Oxera

Retail Distribution Review proposals:

Impact on market structure and competition

Prepared for the Financial Services Authority

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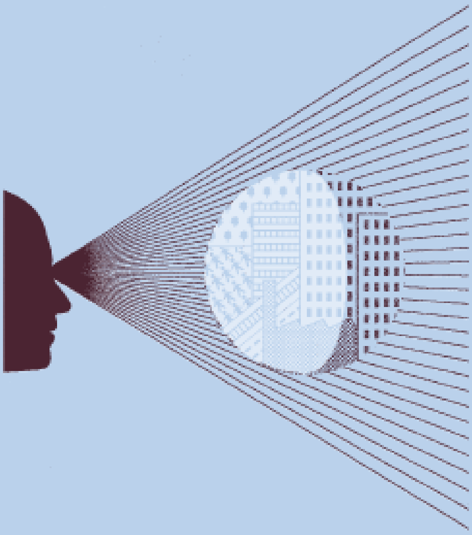

Executive summary

The current state of the market

The structure of the market for retail investment products in the UK is characterised at the provider level by large numbers of providers and advisers, and a number of different types of distribution channel. There is little evidence of prohibitive barriers to entry in either the market for products or the market for advice. There is some evidence of vertical integration, with some providers, particularly life assurance companies, acquiring interests in adviser firms.

In terms of the current level of competition between providers, the research reviewed in this report suggests that a significant proportion of this competition is aimed at persuading advisers to recommend a particular provider's products, rather than marketing the efficacy of products to consumers directly. When providers compete with each other directly, this tends to be on the basis of factors such as past performance, reputation and price. At the distribution level, there is a perception that competition between advisers may be limited, as most consumers do not appear to shop around for advice. Any competition that does exist appears to be based on quality of service and access to products, rather than price. Commission bias has been identified as a feature of the market, although to what extent there is actual bias across all product groups is unclear.

This research reviewed in this report also suggests that asymmetric information distorts competition in the market for financial products, making it difficult for consumers to choose an appropriate product. There is a lack of transparency about product charges, with rebating and discounting of stated charges being commonplace. Once products have been purchased, there is limited evidence of switching if performance is not satisfactory.

With regard to the evolution of the market, it is noted that significant technological developments have taken place in recent years, mainly around the development of the platforms. These have given advisers the opportunity to offer consumers a more holistic service, involving more efficient portfolio management services. In addition, platforms aimed directly at consumers provide easy access to a wide range of products and enable individual portfolio management. However, aside from the potential benefits of platforms, the Financial Services Authority (FSA) has identified concerns around their charging structures, in particular relating to their complexity and lack of transparency.

Changes to the rules as a result of the Retail Distribution Review package

This report assesses the impact on market structure and competition of the following changes proposed by the Retail Distribution Review (RDR) package.

– *Remuneration of advisers*—under the new regime, advisers will be required to set their own charges for advice, and product provider influence over adviser remuneration will be removed as far as possible. Both independent and non-independent advisory firms will have to disclose, separately, the costs of advisory services, and differentiate these from the underlying product costs.

– *Independence requirements*—as set out in the FSA's December 2008 Feedback Statement, the current notion of 'whole of market' advice will be replaced with independence requirements, part of which is a requirement for advisers to consider products in the 'relevant market'. The RDR recognises the importance of independent financial advisers (IFAs) being able to review, comprehensively and independently, the 'relevant market' in order that their advice can be considered independent. The independent advice needs to be based on an analysis that is comprehensive and fair relative to what the client requires.

– *Professional standards*—to provide a common framework for professional standards across all advice channels, the FSA will establish an advisory Professional Standards Board, with a view to consulting on whether it should become independent, with a similar remit to that of standards boards in other professions. There will be a benchmark qualification of at least QCF[1] Level 4 for all investment advisers in both the independent and non-independent sectors.

– *Capital requirements*—a consistent set of capital requirements will be established for all personal investment firms. The overall minimum capital requirement will be raised from £10,000 to £20,000, and the Expenditure Based Requirement will be extended to all firms, based on three months of annual fixed expenditure. Furthermore, firms will be required to hold additional capital, based on a sliding scale, as a provision against potential liability for any activities excluded by their professional indemnity insurance policies.[2]

Impact on market structure

The available evidence suggests that some smaller firms will exit the market as a result of the increased capital requirements; others may choose to join networks or large IFA firms. On the other hand, over half of IFA firms already hold sufficient capital to meet the new rules and some others will be required to raise only a small additional amount. While barriers to entry are currently low, the increased capital requirements will raise the barriers to new entrants, although Oxera has seen no evidence on whether this will have a material impact on potential entrants' decisions. Overall, there is no evidence to suggest that, on their own, the revisions to the capital adequacy requirements will lead to a significant change in the market structure.

The proposal in the RDR to raise professional standards is considered a potential driver of changes to market structure, the main concern being that some advisers—in particular older ones—would choose to leave the market by retiring early, rather than studying to attain QCF Level 4. The survey evidence shows that over 10% of advisers would retire earlier than planned or would otherwise leave the industry. However, the FSA is likely to introduce alternative assessments, which may be more in line with the preferences of experienced advisers for obtaining the Level 4 qualification. Overall, the changes to professional standards are not expected to have a significant impact on market structure.

The new independence requirements are raised as another potential driver of changes to market structure, as they will increase the costs of those wishing to call themselves IFAs after implementation of the RDR proposals. Survey evidence and feedback from the Oxera interviews indicates that IFAs will face additional ongoing costs as a result of the new independence requirements, and that some IFAs may choose to specialise in certain product areas or to join networks in order to reduce these costs. However, the available evidence does not suggest that the new independence requirements will lead to a significant change in the market structure.

Another key element of the RDR package is the new remuneration structure. One issue is that the current cross-subsidies between large and small investors would be unwound,

[1] The QCA framework is now called QCF.

[2] These proposals are contained in FSA (2008), 'Review of prudential rules for personal investment firms', Consultation Paper CP08/20, November.

leading to some small clients facing charges for advice that would make the independent advice route unacceptably expensive, causing them to switch to other channels. The evidence from surveys and interviews suggests that this is more likely to be a long-term than a short-term issue since, initially at least, many advisers are expecting to be able to charge customers in a way that is very similar to the current structure and which would allow any cross-subsidy to remain. In the long term, the unwinding of cross-subsidies is a realistic possibility.

Another issue relating to adviser remuneration is the extent to which providers will continue to be able to influence the choice of adviser post-RDR when the providers are no longer able to vary commission payments. If this influence is significantly reduced, the question is whether providers will seek alternative routes to market, such as vertical integration. The evidence suggests that they will continue to try to influence advisers' decisions to some extent. In some cases, this will be in ways that also benefit consumers; in other cases, the benefits to advisers may be at the expense of product improvements that would benefit consumers.

Overall, the level of provider influence is likely to be reduced, which may, in theory, lead providers to consider other routes, such as vertical integration. However, this theory is not borne out by the survey evidence or the interviews carried out by Oxera.

Related to the issue of providers using alternative routes to market post-RDR, the report also considers whether the RDR package removes any obstacles to the use of particular distribution channels, such as vertical integration or execution-only sales. The report finds that there may be some marginal effect but that, overall, the main reasons for providers to use IFAs will still be present post-RDR, and so the structure of the market will not change significantly.

The report then considers the combined effect of the RDR proposals on market structure. Although the analysis suggests that no single element of the RDR package would lead to significant changes to market structure, consideration must also be given to the possibility that some combination of effects could lead to a significant change. A number of sources have estimated the likely reduction in the number of IFAs as a result of the RDR package as a whole. These consistently suggest that some IFAs will exit the market, but there is no clear consensus on how many. However, only one of the primary research sources suggests a drop of more than 20% in the number of either advisers or firms. Furthermore, all of these estimates were produced before the FSA's proposals for alternative assessments for advisers wishing to obtain QCF Level 4.

Overall, the report concludes that the post-RDR landscape is likely to feature fewer small independent IFAs, some of which will leave the market entirely, while others will join larger firms or networks in the independent or non-independent sectors. This may lead some consumers to experience reduced choice in the short term. However, if demand for advice outstrips supply, given that entry barriers are unlikely to be prohibitive (although higher as a result of RDR) new entry or expansion by existing players would fill the gap.

Impact on the nature of competition

In terms of the impact on competition across distribution channels, an increase in competition would require factory gate prices (FGPs) to become transparent across channels. The evidence on this is mixed, with some of those interviewed expecting multiple FGPs to be offered across different channels, and survey evidence indicating that some providers will offer multiple FGPs even within the adviser distribution channel. However, other providers expect to offer a single FGP to advisers.

Whether the FGP becomes a focal point for competition between channels will depend on whether, for example, networks and larger IFAs start to compete on FGPs and use them to attract clients. This could mean that FGPs become more transparent and could be used by consumers to compare products and prices within and across distribution channels, although this would require consumers to be proactive in this regard.

The report also considers the impact of the RDR package on competition within distribution channels. In particular, it examines mechanisms which might lead to higher or lower FGPs in the IFA channel. IFAs' incentives to impose pressure on providers to reduce FGPs will be weaker than their current incentive to negotiate high commissions (which result in competitive-derived FGPs at present). This is because, under the current regime higher commissions lead immediately to higher adviser incomes, while under the new regime, a lower FGP will not result directly in revenues to the IFAs (although to some extent they may benefit indirectly from negotiating lower FGPs if they manage to attract more customers and/or increase their sales and profits as a result of these lower FGPs).

Consumers could impose competitive pressure on providers (by shopping around for the best product), but are less able to do so than advisers because they tend to be less well informed. However, if the FGPs become a focal point of competition between advisers, or in the direct sales route, end-customers may reassert this competitive pressure.

In terms of validating this mechanism, the evidence for the RDR leading to higher FGPs was mixed, with survey evidence showing that larger providers were more like to expect higher profitability post-RDR than smaller ones.[3] Overall, while the report concludes that there is a risk of higher FGPs in the short term, in the longer term there are ways in which higher FGPs may be competed away, such as through increased transparency, leading to competition on wholesale prices via end-customer behaviour and through alternative ways (such as improving back-office support systems to advisers) that providers will compete to influence advisers' decisions.

Mechanisms which would lead to lower FGPs in the IFA channel post-RDR are also explored. These rely on price being an important driver of competition and the existence of a significant proportion of sophisticated customers whose shopping behaviour could reduce the FGPs both for themselves and for less sophisticated consumers. However, the available evidence suggests that price is not necessarily the main driver of competition. Furthermore, there is not sufficient evidence of a sizeable proportion of sophisticated consumers. Therefore it is not expected that, at least in the short term, fierce competition around FGPs would arise as a result of RDR.

In terms of the impact on competition in the market for advice, the report considers whether the introduction of explicit charging for advice would lead to price discrimination and excessive charges in some cases. Although it is difficult to draw firm conclusions about whether this is likely to happen, it is noted that price discrimination already occurs through commission rebating, although this is limited by the size of the commission.

In terms of product quality, providers may have incentives in the long term to raise the quality of products for consumers or to improve their back-office support systems to advisers, which may indirectly benefit consumers. To the extent that advisers maintain their gatekeeper role, it is expected that providers will compete to offer good service in terms of responsiveness and efficient handling of requests. Consumers will also benefit indirectly from this in terms of faster response times to their queries that are routed through advisers, and potentially also for customers paying by the hour, fewer hours billed by their advisers. If providers start competing more directly for consumers, they will also have incentives to improve the quality of their products, which would directly benefit consumers. It is difficult to assess which

[3] This result is based on a small sample. Furthermore, the evidence suggests that the increase in expected profitability is at least partly due to expectations of higher persistency rates.

competitive strategy is most likely to dominate—the competitive strategy is likely to vary by firm.

On product suitability, the incentive trade-off between commission payments and suitability will be removed by RDR. All else equal, this is expected to lead to an increase in the suitability of the products sold. This is beyond the scope of this study and has been assessed in more detail by the FSA.

A number of other potential impacts on competition are noted, including a potential bias by advisers towards products not covered by the RDR. Another potential source of bias could be that advisers will be less inclined to offer products that cannot include provider-facilitated payments to advisers. However, the FSA is currently looking at the potential for read-across of the RDR proposals to other sectors and developing its supervision strategy.

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1 Introduction

1.1 Objectives and remit

The Financial Services Authority (FSA) commissioned Oxera to assess the impact on market structure and competition of the proposals that emerged from the Retail Distribution Review (RDR).[4] This is to inform one element of the FSA's cost–benefit analysis (CBA) of the RDR proposals. The other elements of the CBA, such as the benefits to consumers, are outside the scope of the Oxera research and have been undertaken by the FSA and other external consultants.

Conducted during the period February–April 2009, the Oxera research looked at the following issues in particular, as requested by the FSA.

– *Vertical integration*—as a result of the new regime, providers may reconsider the advantages and disadvantages of the distribution channels and vertical integration (eg, using direct sales force to distribute products). Although vertical integration is a normal feature of many markets and not necessarily harmful, there is a concern that it could affect the viability of those market segments that are not vertically integrated, which could ultimately affect the way in which consumers gain access to products and advice about which product(s) to choose. Where there is vertical integration, it is unlikely that advice covering the whole market will be available within the sales process.

– *Competition in the market for financial services products*—this refers to competition in the provider markets; namely, the manufacturing of retail investment products, including pensions, collective investment schemes (CIS) and life investments. The FSA's high-level CBA included in the Feedback Statement on the RDR indicated that the new remuneration model could mean that providers will compete against each other not on commission levels, but rather for consumers, based on the price and quality of their products.[5] This could raise product quality and/or reduce product charges (ie, lower factory gate prices, FGPs). The question is whether this benefit is likely to materialise.

– *Competition in the market for advice*—the high-level CBA indicated that the price of financial advice may fall to the extent that the new remuneration model gives consumers more power over the price they pay, and that they exercise this power by negotiating with their adviser and shopping around more. However, there is a concern that the new regime may result in the adviser applying price discrimination, charging more to those who are more willing to pay (and perhaps less well informed) than to others. Although price discrimination does not necessarily harm consumer welfare, there may be a concern that some people run the risk of paying excessive charges.

[4] See, for example, FSA (2007), 'Discussion Paper 07/1, A Review of Retail Distribution', June, and FSA (2008), 'Feedback Statement 08/6', November.
[5] FSA (2008), 'Feedback Statement 08/6', November.

1.2 Methodology and information sources

Using the methodology for assessing the benefits of regulation prepared by Oxera for the FSA in 2006, the research for this study:[6]

- analyses the current state of the market, looking in particular at the features relevant to an assessment of the impact of the RDR proposals on market structure and competition;
- highlights the changes in the rules that are most likely to have an impact on market structure and competition;
- identifies the mechanisms through which the changes in the rules could affect market outcomes, where possible distinguishing between the short and long run;
- examines which of these mechanisms are likely to be valid;
- draws conclusions about market structure, competition, price and quality.

Furthermore, although a full assessment of the effectiveness of supervision is beyond the scope of this study, the relevance of supervisory measures is considered.

The assessment presented here is based on secondary research (including the results of a survey conducted by Deloitte on behalf of the FSA) and interviews conducted by Oxera with three providers and around 15 intermediaries. Furthermore, meetings were held with the Association of British Insurers (ABI), the Association of Independent Financial Advisors (AIFA), the Association of Private Client Investment Managers and Stockbrokers (APCIMS), the British Bankers' Association (BBA), and the Investment Management Association (IMA).

The research was subject to a number of limitations, as follows.

- Due to time constraints, only very limited primary research was conducted. However, in its secondary research, Oxera used the considerable amount of analysis of the RDR proposals available within the FSA and in the public domain.

