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Agenda

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Buying investment products from 2012: the impact of the Retail Distribution Review

The UK Financial Services Authority's Retail Distribution Review (RDR) proposes to improve from 2012 outcomes for retail consumers of financial investment products. Drawing on insights from a recent industry survey, how is the RDR likely to affect market structure, and how will consumers respond to the proposals?

The Financial Services Authority (FSA) has a long-standing concern about how investment products are distributed to retail consumers. To improve outcomes for consumers, its Retail Distribution Review (RDR) proposals seek to:[1]

- increase clarity for consumers by requiring firms to explain whether their services are 'independent' or 'restricted'. If a financial advisory firm is not able to conduct a comprehensive and unbiased review of relevant products on the market, it cannot call itself 'independent' and would be classified as 'restricted';
- remove provider influence over adviser remuneration by requiring advisers to set their own charges for advice. Advisory firms will have to disclose separately the costs of advisory services, and distinguish these from the underlying product costs;
- improve advisers' professional standards;
- introduce new prudential capital requirements for personal investment firms.

A previous *Agenda* article looked at the reasons behind these changes, focusing on arguably the most significant change: to replace all forms of payment from the product provider to the adviser with a system in which consumers pay the adviser directly for the advice they receive.[2] As a result, consumers would be faced with a clear distinction between the wholesale price of a product (the 'factory gate price', or FGP) and the price of the advice that they receive. The main aim is to eliminate provider and product bias whereby advisers recommend a provider or product that may deliver the highest commission rates to them, but that may not be the most appropriate solution to a customer's particular needs.

Drawing on insights from a recent industry survey commissioned by the FSA of more than 1,000 financial advisory firms, this article assesses the impact that the new regime is likely to have on market structure, and how consumers may respond to the proposals.[3] For example, survey responses have cited concern about firms being induced to exit the industry as a result of the new regime, and consumers being unable to afford to pay for the advice that advisory firms offer post-RDR. The RDR proposals have now been translated into rules, and the new regime will be implemented by the end of 2012.

Impact on market structure

Regarding market structure, it is particularly relevant to assess how the new regime influences:

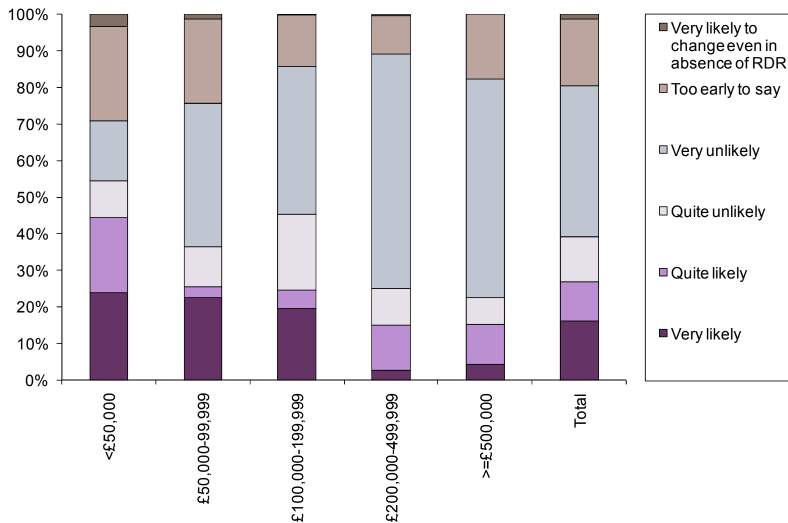
- the likelihood of financial advisory firms leaving the industry and how this could affect market capacity;
- the impact on the value chain in the distribution of retail financial products.

The main prospective drivers for exit have been identified in survey evidence and interviews as:

- **the improvement in professional standards**—the obligation for financial advisers to increase their qualifications has been argued to be a cumbersome and costly exercise;
- **the change in adviser charging**—for a large number of advisory firms, commissions are the main source of revenues which, depending on the type of

This article is based on the Oxera report 'Retail Distribution Review Proposals: Impact on Market Structure and Competition', prepared for the Financial Services Authority, March 2010. Available at http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf.

Figure 1 Likelihood of exit, by firm revenue



Source: Oxera (2010), 'Retail Distribution Review Proposals: Impact on Market Structure and Competition', prepared for the Financial Services Authority, March, slide 7.

clients they have could make the transition to a fee-based structure challenging.

