimates the average cost for advisers to be around £37–£45 per hour.[46] If the firms where no change in behaviour occurs were eliminated, the average incremental time would (under most circumstances) increase.[47] On the assumption that the incremental time savings were 50% of the average total costs for this group, the incremental cost savings for those firms that would change their behaviour is around £25–£32. An upper boundary for the cost savings could be 100% of the average costs: £50–£60.[48]

As set out in section 3.2.4, not producing the suitability letter (or something similar) is likely to cause additional costs to be incurred by the FSA, FOS and consumers (and possibly firms as well), irrespective of whether the product actually sold changes (ie, a less suitable product is sold). The estimate set out above suggests that these costs to others (which are benefits of the suitability letter requirement) are in the order of £8 per letter. Therefore, for the suitability letter requirement to provide benefits above costs in total, the benefits arising from the consumer purchasing more suitable products need to cover the remaining incremental costs after these other benefits have been taken into account. Using £30 and £50 as the range for the relevant incremental costs for those firms that would significantly change their behaviour, the additional benefits needed from changing the purchase decision are in the range £22–

[45] The estimate in the Deloitte study is that the average time taken to produce the suitability letter is 1.4 hours and that, on average, 30% of this is incremental (see p. 52).

[46] Real Assurance Risk Management (2006), 'Estimation of FSA Administrative Burdens', June, p. 26.

[47] If the firms that would not change their behaviour have a very different average total time cost for the suitability letter compared with the average for the full sample, the average total time for those who would change their behaviour would also be significantly different. As it could be higher or lower, the impact on the incremental costs of those who would change their behaviour is uncertain. The Deloitte data does not allow this impact to be explored.

[48] Because of the uncertainty in the underlying data, the figures are all rounded to a maximum of two significant figures. The logic of the calculation is as follows: 50% of 1.4 hours is 0.7 hours, which represents a cost of £25.90 and £31.50 at £37 and £45 per hour respectively. The upper boundary for the average savings is all the cost of the suitability letter, or 1.4 hours. This translates to £51.80 and £63 respectively.

£42.[49] It is these values that are used in the following analysis. (Appendix 3 sets out the same tables using £30 and £50 as the benefit level required, which equates to the outcome where the full costs of the suitability letter are required to come from the benefits of the change in product sold.)

For some of these pairings, the calculation of the damage to consumers is relatively straightforward. The results for these pairings are set out below.

Commission bias

If all other things are equal, the damage of commission bias is equal to the additional amount of money paid by the product provider to the adviser/intermediary firm. There is, therefore, a clear incentive on the adviser to recommend a product with a high commission compared with a low commission. The damage to customers (if the commission rate is the only difference between the products) will depend on the difference in the commission rates and the amount of money being invested. Table 3.3 sets out the damage in money terms for a single-payment product for a number of investment sizes and differences in initial commission rates.

Table 3.3 Impact of initial commission bias on consumers (£ damage/transaction)

	Commission rate difference (percentage points)				
Investment (£)	0.25	0.5	0.75	1	2
500	1.25	2.50	3.75	5.00	10.00
1,000	2.50	5.00	7.50	10.00	20.00
5,000	12.50	25.00	37.50	50.00	100.00
10,000	25.00	50.00	75.00	100.00	200.00
50,000	125.00	250.00	375.00	500.00	1,000.00

Source: Oxera calculations.

Tables 3.4 and 3.5 set out the damage to customers in terms of the minimum frequency with which the customer would need to obtain the better product in order for customers overall to be better off. In other words, when the benefits flowing from the better product outweigh the additional costs incurred by the adviser in producing the suitability letter using two levels of average costs that need to be covered: £22 and £42.

[49] The figures £30 and £50 are used as convenient figures to cover the likely range of incremental costs of the suitability letter for those firms that would change their behaviour. Using apparently more precise figures of £25–£32 and £50–£60 risks overcomplicating the analysis with little, if any, increase in precision.

Table 3.4 Frequency with which a transaction with a less suitable product would need to be stopped by the suitability letter requirement for the benefits to outweigh the costs of the letter (average benefit needed of £22)[50]

	Commission rate difference (percentage points)				
Investment (£)	0.25	0.5	0.75	1	2
500	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
1,000	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
5,000	More than every transaction	88%	59%	44%	22%
10,000	88%	44%	29%	22%	11%
50,000	18%	9%	6%	4%	2%

Source: Oxera calculations.

Table 3.5 Frequency with which a transaction with a less suitable product would need to be stopped by the suitability letter requirement for the benefits to outweigh the costs of the letter (average benefit needed of £42)

	Commission rate difference (percentage points)				
Investment (£)	0.25	0.5	0.75	1	2
500	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
1,000	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
5,000	More than every transaction	More than every transaction	More than every transaction	84%	42%
10,000	More than every transaction	84%	56%	42%	21%
50,000	34%	17%	11%	8%	4%

Source: Oxera calculations.

Commission bias may also manifest itself in the form of a bias to enable the adviser to obtain additional *trail* commission payments. Trail commissions are (generally) paid by the product provider to the adviser who sold the product for a number of years after the sale has been made (possibly for as long as the customer retains the investment product). As the commission payment is made by the product provider to the adviser, the trail commission is usually included in the management fee levied on the product by the product provider. All other things being equal, higher trail commissions will manifest themselves as higher management fees, and the damage caused to consumers will arise from this source (see below).

Higher management fees (including higher trail commissions)

Instead of reducing the net amount of money invested through differences in initial commission rates, identical products may exhibit differences in the management fee charged by the product provider. The differential in management fees may be used to differentially reward the adviser (ie, different levels of trail commissions), in which case there is a direct

[50] As already noted, references to 'less suitable' products throughout this report should be read as meaning less suitable for the consumer in question, bearing in mind the consumer's needs and circumstances, rather than any suggestion that a product is inherently unsuitable to be sold.

financial incentive on the provider to recommend the product with the higher management fee. Under these circumstances the customer may be worse off by more than the additional initial commissions/fees paid to the adviser. Alternatively, the adviser may seek to reduce their costs by reducing their search time and will fail to identify a better product with a lower management fee, even if the trail commissions are the same. Again, the customer may be worse off than the cost savings to the adviser. Table 3.6 sets out the monetary damage where the difference in annual management fees is 0.5% of assets under management for a long-term (10- and 20-year) investment plan at several different annual investment levels.

Table 3.6 Damage to customers as a result of differentials in management fees of 0.5% (£ in current money terms)

Annual investment	10-year	20-year
500	102	415
1,000	204	830
5,000	1,022	4,148
10,000	2,044	8,296

Note: The annual management charge differential is between 1% and 1.5% of assets under management. The real return is assumed to be 5% and the net present value (NPV) discount rate is 3% real.
Source: Oxera calculations.

Tables 3.7 and 3.8 translate the monetary values into the proportion of sales that would need to be changed by the suitability letter requirement to provide a benefit higher than the costs that need to be covered: £22 and £42.

Table 3.7 Frequency with which transactions resulting in a less suitable product would need to be stopped: difference in management fee 0.5% and benefit required of £22

Annual investment	10-year	20-year
500	22%	5%
1,000	11%	3%
5,000	2%	0.5%
10,000	1%	0.3%

Source: Oxera calculations.

Table 3.8 Frequency with which transactions resulting in a less suitable product would need to be stopped: difference in management fee 0.5% and benefit required of £42

Annual investment	10-year	20-year
500	41%	10%
1,000	21%	5%
5,000	4%	1%
10,000	2%	0.5%

Source: Oxera calculations.

Tax advantage on initial investment

If a customer has the option of investing income before income tax is paid, the damage to the customer is proportional to the tax wedge (eg, between no tax and the standard rate of 22%; between the higher rate of 40% and no tax; and between the standard rate and the higher

rate) and the size of the investment. Table 3.9 sets out the financial damage for a number of investment sizes and possible tax benefits. Tables 3.10 and 3.11 translate these results into the frequency with which less suitable transactions would need to be stopped where the benefit needed from the suitability letter requirement is £22 and £42.

Table 3.9 Impact on consumers of failing to take up a taxation advantage on initial investment (£)

Investment amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	110	200	90
1,000	220	400	180
5,000	1,100	2,000	900
10,000	2,200	4,000	1,800
50,000	11,000	20,000	9,000

Source: Oxera calculations.