- The sample of firms interviewed is not representative of the whole market, but contains a mix of types of firm, including providers, platforms, networks, large and small independent financial advisers (IFAs), multi- and single-tied firms. Oxera also made use of the Deloitte (2009) survey, which was also undertaken among a mix of types of firm.[7]

- The assumption of constant consumer preferences in the short term was made. In practice, this means that consumers were not expected to initiate any changes in their market behaviour, although they may respond directly to changes initiated by providers or intermediaries. This also means that, for this analysis, Oxera assumed that the demand for advice and financial services products does not change significantly. In the short term this assumption seems reasonable, given the feedback from the interviews that consumers would not generally notice a big change in the market they face. Over a longer timeframe, this assumption should be tested, as more explicit charging for advice may alter consumers' willingness to pay for it. Furthermore, no primary analysis was undertaken of the impact of changing the 'labelling' of firms (ie, the restriction on the use of the term 'independent' when related to advice, and the term(s) that might be used to describe non-independent retail intermediaries). Although research carried out for the FSA indicates that labelling may influence choice of adviser, a distinction is already made between independent and tied advice. As such, the *change* in the dynamics of choice, if any, is less clear cut.[8]

- The impact on market structure and competition depend to some extent on the exact details of the rules. When conducting this research, some of these details were still

[6] Oxera (2006), 'A Framework for Assessing the Benefits of Financial Regulation', prepared for the FSA, September.
[7] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th.
[8] IFF (2009), 'Labelling of services and adviser remuneration', prepared for the FSA, forthcoming.

being designed and finalised by the FSA. Where there was uncertainty about the rules, this is noted in the report.

1.3 Changes to the rules as a result of the RDR package

Oxera identified the following changes as a result of the RDR proposals that are relevant to assessing the impact on market structure and competition.

– *Remuneration of advisers*—under the new regime, advisers will be required to set their own charges for advice, and product provider influence over adviser remuneration will be removed as far as possible. Both independent and non-independent advisory firms will have to disclose, separately, the costs of advisory services, and differentiate these from the underlying product costs.

– *Independence requirements*—as set out in the FSA's December 2008 Feedback Statement, the current notion of 'whole of market' advice will be replaced with independence requirements, part of which is a requirement for advisers to consider products in the 'relevant market'. The RDR recognises the importance of IFAs being able to review comprehensively and independently the 'relevant market' in order that their advice can be considered independent. At the same time, it recognises that independent advice can also be given if a firm specialises in a relatively narrow field, provided that the relevant market is considered in accordance with the new independence requirements. To define the scope of a relevant market, it needs to be considered whether a client could expect to receive a suitable outcome from elsewhere, the reason for taking the advice and the degree of substitutability with other products or investment types. The RDR presents pensions as an example of a relevant market since, for some clients, this would be the only way of obtaining the outcome they require. However, investment bonds are not classed as a relevant market, for example, because several other products could be defined as direct substitutes. Underlying this concept is a requirement that independent advice needs to be based on an analysis that is comprehensive and fair relative to what the client requires.

– *Professional standards*—to provide a common framework for professional standards across all advice channels, the FSA will establish an advisory Professional Standards Board, with a view to consulting on whether it should become independent, with a similar remit to that of standards boards in other professions. There will be a benchmark qualification of at least QCF[9] Level 4 for all investment advisers in both the independent and non-independent sectors.

– *Capital requirements*—a consistent set of capital requirements will be established for all personal investment firms.[10] The overall minimum capital requirement will be raised from £10,000 to £20,000, and the Expenditure Based Requirement will be extended to all firms, based on three months of annual fixed expenditure. Furthermore, firms will be required to hold additional capital, based on a sliding scale, as a provision against potential liability for any activities excluded by their professional indemnity insurance policies.[11]

[9] The QCA framework is now called QCF.

[10] 'Broadly, a personal investment firm is a firm for whom the most substantial part of its gross income is derived from a) advising on investments, or arranging deals in investments, in relation to packaged products; and b) managing investments for retail customers. Such firms would have been regulated by the Personal Investment Authority before the FSA obtained its statutory powers in 2001.' FSA (2007), 'Review of the Prudential Rules for Personal Investment Firms', Discussion Paper 07/4, July, footnote 1, p. 3.

[11] These proposals are contained in FSA (2008), 'Review of prudential rules for personal investment firms', Consultation Paper CP08/20, November.

1.4 Structure of report

The report is structured as follows.

– Section 2 provides a high-level description of the current market for advice and retail investment products, and assesses the nature of competition on the basis of a number of standard competition indicators.

– Sections 3 and 4 provide, respectively, assessments of the impact on market structure and on competition in the markets for retail investment products and advice.

2 Current state of the market

This section provides a high-level description of the current market for the provision of advice on retail investment products, focusing on some of the elements that will be changed by the RDR proposals (such as remunerating intermediaries through commissions).[12] Furthermore, it assesses the nature of competition in the market in relation to a limited number of standard competition indicators. This provides the baseline against which to analyse the impact of the RDR proposals.

A number of studies have assessed various aspects of the market for retail investment products.[13] Furthermore, in 2007 the OFT conducted research into markets with commission, in which references were made to the distribution of retail financial products.[14]

However, there has been no comprehensive assessment of the competitive environment in the provision of financial advice for retail customers. The following sections are not intended to constitute a comprehensive analysis of all aspects of the market. Rather, a partial analysis is presented, concentrating on those areas of relevance to an assessment of the RDR proposals (eg, the channels used for product distribution and the product pricing models). This assessment is based on secondary research only.

2.1 The main characteristics of the market

The retail investment market comprises, at a high level, two broad groups of products: protection products (including pure protection products such as critical illness cover and general insurance), and savings and investments (including collective investment schemes and pension products). The range of products covered by the RDR includes all investment products (except for group personal pensions sold through financial advisers when advice is given to the employer rather than directly to the employee) and protection products with investment elements. Pure protection products and mortgages are not within the scope of the RDR. Box 2.1 below provides more detail on the retail products.

These products are sold through a variety of distribution channels, including via intermediaries. If the products are sold through intermediaries such as financial advisers, most of the sales will be on a commission basis, with the adviser receiving income from the provider in the form of a certain percentage of the sale price. The purchaser of these products will pay this commission in the form of product charges, which will include an element relating to the administrative costs incurred by the provider in the provision of the product, as well as providing the revenue to cover the costs to the customer of the adviser or other intermediary. The intermediary has the option of rebating some or all of the commission received from the provider in the form of lump-sum payments, or through the purchase of additional units of the investment at no extra cost to the customer. As an alternative to being commission-based, an intermediary can also offer a fee-based service, in which case the client pays a fee directly for all or part of the advice. The fee will be based on the time taken,

[12] In this section, the word 'market' is used to describe in general terms the competitive landscape in which financial products are sold. The report does not define 'relevant markets' in the sense used in competition policy.

[13] These include the Sandler Review of the market for medium- and long-term retail savings in 2002 and the Office of Fair Trading (OFT) Competition Review of the Financial Services and Markets Act (FSMA) in 2004. HM Treasury (2002), 'Sandler Review: Medium and Long Term Retail Savings in the UK', July. OFT (2004), 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition', March. There have also been Competition Commission and OFT market and merger investigations into specific financial services markets, such as payment protection insurance, as well as mergers in the sector involving banks, building societies and insurance companies.

[14] OFT (2007), 'Competition in markets with commission rates', January.

or as a percentage of the investment made. The product is then purchased at a price that excludes the commission that would otherwise pay the intermediary.

The value chain in the retail investment market contains not just the product provider, the adviser/sales person and the purchaser of the product, but also the fund manager, who is employed by the provider (either within the same group or externally) to manage the portfolio of assets underpinning the product. More recently, the platform provider has become part of the chain, providing administration services to ensure efficient management of a wide range of retail investment products. Their activities may include product writing, marketing, distribution, advice, execution services, administration and compliance.

Box 2.1 Categorisation of retail products sold in the UK

A broad range of products is sold to retail customers through a wide range of distribution routes. In general, these products fall into two broad categories: regular premium products and single premium products. Within this broad categorisation several individual product groups may be identified in which the products sold may be in the form of either regular or single premium. These product groups are as follows:

life assurance	personal pensions
group pension products	retirement planning
investment bonds	personal protection
group protection	collective investment schemes
ISAs	open-ended investment companies (OEICs) and unit trusts

Within this high-level categorisation, the products can be further grouped according to specific characteristics for life assurance and pensions, as follows.

Regular premium life products

– savings-related endowments
– mortgage-related endowments
– protection term
– mortgage-related term assurance
– whole-of-life
– income protection
– stand-alone critical illness term
– stand-alone critical illness whole life

Single premium life products

– unit-linked bonds
– distribution bonds
– with-profit bonds
– guaranteed bonds
– purchased life annuities
– child trust funds

Regular premium pension products

– personal pensions
– stakeholder pensions
– self-invested personal pensions
– free-standing additional voluntary contributions
– group personal pensions

Single premium pension products

– personal pensions
– stakeholder pensions
– self-invested personal pensions
– free-standing additional voluntary contributions
– group personal pensions
– employer-sponsored stakeholder

2.2 Product pricing

The ‘price’ that the consumer pays for these products can vary considerably depending on the charging structure and the distribution channel through which the products are sold. When consumers purchase a retail investment product, they will incur explicit charges, which commonly include the following.

– **Initial charges** reflect the costs of developing and marketing the product, and the administrative costs associated with its purchase. They usually also reflect the initial commission paid by the product provider to the intermediary distributing the product. In addition there may be a one-off charge in the form of an exit fee upon redemption of the product.

- **Annual charges**—these ongoing charges reflect the annual management charges (AMC) as well as other expenses. They may also reflect a trail commission paid to the distributor. The actual total ongoing costs are commonly measured by the total expense ratio (TER).

However, these charges, which are levied and disclosed at the provider level, do not necessarily capture what consumers actually pay for the product, for two main reasons:

- **rebates and discounts**—the distributor of the product may rebate to the consumer (part of) the initial or trail commissions received from the product provider. In addition, the stated charges (initial or AMC) may be discounted by the product provider such that the actual charges are lower than those stated;

- **additional distribution fees**—these may be levied at the distribution level, adding an extra layer of charges to those levied at the provider level. For example, the consumer may pay a direct fee to the adviser or other intermediary, but may be rebated all or part of the commission; in this case, the rebated commission is not a charge that the consumer pays, but the fee is. In addition, intermediaries may sell certain services independently from either product provision or advice—for example, platform charges where an intermediary providing the infrastructure to (self-) manage a portfolio of investments charges the end-customer a fee for doing so.

2.3 Distribution channels

As noted, consumers can purchase these products through a number of distribution channels. In general terms, the consumer may purchase through the advised or non-advised routes. In the former, they will receive information and recommendations from a representative of a firm authorised to give such advice. At present financial advisers fall into four distinct categories:

- **independent financial advisers (IFAs**), who provide advice on products from across the whole market (for particular products) and offer the consumer the possibility of paying for this advice in the form of a fee;
- **whole-of-market**, who also provide advice on products from across the whole market but do not offer the fee option, although a consumer may still offer to pay the adviser in this way;
- **multi-tied**, where the adviser will recommend products from a limited range of providers (the panel);
- **single-tied**, in which case the adviser will recommend products from one provider only.

Table 2.1 below shows the proportions of new life and pensions business by distribution channel between 2003 and 2007, while Table 2.2 shows the breakdown of gross retail sales of investment products, by distribution channel, including equities, fixed interest securities, unit trusts and OEICs between 2005 and 2009.

Table 2.1 Life and pensions new business by distribution channel as a percentage of the total, 2003–07

	2003	2004	2005	2006	2007
IFA/whole of market adviser	39.7	43.3	46.7	51.9	48.3
Multi-tied adviser	1.9	2.4	2.6	3.5	3.7
Single-tied adviser	7.7	7.0	7.4	7.3	8.7
Single-tied bancassurance	10.9	11.9	12.0	9.4	12.0
Multi-tied bancassurance	34.8	32.5	28.6	24.7	24.2
Non-intermediated	5.0	2.9	2.7	3.2	3.1

Source: Datamonitor (2008), 'UK IFAs 2008', November, ABI and Oxera calculations.

Table 2.2 Gross retail sales of investment fund products by distribution channel as a percentage of the UK total, 2005–09

	April 2005	April 2006	April 2007	April 2008	April 2009
Direct from public	9.3	8.0	7.6	6.3	4.8
Intermediary	73.1	77.7	82.7	84.1	85.4
Sales force/tied agent	14.4	10.7	7.3	7.9	8.5
Private client	3.3	3.6	2.5	1.7	1.3

Source: IMA (2005–08), 'Gross retail sales by sector and distribution channel', monthly statistics.

This shows that life and pensions are predominantly sold through the IFA advised or multi-tied bancassurance channels. The latter, however, experienced a declining trend over the period, while the former has been growing in importance (with the exception of 2007). An additional notable feature is the small proportion of new business in this area sold through the non-intermediated route. This may be because consumers are more likely to use advisers (whether independent or not) when products are perceived to be more complicated. This was confirmed in the Consumer Purchasing Outcomes Survey, where 42% of respondents who were close to acquiring a pension, or had already acquired one, had used advice from an IFA as the most common source of information.[15]

A similar pattern emerges in relation to the distribution channels used by investment funds.[16] Table 2.2 shows a trend away from direct sales and sales forces/tied agents and towards intermediaries. The most recent data, for April 2009, shows that gross retail sales of investment funds through intermediaries accounted for 85.4% of the total, with 4.8% of funds sold directly to the public by fund managers and 8.5% sold by sales forces or tied agents.[17] In the case of investment funds, anecdotal evidence indicates a significant move towards sales through fund and life company platforms, which could explain the increase in intermediated sales.[18]

At the end of 2008 there were 12,129 advisory firms in the UK.[19] The total number appears to have been declining in recent years, although it is difficult to obtain exact figures due to changing definitions. Within the broad group of IFAs, Table 2.3, which presents a breakdown by number of sales staff, indicates that over 75% of IFA firms employed fewer than four sales staff, and these represent around half the total number of advisers/sales staff.

[15] FSA (2008), 'Consumer Purchasing and Outcomes Survey', July, p. 35.
[16] IMA (2008), 'Asset management in the UK 2007', July, p. 65
[17] IMA (2009), 'Distribution Trends', May.
[18] Ibid. p.65.
[19] Datamonitor (2008), 'UK IFAs 2008', November, based on information from Matrix-Data

Table 2.3 Number of sales staff, 2007–08

	2007	2008
More than 50 sales staff	63	50
21–50 sales staff	112	116
11–20 sales staff	318	309
5–10 sales staff	1,544	1,333
1–4 sales staff	10,172	9,258
Unknown	876	1,063
Total	**13,085**	**12,129**

Source: Datamonitor (2008), 'UK IFAs 2008', November, based on information from Matrix-Data.

Many of these advisers will be part of networks, which provide them with administration and compliance support.

The consumer may also purchase the product directly from the provider or from a funds supermarket, a stockbroker or some other form of execution-only broker. These routes may be used even if the consumer has previously obtained a recommendation from an adviser.

As the total charges can vary by distribution channel, consumers may incur different charges on the same product, depending on how they purchase it. Table 2.4 shows the purchasing routes that a consumer may use, together with the impact on the product charges of using a particular route. The table presents a stylised illustration only, drawing from interviews with product providers and intermediaries, as well as other sources.