There has been considerable variation in estimates of the likelihood of exit due to the RDR proposals. For example, a report published in February 2009 suggested that the combined effect of the proposals would be to reduce the number of IFA (independent financial adviser) firms by 35–40% by 2013,[4] while a survey also in 2009 suggested a smaller number of firms exiting, with only 4% of all directly authorised firms stating that they would consider leaving the market.[5]

The new survey evidence analysed by Oxera suggests that the reduction in the number of advisory firms is unlikely to be more than around 23%[6] when the RDR proposals come into effect at the end of 2012.[7] The likelihood of exit is greater for smaller firms, one of the reasons being that their advisers may already be close to retiring, thus making the investment in raising professional standards or introducing a new remuneration model not worthwhile. So, for example, 46% of firms with revenues amounting to less than £50,000 reported that they are 'very' or 'quite' likely to close or sell their main advisory capability (see Figure 1). Similarly, IFAs and other advisory firms employing a relatively small number of advisers are more likely to exit than those with more advisers.

While much of the debate has centred on the proportion of firms that will be exiting as a result of the proposals, the finding on how the reduction in firms translates into a reduction in market capacity is also important. The impact is not one-for-one; instead, although 23% of firms are planning to exit the market due to the RDR proposals, because smaller firms are more likely to do so than larger firms, this translates into only an 11% reduction in advisers, a 9% reduction in industry revenues, and an 11% reduction in the number of clients advised. In sum, although the exact impact remains uncertain, based on firms' current views on how they would respond to the proposals, a large number of advisory firms and advisers intend to stay in the market. In addition, as long as entry barriers are not prohibitive, in the longer term, new entry and expansion by existing players may fill any gap created in the market for advice. Although the impact on capacity is not insignificant, it is unlikely to affect the competitive dynamics in the market.

How will the value chain and sales channel be affected?

It is expected that there will be some changes to the value chain and sales channel for retail financial products in response to the RDR proposals. This includes the possibility that firms will change their advisory status, or that larger, integrated advisory firms will gain more market share.

In particular, it has been suggested that some firms may move from an 'independent' to a 'restricted' model due to the costs that would be incurred in meeting the independence requirement (ie, ensuring that all product providers in the market are considered when making recommendations). This has been borne out by survey evidence—of the 15% of advisory firms that stated that they are 'likely' or 'very likely' to change status in response to the RDR, 80% indicated that they will offer restricted advice post-RDR. This may imply a narrower range of investment products which those retail consumers using restricted advice can access through their financial advisers, compared with those using independent advice after 2012.

It has also been suggested that larger, integrated advisory firms may gain a greater share of the market. As discussed, the survey results show that larger firms are less likely to exit, in part because they face a smaller cost increase (relative to their revenues per adviser). So, larger, integrated advisory firms—such as high street banks, which offer their own retail investment products—may benefit from economies of scale.

In terms of the wider impact of the RDR proposals, if they induce advisers to shift their focus away from retail investment products, this may have a knock-on effect on the market for advice regarding other financial products. Advisory firms have claimed that they will reduce their provision of advice on retail investment products due to a shortage of qualified advisers and the increased cost of providing advice with higher professional standards, and because advisers anticipate a reduction in consumer demand due to the new adviser remuneration model. Specifically, around 60% of advisers surveyed commented that they will seek to increase revenues from retail mortgages and retail protection products to compensate for any decrease in revenues from advice on retail investment products.

Finally, the survey suggests that platforms are likely to become more important in the market post-RDR. Platforms are services used by intermediaries (and sometimes directly by consumers) to view and administer investment portfolios.[8] They allow advisers and consumers to manage portfolios of investments online, and also allow product providers and advisers to outsource certain administrative duties.

Around 47% of advisers would increase the use of platforms post-RDR, and 37% of providers indicated that the share of products distributed through platforms would increase. The FSA has recently published a discussion paper about platforms in which it explores whether specific further regulation of platforms would be desirable.[9]

How will retail consumers respond to the proposals?

There are implications for consumer choice if, as discussed above:

- consumers find that smaller advisory firms have exited the market because of the relatively high costs they face in raising professional standards and operating the new adviser remuneration model;
- there is likely to be a move towards consumers seeking advice from larger, integrated firms such as their high street banks;
- financial advisers increasingly adopt a restricted status, implying a more limited range of products offered to the consumer (compared with consumers using independent advice after 2012). Survey evidence suggests that 41% of firms that expect to change status under the new regime are planning to adopt a restricted status with a reduction in their present scope of advice, while 39% are planning to become restricted but to maintain their present scope of advice. This implies that around half of the advisers who adopt a restricted status in the new regime will offer advice with a more limited scope and range of products than at present.

Some further effects on retail consumers are discussed below, relating to consumer willingness to pay; the impact on the demand for financial products; and the potential move to execution-only channels.

Are consumers willing to pay?