Table 3.10 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage and benefit required of £22

Investment amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	20%	11%	24%
1,000	10%	6%	12%
5,000	2%	1%	2%
10,000	1%	0.6%	1%
50,000	0.2%	0.1%	0.2%

Source: Oxera calculations.

Table 3.11 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage and benefit required of £42

Investment amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	38%	21%	47%
1,000	19%	11%	23%
5,000	4%	2%	5%
10,000	2%	1%	2%
50,000	0.4%	0.2%	0.5%

Source: Oxera calculations.

Tax advantage on returns to investment

The damage to the customer is proportional to the tax differential and the amount invested, and the nominal return and the customer's discount rate. The rate of tax on interest from savings, dividends from equities or capital gains from buying and selling securities are complex. For the purpose of this analysis, the tax benefits that are assumed to be available are between 20% (basic rate of tax paid on income from savings) and 40% (higher rate of tax paid on income from savings). (If the income is generated from dividends, the tax rates are

different: 10% and 32.5%, so the damage from not benefiting from the tax advantage is lower.)

Table 3.12 sets out the damage for two investment periods and for a number of single investments.

Table 3.12 NPV of damage to customers from the failure to exploit a tax advantage on savings income generated from an investment (£ in current money terms)

	10-year investment			20-year investment		
Invested amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	£54	£108	£54	£87	£174	£87
1,000	£108	£216	£108	£174	£349	£174
5,000	£541	£1,081	£541	£872	£1,745	£872
10,000	£1,081	£2,162	£1,081	£1,745	£3,489	£1,745
50,000	£5,405	£10,810	£5,405	£8,724	£17,447	£8,724

Note: The investment returns 7% nominal, and the discount rate is 5% nominal.
Source: Oxera calculations.

Tables 3.13 and 3.14 express these results in the form of the proportion of less suitable sales that would need to be stopped where the benefit required from the suitability letter requirement is £22 and £42.

Table 3.13 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage on savings income generated and benefit required of £22

	10-year investment			20-year investment		
Invested amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	41%	20%	41%	25%	13%	25%
1,000	20%	10%	20%	13%	6%	13%
5,000	4%	2%	4%	3%	1%	3%
10,000	2%	1%	2%	1%	0.6%	1%
50,000	0.4%	0.2%	0.4%	0.3%	0.1%	0.3%

Source: Oxera calculations.

Table 3.14 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage on savings income generated and benefit required of £42

	10-year investment			20-year investment		
Invested amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	78%	39%	78%	48%	24%	48%
1,000	39%	19%	39%	24%	12%	24%
5,000	8%	4%	8%	5%	2%	5%
10,000	4%	2%	4%	2%	1.2%	2%
50,000	0.8%	0.4%	0.8%	0.5%	0.2%	0.5%

Source: Oxera calculations.

For the other pairs of products, the damage caused to customers will depend, at least partly, on their appetite for risk. The critical difference between the pairs is the distribution of the potential outcomes. Some of the products have a certain, or fairly certain outcome (for example, paying off an existing debt), while others will return a variable amount depending on the market conditions over the period of the investment. Valuing the consumer damage at the time the product is sold is far from straightforward, as the damage that will actually be caused is idiosyncratic to that time period. Over some, or even many, time periods, the product that is generally less suitable may deliver a better outcome for the consumer than the product that is more suitable. Indeed, the general pattern of investment products is that products with a higher variability of outcome will, on average over many different time periods, provide a higher return to consumers than investments with more certain outcomes.

The damage to consumers is therefore dependent on the relative valuations that consumers place on receiving higher returns and lower returns than the average return for that product. Different consumers will place different relative valuations on these different, possible, outcomes, so the damage is idiosyncratic to individual customers. In addition, the relative distributions of outcomes between products is likely to change depending on the length of time the customer holds the investment. Thus, not only does the current risk appetite of the consumer matter, but also the intended investment period.

Notwithstanding these difficulties, the potential damage that can be caused by purchasing a product with the wrong risk/reward profile is clearly significant. A customer who cannot afford to see the absolute value of their investment fall is likely to place a very large (negative) value on even a small possibility that they lose, say, half their money in a stock market crash.

To evaluate the overall impact of the suitability letter requirement, some measure of benefits is required if one of the outcomes of removing the requirement is that consumers are sold products where the risk–reward profile is less closely aligned with their risk appetite. Appendix 1 sets out this valuation problem in more detail.

To operationalise the valuation for the tables below, a relatively simple assumption has been made that the average damage caused by being sold the wrong product is the sum of the outcomes where the worse product delivers an outcome below that of the *average* outcome of the better product, multiplied by the probability of that outcome. The methodology used to undertake these calculations is discussed in greater detail in Appendix 1, but this is likely to overestimate the damage caused by the sale of the less suitable product in the pair.

The results reported in Tables 3.15 and 3.16 are in terms of the number of mis-sold contracts that would need to be prevented per average sale of the second product in the pair for the benefits to equal the costs. These calculations are undertaken over one- and five- year

investment periods using historical data on the returns to equities and bonds, as well as assumptions on the interest rate paid on cash ISAs and the management charge for equity ISAs.[51] For example, with respect to the first pair, for the benefits of the suitability letter to be equal to the costs that still need to be offset, the letter would need to prevent the mis-selling in around 10% of transactions (or around one in every ten equity ISA sales). If the cost of producing a suitability letter for equity ISAs were less than the average cost assumed here, this ratio would increase.

In addition, the volatility of the outcome with riskier products will result in some consumers potentially losing more than their investment as a result of consequential damage flowing from the initial loss of their investment (for example, being tipped into bankruptcy), and consumers may independently value a reduction in the uncertainty (pure uncertainty) of the outcome through time that would not necessarily be captured by a simple monetary valuation of the probability of the single point outcome. These consequential damages should also be taken into account through a more detailed analysis of both the (negative) value consumers would place on this type of outcome and the frequency with which such an outcome is likely to occur. The additional valuation of the reduction in uncertainty should also be established. However, this has not been possible within the scope of this project. If these additional (negative) valuations are large the benefits from switching from the risky to the less risky product from this mechanism are also significant, and would consequently reduce the frequency with which the suitability letter requirement would need to stop less suitable sales before the requirement covered its costs.

The objectives of the FSA with respect to consumer protection may also be relevant here in the potential trade-off between the general costs of regulation (ie, the cost of the suitability letter requirement) and the distribution of the negative consequences of its removal. The FSA's objectives may require it to assign a large benefit to the reduction of negative outcomes, even if infrequent, particularly if the consumers who are likely to suffer these outcomes are especially vulnerable. To take this into account, the underlying assumption that the benefits to be measured are based on the simple aggregation of the monetary valuation of those benefits by consumers would need to be modified to include an additional element of value to capture these objectives of the FSA.

[51] This is important because the difference in returns between some of these pairs of products (eg, bonds versus equities) should increase over time.

Table 3.15 Summary of benefits calculations for products with different risk–reward profiles, (excluding the impact of consequential damage and pure uncertainty), benefit required of £22: required number of 'mis-sold' contracts avoided

		Length of investment (years)	
	Investment (£)	1	5
Reducing debt versus equity ISA	4,088	10%	13%
Cash ISA versus equity ISA	4,088	14%	36%
Unit trust versus investment bond	47,485	4%	See note
Bond versus equity	18,811	2%	2%

Note: Sales data is taken from ABI statistics for 2005. The cost of debt is assumed to be 6% real. Bond and equity returns are in real terms, based on data from 1987 to 2006. The real return on the cash ISA is assumed to be 2.5%, and the annual management charge on the equity ISA is assumed to be 1%, in line with industry guidance. Assumptions used for the unit trust/investment bond comparison are based on industry guidance. The tax benefit of investment bonds is 1%; the bid–offer spread on unit trusts is 3%, and the exit charge on investment bonds is 5% initially, declining to zero after five years. Unit trust and investment bonds are analysed for a one-year investment horizon because, after five years, the exit charge on investment bonds is zero, and therefore investment bonds will be the more suitable 'wrapper' as they have lower charges (net of the tax benefit). The bond versus equity calculation uses the average sale of products in the ABI statistics as the investment in equities.
Source: ABI statistics, Datastream, Deloitte (2006), Real Assurance (2006), and Oxera analysis.