Table 2.4 Illustration of charging structures by distribution channel

Distributed via	Main remuneration method	Rebates/discounts offered on provider charges
Financial adviser	Two possible methods: – product provider pays commission to adviser (commission-based advice) – consumer pays a fee to adviser (fee-based advice)	Initial commission may be rebated to consumer—in particular, when the adviser is remunerated on a fee basis. Rebating may also apply to the trail commission Adviser may negotiate a discount on the initial charge or AMC
Adviser with wrap	In addition to the remuneration for the adviser (as above), there may be a commission payment from the product provider to the wrap platform provider, or an additional fee paid by the consumer for the wrap	Rebating and discounts are common
Fund supermarket	Commission paid by product provider. Possible additional fee paid by consumer	Rebates and discounts are common
Stockbroker, execution-only broker, etc	Fee paid by consumer	Rebates and discounts are common
Direct by product provider	Paid via initial charge and AMC	Often no rebates or discounts. Provider keeps commission, even that part designed to pay for the advice

Source: Oxera (2008) 'Towards evaluating consumer outcomes in the retail packaged investment products market: A methodology', prepared for the FSA, September.

Where the consumer purchases a product via an adviser, the adviser may rebate a proportion of the commission it has received from the product provider. This is particularly likely when the adviser is remunerated on a fee basis directly by the consumer. Instead of cash being returned to the consumer, the rebate may take the form of a purchase of further units of the product at no additional cost to the consumer. It may also take the form of a direct reduction in, or discount on, the charge the consumer has to pay when purchasing the product. In addition to a rebate on the initial charge, it may be that rebates or discounts are offered on ongoing management charges.

While, previously, distribution via advisers or directly by the provider was the main route for consumers to purchase products, there have been changes over the past few years, in particular with the emergence of provider platforms and discount brokers (or execution-only brokers) which serve the retail markets.

Provider platforms are services used by intermediaries (and sometimes consumers directly) to view and administer investment portfolios; they include wraps and fund supermarkets.[20] Wraps allow advisers and consumers to manage portfolios of investments online; they also allow product providers and advisers to outsource certain administrative duties. Unlike wraps, fund supermarkets are online services that sell products directly to consumers.

Platforms are remunerated in a number of ways, but the two principal methods are as follows:

– some platforms charge an explicit fee to the consumer, and any product discounts or rebates received are then passed on;
– other platforms receive a share of product charges negotiated with the product provider.

Without the presence of a platform, resources would be spent by the product provider and adviser to undertake the administrative tasks. With a platform, these resources are expended at the platform level and reimbursed accordingly, which can mean that there is no change to the actual price of the investment. For example, without the platform, an AMC of 1.5% may be shared equally by product provider and adviser, with the provider keeping 75 basis points (bp) and paying 75bp in commission to the adviser. Where a platform is used, the product provider may pay 25bp to the platform as remuneration for the outsourced administrative services and keep 50bp. In this case, there is merely a redistribution within the investment value chain, while the total price to the consumer is the same. However, there may be an additional fee for the use of the platform, which in turn would increase total charges. Alternatively, efficiency gains from employing a platform may free up resources that could be returned to the investor in the form of further rebates or discounts, thereby reducing total charges.

Like wraps, fund supermarkets and discount brokers selling directly to consumers in the retail market may be able to buy products on a wholesale basis from the product provider, reducing the sales costs of the provider and thus gaining a discount on the purchase. They may then sell these products on to consumers at a higher rate than that charged by the product provider, but pass some of the saving on to consumers in the form of rebates or discounts.

Fund supermarkets or discount brokers may purchase products directly from the product provider, often at the creation price without initial charge. The purchase is treated as an aggregate product which is then separated and sold on an individual basis to the consumers of the supermarket or discount broker. The account records of the product provider may therefore show a single sale of a product rather than multiple sales to the end-consumers. This will also affect the way in which the AMC is charged. In this case, the wrap pays a single AMC to the product provider, while at the same time it may charge a different AMC to each of its customers.

[20] For a definition and further explanation, see FSA (2007), ‘Platforms: the role of wraps and fund supermarkets’, Discussion Paper 07/2, June.

It is not only the distribution channel that can affect the charging structure and level of total charges paid by a consumer, the way in which a product is packaged may also have an effect.

– *Tax wrappers*—consumers can purchase retail investment products as part of tax-efficient wrappers, such as ISAs or stakeholder pensions. While charges arise for these wrappers, the stated charges of the underlying funds may be heavily discounted or may not actually be paid (eg, no initial charge may be payable).

– *Multi-manager funds*—in addition to tax wrappers, there has been an increase in the sales of multi-manager funds directly to retail investors. Multi-manager strategies enable a retail investor to invest in a range of funds and asset classes while delegating the administration and choice of fund selection to another manager. There are two principal types of multi-manager funds:

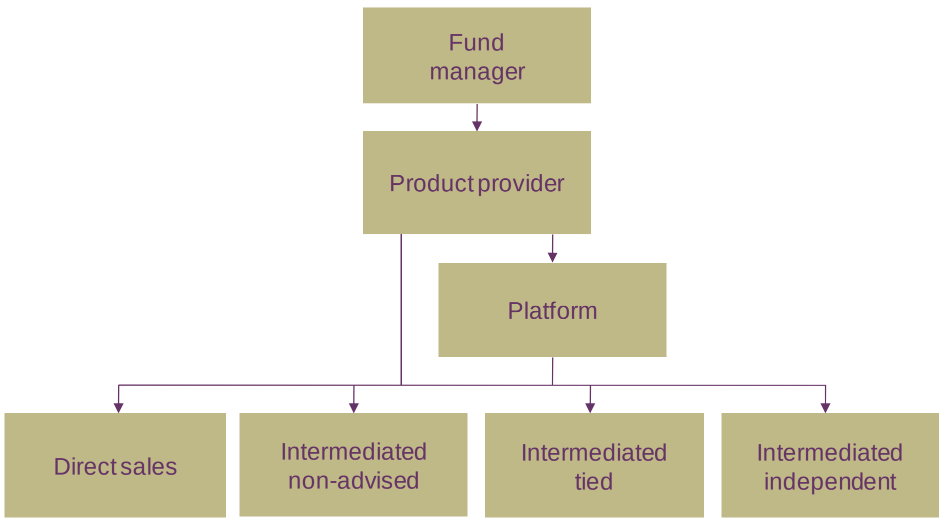
  – fund of funds (FoF): the investor invests in a fund that itself holds a portfolio of units in mutual funds (unit trusts or OEICs), private equity funds, hedge funds, or investment trusts;
  – manager of managers (MoM): the investor invests in a fund that uses the capital to create separate mandates for other fund managers to manage.

In terms of charges, an investor in a multi-manager fund faces a similar charging structure to an investor investing in a mutual fund, but these charges go towards remunerating the multi-manager fund operator as well as paying for the charges of the underlying funds (in the case of an FoF) or the management fees (in the case of an MoM fund). However, at least in the case of a FoF, the price at which the fund can buy underlying fund units may well be lower than if the investor were buying units in the underlying funds directly.

2.4 Description of the value chain

At present, the retail investment value chain involves several agents (see Figure 2.1). These range from the fund manager, responsible for managing the underlying assets in a product portfolio, through the product provider, packaging the portfolio in the most suitable form for a wide variety of investors, via the intermediary, responsible for advising the ultimate purchaser on the suitability of the product to match their particular requirements. The same overall structure applies to both pure savings/investment products as well as those combining an insurance element with investments.

Figure 2.1 Value chain



Source: Oxera.

Costs will arise at all stages along the chain, beginning with the fund manager who will incur dealing and administration costs for the portfolio on which the retail product is based. It is not straightforward to isolate these particular costs for a specific retail portfolio because managers responsible for retail products will tend to combine the assets in a range of funds, both retail and wholesale, that they have under management. The costs of this fund management will be passed on to the product provider in the form of management fees. However, many retail fund providers will make use of their in-house management operations to undertake such activity. As a result, it may be difficult to separate out the costs of this activity from those incurred in providing a retail product that is in the most suitable form for the consumer.

The product provider is responsible for allocating the assets to a particular (retail) fund and packaging this fund in the most appropriate form. Costs will be incurred in structuring the fund and in its ongoing administration. In addition, the provider will incur costs in supporting the distribution of the product, which it may undertake itself, or through an intermediary such as a financial adviser.

An adviser's costs will arise mainly from prospecting for, and negotiating with, potential customers (marketing) and providing the advice that is given before the consumer makes the final purchase. The adviser will need to be familiar with the product markets in which (and between which) they are providing advice, and this information needs to be updated regularly. Before the purchase being made, the adviser must comply with regulatory requirements to ensure that the purchaser is provided with adequate and appropriate information in order to make a suitable choice. These requirements will involve the adviser spending time discussing the client's circumstances and investment needs before a recommendation is made. Following this, information on the most suitable products must be provided, including an indication of potential risks and returns according to standardised regulatory requirements.

After a purchase has been made, the adviser must provide documentation to confirm their assessment of the client's circumstances and the appropriateness of the product recommended. In the case of certain retail products (eg, company pensions), the adviser may also need to monitor the product and provide updated advice as necessary on an ongoing basis. At all stages, for regulatory purposes, the adviser must ensure that records are kept of the advice given and the transactions undertaken.

If the adviser is part of a network, some of the compliance activity and administration of the client's assets may be undertaken centrally.

It is generally understood that, in recent years, the development of platforms has further reduced the potential administration costs incurred by advisers. These, largely online, services enable the adviser to screen investments on offer more efficiently, as well as enabling a more holistic approach to be taken to the management of a client portfolio.

2.5 Assessment of a number of standard competition indicators

This section assesses the nature of competition on the basis of a limited number of key competition indicators.

2.5.1 Concentration in the product markets

It is difficult to determine the precise number of providers of packaged products in the UK. In 2007, 255 firms were authorised to carry out long-term business.[21] As at March 2009 there were 159 authorised banks incorporated in the UK,[22] while at the end of 2008 there were an

[21] ABI (2008), 'UK Insurance Key Facts', September, p. 6.
[22] FSA (2009), 'List of Banks as of 31/03/2009'.

additional 53 building societies.[23] Many of these offer packaged products. In addition, there are independent fund managers authorised to provide retail investment products, together with some firms that provide products for the retail market which have been developed by others (this would include Virgin and M&S).

In the market for unit trusts and OEICs, industry data indicates that the top five fund managers had a combined share of 27.6%, and the top ten fund managers had a combined share of 45% in 2005.[24]

In summary, from the existing evidence, it would appear that the product market overall is not concentrated.

2.5.2 Degree of vertical integration

Referring to the organisation of transactions along a supply chain, vertical integration may affect competition by constituting a barrier to entry for non-integrated firms. The supply chain for retail savings and investment products broadly comprises the producers, the distribution channels and third-party service providers. This third group includes fund managers, platforms and third-party administrators. This section considers the relationship between producers and distribution channels.

Traditionally, life assurance companies used extensive direct sales forces to distribute their products. However, these sales forces were associated with high costs relative to the revenues they generated, and were increasingly replaced as a distribution channel by advisers who were not directly employed by the producer.

The situation with banks has developed somewhat differently, as they have only more recently become involved in the sale of retail investment products (as opposed to traditional savings products). Some banks acquired providers of both investment and protection products (eg, Lloyds' acquisition of the leading life assurance company, Scottish Widows, in 1999), while the creation of banking groups, such as HBOS, resulted in the bank being able to offer more long-term investment products in addition to its more traditional range of savings products. In contrast to life assurance companies, the banks have been able to use their extensive branch networks to distribute a range of both protection and savings and investment products.

While there has been evidence of different types of provider coming together under one umbrella organisation, there have also been cases of providers themselves moving down the value chain to incorporate previously independent distribution networks into their businesses (examples include Aegon, Skandia and Aviva).

In terms of the implications for competition, the OFT study on the effects on competition of the Financial Services and Markets Act 2000 found that there were no significant concerns about anti-competitive effects, even when vertical integration had taken place in distribution.[25]

2.5.3 Concentration in the advice market

As noted in section 2.3, there were 12,129 advisory firms in the UK in 2008.[26] This represents a decline of 7.3% from the 2007 figure of 13,085. The 2007 figure, in turn, represents a decline of 2.8% from the 13,458 recorded in 2006. These figures do not represent the total number of individual agents offering advice; in 2008, 50 firms had more than 50 sales staff, with a further 116 firms having 21–50 sales staff. A number of the firms

[23] Building Societies Association (2008), 'Statistics 2008'.

[24] Datamonitor (2007), 'UK Collective Investments 2007', August.

[25] OFT (2004), 'Review of the Impact of the Financial Services and Markets Act 2000 on Competition', March.

[26] All figures in this section are taken from Datamonitor (2008), 'UK IFAs 2008', November, based on information from Matrix-Data.

and their sales staff may also be incorporated into networks. In 2008, 26 networks had 12,051 individual sales staff acting on their behalf.

In terms of market share, the top five networks, by turnover, had an estimated combined market share of 15.2% in 2007. The largest 25 networks had a combined market share of just 21%.[27] It was not possible to obtain market share figures for other large firms.

Again, when looking at this market from a competition perspective, there appears to be no evidence of significant concentration in the market for (independent) advice.

2.5.4 Entry barriers

The financial services sector, in general, has seen a number of acquisitions and mergers in recent years which have been subject to investigation by the OFT. In the case of Barclays and Gerrard Management in 2003, it was found that qualifications and licensing requirements did constitute a barrier in the wealth management industry, but that this was not significant as entry was more likely to come from others already active in financial services.[28] Likewise, in the case of CGU and Gresham Insurance in 2005,[29] regulatory authorisation and capital adequacy were also seen as barriers to entry in general insurance, but they were not believed to be prohibitive. Finally, in the case of Pearl and Resolution in 2008,[30] entry barriers in life assurance were said to be low.

Regulatory requirements for advisers, in the form of training, competency standards and capital requirements, may constitute a barrier to entry. However, the high number of individual advisers still working in the industry seems to indicate that these may not be so significant as to give rise to a concentrated market.

Non-regulatory barriers may also be apparent, however. These could take the form of the need to develop expertise and competency in the assessment of an increasing range of investment and protection products which are also becoming more complex. Past performance and reputation are also important considerations when choosing an adviser, and the costs of acquiring such a reputation may be significant. In addition, advisers may need to establish a reputation with providers and this may only develop over time. These may constitute barriers to entry for those without any expertise in the field. However, some of the independent advisers entering the market may have had previous industry experience so that, again, high levels of concentration may not result.

Finally, an additional non-regulatory barrier may take the form of recent advances in technology (in particular, the development of wrap platforms), which may require advisers to develop systems that enable them to integrate with the platform. Again, this could constitute a barrier for some new entrants, but the technical requirements may not be onerous and may have low costs relative to the potential benefits.

Overall, then, although potential barriers to entry do exist in the advice market, it seems unlikely that they have been prohibitive in the past.

2.5.5 Asymmetric information

Asymmetric information in the market for both investment and protection products, whereby consumers are less well informed than advisers or providers, can take two forms:

– non-transparent product offerings, which arise in markets where products are diverse and information about them and their terms is not transparent (for instance, whether there are exit restrictions or charges);

[27] Ibid, p. 71.
[28] OFT (2003), 'Anticipated Acquisition by Barclay's Bank plc of Gerrard Management Services Ltd.', December 12th.
[29] OFT (2005), 'Completed Acquisition by CGU International Insurance plc of Gresham Insurance Company Limited', July 28th.
[30] OFT (2008), 'Anticipated Acquisition by Pearl Group Ltd. of Resolution plc', January 18th.

– non-transparent quality or performance of products, providers or, in this case, distributors. This may occur even where consumers are sophisticated, and may result in incentive misalignment between providers, distributors and consumers.

In the case of retail investment and protection products, asymmetric information may arise both between product provider and consumer, and between adviser and consumer.