One of the major concerns about the RDR proposals has been that consumers are unlikely to be willing to pay for financial advice. Consumers are currently paying for advice, but only indirectly via the commissions that are recovered through the prices that they pay for the products. Many may not appreciate that this is the case, and may see the advice as being provided free of charge.

Regarding consumers' low willingness to pay, 46% of advisers surveyed believe that clients would be prepared to pay less than the hourly fee that they effectively currently pay through commissions (while the others think that their clients would be willing to pay the same or more). In fact, survey evidence suggests that 19% of advisers anticipate that the level of up-front hourly fees which their clients would be willing to pay under the new regime would be zero.

If consumers are unwilling to pay for financial advice (or unwilling to pay the fees that an adviser would require to cover costs), it is argued that it will be difficult for firms to adopt an 'adviser charging model'. The evidence suggests, however, that many advisory firms consider that they will be able to make the change to operating their own charging tariffs; 18% of advisory firms stated that they already operate such an adviser charging model, while 44% of firms anticipate that they will be able to move to such a model. Furthermore, provider facilitation of payments is likely to smooth the transition to advisers operating their own charging tariffs; nearly 70% of life insurance companies and 25% of investment managers stated that they are 'very' or 'quite' likely to collect adviser charges from consumers (when collecting product charges), and to pass these on to the advisers. Furthermore, as discussed, platforms are likely to play a role here as well.

Implications for the demand for financial products

So what will happen to those clients identified by advisers as unwilling to pay for financial advice? Around 40% of advisers surveyed feel that such clients would not make a purchase at all, while 30% suggest that clients would make an 'unadvised' purchase. This unwillingness to pay for advice therefore has implications for the demand for financial products, and the use of execution-only sales channels.

- A small majority of advisers do not expect a reduction in the demand for financial products—56% suggested that clients will spend the same as before on such products.

- Since 30% of advisers expect clients to resort to unadvised purchases, it appears that the RDR proposals may increase the use of the execution-only channel. However, the order of magnitude of the impact is not altogether clear. The survey indicates that 12% of providers feel that the share of the execution-only channel will increase a little (5–20%), and that 9% consider that it would increase significantly (more than 20%). On the other hand, most of the advisory firms surveyed did not have plans themselves to provide a route for clients to access products without advice—only 15% claimed that they would provide a route for unadvised sales.

A simplified advice or sales regime?

The reform of the retail distribution market in the UK has fundamental implications for how retail consumers receive financial advice and access investment products. The RDR proposals are likely to achieve the intended improvement in the quality of financial advice, but could increase the cost of advice and may exclude some consumers from the market.

It is therefore not surprising that the industry has asked for the introduction of a simplified advice regime to make the sales and advice less costly for those consumers who may have more straightforward needs. What does this mean for consumers buying retail investment products from 2012? While the RDR has reduced the likelihood of a consumer being sold an inappropriate product by raising advisers' professional standards and reforming adviser remuneration, it is likely to drive some consumers to non-advised or simplified advice channels. There is still a possibility that they will buy inappropriate products within these channels. Hence, the debate about the optimal distribution of retail financial services continues.

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[1] Financial Services Authority (2009), 'Distribution of Retail Investments: Delivering the RDR', June.
[2] Oxera (2009), 'Reform of Retail Financial Services: The End of Commission Payments?', *Agenda*, August. Available at www.oxera.com.
[3] Findings reported in Oxera (2010), 'Retail Distribution Review Proposals: Impact on Market Structure and Competition', prepared for the FSA, March. Oxera's findings are based on a survey of retail investment firms to which over 1,040 responses were received for advisory firms, and just under 60 responses from providers. The results were weighted by the size of the firm and the status of advisers.
[4] Ernst & Young (2009), 'In Shifting Sands: UK Life and Pensions Outlook', February.
[5] Deloitte (2009), 'Firm Behaviour & Incremental Costs', research for the FSA, May 14th.
[6] This estimate is based on the finding that 25% of advisory firms have reported that they are likely to exit the market, of which 7.5% indicated that they would do so even if the RDR did not go ahead—especially smaller firms with between one and 19 advisers. This means that around 23% of advisory firms would exit the market because of the RDR proposals.
[7] Financial Services Authority (2010), 'Distribution of Retail Investments: Delivering the RDR—Feedback to CP09/18 and Final Rules', March.
[8] These include wraps and fund supermarkets. For a definition and further explanation, see Financial Services Authority (2007), 'Platforms: The Role of Wraps and Fund Supermarkets', Discussion Paper 07/2, June.
[9] Financial Services Authority (2010), 'Platforms: Delivering the RDR and Other Issues for Discussion', Discussion Paper 10/2, March.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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