Table 3.16 Summary of benefits calculations for products with different risk–reward profiles, (excluding the impact of consequential damage and pure uncertainty), benefit required of £42: required number of 'mis-sold' contracts avoided

		Length of investment (years)	
	Investment (£)	1	5
Reducing debt versus equity ISA	4,088	20%	26%
Cash ISA versus equity ISA	4,088	20%	24%
Unit trust versus investment bond	47,485	8%	See note
Bond versus equity	18,811	4%	3%

Note: See note to Table 3.15 above.

3.3 The total benefit impact of the suitability letter requirement

Subject to considerable uncertainty, it is possible to estimate the impact of ceasing to produce the suitability letter for those firms that would do so. The costs have been identified in the preceding sections and expressed as the frequency with which the product sold would need to change to a more suitable product, using a number of product pairs as examples.

The results presented in Tables 3.4 to 3.16 indicate that there are many types of less suitable products that require a fairly modest reduction in the number of mis-sellings for the suitability letter requirement to cover its costs. This is particularly so for large investments, reflecting the fact that the damage is often proportional to the size of the investment, but the costs of meeting the suitability requirement (which entail market search costs and establishing the relevant customer characteristics) are likely to be largely fixed per customer transaction.[52] In addition, the tables set out the outcome for single dimensions along which products may be less suitable. In practice, some products may be less suitable in more than

[52] The Deloitte data is not detailed enough to validate this supposition.

one dimension, with the consequential damage to them usually additive. For example, a high-risk product may also carry high commission and high management fees, so the contrast between the less and more suitable product would need to account for the damage along the risk–reward profile, the initial commission bias and the higher management fees (possibly including higher trail commission bias as well). Where this occurs, the frequency with which the sale of the less suitable product needs to be stopped for the suitability letter to cover its costs will fall.[53] Table 3.17 sets out the outcome for a product pair where the initial commission bias is 0.5% higher than necessary, the management charge is 0.5% higher than necessary, and there is a failure to exploit a tax advantage (no tax to standard rate).

Table 3.17 Frequency with which transactions resulting in a less suitable product would need to be stopped: multiple damage, initial commission, management fees and failure to benefit from a tax advantage on investment

	Additional benefits needed	
Amount invested	£42	£22
500	20%	10%
1,000	10%	5%
5,000	2%	1%

Source: Oxera calculations

In addition, there are some clear benefits to advisers and firms either to sell less suitable products (eg, commission bias) or to reduce costs by reducing research and search costs. The size of the cost savings indicated in the Deloitte study suggests that at least some firms would do at least one of these. Therefore, the critical part of quantifying the benefits to ascertain whether the benefits outweigh the costs is to establish the frequency with which the sale of less suitable products would actually occur for those firms that would change their behaviour in the absence of the suitability letter requirement.

There appears to be no *direct* empirical evidence available that would help estimate the impact on the selling of less suitable products. However, there is a clear incentive on advisers to reduce their costs and increase their income by selling less suitable products either deliberately or by not establishing what a suitable product would be. Both of these motivations should have an impact on the quality of advice, and there is likely to be a relationship between the quality of advice, the product chosen and the inputs required to deliver that quality of advice.

In carrying out its supervision function, the FSA undertook thematic research in early 2006 to evaluate the processes used by investment firms to ensure the quality of their advice to customers in respect of investment products. A similar project in the area of mortgages followed in late 2006. Although this research focused on the Quality of Advice Processes rather than the actual outcomes for customers, and the snapshot nature of the research makes it difficult to establish causality, the findings seem to indicate that there is some correlation between the quality of the advice and the quality of the suitability letter.

For example, the Quality of Advice Processes findings for investment business, as published in July 2006, noted that the suitability letter, in particular, is an area that requires significant improvement in over half of firms.[54] This was based on a supervisory review of around 500 customer cases drawn from the 50 or so firms visited as part of the project.

[53] To add the impact of two dimensions together, the percentage figures in the tables in section 3 should be converted to the equivalent of 1 in X, and one dimension taken from these tables. To add other dimensions, the tables in Appendix 3 should be used, converted into 1 in Y, and then the X and Y added together—ie, the combined impact is 1 in (X+Y).

[54] http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/advice/index.shtml.

While it was not the purpose of the project to assess the outcomes for customers, supervisors did flag up obvious cases where they judged the advice was not suitable or fair. (Note that this judgement was based purely on the information on file, and would not have picked up cases where further investigation might have revealed unsuitable sales—eg, where focused advice had been given without adequate explanation of the risks involved as a result of the advice being focused). Supervisors flagged nearly twice as many obvious cases of unsuitability (15%) in firms where the suitability letter was of less-than-adequate quality, compared with obvious cases of unsuitability (8%) in firms where the suitability letter was of more-than-adequate quality. In addition, the obvious cases of unsuitability flagged by supervisors were more associated with cases where the attitude to risk had not been properly established, which in turn were more associated with firms where the suitability letter was of less-than-adequate quality.[55]

Generally it seems that the quality of advice increases if information about customers and the market is established and the general quality of the suitability letter of the firm is high. This is consistent with a causal chain linking the requirement to produce a suitability letter and an increase in the quality of the advice given. However, based on available data it is not possible to unambiguously demonstrate causality. It is possible that both the suitability letter quality or existence and the suitability and fairness of the advice are being driven from some other characteristic of the firm or adviser. Under these circumstances, those firms that would change their behaviour if the suitability letter requirement were removed would still provide the same advice, notwithstanding the change in their output with respect to the letter, or to the inputs required for the letter.

Nonetheless, one of the simplest explanations seems to be that there is a causal link between how well firms currently meet the suitability letter requirement and the suitability of the advice or product bought.

The final link between the reduction in costs to firms from removing the suitability letter requirement and the damage to consumers from obtaining a less suitable product needs some estimate of the frequency with which changed advice (and hence changed purchase) would actually occur.

The tables above indicate the frequency of unsuitable sales that need to be avoided for the benefits of the letter to equal the costs. In order to establish whether, in practice, the suitability letter actually reduces the sale of unsuitable products by a sufficient frequency, further empirical information is required. In particular robust data on the proportion of sales which are currently unsuitable and the proportion of sales which are accompanied by adequate suitability letters would be crucial so that the current market outcome can be analysed statistically to conclude whether the presence of a suitability letter is associated with an increase in the frequency of suitable advice being provided.

In addition, however, to arrive at a firmer measure of the benefits relative to the costs, it would be extremely useful to establish:

– on a case-by-case basis, the actual damage caused where deficiencies have been found in the suitability and fairness of advice;

– in more detail what precise activities would change when firms are claiming a high incremental cost of the suitability letter requirement, to be able to better match the impact to the potential costs.

[55] Information from the FSA.

4 Conclusion

This report sets out the analysis Oxera has carried out on the FSA's current regulatory requirements for a suitability letter, within the framework Oxera developed for the FSA for assessing the benefits of regulation.[56] The markets for retail investment and pension advice are characterised by information asymmetries between the adviser and the consumer. Where information imbalances lead to mis-selling, not only are consumers potentially sold a product that does not meet their needs, but consumer confidence may also be damaged, and consumers may be put off buying any products from which they might have benefited. The regulatory intention is that the suitability letter plays a part in redressing such imbalances by increasing the probability that consumers are sold a product that meets their needs, and thereby maintaining consumer confidence.

A fully comprehensive analysis was beyond the scope of this report. To quantify in full and provide evidence for the benefits of a requirement such as the suitability letter would require much more extensive research and evidence-gathering across a larger sample of firms and consumers than has proved possible for this project. (Particular areas where further research would be likely to be informative are set out below.)

On the basis of the work undertaken for this project and the evidence available, there is good evidence that a substantial proportion of the costs of producing the suitability letter may be offset by the additional costs that would be incurred in the post-transaction process if a suitability letter (or something similar) were not produced. By examining the use made of suitability letters by supervisors, by the FOS, and by firms in their internal control processes, it is possible to estimate the potential additional costs that would be incurred if the suitability letter were not available (eg, as a result of those concerned having to establish other approaches to monitoring or establishing the suitability of advice, or handling and evaluating complaints). However, it seems unlikely that this class of benefits would fully cover the cost of the suitability letter requirement, as assessed in Deloitte's Cost of Regulation Study (calculated from the range of costs reported by its sample of 32 firms).