With regard to the former, product and service disclosure and rules on financial promotions have been used in an attempt to reduce the lack of information about the wide variety of products offered. However, as products have become more sophisticated, the degree of asymmetric information may have grown. Research indicates that consumer outcomes may also have been affected by a lack of transparency about product charges. For example, in a survey of consumer attitudes to financial services, 51% of respondents commented that charges on pension products were difficult to understand.[31] As a result, the consumer relies on the adviser for an understanding of these charges but, as is highlighted in section 2.5.12 below, the adviser may face a conflict of interest. In addition, in the case of retail financial services, the asymmetric information problem may be magnified for some consumers and for some products as a result of the relatively low level of financial capability.

The purpose of this study, however, is to focus on the asymmetry of information that exists when the 'product' under consideration is advice and the relationship is between consumer and adviser. Here, again, both forms of asymmetric information are apparent. The RDR has found that there is a lack of transparency with regard to the advice process—in particular, the payment that a consumer makes for advice. Likewise, it is difficult for consumers to judge the quality of advice at the point that it is given. Poor-quality advice (which could take the form of unsuitable product recommendations) may become apparent only at some later date. Regulatory attempts have been made to mitigate this information asymmetry, with the introduction of the menu of commission charges, clearer information on expected product returns (reduction in yield calculations) and the suitability letter. The letter was meant to ensure that the advice process had followed recommended guidelines and resulted in the recommendation of the most appropriate product, given the buyer's individual circumstances.

There is therefore, to some extent, asymmetric information in retail investment markets. The 2007 OFT study on markets with commission concluded that asymmetric information and bounded rationality (whereby consumers are unable to consider all options potentially open to them) were more likely to be problems when payment was by commission. In particular, the study highlighted cases where a large proportion of the agent's business was involved in providing advice. However, it did not find that these characteristics were necessarily associated with a lack of competition—indeed, the study found that markets where strong price competition prevailed may also be associated with bad advice and distorted incentives.

In summary, consumers of retail investment and protection products are less well informed about the products than either advisers or providers. As a result, the consumer relies on the adviser for product information. However, there is also a current lack of clarity about the advice process in terms of both the payment for advice and its quality. Consequently, consumers who are less well informed find it difficult to shop around for both products and advice.

2.5.6 Factors underpinning consumer decision-making

In the past few years research has been conducted focusing specifically on the factors underpinning consumer decision-making when it comes to buying financial services products. This section summarises some of the evidence from the 2006 Financial Services

[31] Financial Services Consumer Panel (2006), 'Survey of consumer attitudes to financial services and their experience in buying them', March, p. 64.

Consumer Panel survey,[32] which suggests that, when making their decisions, consumers use a variety of information sources, and the type of information used depends on the nature of the product being purchased. Overall, product information collected from a branch and advisers were the most important sources. For example, around 51% of savings product purchases were based on information from a branch, while 47% of mortgages were taken out on the basis of contact with an adviser.

Although consumers use a wide variety of sources, 55% of all product purchases were based on only one source of information or advice. Broken down by product category, the product with the highest proportion using just one source was pensions, with 62%. Only 25% of purchases used three or more sources, with the highest incidence of multiple sources being in the purchase of investment products (30%).

The way consumers shop around between providers varies by product. For example, the survey suggests that consumers do make an attempt to shop around for savings products on their own, but, in the case of mortgages, the shopping around is done on their behalf by advisers or brokers.

When consumers made a purchase decision, around 48% of product purchases were made by the respondent alone with no other sources of influence. A further 38% of purchases were made on the basis of the consumer having a general idea of what they wanted but then being influenced in their final choice by an adviser. Only 13% of purchases were made leaving the decision entirely to the adviser. Adviser influence was most common in the purchase of life assurance, mortgages and pensions.

When consumers did use an adviser, 43% claimed to have used an IFA, with a further 35% making use of an adviser at a bank or building society. Most use of IFAs occurred in the purchase of mortgages and life assurance, although there was a feeling that many of the respondents who claimed to be using an IFA for mortgage advice were in fact using a mortgage broker, pointing to a lack of clarity among some respondents as to the status of some advisers. In the case of savings products, 59% of purchases were made after consultation with a bank or building society adviser.

In summary, consumers, in total, use a wide variety of information sources, but, individually, they seem to make little use of all the sources available to them. The evidence shows that a limited number use an adviser as their sole source of information for decision-making. There is little systematic evidence, however, to show how the consumer selects an adviser.

2.5.7 Switching

When considering switching, it is useful to examine behaviour across a number of dimensions:

– switching within product groups (eg, unit trusts) with the same provider;
– switching within product groups between different providers (Provider A unit trust to Provider B unit trust);
– switching between different product groups (eg, unit trust to investment bond) with the same provider;
– switching between different product groups between different providers (Provider A unit trust to Provider B investment bond);
– switching between financial advisers.

Although data on the degree of switching between products is not readily available, there is some evidence to show switching in personal pensions is around 3.7% per annum. This

[32] All evidence in this section comes from Financial Services Consumer Panel (2006), 'Survey of consumer attitudes to financial services and their experience in buying them'.

compares with rates of 6% in mortgages and home insurance, 9.6% in car insurance, 10.3% in pay-TV and 13% in the gas market, for example.[33]

However, data on switching behaviour needs to be treated with some caution. A number of factors, such as household income and employment status, affect the degree of switching (in particular, in financial products). A low switching rate is therefore not necessarily indicative of low levels of competition. For example, when a firm lowers price or improves quality, its competitors may react quickly so that there is no need for switching to take place for a consumer to gain from the benefits of competition. This indicates that the *threat* of switching is credible and imposes competitive pressure on firms. Furthermore, in growing markets, the competition for new business may be sufficient to keep prices down despite low switching rates.

Similarly, a high switching rate is not necessarily an indication of intense competition. For example, in markets characterised by commission payments from producer to intermediary, high switching rates may be associated with intermediaries encouraging consumers to switch products in order to generate higher commission income for themselves.

The FSA does publish data on persistency rates illustrating the extent to which payments are allowed to lapse. This data shows that consumers are willing to switch between financial products in some areas, notably general insurance. However, low levels of persistency are also associated with failure to maintain regular premium payments into products such as personal pensions, and here it is difficult to determine whether the savings generated by not maintaining payments into one financial product are then invested elsewhere.

2.5.8 Factors on which providers compete

As most providers use intermediaries to sell their products, they seem to compete for access to intermediaries rather than directly for consumers (for example, the proportion of direct sales is relatively limited). The Consumer Purchasing and Outcomes Survey showed that few consumers used advertising as a source of information when buying products, although this did vary between product categories.[34] The responses ranged from 4% who used adverts when taking out a mortgage, to 16% who used them when buying an investment product. By contrast, company information, in the form of product leaflets and brochures, was widely used—on average, by around 55% of prospective or actual purchasers across all product types.

When the survey analysed the most useful, or sole, source of information used by purchasers, it found that only 2% of buyers of an investment product found adverts useful.

Although it was not possible to gather definitive evidence on the factors on which providers compete, it can be inferred from the Consumer Purchasing and Outcomes Survey that past performance of products may be one key area. When asked to identify the reasons for taking out a particular product, consumers cited past performance or the cost of the product (including any financial incentives for taking it out) in 56% of mortgage purchases and 46% of investment purchases. However, in addition, significant minorities based purchase decisions on an existing relationship or the reputation of the provider.

Anecdotal evidence suggests that product providers compete with each other for access to intermediaries. This was also highlighted in the 2002 Sandler Review, which concluded that providers found it difficult to market the benefits of products directly to consumers and therefore tended to concentrate on persuading advisers to recommend their products, through either the use of commission rates or the provision of other services.[35] Some life companies in particular have enhanced their competitive position in terms of IFA business by

[33] Oxera (2006), 'How to Evaluate Alternative Proposals for Personal Account Pensions', report for the ABI, October, p. 57.
[34] FSA (2008), 'Consumer Purchasing and Outcomes Survey', July.
[35] HM Treasury (2002), 'Sandler Review: Medium and Long Term Retail Savings in the UK', July.

offering advisers the opportunity to make use of wrap platforms. This, in turn, should allow the advisers to offer an improved service to their customers through a wider choice of products, better tax management and more efficient switching of the assets in their portfolios.

In summary, there appears to be little evidence that providers compete directly with each other for consumers, but they do compete for access to intermediaries. Such competition may take the form of offering higher commission rates or access to other services such as wrap platforms. It has not been possible to determine the extent to which the latter results in benefits for consumers, although, in so far as it should provide consumers with a wider product range and more effective management of their portfolios, consumer outcomes should improve.

2.5.9 Factors on which intermediaries compete

Many of an adviser's clients are likely to have been acquired on the basis of recommendations from lawyers or accountants, in which case there is little need for them to spend significant time on marketing or looking for new clients. This is consistent with the view that consumers are more likely to make use of an adviser if they have a specified endowment to invest. This could take the form of a legacy or other windfall gain, a change in personal circumstances (such as marriage, divorce, redundancy or starting a family), or the need to purchase an annuity with the proceeds from a pension scheme. In many of these cases, a lawyer or accountant will have been involved and may recommend that the consumer obtains financial advice.

When advisers do compete with each other, anecdotal evidence suggests that they will tend to use quality of service and access to a wide range of products as the basis for acquiring new customers. Price tends not to be used since most advisers will be remunerated indirectly for the advice they give through commission payments from providers. When advisers use fees, payable directly by clients, as the basis for their remuneration, there is no evidence that they use lower fees as the main marketing tool to attract new customers.

In summary, there is little evidence that advisers compete directly with each other for clients. Instead, they seem to rely on being recommended by other professional services firms such as lawyers and accountants. When there is competition between them, it tends to be on the basis of quality of service and access to products rather than price.

2.5.10 Level of commissions over time

For commission-based intermediaries, revenue comprises the sum of initial and renewal commissions plus any trail commission that is paid over time. Initial commission can be indemnified or non-indemnified, and, like renewal commission, is paid to the adviser by the provider as a percentage of the transaction or premium value. Trail commission is paid as a percentage of the ongoing fund value and reflects ongoing advice.

In recent years there has been some indication that intermediaries have begun to increase their reliance on trail commission as a source of revenue.[36] This provides a more secure stream of long-term income as the firm becomes less reliant on current-year transactions.

Under the new regulatory regime, after de-polarisation, advisers were required to provide customers with a 'menu' showing the commission they were generating on a particular product sale compared with a market-average commission rate calculated by the FSA. These market-average commissions were based on a variety of commission profiles, including initial only, initial plus trail and trail only. They show the net present value of current and future commission streams. One problem associated with them is that they do not take account of any rebating between the adviser and the customer, and as such do not necessarily represent the actual revenue earned by advisers.

[36] Deloitte (2008), 'Costing Intermediary Services', report for the FSA, November, p. 14.

In addition, the rates need to be combined with the actual value of premium income generated by advisers in order to gain a more accurate picture of their revenue streams. However, they do provide some measure of the comparative income streams that advisers may generate from the different types of product they are recommending to customers. Table 2.5 shows the net present value of market-average commission rates between 2005 and 2007, as calculated by the FSA for the menu.

Table 2.5 Net present value of market-average commission rates, 2005–07 (%)

	2005	2006	2007
Single premium			
Collective investments	3.59	3.94	3.96
Investment bonds	5.25	4.98	4.32
Annuities	1.32	1.32	1.36
Income drawdown	5.09	5.09	5.35
Personal pensions	4.77	4.77	5.58
Regular premium			
Collective investments	26.49	26.49	24.09
Endowments	43.63	43.63	40.38
Life assurance	105.04	105.04	110.66
10-year pensions	18.17	18.17	18.51
25-year pensions	29.37	29.37	31.03

Source: FSA menu calculations.

Although the data should not be considered conclusive evidence, it suggests that, in percentage terms, average commission rates on single premium products increased between 2005 and 2007. The exception is investment bonds, where the trend has been lower. In the case of regular premium products, there has been a decline in commission rates on collective investments and endowments, but increases have been seen elsewhere.

2.5.11 Level of product charges over time

Evidence on the actual product charges paid by consumers is difficult to obtain due to the practice of rebating and discounting undertaken by advisers and discount brokers or fund supermarkets. This is likely to result in some consumers paying little, if any, initial product charge, and may also result in some discount on the AMC.

However, data is available on the product charges stated by providers. Although this does not indicate what consumers have actually paid (this would require data on sales), it provides an approximate indication of changes in charges over time. Table 2.6 shows that average initial charges declined steadily between 2000 and 2006, although there were signs of a reversal of this trend in 2007. However, in contrast, there has been a steady increase in the AMC over the same period (with some stabilisation apparent in this trend in 2007). In the absence of rebates, this suggests that, overall, the changes have resulted in customers being better off over short time periods (eg, around three years, when the reduction in the initial charge outweighs the increase in the AMC), but not necessarily over longer periods of time (eg, five years or more).

Table 2.6 Average provider charges for collective investment schemes, 2000–07 (%)

	Mean initial charge	Mean AMC
2007	3.80	1.45
2006	3.66	1.45
2004	3.67	1.43
2002	3.94	1.38
2000	4.35	1.36

Source: FSA and Oxera calculations.

2.5.12 Commission bias

In markets involving commission payments to an intermediary, there are incentives for the intermediary to recommend either an individual product that offers the highest commission rates, or products from a particular provider offering high commission rates in general. The former may be termed product bias, the latter provider bias.

In the case of retail financial services, there is a perception that both product and provider bias has existed in the past, although actual evidence to support this perception has often been hard to identify. In a 2002 study for the FSA, evidence was found of provider bias, but only for single premium products, while there was no evidence of such bias for regular premium products. With regard to product bias, the study found evidence of this in certain products, such as ISAs and investment bonds, but it was not widespread.[37] Since then further research has reached similar conclusions.[38]

2.5.13 Technological advances

The major technological advance in retail distribution in recent years has been the emergence of wrap platforms, which were developed by either independent providers or life companies. Platforms take various forms but, essentially, are an online service which may be used by an intermediary or, in some cases, a consumer to view and administer a portfolio of investments.

Platforms allow the adviser or consumer to assess the overall performance of a portfolio and its risk characteristics, while also allowing a wide variety of products to be bought and sold, including ISAs, self-invested personal pensions, life assurance products and collective investment schemes. There has been rapid growth in the use of wraps by intermediaries. According to the FSA, intermediary use of platforms for new business is somewhere between 30% and 70%.[39]

Many life assurance companies have established wrap platforms, but others have been established, or financed, by fund managers, intermediary firms themselves, or technology providers. Many of these firms may see the establishment of a platform as a key part of their marketing strategy. A number of platform providers allow consumers to access their services directly, although the majority are targeted at advisers. Some of these have to be integrated into the intermediary's back-office systems.

A variety of methods are used in the payment of platform providers. Some will charge an explicit fee and then pass on any product discounts or rebates received; others retain a share of product charges negotiated with product providers.

[37] CRA International (2002), 'Polarisation: research into the effect of commission based remuneration on advice', a report for the FSA, January.
[38] See, for example, CRA (2005), 'Financial Advice: How should we pay for it?', a report for ABI, February.
[39] FSA (2007), 'Platforms: the role of wraps and fund supermarkets', Discussion Paper 07/2, June.

Although the number of wrap providers has grown significantly, there is debate over the extent to which the concept meets the needs of all types of consumer. Until now, platforms have been most relevant for high-net-worth individuals who require efficient management of a wide variety of assets and have complex investment needs.

2.6 Main findings on the current state of the market

The market for retail investment products is characterised by large numbers of both providers and products. The research reviewed in this section indicates that there is limited competition between providers, with a significant proportion of this aimed at persuading advisers to recommend their products (ie, commission or services to advisers), rather than marketing the efficacy of products to consumers directly. When providers compete directly with each other, it tends to be on the basis of factors such as past performance, reputation and price. This is in contrast to advisers, for whom price is not a significant factor in attracting clients.