There are a number of other routes by which the suitability letter may have an impact on consumers. One such route is that the suitability letter triggers a change (to a more suitable product) once the consumer receives the letter. However, the rules surrounding the timing of the requirement and existing evidence on how consumers use the letter indicates that changing the customer's purchase decisions is unlikely, and that this is not a primary focus of the requirement from the regulator's point of view (which has been confirmed by the FSA).

Another route is that the requirement to provide a suitability letter improves the advice given to consumers, so that the initial purchase decision is improved. This suggests, however, that if quantifiable benefits were to equal or exceed the costs as measured in the Deloitte study, there would need to be a sufficient impact on the quality of advice provided by firms in respect of the relevant investment products, and, hence, a noticeable change in the products actually bought by consumers towards those that were more suitable for their needs or objectives. Thus, the requirement to provide a suitability letter would be expected to involve an impact on firms' behaviour and attitude to compliance with the overarching suitability obligation, possibly through their approach to mitigating regulatory risk (eg, in the knowledge that regulators can review suitability letters and potentially expose failings).

The findings of the research and analysis conducted for this project (including an examination of the FSA's Quality of Advice Process findings) are *consistent* with there being

[56] Oxera (2006), 'A Framework for Assessing the Benefits of Financial Regulation', September.

significant benefits from this impact, although there is insufficient evidence to *quantify* such benefits. Nevertheless, the findings are consistent with:

– lower quality of the suitability letter (including not providing one at all) being an indicator of less suitable advice;

– there being incentives for firms and advisers to reduce the costs of researching the market. This is, in turn, consistent with evidence that less research results in less suitable advice;

– there being potential for the aggregate incremental costs of the production of the letter to be matched by quantifiable benefits if unsuitable recommendations could be prevented at a plausible frequency in relation to plausible transaction sizes.

For those firms that state that they would continue to produce a suitability letter, or something very similar, even in the absence of a regulatory requirement to do so, the requirement would clearly impose few, if any, costs, but equally deliver few benefits. However, for those firms that would change their behaviour significantly (possibly around 15%, according to the Deloitte study), there would be cost savings to them if the requirement were removed, but also potential costs to consumers arising from that change in the firms' behaviour. *If* such behavioural change were also to involve firms reducing costs on such matters as searching the market to inform the recommendation then consumer damage could be expected to increase.

Recommendations for possible further analysis

Additional empirical evidence would be useful to support more definite conclusions, and in particular to demonstrate whether, in the absence of a suitability letter requirement, the quality of advice would fall sufficiently to damage consumers to an extent greater than the costs of the suitability letter that cannot be offset by post-transaction costs.

In particular, additional evidence would be useful to establish:

– with more certainty, what changes in firms' behaviour are leading to the high incremental costs of complying with the suitability letter requirement (as reported by the Deloitte study), and the relationship between these changes and the required inputs to the advice process;

– any definitive causality between a reduction in expenditure on the suitability letter and a reduction in the quality of advice given;

– empirically, the frequency with which less suitable advice would be given in the absence of a suitability letter, and the specific damage caused by the recommendation of a specific product that was less suitable for a consumer.

Such evidence could be generated by further research along the following lines:

– obtaining more information from firms describing in greater detail what they would do differently in the absence of the suitability letter requirement;

– using analysis of past cases to establish, on a case-by-case basis, the damage resulting from less suitable advice and precise failings in the research/advisory process that allows a less suitable product to be recommended.

Finally, for less suitable recommendations where the damage may arise from less suitable risk–reward profiles, a better method of measuring damage would enable a more robust evaluation of the costs and benefits of regulatory interventions designed to assist consumers.

The impact of many regulatory measures appears to be to ensure a better fit between the risk profile of the product and the risk appetite of the consumer. However, by the very nature of the intervention, it is likely that the costs are spread across many consumers, but the benefits are realised by a few. Having a robust methodology of measuring whether the overall valuation of the benefits outweighs the overall costs would seem to be important in ensuring that regulation is delivering value for money for customers as a whole.

Such research should encompass the costs of consequential damage, as well as the damage within the different risk–reward profiles, so as to capture the real impact on risk-averse investors.

However, primary research (probably using simulations, together with stated- and revealed-preference surveys) would appear to be required to establish consumer valuations of the rather different outcomes that can arise over the long investment periods typical of many of the long-term 'packaged products', and which the suitability requirement seeks to address.

Some further work being considered by the FSA to follow up its previous Quality of Advice Process studies may provide evidence to help answer some of these questions.

A1 Quantification methodology: less suitable products[57]

A1.1 Conceptual framework

A suitability letter may result in a better fit between what consumers buy and what they in fact need. The mechanisms by which this may occur were discussed in section 3. This potential change to market outcomes may result in more optimal consumer decisions, and therefore benefits from the reduced sale of less suitable products. This appendix outlines a conceptual framework by which the benefits of a reduction in the sale of less suitable products can be quantified, and sets out a practical approach by which these benefits can be estimated.

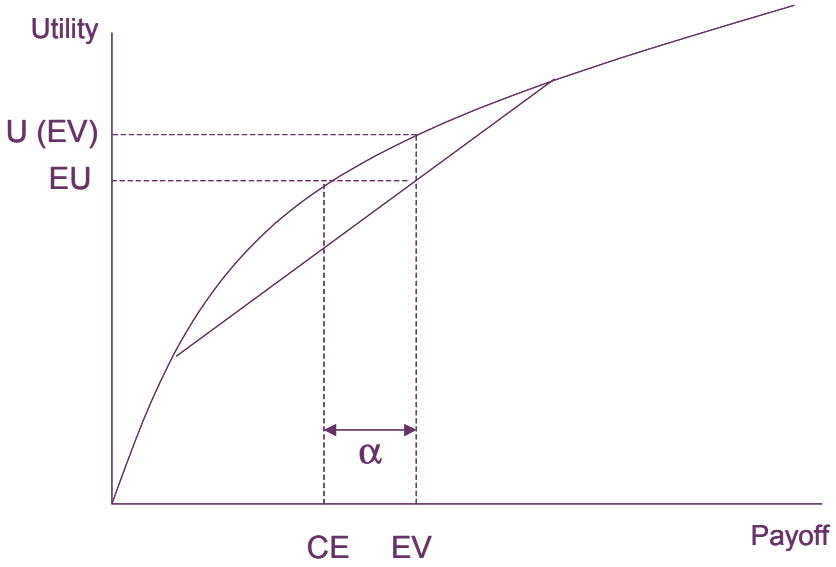
A1.1.1 Utility functions and indifference curves

In theory, given the choice between financial products with a certain return and an uncertain return, which both have the same expected value (ie, the same average return), rational, risk-averse consumers would choose the financial product with a certain return. This is because, while the expected return of both decisions is the same, a rational risk-averse consumer prefers less risk to more risk. In other words, such a consumer will derive more 'utility' when the risk is lower. One approach to quantifying the benefit from a reduction in the sale of less suitable financial products is therefore to measure the difference in utility between the less and more suitable financial products, and to value that change. The concept of 'certainty equivalence' is, in this context, important.

The certainty equivalent is the amount of money a consumer would be willing to pay for the prospect of obtaining, for certain, the expected return offered by the risky product. For a risk-averse consumer, the certainty equivalent value is below the expected value (EV) (ie, the average return) of the risky product, but the utility levels (EU) of the certainty equivalent and the expected value are the same. The risk premium is the difference between the expected value and the certainty equivalent, as illustrated in Figure A1.1. This shows a typical concave utility function, where the gradient of the slope decreases as expected returns increase. This is because, for this utility function, consumers derive less utility from each succeeding increase in payoff and become increasingly risk-averse as the expected variation in return increases. In other words, for each additional unit of risk, these consumers would require an increasingly large rise in the average expected return.

[57] As noted, references to 'less suitable' products throughout this report should be read as meaning less suitable for the consumer in question, bearing in mind the consumer's needs and circumstances, rather than any suggestion that a product is inherently unsuitable to be sold.

Figure A1.1 Expected utility and certainty equivalent



Source: FSA and Oxera analysis.