There are also large numbers of financial advisers in the UK, although there is the perception that competition between them may not be significant, as most consumers do not seem to shop around for advice. Any competition that does exist appears to be based on quality of service and access to products, rather than price. Commission bias has been identified as a feature of the market, although it is unclear to what extent there is actual bias across all product groups.

In terms of market structure, there is little evidence of barriers to entry in either the market for products or the market for advice. There is some evidence of vertical integration, with some providers, particularly life assurance companies, acquiring interests in adviser firms.

Asymmetric information exists in the market for financial products, which makes it difficult for consumers to make an efficient choice of product. There is a lack of transparency about product charges, with rebating and discounting of stated charges being commonplace. Once products have been purchased there is limited evidence of switching if performance is not satisfactory.

Consumers, in general, appear to use a wide variety of information sources when making financial decisions, although, individually, their use of available sources is more limited. Consumers' efforts to shop around between providers vary by product, with mortgages and savings products being two areas where there was evidence of such activity. Advisers were used, in the main, to assist in searching for mortgages and life assurance, but even then a relatively small proportion of purchases were made on the basis of adviser recommendation alone. Overall, it was not possible to ascertain the extent to which consumers shop around between advisers, but anecdotal evidence suggests that this is limited. Likewise, no evidence was obtained on why consumers choose a particular adviser.

There have been significant technological developments in recent years, mainly around the concept of the wrap platform. These have given advisers the opportunity to offer a more holistic service to consumers, leading to more efficient portfolio management services. In addition, those platforms aimed directly at the consumer enable them to access a wide range of products and to undertake their own portfolio management. However, the FSA has identified the complexity and lack of transparency of charging structures for these platforms as issues of potential concern.

3 Impact on market structure

The changes as a result of the RDR proposals and Prudential proposals for personal investment firms may affect the relative attractiveness of certain distribution channels. This is assessed below in relation to the changes to capital requirements, professional standards, the remuneration model, and the new independence requirements, from the perspectives of both a distributor and a provider.

Distribution channels can be affected by changes in costs (eg, an increase in compliance costs as a result of the RDR proposals), changes in potential revenues (eg, more or less competitive pressure), and the extent to which the RDR proposals may introduce or remove barriers to the use of certain distribution channels.

3.1 Impact of capital requirements

3.1.1 Mechanisms

Although separate from the RDR, the prudential review for personal investment firms has many overlaps, and the consultation paper was published in November 2008 alongside the RDR Feedback Statement.[40]

The proposals will mean that all personal investment firms will be required to hold capital of three months' worth of relevant annual expenditure, or a minimum of £20,000 (whichever is the higher). This has removed a series of complex rules whereby different firms have been subject to different requirements, therefore removing the risk of arbitrage.

The Feedback Statement to the discussion paper, and the structured interviews conducted by Oxera, have identified that an increase in capital requirements may make the business of existing firms more costly and financially less attractive. It may lead to existing firms

– exiting the market; or
– joining a network; or
– merging.

For firms considering entering the market, the new capital requirements will increase barriers to entry.

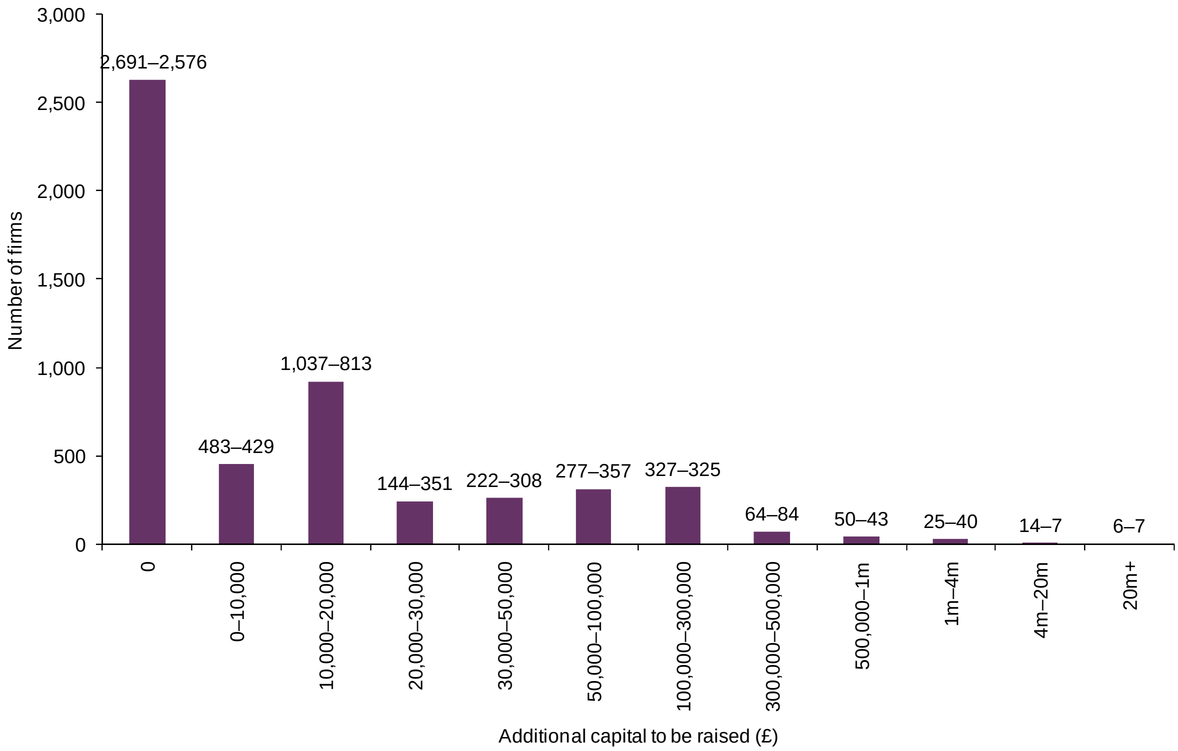
3.1.2 Validation of mechanisms

The high-level CBA conducted by the FSA indicates that of a total of 5,340 firms, between 2,576 and 2,691 will not need to raise additional capital following the increase in the minimum requirements.[41] While around half the number of firms will not need to raise further capital, Figure 3.1 below shows that a number need to raise a not insignificant amount of additional capital to comply with the requirement.

[40] FSA (2008), 'Review of the Prudential Rules for Personal Investment Firms', Consultation Paper 08/20, November.

[41] FSA (2008), 'Review of the Prudential Rules for Personal Investment Firms', Consultation Paper 08/20, November, Annex 2, p. 3, paras 9–10.

Figure 3.1 Number of firms that will require additional capital



Source: FSA (2008), 'Review of the Prudential Rules for Personal Investment Firms', Consultation Paper 08/20, November, Annex 2, p. 3, para 9.

The Feedback Statement indicates that some firms, sole traders and partnerships have buffers of £15,000–£30,000 above the current regulatory requirements.[42] The impact of the increase in capital requirements will therefore also depend on whether firms that currently maintain a capital buffer over and above the current minimum requirements will retain the same buffer over and above the proposed new requirements.

Previous FSA research on prudential requirements for banks found that many maintain capital buffers above the regulatory minimum even when the minimum is increased.[43] This might suggest that IFAs will react in the same way to the proposed increases and will maintain buffers in excess of the new minimum requirements. On the other hand it is not clear that the drivers which lead banks to maintain capital buffers would also lead to the same behaviour among IFA firms. There are a number of other reasons why some IFAs currently have capital buffers. For example, Oxera is aware, anecdotally at least, that some IFAs have increased their capital holdings in anticipation of a change in the rules. It is not expected that such firms would maintain the same level of buffer once the new requirements are introduced. Also, given that the current minimum of £10,000 was set in 1994, it is likely that some firms will have assessed that this level of capital is no longer sufficient for an orderly winding down of their firm, and so have chosen to go beyond the minimum requirements.

Furthermore, the mechanism being considered is whether firms will exit the market as a result of the new capital requirements, and the consequent effect on market structure. While some firms may wish to maintain a buffer over and above any regulatory requirements, it

[42] FSA (2008), 'Review of the Prudential Rules for Personal Investment Firms—Feedback on DP07/4', Feedback Statement 08/2, April, p. 34, para 5.13.
[43] FSA (2009), 'On the Behaviour and Determinants of Risk- Based Capital Ratios: Revisiting the Evidence from UK Banking Institutions', March.

seems unlikely that such firms would choose to exit the market simply because they were not able to maintain their desired buffer.

During the course of Oxera's structured interviews with the industry, both financial advisory firms and product providers stated that smaller firms were already leaving the sector in anticipation of the new capital requirements (and other requirements such as professional standards).

Aside from exiting the market, existing firms could either merge or join a network in order to comply with the new capital requirements. For new firms, the higher requirement could also act as a barrier to entry. A number of firms interviewed by Oxera indicted that large IFA firms and networks will benefit as small advisers turn to them for protection from the increased regulatory burden. By joining a large firm or network which does not require the IFA to be directly authorised, they will no longer have to meet the capital adequacy rules, unless this is separately required by the firm or the network.

The Feedback Statement indicated that, unlike those firms with significant capital buffers, some partnerships and sole traders hold just above the required amount of capital.[44] There is unlikely to be any effect on networks as they are already subject to a capital requirement based on 13-weeks' expenditure.[45] According to the FSA's high-level CBA, a number of very large firms will have to increase their capital requirements significantly. This evidence is replicated in Figure 3.1, which shows that up to 14 firms will need to raise between £4m and £20m each, and up to a further seven firms will be required to raise more than £20m each. These firms are likely to cover a combination of regulated and non-regulated activities. Oxera has seen no evidence on whether such firms are expected to react to the increase in capital requirements by exiting the market.

The capital requirement proposals are intended to mitigate the impact in the event of a personal investment firm failing, not to change its behaviour, and this is one of several issues being addressed in the RDR. Therefore, the capital requirement would apply to the whole business, not only the regulated advisory activities. Firms with high expenditure, either due to significant non-regulated activities or because they are large firms, may choose to change their corporate structure in order to limit the expenditure for the purposes of calculating their capital requirements. This may result in the establishment of subsidiaries for the regulated advisory business.

The available evidence suggests that some smaller firms will exit the market as a result of the increased capital requirements. Others may choose to join networks or large IFA firms. On the other hand, over half of IFA firms already hold sufficient capital to meet the new rules and some others will be required to raise only a small additional amount. While barriers to entry are currently low, the increased capital requirements will raise the barriers to new entrants, although Oxera has seen no evidence on whether this will have a material impact on potential entrants' decisions. Overall, there is no evidence to suggest that, on their own, the revisions to the capital adequacy requirements will lead to a significant change in the market structure. Section 3.6 considers the combined effects of the RDR proposals on market structure.

[44] FSA (2008), 'Review of the Prudential Rules for Personal Investment Firms—Feedback on DP07/4', Feedback Statement 08/2, April, p. 34, para 5.14.
[45] FSA (2007), 'Review of the Prudential Rules for Personal Investment Firms', Discussion Paper 07/4, p. 39, para 7.8.

3.2 Impact of raising professional standards

3.2.1 Mechanisms

The proposals for professional standards will mean that all advisers, irrespective of whether they are IFAs, financial advisers or sales advisers, will need to have Level 4 QCF (rather than the current requirement of Level 3), thereby creating a level playing field between the different types of adviser. According to the FSA, 'grandfathering', whereby existing advisers without the proposed minimum qualification can continue to practise due to their experience, will not be allowed.

The imposition of a minimum professional standard may result in older advisers retiring early rather than studying to attain the QCF Level 4 qualification. This is driven by the fact that older advisers would have less time on average to recoup the costs of training than younger advisers.

3.2.2 Validation of mechanisms

Data provided to Oxera by the FSA shows that there are a significant number of advisers aged over 55. In March 2009, 22% of advisers were aged 56 or over, and the proportion of advisers over the age of 50 was 37%.[46]

The issue of age distribution is highlighted in a recent Datamonitor report:

> there is growing concern that there are not enough young advisors entering the industry[47]

This concern is borne out by the current lack of younger advisers—in March 2009, only 3.7% of advisers were under the age of 30.[48]

However, it should also be noted that the average age of a financial adviser is currently 47.[49] A report published by the FSA in 2007 found that two-thirds of advisers were aged between 35 and 55.[50]

According to a survey by NMG,[51] 33–35% of advisers in IFA firms report holding a QCF Level 4 equivalent qualification. Evidence suggests, however, that some older advisers are not planning to take the Level 4 qualification. The NMG Financial Services Consulting results from the IFA Census indicate that the average age of those advisers who were not willing to transition to the higher qualification and adviser charging remuneration model was 53 years.[52] This is consistent with the feedback from interviews carried out by Oxera, in which it was suggested that older advisers might not want to study for the higher qualification as they had fewer years remaining before they retired.

[46] Based on Tardis data extracted on March 26th 2009.
[47] Datamonitor (2008), 'UK IFAs 2008', November, p. 57.
[48] Based on FSA Tardis data extracted on March 26th 2009.
[49] Ibid.
[50] FSA (2007), 'Financial Risk Outlook 2007', p. 95.
[51] NMG Financial Services Consulting (2009) 'IFA Census–Quarterly Trends—Q1 2009 (January–March)', April, Slide 14.
[52] NMG Financial Services Consulting (2009), ''IFA Census–Quarterly Trends—Q1 2009 (January–March)', April, slide 20.

Table 3.1 Age distribution of advisers who will not transition to QCF Level 4 and an adviser charging remuneration model

Age (years)	Percentage of respondents (%)
18–34	4
35–44	15
45–54	28
55–64	42
65+	8
Prefer not to answer	2

Note: Total may not sum to 100% due to rounding. The above results are based on 123 out of the 694 survey respondents.
Source: NMG Financial Services Consulting (2009), 'IFA Census–Quarterly Trends—Q1 2009 (January–March)', April, slide 20.

Table 3.2 Transition status by segment

Characteristics[1]	Percentage of respondents (%)
Fully transitioned	9.5
Advanced transitioners	14.4
Early-stage transitioners	29.7
Late transitioners	17.0
Will not transition	17.7

Note: Total of 694 respondents. [1] *Fully transitioned*: already hold Level 4 qualification and have implemented an Adviser Charge-equivalent remuneration model. *Advanced transitioners*: hold Level 4 qualification and/or are well advanced towards achieving this, and have implemented an Adviser Charge-equivalent remuneration model, or have clear plans to do so. *Early-stage transitioners*: have clear plans in place to achieve Level 4 qualification and have clear plans in place to implement an Adviser Charge-equivalent remuneration model. *Late transitioners*: express an intention to achieve Level 4 qualification in the near future and express a longer-term intention to implement an Adviser Charge-equivalent remuneration model. *Will not transition*: do not hold Level 4 qualification and do not intend to take the qualification, and do not intend to migrate to Adviser Charge-equivalent remuneration model.
Source: NMG Financial Services Consulting (2009), 'IFA Census–Quarterly Trends—Q1 2009 (January–March)', April, slide 19.

A survey of IFAs in December 2008 indicated that around a quarter of advisers will choose to leave the market, or take on non-advisory roles, rather than take the proposed higher, Level 4, qualification. In particular, advisers who would retire earlier than planned or leave the industry account for over 10% of the total. Around 6–7% are advisers who had already planned to retire.[53] Their decision is therefore not attributable to the RDR proposals.

Evidence to suggest a smaller impact of this mechanism comes from the 2009 IFA Census, which finds that 9.5% of firms are already fully transitioned to both Level 4 and an adviser charging-equivalent remuneration model.[54] The survey carried out by Deloitte indicated a similar result, showing that 14% of directly authorised firms require their advisers to already be qualified to Level 4 or above.[55]

[53] NMG Financial Services Consulting (2009), 'Implications for the Adviser Sector Insights Report No 4', January, slide 5.
[54] Of the 694 firms that responded, 56 firms are fully transitioned. See NMG Financial Services Consulting (2009), 'IFA Census–Quarterly Trends—Q1 2009 (January–March', April, slide 19.
[55] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 60; it is noted that Deloitte examines the transition to the higher qualification only, whereas NMG examines the transition to both the higher qualification and the new remuneration model.