Where both products are risky, the difference between the certainty equivalents of the two products indicates the net damage to a consumer of being recommended the less suitable product. The methodological steps that would be required to estimate certainty equivalents can be described as follows:

– calculate the utility associated with each level of payoff;
– calculate the expected utility by summing the utility levels associated with each payoff multiplied by the probabilities associated with those payoffs;
– input the expected utility into the inverse of the utility function in order to give the certainty equivalent.

The benefit caused from choosing the suitable product (assumed to be bonds in this example) over the more risky unsuitable product (assumed to be equities in this example) can be ascertained by finding the difference in the certainty equivalents of each product. Such that:

$$\text{benefit} = CE_{\text{of equity}} - CE_{\text{of bonds}}$$

As the utility function may be specific to an individual, it is possible to plot combinations of risk and return that deliver the same utility to consumers (see Figure A1.2). Figure A1.2 highlights a typical indifference curve formation. Consistent with a concave utility function, the indifference curves are increasing in curvature, as each additional unit of risk requires increasing units of return.

Figure A1.2 Indifference curves

Within the indifference curve framework, a consumer can attempt to:

– maximise the average return from an individual product or portfolio given a particular level of preferred risk; *or*
– minimise the level of risk of an individual product or portfolio associated with a particular desired average rate of return.

In Figure A1.2, various indifference curves are plotted. A consumer faced with two products that lie on different indifference curves (ie, the lines on which A and B lie) should therefore choose the financial product that lies on a higher curve. The solid line, 'market output', represents the range of products (or combination of products) that is available to this particular consumer. For simplicity, Figure A1.2 assumes that the trade-off between risk and return in this range of products or portfolios is linear, although this may not necessarily be the case.

For this consumer, the optimal choice of product would lie at point A because, along the market output line that comprises all the products available to a consumer, this is on the highest indifference curve. If a consumer has instead been advised to purchase product B, which is on a lower indifference curve, a damage to that consumer has occurred because, while B offers a higher average return, risk also increases. Furthermore, for this consumer, the combination of risk and return offered at A is preferable to that at B.

The damage that occurs if a consumer instead chooses product B can be measured by asking what additional return needs to be provided to the consumer to make them indifferent to the choice between points A and B. This additional return is represented above by the distance b to c along the vertical axis, and would ensure that the consumer remained as well-off as they would have been had they purchased product A (ie, they are on the same indifference curve). Points A and B do not necessarily need to represent the most optimal and a less than optimal product. Rather, they represent a more optimal (and therefore more suitable) and a less optimal (and therefore less suitable) product pair.

However, this does not take into account the ex ante risk to the consumer at the point when they make a decision between the two products. Therefore, the appropriate measure of damage is the change in the required returns when the outcomes are certain, These are the

(theoretical) risk-free products that would occur at points d and e on the vertical (risk-free) axis (and is consistent with the certainty equivalent previously discussed).

Within this general framework, it is possible to consider several combinations of consumer decisions. Only some of the choices require the adjustments relating to indifference curves or certainty equivalents.

- **Reduce debt or invest in a risk-free product**—rather than reducing debt, consumers may be advised to put their money into a risk-free product, such as a cash ISA.[58] This is arguably the most straightforward quantification. If the average interest rate paid by consumers on their debt is, for example, 10% and a cash ISA returns 5%, the damage of being advised to invest in a cash ISA is equal to 5% (plus any charges levied directly by the adviser). This is because, by reducing debt, a consumer could have saved interest equal to 10% of that reduced debt, while the benefit of saving in a cash ISA would only be 5%.[59] Because there is no risk–reward trade-off in this example, the returns are already in the form of certainty equivalents.

- **Risk-free product or consumer decision against an uncertain outcome**—rather than reducing debt or investing in a cash ISA, consumers may be advised to invest their money in a product with uncertain income. While reducing debt has a certain outcome (eg, avoidance of interest), this is not the case with many financial products (eg, an equity ISA). In this case, the quantification depends on the valuation that the consumer would place on the product compared with the certain outcome. The amount the consumer would have to be paid to accept the uncertain outcome instead of the certain outcome is the measure of the damage to the consumer of being sold the uncertain product.

- **Products with the same risk but different net returns**—this scenario could arise from a consumer choosing between products with the same risk but different returns (net of taxes and charges)—eg, a unit trust and an investment bond. The damage is straightforward to calculate as the difference in the taxes or the charges between the two products or consumer decisions. Where an adviser recommends a less suitable product on the basis of product bias, assuming the underlying risk characteristics are the same, the damage to consumers can be measured as the difference in net charges to consumers.

- **Products both with uncertain outcomes**—this scenario is the most difficult to quantify because both products have uncertain outcomes which, at the point of sale, can only be estimated. Using the utility methodology outlined above, each product can be linked to a product with a certain outcome to which the consumer would assign the same value (the certainty equivalent value). The difference between the certainty equivalent values is the damage (benefit) to the customer of choosing the less (more) suitable product.

A1.1.3 Implementation of the framework

To put this approach into practice, it is necessary to calculate the risk–return profiles of the typical type of less suitable products that might be sold as a result of the removal of the suitability letter requirement, and compare them with the, more suitable, product sold with the suitability letter requirement in place. Using an appropriate utility function, the certainty equivalent can be calculated, and the damage suffered by a consumer with that utility function who is sold the less suitable product can be calculated.

[58] Although it is worth noting that cash ISAs are not covered by the suitability letter requirement.

[59] There is an additional complication here because cash ISAs are tax-free, although this is not discussed in this example, and some loans may have early repayment penalties which would also need to be taken into account in the individual circumstance.

Oxera has attempted to calculate the certainty equivalent values on the historical real returns to bonds and equities using a range of possible utility functions, including a number of those identified in the academic literature.[60] However, the results obtained from these calculations suggested that the various forms of utility function adopted did not ensure meaningful and intuitively plausible estimates of the certainty equivalent value of these products measured over different time periods. Over the range of outcomes that are likely to arise over long time periods (eg, a comparison between investing in government bonds and equities over a 20-year holding period), a utility function that continues to value additional returns positively, while reflecting the consumer's (negative) valuation of the downside outcomes, is necessary. Without specific information on how consumers value these large differences in (low-probability) outcomes, it is difficult to develop a methodology that is generalisable to encompass the many different product pairings that represent less suitable and more suitable advice/products. Although such a function may already have been generated, Oxera has been unable to find any empirically derived utility functions that address this specific issue of long-term investments. Further research to identify the most appropriate form of the utility function for this type of analysis may therefore be useful.

With respect to the method based on indifference curves, a significant amount of survey data would be required to populate indifference curves. As far as Oxera is able to ascertain, this data does not readily exist, and generating it was outside the scope, and timing, of this project. Further research on consumer indifference curves for financial products may be useful. An alternative approach is for financial advisers, as experts facing consumers, to indicate themselves what additional return would be required to ensure that a consumer was indifferent between two relevant product pairs. However, while Oxera asked for this information from the firms interviewed, the firms were not able to identify what the additional return parameter should be for alternative product pairs.

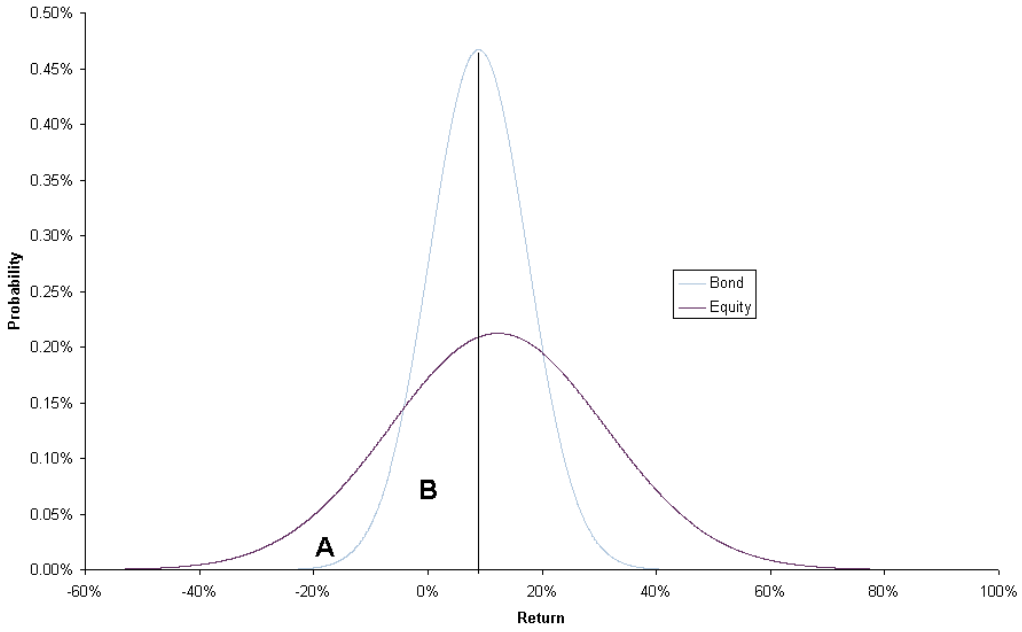
A1.2 Practical approaches to the quantification of benefits

As set out above, while the approach to quantifying benefits based on utility functions is the conceptual ideal, implementing this in practice is not straightforward, as different forms of the utility function that are available do not appear to lead to meaningful results for this particular type of analysis. An alternative, practical, approach is to compare the distribution of returns from the two products (the less and more suitable) and measure the losses suffered by those consumers who are worse off as a result of purchasing the less suitable product. This can be done, on an illustrative basis, for bonds and equities, which are both products with uncertain outcomes.

Using historical monthly data on UK gilts and the FTSE All-share index from 1987 to 2006, Oxera constructed sample probability distribution functions, which plot expected real returns against frequency. These probability distribution functions were calculated for a range of holding periods by scaling up the monthly returns. For example, the one-year holding period is calculated by compounding the average monthly return by 12. It is possible to estimate the potential damage caused from purchasing the less suitable product (in this example, equities) by comparing the probability distributions for equities and bonds. In Figure A1.3 below, the probability distribution functions for a one-year holding period are plotted. Damages can be estimated by looking at the area below the equity probability distribution function to the left of the mean of the returns to bonds. This approach is effectively comparable to that of the FOS, which, when finding in favour of a consumer, seeks to return the consumer to the position they would have been in if they had not purchased the inappropriate product.

[60] See, for example, Holt, C.A. and Laury, S.K. (2002), 'Risk aversion and incentive effects', *American Economic Review*, **92**:5, 1133–65.

Figure A1.3 Equity and bond probability distribution functions, one-year holding period



Source: Oxera calculations

By identifying the area under these curves that corresponds to outcomes in which investors in equities are worse off than those in bonds, it is possible to estimate the potential damage caused by purchasing the less suitable product (in this example, equities). The area **A** represents the total damage to customers who are unambiguously worse off from being sold the wrong product, while the area **A** plus **B** calculates the damage of being sold the wrong product compared with the average return from the more suitable product (ie, making an assumption that the more suitable product is risk-free at its average return). Using the average incremental cost of the suitability letter (discussed in section 3), it is then possible to compare the damage of an average investment in equities (where bonds should have been sold) in relation to the incremental cost of producing a suitability letter. This comparison is reported in Tables A1.1 and A1.2 for a single investment of around £19,0000, based on the damage calculated for areas A plus B, and A only (and in more detail for other pairs of products examined in section 3.2).

Table A1.1 Bonds versus equity estimate of damage (incremental cost of letter is £30): required proportion of 'mis-sold' contracts that need to be prevented by the suitability letter requirement

		Length of investment (years)		
	Investment	1	5	10
Bond versus equity (area A + B)	£18,811	2.7%	2.2%	5.7%
Bond versus equity (area A only)	£18,811	4.7%	5.5%	54.9%

Note: Sales data is taken from ABI statistics for 2005. Bond and equity returns are in real terms, based on data from 1987 to 2006. The bond versus equity calculation uses as the starting investment the average sale of products in the ABI statistics as the investment in equities.
Source: ABI statistics, Datastream, Deloitte (2006), Real Assurance (2006), and Oxera analysis.

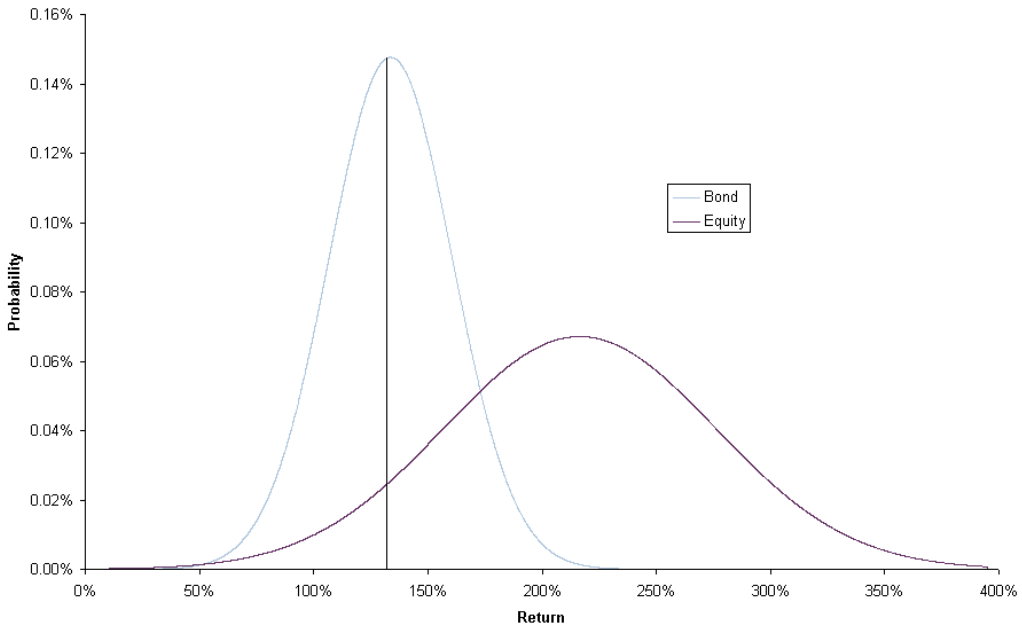
Table A1.2 Bonds versus equity estimate of damage (incremental cost of letter is £50): required proportion of 'mis-sold' contracts that need to be prevented by the suitability letter requirement

		Length of investment (years)		
	Investment	1	5	10
Bond versus equity (area A + B)	£18,811	4.5%	3.6%	9.5%
Bond versus equity (area A only)	£18,811	7.8%	9.2%	91.5%

Note: See note to Table A1.1.
Source: ABI statistics, Datastream, Deloitte (2006), Real Assurance (2006), and Oxera analysis.

The one-year damage measured in this way is the damage for that one year. Holding the wrong product for longer increases the damage, but this increase in damage is potentially offset by the widening monetary value of the average returns and the relative movement of the probability distribution of the two products. Figure A1.4 sets out the results after ten years, when the widening of the movement in the relative probability distribution dominates. There are very few customers who are now worse off as a result of being sold the less suitable product (particularly if the damage is measured by area **A**), so the total damage caused is now lower than for the one-year holding period. As a result, all other things being equal, for investments held over longer time periods, the effectiveness of the suitability letter requirement in reducing mis-sold products has to increase. (In addition, in assessing the impact of long holding periods, an evaluation of the probability of the consumer having to liquidate their investments before the predicted time should be taken into account. This complexity has been ignored in this methodology.)

Figure A1.4 Equity and bond probability distribution functions, ten-year holding period



Source: Oxera calculations

The precise relationship between the risk–reward profiles of the two products will determine whether the increase in damage from holding the wrong product for longer is more than countered by the change in relationship between the two probability distribution functions.

The size of the investment also has an impact on the quantity of damage in any time period. If, as is likely, the cost of the suitability letter does not vary significantly with the absolute size of the investment made, the smaller the investment, the higher the number of more suitable products that must be sold if the cost of the suitability letter is to be outweighed by the benefits.

The main disadvantages of this approach is that it:

– attaches a utility value of zero to the additional returns made by investors who were sold the wrong product, but who, in the event, turned out to be better off;

– applies no additional weight to very bad outcomes, over and above the nominal monetary difference between the two outcomes, and consumers may also place a negative value just on the additional uncertainty of the outcome through time, which would also not be captured.

As a result, compared with the utility function approach, this method overestimates the damage caused by purchasing the wrong product from the impact of the first problem, but underestimates the damage as a result of the second.