The Deloitte (2009) survey indicated that firms were split approximately equally on whether they would allow advisers to take paid leave to study for the higher qualification. The results show that larger firms (both commission- and fee-based) were more likely to offer paid leave.[56] Deloitte has estimated the training cost for each registered individual as being £2,100 (median average) for external costs, such as course and exam fees, and £523 for paid leave.[57] The median cost of being a member of the professional body was estimated to be £35.[58]

However, since the publication of the Feedback Statement, the FSA has proposed ‘alternative assessments’, which may be more in line with the preferences of experienced advisers for obtaining the QCF Level 4 qualification. This would mitigate the number of advisers who would have left the market prematurely. Advisers currently working towards Level 4 qualification would be allowed to provide advice under supervision by another qualified member of staff. The available evidence suggests that a number of advisers would leave the market as a result of the required higher professional standards. However, the FSA’s proposed alternative assessments will allow some of those advisers to remain in the industry, thereby reducing the magnitude of this effect. Oxera understands that the assessments will be targeted at experienced advisers.

Overall, these results indicate that the market for advice will become more concentrated, with smaller firms being more likely to exit the market. However, competition concerns only arise if the market becomes so concentrated that competition is harmed and entry barriers prevent healthy competition from being maintained. In this case, there is no evidence to suggest that there will be insufficient remaining competition, or that entry barriers will be substantially increased. There is no evidence to suggest that the level of increased concentration expected as a result of the RDR proposals will lead to consumer harm.

3.3 Impact of the new independence requirements on market structure

3.3.1 Mechanisms

As part of the RDR proposals, new independence requirements will be introduced. As set out in the FSA’s December 2008 Feedback Statement, the current notion of ‘whole of market’ advice will be replaced with independence requirements, part of which is a requirement for advisers to consider products in the ‘relevant market’, which will have different meanings for different firms.[59] The Feedback Statement gives examples of what would, and would not, constitute a relevant market. Pensions, ethical investments and Islamic finance are deemed relevant markets because it is considered that some clients would not be able to obtain their required outcome from any other type of product. Products such as investment bonds, however, do not form a relevant market because other products are directly substitutable.

The other key element of the independence requirements is that advisers’ research must go beyond packaged products to include other financial products, such as National Savings. Lying behind this concept is a requirement that independent advice should come from a comprehensive and fair review of what is available to meet the requirements of the client.

The FSA has indicated that IFAs can comply with the new requirements by using a panel or panels that fully cover the relevant market in which they operate and are regularly updated. Alternatively, it would be legitimate for IFAs to use a software package that searches the relevant market.

These changes could have the following impacts.

[56] Ibid, p. 61.
[57] Ibid, p. 62.
[58] Ibid. p. 63.
[59] FSA (2008), ‘Review of the Prudential Rules for Personal Investment Firms—Feedback on DP07/4’, Feedback Statement 08/2, April, para 4.53.

– *Increased costs to IFAs*—there will be costs to many IFAs as a result of complying with the new independence requirements, since they will be required to carry out research across a wider range of products than at present, or will have to outsource this extra effort by using panels or market search services. The higher costs are likely to lead to some IFAs changing their status, as follows.

  – *IFAs join (multi-tied) networks*—some IFAs may choose to join an IFA network in order to reduce the costs of offering independent advice, as the network would provide the research support. However, it is not clear whether this would be significantly cheaper than IFAs remaining outside a network and simply buying panel services. Joining a multi-tied network would reduce an adviser's search costs, as the limited panel would be chosen by the network and the research costs for the individual adviser would be significantly lower.

  – *IFAs leave the industry or decide to work as introducers or para-planners*—the increased costs may lead IFAs to leave the industry altogether if they are currently finding it only marginally profitable, or to take up a role which does not allow them to offer investment advice to clients, such as becoming an introducer or para-planner.

The extent to which IFAs will incur higher costs may also depend on how strictly, in practice, they interpret the new independence requirements. This, in turn, will depend on the risk of being caught and the level of sanction imposed in the case of non-compliance.

The increase in costs is likely to be offset to some extent by the behavioural response of IFAs to the new independence requirements, as it is likely that they will adapt to the new rules in order to minimise their costs. For example, an IFA firm that mainly sells pensions but also a small number of investment bonds may decide that is not worthwhile offering the latter on an independent basis after the introduction of the RDR proposals due to the increased costs of surveying the relevant market in accordance with the new independence requirements. The firm can reduce its costs by choosing to specialise in pension products, requiring it to survey the relevant market for pensions only. It can still offer investment bonds, but must make clear to clients that it is only able to offer restricted, non-independent advice.

As a result, the new independence requirements may lead to an increase in IFAs choosing to specialise in certain markets. In its Feedback Statement, the FSA outlines three markets in which firms may specialise, but over time other clearly defined markets may become apparent where advisers can specialise and thus reduce their costs.

3.3.2 Validation of mechanisms

It is difficult to estimate precisely the increase in the costs as a result of the new independence requirements. This is partly because the new rules are untested and, more importantly, because the increase in costs will depend on the relevant market, or markets, in which each IFA firm chooses to offer advice.

The Deloitte (2009) survey asked adviser firms about the likely impact of the new independence requirements.[60] Although virtually all firms (97%) said that they currently recommend products from the whole of the relevant market, 58% said they would face an increase in costs as a result of the new independence requirements; 24% said the costs would be 'significantly more expensive'.

Respondents anticipated that they would have to spend an additional five hours per week on research as a result of the new independence requirements.[61] Firms were asked to estimate the financial impact of the change. The median response was £2,000 per registered

[60] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 64.
[61] The median response was five hours; the mean was ten hours.

individual per year. This made up the majority of additional ongoing costs (57%) that firms estimated they would face after the change.

In broad terms, the results from the Deloitte (2009) survey indicate that IFAs expect the new independence requirements to lead to an increase in their ongoing costs. Furthermore, the survey shows that IFAs expect this to be the largest of the ongoing costs they will face as a result of the RDR proposals. However, there is nothing in the Deloitte results to indicate that the new independence requirements are likely to lead to IFAs moving to other channels, such as networks or multi-tied networks, to avoid or reduce these costs. (Table 2.1 above shows the current split between IFAs, tied/multi-tied advisers and bancassurance in the area of new life and pension sales.) It is therefore not possible to draw any direct conclusions from this evidence about possible changes to market structure.

The impact of the new independence requirements was discussed during the Oxera interviews with providers and advisers. One interviewee noted that the new independence requirements would lead to increased costs for IFAs and that only a very small proportion of them would be able to meet the requirements. A number of firms noted that some IFAs would be likely to turn to multi-tied networks when they are unable to meet the independence requirements after implementation of the RDR proposals. It was argued that these networks are also attractive to consumers, the vast majority of whom would not benefit significantly from using an adviser that met the new independence requirements. Therefore, it was further argued that multi-tied adviser firms and networks will benefit from RDR as they attract price-sensitive customers who do not value the costly IFA route. They will also benefit by attracting advisers unable to remain independent under the RDR requirements.

The scenario of IFAs switching to working for multi-tied networks may arise to some extent, but the evidence does not suggest that, on its own, the new independence requirements will lead to a significant change in the market structure. Therefore there are no implications in terms of significant changes in competition, price or quality experienced by consumers. Section 3.6 considers the combined effects of the RDR proposals on market structure.

3.4 Impact of new remuneration structure on market structure

3.4.1 Unwinding of cross-subsidies between large and small transactions

Mechanisms

One way in which the proposed remuneration structure could have an impact on market structure is if it affects the types of customer able to access the IFA channel. If the RDR proposals lead to an increase in charging hourly fees, this will remove the cross-subsidy that exists between those investing larger amounts and those investing smaller amounts. On the other hand, if advisers choose to base their charges on the value of the funds invested, the cross-subsidy will continue in the same way as under the commission-based system. However, with the volume effect more explicit, customers may be more likely to ask for, and be given, volume discounts, unwinding the cross-subsidy even within an apparent commission-like system. In this case, IFAs will be less able to extract revenues from customers with more to invest and consequently may need to charge more to those with less to invest, although this will be possible only to a limited extent. If the cost of advice becomes an unacceptably high proportion of the amount invested, small investors are less likely to continue using the IFA route, and may instead switch to non-independent advice, or non-advised sales. Some consumers may even choose not to buy an investment product at all.

Validation of mechanisms

Short-run effects

The likely effects of switching to an hourly charging system are discussed in the Deloitte report:

> Even at the relatively low fee level £91.50 per hour, which firms believe their commission-based customers would pay, the fee represents around 15-20% of the premium for the smallest case band (and in excess of 5% for many products in the second smallest band). Fees at this level are unlikely to be acceptable to the customers for such transactions.[62]

The same report notes that, under the RDR proposals, some investors with large amounts to invest who do not currently receive advice will choose to receive it because the reduction in the cross-subsidy will lower their costs of advice.[63]

The extent to which these effects will occur in practice depends on the increase in price transparency (for advice) that occurs as a result of the RDR proposals, and the extent to which larger investors who currently have their advice paid for through commission are willing and able to change their behaviour in light of the proposals and start either negotiating on price with IFAs who charge percentage fees, or voting with their feet and switching to advisers that offer fixed or hourly rates.

The majority of those interviewed by Oxera did not expect the change to the remuneration system to have a significant impact on the market structure. The consensus was that the new system would be flexible enough to allow advisers to present to consumers a fee charging structure that appeared similar to the current system. Those consumers who currently pay for advice via upfront fees would continue to do so; those who have their fees paid through commission would still have their fees paid to the adviser by the provider out of the product charges. This would be taken from the total sum of money invested.

Some technical issues remain on how different levels of ongoing adviser fees can be paid to advisers by providers from certain products, such as collective investments. These issues were raised during the interviews. Oxera understands that, in general, none of the problems identified would have such a significant impact on how products are sold post-RDR that they would alter the conclusions of this study on how the new remuneration structure will affect market structure.

One issue around provider-assisted remuneration that may be significant is that, while the new independence requirements mean that advisers will need to consider non-packaged products such as National Savings, there is no scope within such products for the provider to pay the adviser. This issue is discussed in more detail in section 4.5.

The Deloitte (2009) survey asked advisers how they are remunerated currently and how this is expected to change post-RDR. The charging approach that is most widely expected (by 79% of respondents) is a combination of upfront and ongoing value-based fees—that is, fees based on the value of the investment.[64] Just under 30% of advisers expected to use hourly fees to charge customers, and around one-third expect to use other charging methods.[65] This may indicate that advisers expect the cross-subsidy to remain. However, as survey respondents were able to select more than one response and were not asked whether they would use a specific charging method for a particular type of consumer, it is not possible to draw strong conclusions from these results. So, for example, an adviser could use fund value-based charging for small investors and hourly fees for large investors, in which case the cross-subsidy would be removed.

[62] Deloitte (2008), 'Costing Intermediary Services', a report for the FSA, November, p. 43. The value of products in the smallest and second smallest price bands varies by product (see Deloitte 2008, Annex 1), but, for example, single premium collective investments in the smallest band are £0–£2,500 and in the second smallest band £2,500–£5,000. Single premium individual pensions in the smallest band are £0–£5,000 and the second smallest band £5,000–£15,000.

[63] Deloitte (2008), 'Costing Intermediary Services', a report for the FSA, November, p. 43.

[64] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 42.

[65] The total does not sum to 100% as respondents were able to select more than one category.

The Deloitte (2009) survey evidence suggests that the expectations about charging structures are broadly the same across firms that currently favour a commission-based charging model and those that currently favour fee-based charging. Given that around 70% of those already using fee-based charging—and therefore not directly affected by this reform—expect to charge customers using value-based fees, this suggests that the value-based charging system will remain viable. It may also suggest that fee-based firms are currently using value-based fees, as it is not obvious why they would have an incentive to change their charging structures as a result of RDR.

The Deloitte (2009) survey also asked advisers whether they would be able to move to adviser-based charging: 21% said no and 33% were unsure.[66] Small commission-based firms, firms with a low proportion of their turnover coming from investment income, and those with less well-off customers were most likely to answer that they would not be able to switch to adviser-based charging. The main reason, cited by 76% of respondents, was that their customers would not be willing to pay for advice explicitly. A smaller proportion (15%) argued that their customers would not be willing to pay enough to make the model financially viable.

These results suggest that half of firms are either unsure that they will be able to switch to adviser charging or are sure that they will not be able to. Taken at face value, this would imply a significant change to the market structure since half of IFAs would be at risk of not being able to meet the new requirements and so may have to exit the market. However, the results need to be treated with caution. The brief explanation of adviser charging set out in the Deloitte questionnaire does not make clear that providers will be able to facilitate payments, which would make the payment less explicit. As the main reason cited for not being able to switch was customer resistance to explicit charging for advice, it is possible that at least some respondents were not aware that provider-facilitated payments to advisers would be part of the new regime. At the same time, this result cannot be ignored, and may suggest that a significant number of advisers—particularly smaller, commission-based firms and those with lower-income customers—could be forced to exit the market as a result of not being able to switch to adviser charging. It also suggests that some of those firms with only a small proportion of investment business may choose to discontinue that part of their business.

Taking together the evidence from the Oxera interviews and the Deloitte (2009) survey, in the short term following implementation of the RDR proposals, it is likely that a charging system which approximates the current system will continue. Those consumers currently paying upfront fees for advice will continue to do so, and those who currently allow their adviser to be paid through commission will move to a system whereby the provider pays the adviser from the funds invested, thereby avoiding upfront fees. The consensus from the Oxera interviews of advisers seems to be that most consumers do not want to pay upfront for advice.

Long-run effects

In the longer term, however, the increased transparency in adviser charges brought about as a result of the RDR may lead a proportion of those investing larger sums of money and paying a percentage of the amount invested to realise that they are effectively subsidising those with smaller amounts to invest. There will be a strong incentive for these people to switch to paying a flat rate or hourly fee. If this change happens to a significant degree, it may cause advisers to switch away from percentage-based charging altogether. This in turn may lead to those with small amounts to invest not using IFAs but instead opting for a tied, or non-advised, route, or in some cases not purchasing a product at all. This conclusion is not affected by whether providers are willing and able to facilitate adviser charging, as it is driven by those with more to invest choosing upfront fixed or hourly charges in order to save money compared with paying a provider-facilitated percentage fee.

[66] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 41.

To some extent, the effect of the adviser remuneration changes will be to reinforce an existing trend away from largely commission payments towards adviser-based charging and commission rebating. As consumers become more financially aware, the effects described above are likely to occur to some extent, even without the RDR proposals, albeit at a slower pace.

Overall, the conclusion is that some unwinding of cross-subsidies is a realistic possibility in the long term. However, the effects of this aspect of the proposals on consumers are limited by the fact that, even in the counterfactual scenario, where the RDR proposals were not implemented, some unwinding of the cross-subsidy would be expected over time.

3.4.2 Alternative arrangements to influence intermediaries

Mechanisms
A central aim of the RDR is to eliminate any undue influence of providers in advisers' decisions to recommend a particular product or provider. By removing commission payments from providers to advisers, the FSA is seeking to eliminate this influence.[67]

In the post-RDR world, where providers are no longer able to influence advisers through commissions, providers will have alternative options to maintain or even grow the market share of their products. The most straightforward option would be for providers to use some of the money saved from commission payments to create better-value products for consumers. This scenario was considered the most likely by a number of interviewees.[68] An alternative option would be for providers to find other ways to influence the adviser's advice, or to consider other routes to market.