Even if the lower of the two values is taken (area A only), there is no guarantee that these two effects cancel each other out. When area A is a large proportion of the total outcomes, the impact of failing to overweight negative consequences will tend to be significant; however, when A is small in area, the impact of failing to assign any value to upside gains will tend to dominate. This method will, for example, assign a cost to the risky product for a risk-averse consumer even if the probability is that only 1% of consumers are £5 worse off compared with the other product, while all other consumers are, on average, say, £10 better off. For a utility function to approximate the same result, it would need to assign a weighting of 198 to the downside risk, with a weighting of 1 to the upside benefit.

Using the example above, a consumer who valued the possible additional losses from an equity holding at, on average, four times or more the possible additional gains would prefer bonds over equities for the five-year holding period when using the lower of the two estimates of damage. However, if their average valuation of the losses were less than four times the possible gains, their preferred product would be equities.

Another approach to identifying the possible impact on market outcomes required for the benefits of the suitability letter to equal the costs is to compare the costs of the suitability letter to average compensation awards. While the FOS does not record the compensation awards that firms have been required to pay to consumers, FSA Enforcement decisions have, previously, indicated the level of the compensation awarded in a number of cases. These cases are set out in Table A1.3.

Table A1.3 Compensation paid in FSA enforcement cases

Firm	Case description	Compensation (page source)	Number of customers compensated (average compensation)
Bradford & Bingley	Sale of Structured Capital at Risk Products and With-Profit Bonds. Advice was unsuitable, while there were also inadequate records of sales and system of controls	c. £6m (p. 1)	6,800 (£882 average compensation award)
Royal Liver Assurance	Sale of with-profit endowment policies to older customers	£474,000 in premiums, plus interest of £63,000 (p. 9)	467 (£1,015 average compensation award)

Firm	Case description	Compensation (page source)	Number of customers compensated (average compensation)
Lloyds TSB	Sale of Extra Income and Growth Plans, with insufficient explanation given to clients to maintain a balanced portfolio and liquid resources	£98m (p. 3)	22,500 (44% of the total number of policies sold, £4,356 average compensation award)
Capita Trust Company	SCARPS sold to clients who should not have bought such a risky product, especially those in retirement or redundancy	c. £3.5m (p. 4)	500 (£7,000 average compensation award)
Lincoln Assurance	Unsuitable sales of ten-year savings plans instead of more suitable products such as ISAs	£8.8m	5,192 (£1,695)
Abbey Life	Unsuitable sales of mortgage endowments	Estimated at £90–£165m	c.44,000 (£2,045–£3,750 average compensation award)

Source: FSA Final Notices.

It is possible to compare the average compensation award across these cases (which is around £2,832 on a simple average basis). However, while it is possible to estimate total compensation paid on this basis, and then compare that to total market sales, this only provides an indication of the extent of possible 'mis-selling' with the requirement in place, not the extent to which mis-selling or damage would be avoided.

A1.3 Quantification limitations—general

Within the confines of this research, it has not been possible to generate a robust practical methodology for quantifying the damage to consumers. In particular, it has not been possible to find an empirically tested utility function that seems to capture the valuations that consumers would apply to the different risk–reward profiles that flow from different long-term investment and savings products. A utility function of this sort would appear to be key to being able to quantify the benefits to consumers of any regulation that has as its objective an improvement in the fit between investors' wants or needs and the product(s) they purchase. Being able to quantify this benefit would also appear to be a necessary (but not necessarily sufficient) condition for being able to carry out a robust cost–benefit analysis of these types of regulation. This would appear to be a fruitful line of further research: either to locate any practical and empirically based utility functions that do cover the type of risk–reward profiles required for this type of analysis; or to carry out primary research to establish such utility functions directly from investors and potential investors.

A2 Quantification methodology: transaction costs and regulation cost savings

A2.1 Mechanisms by which cost savings may exist

The FSA uses the suitability letter produced by firms for packaged products as part of the supervision of firms and more general thematic analysis of the retail financial sector, as well as during investigations when firms break the FSA's rules or the provisions under the Financial Services and Markets Act 2000.

If the suitability letter requirement did not exist, and if firms that currently produced the letter stopped doing so, or produced letters of poorer quality, the cost of supervision and enforcement may increase if the objective is to ensure that the same quality of supervision and enforcement is maintained. This is because, while it may still be possible to obtain similar information to that recorded in the suitability letter (eg, via speaking to advisers and firms' customers), the cost of doing so may be higher and may be less reliable.

If the actual requirement to produce a suitability letter were removed, and if the same number of firms continued to produce a letter of similar quality, there would be no cost savings to the FSA.

There may be cost savings to the FOS and consumers if the presence of a suitability letter leads to a reduction in the number of (unjustifiable) complaints and/or reduces the cost per case examined by the FOS, or the cost to consumers of making complaints.

A2.2 Quantification of cost savings: to the FSA and FOS

The approach to quantifying the cost savings associated with the suitability letter can be summarised in a series of steps.

– What are the total costs of the FSA division concerned or the FOS?
– What proportion of total costs relates to activities that are affected by whether the suitability letter is present?
– For these activities, by how much would the time spent (and therefore the labour costs) on activities that are affected by the presence or otherwise of the suitability letter increase if no suitability letter were in place, assuming that there is an objective to maintain the same quality of supervision or other activity.

Estimates of cost savings in the counterfactual scenario of no suitability letter requirement should seek to estimate the increase in costs that would need to be incurred to ensure that the same quality of supervision or other regulatory activity is maintained. If this is not the case, less effective supervision or other regulatory activity could result in additional costs—for example, in terms of more instances of products being 'mis-sold' or complaints taking longer to process. Therefore, estimating the additional cost required to maintain the same quality of supervision is the most direct of way of estimating cost savings from this mechanism.

Oxera asked, via a data request, for the above information and data from the FSA's Small Firm Division, Retail Firms Division, Major Retail Groups Division, Enforcement Division and the FOS.

Only the Small Firm Division and Enforcement were able to estimate the proportion of costs where the suitability letter was relevant and the extent to which time spent, and therefore costs, would increase without a suitability letter. This does not mean that the absence of a suitability letter would not increase the costs of Major Retail Groups Division, the Retail Firms Division or the FOS, but rather that they were not able to estimate by how much these costs would increase, although they were able to provide qualitative guidance (reported below) which have been used in the assumptions.

– The **Small Firm Division** indicated that having suitability letters in place reduces the amount of time it would need to spend in discussions with advisers and that, without the letter, the amount of time required to give feedback to senior management on failures in the advice process would also increase. (The SFD approach to visits does not follow the ARROW risk assessment visit route, in that the SFD follows either a thematic or crystallised risk approach to visits and does not undertake risk assessments per se.)

– The **Retail Firms Division** does not, in general, look at suitability letters as part of a normal ARROW visit, but only assesses them when it has cause for concern, is considering specific supervisory tools, or is recommending that the Enforcement Division review a firm.

– The **Major Retail Groups Division** was able to confirm that if firms stopped producing the suitability letter, file reviewing and determining whether an advised sale was suitable would be significantly more difficult and time-consuming.

– The **Enforcement Division** was able to provide indicative estimates of how much the absence of a suitability letter could add to the time needed to investigate an 'average' case, while noting that there are in practice few average cases. Furthermore, these estimates do not include the additional time that may be required to reach an outcome in a case. (For example, if the absence of a suitability letter led to evidential weaknesses in the FSA's case, there might be a risk that cases would be less likely to settle.) The estimated cost savings for FSA Enforcement are based on a 'hypothetical' case where a sample of 100 customer files, which may involve 20–30 different advisers, is reviewed. Clearly, not all cases reviewed by FSA Enforcement will correspond to this hypothetical case, but no adjustment for this has been made, as no specific guidance on how typical these cases might be has been provided. Therefore, this factor should be borne in mind when evaluating the estimated cost savings.[61]

– The **FOS** indicated that the majority of investment business complaints involve suitability, so potentially a high proportion of its costs are relevant to this quantification.[62] The FOS was not, however, able to estimate by how much costs would increase if the suitability letter were not produced, but did indicate that it was likely that both the cost per case and the total number of cases would increase if firms stopped producing the suitability letter.