Provider ownership and financing of advisers: one route for this influence to occur could be through full or partial ownership of adviser firms or through financing arrangements. The FSA has made clear that, post-RDR, providers will still be permitted to own, part-own or finance distributors, as preventing this may limit access to capital for distributors at a time when firms are finding it difficult to access capital in any case.[69] The FSA also notes that its previous research on providers taking a financial interest in distributors 'did not find evidence of a systemic cross-industry issue at present'.[70]

While there may be no evidence of ownership leading to adviser bias under the current regime, in part this may be because providers can influence advisers directly through commission, so there is no need to use less direct methods of influence. Although it is difficult to predict in advance, once the method of direct influence through commission is removed, providers may begin to use less direct methods.

Other, softer, forms of influence: providers can influence advisers through other ways, such as offering them free or subsidised training courses, or providing graduate training schemes. The former option is particularly relevant since the costs to some advisers of reaching the required level of qualification is a significant issue (see section 3.2).

Providers may also be able to influence advisers' decisions by tailoring their products to the advisers' needs—for example, by improving administration and support/back-office functions. This could benefit consumers indirectly, although there is also a risk that provider efforts to

[67] To prevent non-UK products with commission payment passporting into the UK, the FSA plans to introduce rules whereby UK providers will not be able to offer commission-laden products and UK IFAs will not be able to accept such products. A number of interviewees expressed concerns over whether this would be possible under EC legislation, and others talked about IFAs getting round the rules by registering in Ireland and passporting into the UK. However, given the uncertainty surrounding these issues, for the purposes of this report it has been assumed that the FSA will be successful in removing commission payments from the system.
[68] It is not possible for Oxera to determine which of the outcomes in terms of provider behaviour are most likely. Therefore all possible outcomes are considered.
[69] FSA (2008), 'Feedback Statement 08/6', November, para 4.58.
[70] FSA (2008), 'Feedback Statement 08/6', November, para 4.58.

compete for advisers come at the expense of providing benefits to consumers (this is discussed further in section 4.3).

Alternative routes to market: as a result of being less able to influence advisers, some providers may seriously consider the possibility of alternative routes to market, such as vertically integrating downstream into direct sales, or striking exclusive deals with tied advisers in the bancassurance channel.

Validation of mechanisms

Continued influence through ownership/financing of advisers or through softer forms of influence: the evidence to validate this mechanism is limited. One interviewee talked about providers starting to look at new forms of indirect influence, such as offering free or subsidised training for advisers, and starting graduate training schemes alongside firms of advisers. On the basis of this very limited evidence, it is not possible to draw firm conclusions. However, providers are unlikely to be willing to pay for the types of adviser benefits described above unless they expect them to affect advisers' decisions on which products to recommend.

Alternative routes to market: while, at a theoretical level, it seems plausible that the vertical integration and/or bancassurance route could become more attractive to providers post-RDR, very few of the Oxera interviewees expected this to happen.

While, when asked, some agreed that vertical integration would become more attractive, they felt that providers have strong reasons for using the adviser channel currently, such as obtaining access to a broad customer base, and risk management in the event of mis-selling or other financial malpractice. It was felt that these reasons will not change post-RDR and any small change in incentives as a result of RDR is unlikely to be significant enough to bring about a change in the market structure. A number of interviewees also noted that some providers had previously sought to sell their products through a direct sales force without success. Therefore, it was unlikely that the effect of RDR would encourage them to actively consider this route in future.

One interviewee expressed the view that providers would move towards striking more deals with banks post-RDR, and that this is why banks and providers had pushed so hard for the term 'sales adviser' to be applied to the banks' internal advisers. However, another interviewee felt that the bancassurance model was already substantially tied up with exclusive deals between banks and providers, and that, in any case (in the short term at least) with many banks in public or part-public ownership, it would be more difficult for providers to strike deals.

The Deloitte (2009) survey results show that some providers do expect to change their distribution strategy as a result of RDR.[71] In total, over half of the respondents expect the RDR proposals to have at least 'some impact' on their distribution strategy, and around 30% expect this impact to be significant. The effect on the independent channel was mixed, with 16% responding that the share going through this route would increase, while 18% responded that it would decrease. The channel that was expected to see the greatest increase was external non-independent advice. Whether an increased use of the independent channel by providers would strengthen competition between the independent and non-independent sectors depends on the extent to which consumers see these routes as substitutes. This is considered in section 4.4.

Supervision

In the absence of commission payments, it appears that there will continue to be ways that providers will be able to influence advisers' decisions to some extent. Ultimately, however, the mechanisms are far less likely to be effective than in the current situation. Furthermore,

[71] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 21.

since the FSA's aim is to remove provider influence, supervision can be expected to play a role in reducing the effects outlined above.

Provider ownership and financing of advisers: the FSA already has supervisory tools to control undue influence through adviser ownership or financing, and is planning to keep the situation under review. Therefore, any harmful effects of ownership are likely to be mitigated by FSA supervision.

Other, softer forms of influence: because the new regime may lead to innovation in the ways in which providers influence advisers, it is not clear whether the FSA's existing tools would be suited to tackle these softer forms of influence. Given the increased incentive once influence through commissions is taken away, this is another area that the FSA may need to keep under review.

3.4.3 Impacts that may increase the level of IFA remuneration

Mechanisms
As set out in section 4.4, it may be argued that the effect of the RDR proposals will be to allow IFAs to charge higher prices to (some) consumers. Currently, the maximum income a commission-based IFA can receive from a sale is limited by the size of the commission. Following the RDR proposals, adviser charges will not be limited in this way.

If the price of advice does increase, this would have the effect of drawing more IFAs into the market, all else equal.

Validation of mechanisms
One piece of evidence that would suggest higher adviser profits post-RDR is the general response from those interviewed by Oxera that consumers would not start shopping around in search of the lowest price for advice. This would suggest that, in theory, advisers' charges will be limited only by consumers' willingness to pay.

Two sources of validation on consumers' willingness to pay come from the Deloitte (2008) study and the Deloitte (2009) survey, both of which suggest that advisers will find it harder to earn fees from consumers who previously used the commission route. In terms of evidence on consumer price sensitivity, the Deloitte (2008) report finds that advisers expect consumers to be willing to pay £91.50 per hour for advisers' time and £40 for support staff. This compares to current average hourly charges of £150 for advisers and £65 for support staff.[72] Many advisers expect to replicate existing commission structures where possible; as such, for many consumers, hourly charging would not be an issue. However, replicating existing commission structures will also provide an anchor point for charges, potentially preventing them from increasing in the short term.

In terms of advisers' expectations of profits post-RDR, the Deloitte (2009) survey reports that 73% of directly authorised firms that responded said that profits would decrease as a result of RDR, with only 10% expecting profitability to increase.[73]

Overall, there is no clear evidence to suggest that adviser profits will, on average, be higher. As such, there is no expectation that more advisers will be drawn into the market as a result of this mechanism.

[72] Deloitte (2008), 'Costing Intermediary Services', a report for the FSA, November, p. 35.

[73] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 43.

3.5 Does the RDR package remove any obstacles to the use of particular distribution channels?

The changes resulting from the RDR proposals may affect the relative attractiveness of different distribution channels. This section assesses to what extent the proposals may remove barriers to the use of certain distribution channels. If providers find it easier to make greater use of a particular distribution channel which previously had not featured significantly in the distribution landscape, this could have a significant impact on market structure.

3.5.1 Vertical integration

Mechanisms
One issue raised during the stakeholder interviews was whether, post-RDR, providers would have greater incentives to increase their use of non-IFA distribution channels, including direct sales to the public. The mechanism driving such a change would be that vertical integration would become more attractive because the cost to consumers of using the traditional IFA or tied adviser route would increase as a result of the costs associated with RDR.

Validation of mechanisms
The general response from those interviewed by Oxera was that the main reasons for using IFAs (namely customer reach and risk management) will remain post-RDR. Furthermore, a number of interviewees commented that providers had tried the direct sales force model, but that this had ended in failure as costs increased and providers were unable to control the regulatory risks created by the actions of their direct sales forces.

As discussed in section 3.4.2 above, the results of the Deloitte (2009) survey suggest that some providers are likely to change their distribution strategy post-RDR, with around half of those who currently use an internal non-independent channel slightly increasing their use of that channel. The other respondents reported that their use of this channel would remain unchanged.

The Deloitte survey also asked providers whether they might consider a number of strategic changes post-RDR, such as partnerships with financial firms, acquisition of distributors, setting up or expanding a direct sales force, increasing focus on non-UK investment markets, and the acquisition of other providers. By far the most common response was that they would not consider any of these options. It is notable that the hurdle for considering an option was set as ‘might consider’, which suggests that these firms would be very unlikely to adopt such strategies post-RDR.

Of the firms that did consider one or more of the strategic options set out in the survey, the most common response was that they might consider setting up partnerships with financial institutions. Nine providers said they might consider setting up or expanding a direct sales force, but it is not clear how many of those already have a direct sales force or would need to set one up from scratch.

Overall, the evidence does not suggest that the direct sales route to market will become significantly more important post-RDR. This is consistent with the conclusion in section 3.4.2 above, which also considers the likelihood of greater vertical integration, but based on a different mechanism.

3.5.2 Execution-only sales

Mechanisms
In principle, RDR could make the execution-only route more popular since the separation of product charges and advice will make it clear how much customers could save by taking this route.

Validation of mechanisms
The interviewees asked about the execution-only route noted that it is a small part of the market and will remain so post-RDR, for three main reasons:

– in general, customers want advice—they want to be told which product is appropriate for them, rather than being given a range of options to choose from;

– there is a liability issue around execution-only products due to the difficulty of distinguishing clearly between what is and what is not an advised sale;

– if the execution-only channel becomes popular, there is a concern that this will lead to cannibalisation of adviser revenues. As such, some providers or platforms may be reluctant to offer competitively priced execution-only products.

By contrast, the Deloitte (2009) survey found that 5–10% of those providers currently using the execution-only channel expected to see a significant increase in the use of that channel as a result of RDR. Around a quarter of those using the execution-only channel said that their use of that channel was likely to increase 'a little'. The majority of those who answered said that their use of the execution-only channel would remain unchanged. These results are consistent with the findings from the Oxera interviews, although these covered only those providers already using the execution-only option. It cannot be discounted that there may be providers who are not using execution-only at the moment but who start using it to a significant degree post-RDR, although Oxera has seen no evidence of this.

3.6 Combined effect of the RDR proposals on market structure

The potential effects of RDR on market structure have been discussed above, focusing on particular mechanisms in isolation. However, even where a particular mechanism is not strong enough to cause significant change to the market structure, it may be that a combination of these mechanisms could have a significant effect, especially where a number of them focus on one particular group of advisers. For example, if older IFAs were more likely to be below the Level 4 qualification standard and more likely to be working in a smaller, less well-capitalised firm, the combined effects on that group might be sufficient to cause a significant change in market structure.

It has been difficult to identify particular circumstances whereby less significant individual mechanisms may combine to produce a mechanism that will have a significant impact on market structure. In addition, given the imperfect evidence available on the effect of each particular mechanism, there is still a degree of uncertainty as to what effect each mechanism will have on its own. As such, any predictions on how these mechanisms will combine and interact multiplies that uncertainty.

However, evidence from a number of sources can help to provide a clearer idea of the overall effects on market structure. All of the predictions are related to market structure in terms of the number of advisers that are expected to leave the market as a result of RDR. As these estimates were produced before it became clear that alternative assessments to obtain the QCF Level 4 qualification are likely to be available, they may overestimate the extent of the exit from the market.

– A report by Ernst & Young in February 2009 suggests that the combined effect of the RDR proposals will be to reduce the number of IFA firms from 16,000 to 10,000 (35–40%) by 2013.[74]

– Internal FSA estimates of *firms* exiting the market put the figure at between 12% and 18%, based on a survey as part of the Discussion Paper Impact study.[75] A more recent

[74] Ernst & Young (2009), 'In Shifting Sands: UK Life and Pensions Outlook', p. 10.

IFA Census survey suggests that 25% of *advisers* say they will leave the advice market, with 6% going elsewhere in the industry, 4% leaving the industry, and 15% retiring (of which 7% would have retired anyway). Subtracting those who would have retired in any case gives a figure of 18%, which is towards the upper end of the FSA's original range.[76] Another recent IFA Census survey reports that, of the IFAs who will not be transitioning, 44% were either sole traders or partnerships.[77]

– Interviewees have suggested to Oxera that there could be a reduction in the number of IFAs of between 30% and 50%.[78]

– The Deloitte (2009) survey suggests a smaller number of firms exiting. The results show that 71% of firms would not consider changing their status as a result of the RDR proposals. 16% responded that it was too early to say, and 13% said they would consider a change in status (of which 9% said they would move to the non-independent sector and 4% said they would exit the market entirely).

Overall, these results suggest that a number of IFAs will exit the market as a result of the RDR proposals, but there is no clear consensus on how large the effect will be. Of the primary research sources, only the Ernst & Young report suggests a drop of more than 20% in the number of either advisers or firms.

At face value, a drop in IFA numbers could represent a significant change to the market structure. If this results in the IFA network providing a significantly less effective route to market for providers, this may in turn lead to providers shifting more business to other distribution channels. However, as noted above, none of these predictions takes into account that alternative assessments are likely to be available and suited to the IFAs most likely to be affected by the changes—namely, older advisers. Taking this change into account, the effect of the RDR proposals on IFA numbers will be less pronounced than suggested by the above estimates.

In conclusion, the post-RDR landscape is likely to feature fewer small independent IFAs, some of which will leave the market entirely, while others will join larger firms or networks, in either the independent or the non-independent sectors. This may lead some consumers to experience reduced choice in the short term. However, if demand for advice outstrips supply, the fact that entry barriers are unlikely to be prohibitive (although higher as a result of RDR), means that the gap would be filled by new entry or expansion by existing players.

[75] The FSA has advised that this range is of limited use because, since the survey was conducted, both the understanding of the RDR has moved on and the proposals have changed substantially.

[76] NMG Financial Services Consulting (2009), 'Implications for the Adviser Sector Insights Report No 4', January.

[77] NMG Financial Services Consulting (2009), 'IFA Census–Quarterly Trends—Q1 2009 (January–March)', April, slide 22; 'partnerships' does not include limited liability partnerships (LLPs).

[78] Interviewees did not always make clear when they were referring to firms or advisers.

4 Impact on nature of competition

Although strengthening competition is not one of the overall aims of the RDR proposals, the FSA's high-level CBA identified some possible positive effects on competition. First, the new remuneration model could mean that providers will compete with each other not around commission levels, but rather for consumers based on the (wholesale) price and quality of their products. This could raise product quality and/or reduce product charges (ie, lower FGPs). Second, the high-level CBA indicated that the price of financial advice may decrease to the extent that the new remuneration model gives consumers more power over the price they pay, and they exercise this power by negotiating with their adviser and shopping around more. However, there is a concern that the new regime may result in the adviser applying price discrimination—ie, charging more to those who are more willing to pay (and perhaps less well informed) than to others. Although price discrimination does not necessarily harm consumer welfare, there may be a concern that some people run the risk of paying excessive charges.

This section considers the impact on competition both across and within distribution channels, before assessing the impact on competition in the market for advice.

4.1 Impact on competition across distribution channels

4.1.1 Mechanism

As indicated in section 2.5, under the current regime the degree of competition both within and between distribution channels appears to be limited. In theory, this may change as a result of the RDR proposals. If the FGP becomes transparent in the market and easily comparable across channels, competition across channels might increase. Consumers may become more aware that similar products are offered through several different distribution channels and that FGPs vary across these channels. For example, they may realise that execution-only is cheaper or may think that using a bancassurer is cheaper because the advice is not given in accordance with the new independence requirements. Therefore, consumers shopping around among different distribution channels could result in more competitive pressure on providers.