Therefore, the cost saving estimates reported in Table A2.1 below may be an underestimate of the total cost savings that could arise, and are themselves highly uncertain. Total cost savings (using averages where a range for the data was provided), assuming that no firms produced a suitability letter, amount to £3.1m (with a range of £1.9m–£4.2m) for the Small Firm Division and the Enforcement Division.

[61] In the hypothetical example the FSA estimated that the absence of the suitability letters would add between 60 and 150 hours to the work. The average case takes around 550 hours. Assuming that the hypothetical case is reasonably typical, the increase in time taken to complete a case in the absence of suitability letters is in the order of 11–27%

[62] In the year to March 31st 2005, the FOS dealt with 110,963 new complaint cases, of which 69,737 related to mortgage endowment and 19,251 were other investment-related. Total FOS expenditure (including financing charges and depreciation) for the same period was £45.8m. Source: FOS (2005), 'Annual Review: Report and Financial Statements', June.

Table A2.1 Estimated cost savings assuming no letter produced, 2005/06 (£m)

	Total costs (£m)	Share of costs where suitability letter affects work (%)	Increase in time spent for these activities (%)	Estimated increase in cost (£m)
Small Firm Division	10.5	10	33	0.35
Enforcement Division	14.2	100	11–27	1.6–3.9

Note: Enforcement Division costs refer to internal costs.
Source: FSA and Oxera calculations.

However, some firms would continue to produce a suitability letter. This means that the suitability letter does not result in incremental costs for these firms. Previous research for the FSA indicates that a range for the share of the costs of the suitability letter that are incremental could be as wide as 0 to 100%. Average incremental costs (not weighted by sales) have been reported at 30%, while the same study suggested that five of the 32 firms (or approximately 16%) sampled would stop producing a suitability letter (or could have an incremental cost for the suitability letter of 100%).[63]

Table A2.2 therefore reports the average cost saving under different assumptions regarding the extent to which firms stop producing a suitability letter.

Table A2.2 Estimated cost savings, 2005/06 (£m)

Counterfactual	Estimated cost saving	Estimated cost saving range
100% of firms stop producing a suitability letter	3.1	1.9–4.2
16%[1] of firms stop producing a letter	0.5	0.3–0.7
30% of firms stop producing a letter	0.9	0.6–1.3
All firms that currently produce the suitability letter continue to do so	0.0	0.0

Note: [1] This refers to the five of the 32 firms sampled who would stop producing a suitability letter according to the sample in Deloitte's Cost of Regulation Study.
Source: FSA and Oxera calculations.

[63] The Cost of Regulation Study indicated that for five of the 32 firms sampled, the cost of the suitability letter was wholly incremental (p. 52). Another study for the FSA suggested that, for the large firms sampled, the incremental cost of producing the suitability letter was negligible (Real Assurance 2006, p. 8).

A3 Break-even tables with the cost of the suitability letter requirement being met only from the changes in the product chosen

The following tables are similar to those in section 3, but are set up with the cost to be recovered from the more suitable product at £30 and £50, reflecting the estimates for the full incremental cost of the suitability letter requirement.

Table A3.1 Frequency with which a transaction with a less suitable product would need to be stopped by the suitability letter requirement for the benefits to outweigh the costs of a suitability letter (average cost of £30)

	Commission rate difference (percentage points)				
Investment (£)	0.25	0.5	0.75	1	2
500	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
1,000	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
5,000	More than every transaction	More than every transaction	80%	60%	30%
10,000	More than every transaction	60%	40%	30%	15%
50,000	24%	12%	8%	6%	3%

Source: Oxera calculations.

Table A3.2 Frequency with which a transaction with a less suitable product would need to be stopped by the suitability letter requirement for the benefits to outweigh the costs of a suitability letter (average cost of £50)

	Commission rate difference (percentage points)				
Investment (£)	0.25	0.5	0.75	1	2
500	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
1,000	More than every transaction	More than every transaction	More than every transaction	More than every transaction	More than every transaction
5,000	More than every transaction	More than every transaction	More than every transaction	100%	50%
10,000	More than every transaction	100%	67%	50%	25%
50,000	40%	20%	13%	10%	5%

Source: Oxera calculations.

Table A3.3 Frequency with which transactions resulting in a less suitable product would need to be stopped: difference in management fee 0.5% and cost of letter £30

Annual investment	10-year	20-year
500	29%	7%
1,000	15%	4%
5,000	3%	1%
10,000	1%	0.4%

Source: Oxera calculations.

Table A3.4 Frequency with which transactions resulting in a less suitable product would need to be stopped: difference in management fee 0.5% and cost of letter £50

Annual investment	10-year	20-year
500	49%	12%
1,000	24%	6%
5,000	5%	1%
10,000	2%	0.6%

Source: Oxera calculations.

Table A3.5 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage at investment and cost of letter £30

Investment amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	27%	15%	33%
1,000	14%	8%	17%
5,000	3%	2%	3%
10,000	1%	1%	2%
50,000	0.3%	0.2%	0.3%

Source: Oxera calculations.

Table A3.6 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage at investment and cost of letter £50

Investment amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	45%	25%	56%
1,000	23%	13%	28%
5,000	5%	3%	6%
10,000	2%	1%	3%
50,000	0.5%	0.3%	0.6%

Source: Oxera calculations.

Table A3.7 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage on (savings) income generated and cost of letter £30

	10-year investment			20-year investment		
Invested amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	56%	28%	56%	34%	17%	34%
1,000	28%	14%	28%	17%	9%	17%
5,000	6%	3%	6%	3%	2%	3%
10,000	3%	1%	3%	2%	0.9%	2%
50,000	0.6%	0.3%	0.6%	0.3%	0.2%	0.3%

Source: Oxera calculations.

Table A3.8 Frequency with which transactions resulting in a less suitable product would need to be stopped: failure to benefit from a tax advantage on (savings) income generated and cost of letter £50

	10-year investment			20-year investment		
Invested amount	No tax and standard rate	No tax and higher rate	Standard rate and higher rate	No tax and standard rate	No tax and higher rate	Standard rate and higher rate
500	93%	46%	93%	57%	29%	57%
1,000	46%	23%	46%	29%	14%	29%
5,000	9%	5%	9%	6%	3%	6%
10,000	5%	2%	5%	3%	1.4%	3%
50,000	0.9%	0.5%	0.9%	0.6%	0.3%	0.6%

Source: Oxera calculations.

Table A3.9 Summary of benefits calculations for products with different risk–reward profiles, cost of suitability letter £30: required number of 'mis-sold' contracts avoided

		Length of investment (years)		
	Investment (£)	1	5	10
Reducing debt versus equity ISA	4,088	14%	17%	More than every transaction
Cash ISA versus equity ISA	4,088	19%	48%	More than every transaction
Unit trust versus investment bond	47,485	6%	See note	See note
Bond versus equity	18,811	3%	2%	6%

Note: Sales data is taken from ABI statistics for 2005. The cost of debt is assumed to be 6% real. Bond and equity returns are in real terms, based on data from 1987 to 2006. The real return on the cash ISA is assumed to be 2.5%, and the annual management charge on the equity ISA is assumed to be 1%, in line with industry guidance. Assumptions used for the unit trust/investment bond comparison are based on industry guidance. The tax benefit of investment bonds is 1%; the bid–offer spread on unit trusts of 3%, and the exit charge on investment bonds is 5% initially, declining to zero after five years. Unit trust and investment bonds are analysed for a one-year investment horizon because, after five years, the exit charge on investment bonds is zero, and therefore investment bonds will be the more suitable 'wrapper' as they have lower charges (net of the tax benefit). The bond versus equity calculation uses the average sale of products in the ABI statistics as the investment in equities.
Source: ABI statistics, Datastream, Deloitte (2006), Real Assurance (2006), and Oxera analysis.

Table A3.10 Summary of benefits calculations for products with different risk/reward profiles, cost of suitability letter £50: required number of 'mis-sold' contracts avoided

		Length of investment (years)		
	Investment (£)	1	5	10
Reducing debt versus equity ISA	4,088	24%	29%	More than every transaction
Cash ISA versus equity ISA	4,088	31%	80%	More than every transaction
Unit trust versus investment bond	47,485	10%	See note	See note
Bond versus equity	18,811	5%	4%	10%

Note: See Table A3.9 above.
Source: ABI statistics, Datastream, Deloitte (2006), Real Assurance (2006), and Oxera analysis.

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