4.1.2 Validation of mechanism

The interviews indicate that it is unlikely that there will be one transparent FGP per product in the market place in order to facilitate customer price comparisons, or to provide an easy reference point for customers to evaluate discounts offered by specific advisers or through specific channels. Providers are likely to vary the FGP by channel and to some extent by intermediary. The FGP is the result of negotiation between the provider and intermediary, and may, for example, depend on the intermediary's sales volume and its customer profile. Furthermore, the specification of products may vary by distribution channel, also making it difficult to compare across channels.

The Deloitte (2009) survey suggests that some providers expect to offer a range of FGPs to advisers.[79] While almost half of the providers who responded said that it is 'very unlikely' that there will be a range of FGPs, around a third said it was 'quite likely' or 'very likely' that a range of FGPs would be offered.[80] This indicates that there will not be a single transparent FGP post-RDR because at least some providers will offer a range of FGPs. In doing so, this

[79] The wording of the Deloitte survey report makes clear that this question was in the context of whether providers would offer different FGPs to advisers, and not that they would offer different FGPs to different channels.
[80] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 22.

may force other providers to follow suit through competitive pressure, particularly if those adopting multiple FGPs from the start are the larger, market-leading, firms.

Price transparency may decline somewhat compared with the current situation. Although the degree of competition across distribution channels is currently limited, consumers who want to shop around can focus on one price, the product charge, which covers both the price for advice (via a commission) and the price for the product. Under the new regime, although more information is introduced by providing a breakdown of the total price into the fee for advice and FGP, this does not necessarily result in more transparency. First, if a consumer wants to shop around on the basis of the total price, they would have to calculate this by adding the price of advice to the product price—not all consumers may be able to do so, and both elements of the addition can vary. Second, the consumer will need to collect information on these two price components. They may not be on distributors' websites and only available on request by approaching, for example, the specific IFAs. In other words, this could make shopping around difficult.

That said, even under the current regime, prices are not always transparent. In cases where advisers rebate part of their commission, the total price will be clear to the consumer only once they have negotiated the rebate with the adviser. This reduces transparency and increases the costs of those wishing to shop around between advisers, thereby limiting the negative impact of any post-RDR reduction in transparency.

It may still be possible that FGPs become transparent in the medium or long term. For example, networks and larger IFA firms may decide to start competing on FGPs; because of their size, they may be able to negotiate lower FGPs and use this to attract clients. Thus, FGPs could become more transparent, enabling consumers to compare products and prices within and across distribution channels. For this mechanism to function, consumers would need to change their behaviour and actively compare products across distribution channels.

4.1.3 Supervision

Although specific measures, such as including FGPs in the FSA price comparison website, may result in more transparency, existing plans for ongoing supervision of providers and intermediaries are unlikely to affect the mechanism in section 4.1.1, because ultimately providers can decide whether to set different FGPs both within and between distribution channels.

4.1.4 Other possible mechanisms

– The degree of competition across channels may also depend on the exact labels for each channel. For example, if consumers attach more value to the label of 'independent advice' than the label that will be introduced for non-independent advice, this may affect their choice of channel and the degree of competition between channels. Such an assessment is beyond the scope of this research; however, the IFF report, discussed in section 1.2 above, concludes that labelling will not have a significant impact.[81]

– The new independence requirements may put pressure on IFAs to justify their recommendation of products that are more expensive than basic products available through other channels. In theory, this could result in some competition between certain basic products and the more complicated packaged investment products. The analogy is the impact of stakeholder pensions on the pricing of personal products via the Regulatory Update 64,[82] where the introduction of simple, cheap stakeholder pensions had an impact on sales and pricing of more expensive alternatives (eg, prices of

[81] IFF (2009), 'Labelling of services and adviser remuneration', prepared for the FSA, forthcoming.

[82] Personal Investment Authority (1999), 'Regulatory Update 64: Advice on Personal Pensions in Advance of the Introduction of Stakeholder Pensions', March.

personal pensions fell). The effectiveness of this mechanism may depend on the degree to which supervision monitors advisers' recommendations.

– To the extent that RDR leads to more transparent FGPs, it could strengthen competition from execution-only products. Because consumers would be able to see more clearly the price they are paying for advice on top of the product, some may decide to avoid the adviser charge by taking the execution-only route. However, as set out in section 4.2, the FGP may differ across channels, making it less easy for consumers to estimate the savings they would make from the execution-only route. Also, as explained in section 3.5, there are several factors that may impose a limit on the growth in execution-only sales. These include the legal risks around whether advice was actually given, and the risk of cannibalising advised sales and ultimately profits if the growth of execution-only leads to products becoming commoditised. Therefore, although this mechanism may be relevant for the long term, its impact (if any) is likely to be limited in the short term.

4.2 Impact on competition within distribution channels

4.2.1 Mechanisms resulting in an increase in FGPs

Under the current regime, since any commissions that IFAs receive result directly in revenues to them, they have a strong incentive to negotiate commissions that are as high as possible (and to recommend products that come with a high commission). Any increase in commission increases their income (at least in the short term, since some of the increase may be rebated to their clients in the long term). At the same time, there is some pressure on providers to keep the total price to consumers down. This is driven by sophisticated consumers shopping around to obtain the lowest total price, and by providers' desire to appear in 'best-buy tables', which tend to make the comparison on the basis of their full charges that include commission payments to the advisers. As a result, raising the product charges to pay for additional commission will affect the ranking of the product achieves in some tables, thereby placing some constraint on the total product price.

Since the competitive pressure from advisers to raise commission rates is likely to be stronger than the pressure from consumers looking at product charges and possibly having to work out the impact of rebates, this suggests an outcome in which total charges to consumers are relatively high, but any excess profits are passed on from providers to advisers (and may, in turn, be passed on to some consumers through rebates). As such, the current implicit FGPs are likely to be competitive—in most cases, the FGP in the current market is not set explicitly, but is derived from the product price minus commissions.

To illustrate by way of a simple example: under the current regime, provider X, which has an underlying cost of 100, initially sets a product price of 120 and a commission payment of 20, while provider Y, which has underlying costs of 95, sets a product price of 110 and commission of 15. This leads to derived FGPs of 100 and 95 respectively. In the extreme case where advisers are only interested in the size of the commission, provider X will gain market share at the expense of provider Y. However, provider Y will have an incentive to increase its commission payment in order to win more business. This will drive up the product price to whatever customers are willing to pay. In this case, it is assumed that this is 120. At a price of 120, provider Y can match provider X's commission of 20. In the third stage, in order to win more market share, provider Y, which has a lower cost base, will have an incentive to increase its commission payments further, to 21. Since provider X is now constrained both by the maximum consumer willingness to pay and by its own cost base, it cannot match the commission increase and will lose market share.

Through this mechanism, product prices under the current regime are driven up towards the maximum that consumers are willing to pay and FGPs are driven down towards costs.

Under the new regime, FGPs may increase somewhat as a result of the following factors.

– IFAs’ incentives to impose pressure on providers to reduce FGPs will be weaker than their current incentive to negotiate high commissions (which result in competitive-derived FGPs at present). This is because a lower FGP will not result directly in revenues to the IFAs (although to some extent they may benefit indirectly from negotiating lower FGPs if they manage to attract more customers and/or increase their sales and profits as a result of these lower FGPs).

– Consumers could impose competitive pressure on providers (by shopping around for the best product), but are less able to do so than advisers because they tend to be less well informed. Furthermore, as explained, FGPs are likely to vary by distribution channel and by distributor, and do not necessarily become transparent in a way that makes comparison easy, possibly making it difficult to shop around within a distribution channel. Shopping around by approaching just one adviser and looking at its product offerings may result in some competitive pressure, but only to a limited extent, since that adviser may offer FGPs that are higher than those available through another adviser.

– The development of the equivalent of the current league tables based on FGPs could help increase the competitive pressure on these prices if *consumers* can then use them to influence sales. However, as that pressure will still generally need to be mediated through advisers, their behaviour in analysing and using FGPs in their advice will be critical. In addition, as seems likely, if FGPs vary by channel and/or by adviser within a channel the creation of these league tables based on FGPs may not be straightforward, and consumers’ ability to exercise choice (directly or indirectly) so as to influence the volume of sales based on these tables may be limited.

– For smaller providers operating in competitive markets who do not have such a strong brand as large providers or otherwise differentiated products, this reduction in competitive pressure from advisers, which can be thought of as countervailing buyer power, may have less effect. This is because the normal competitive pressures from other providers in the market may keep their profits low. However, for larger providers with strong brands, the reduction in the incentive for advisers to exercise their buyer power may mean that providers can increase their margins.

4.2.2 Validation of mechanisms

The scope for an increase in margins (and FGPs) (in the short term) was confirmed in the interviews conducted by Oxera. A number of firms indicated that higher provider profitability was expected as advisers will no longer be chasing the highest commissions. One provider commented that, in the medium term, the expected increased profits would be reinvested in product innovation in order to remain competitive.

The Deloitte (2009) survey indicates that 9% of providers expect their margins to increase as a result of the implementation of the RDR proposals. Around half of firms expected to see no change and 21% of firms expected profitability to fall. A further 18% were unsure of what impact the proposals would have on their profitability. However, among the larger providers (with turnover of £500m or more), around half expected their profitability to increase as a result of RDR. This suggests that, on a weighted average basis, the proportion of the market where higher profits are expected is greater than 9%. However, these figures should be interpreted with caution as they are based on a small sample (68 responses).[83]

Profitability may increase as a result of various factors, including the mechanism described above. Another factor could be a change in persistency. The Deloitte survey results indicate that firms which expected increased profitability also expected increased persistency,

[83] Deloitte (2009), ‘Firm behaviour and incremental compliance costs’, research for the FSA, May 14th, p. 26.

although, as mentioned above, the results are based on a small sample, so it was not appropriate to carry out formal correlation analysis.[84]

The creation of league tables based on FGPs was not discussed in the interviews and there was still some uncertainty as to how FGPs would be described. Although this appeared to be more a result of interviewees not having addressed the issue of league tables rather than a definitive view that they would not emerge, it suggests that, at least in the short run, there may be a loss of some comparative information on product prices to which consumers could easily gain access (albeit recognising that the current league tables are not perfect).

It is also possible that the way platforms develop could encompass a role of getting a version of FGPs into the public domain, thereby facilitating the creation of comparisons of product charges at the wholesale (or near wholesale) level. Such an outcome would seem more likely if consumers gravitate towards more unadvised sales, so using platforms as a means of direct access to providers' products. However, for reasons set out in section 3.5.2, it does not seem that direct access of this form will increase as a result of RDR since, in general, consumers require advice on which product to buy rather than a range of options.

Although, overall, the evidence is mixed, there remains a risk that FGPs and provider profits could increase as a result of RDR. If this does occur, it is more likely to be a short-term effect. In the medium to long term, any increase in provider margins may be competed away, for example, if sufficient price transparency is created (by means of price comparison websites including FGPs, and networks and larger firms competing on FGPs). Increased profits may also be competed away in the long term as providers compete to provide services to advisers, such as back-office support. It has not been possible to assess the likelihood that this will happen, as this is outside the scope of the study.

4.2.3 Supervision

It is not clear how supervision would prevent FGPs from increasing in the short term. In the long term, by monitoring advisers' recommendations and sales of products, and intervening where possible, supervision may make advisers focus more on this price aspect of products where this is appropriate.

To the extent that commission payments are replaced by other, softer, forms of influence, including offering additional 'free' services that benefit advisers but not necessarily consumers, any consumer harm arising from such arrangements may be harder to monitor than under the current system of explicit commissions. This is because commissions are clearly visible whereas softer forms of influence may be harder to identify and quantify.

4.2.4 Mechanisms resulting in fierce competition between providers and lower FGPs

Under the new regime, the adviser shops around on behalf of its client, and, in theory, will behave as a well-informed professional shopper. Although price is not the only factor on which products are compared, the adviser would be able to assess the trade-offs between price and quality, and would therefore be very sensitive to relative price changes at the wholesale level. This would suggest high price elasticity of demand at the wholesale level, potentially resulting in fiercer competition among providers than is currently the case.

Fierce competition could be facilitated by entry from new players in the market looking to win market share with low FGPs. An example from the current regime is the US provider Vanguard, which has entered the market offering low charges (without commissions). An example of an existing player successfully competing on price is Fidelity, which lowered the annual charges on its UK Index fund in 2005 from 0.7% to less than 0.3%.[85] If competition over FGPs were to develop as a result of the RDR proposals, such firms may be able to

[84] Furthermore, even if it were possible to establish a clear correlation between providers' expectations of higher persistency and expectations of higher profits, it would not be possible to conclude that there are no other drivers of higher profit expectations aside from persistency.
[85] Lipper FMI (2009) 'Review of UK fund fees', April.

enter and grow more successful than at present, as they would be able to compete directly with other providers on the basis of their low FGPs.

This would only happen if:

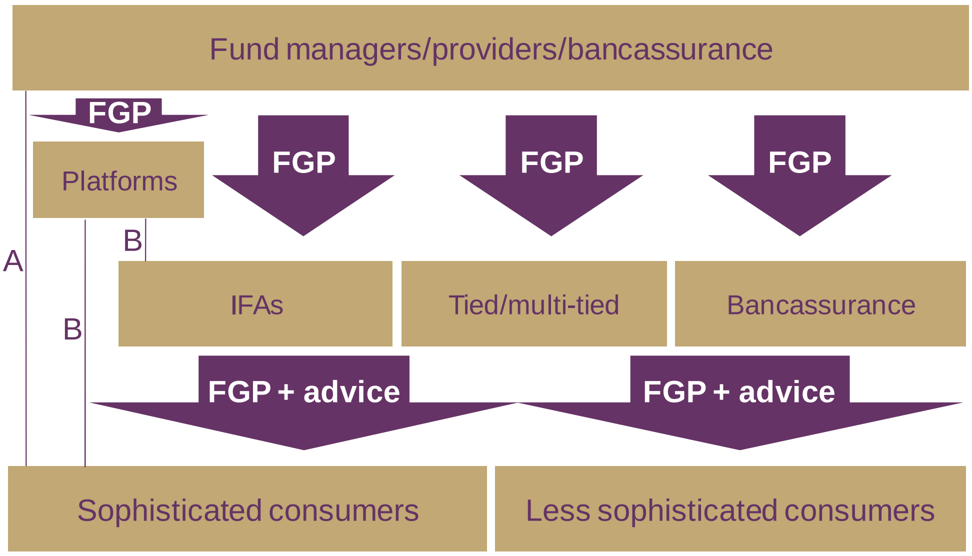
– intermediaries see similar products from different suppliers to be very close substitutes for most individual customers. If not, the non-price factors that lead to recommendation decisions may outweigh price-based choices as a result of small changes in FGPs, and the price elasticity of demand may not change significantly compared with the current regime;

– providers do not manage to avoid this type of competition. This all-or-nothing type of competition could incentivise them to coordinate their behaviour in order to maintain profit levels or influence advisers' recommendations, for example by replacing commissions with other arrangements that benefit advisers.

A further mechanism that could result in lower FGPs is that, unlike under the current regime, the efforts of sophisticated customers to shop around for the lowest FGP could also benefit less sophisticated consumers by lowering the FGPs for everyone. This compares with the current system in which, although sophisticated consumers can benefit all consumers by shopping around for the lowest total price, they are also more likely to benefit from commission rebates. As these are typically negotiated on an individual basis, there is no benefit to less sophisticated consumers.

Figure 4.1 shows a stylised view of the post-RDR charging structure. If advisers cannot discriminate between sophisticated and less-sophisticated customers in terms of different FGPs then less sophisticated customers may benefit. However, this effect will be weakened if sophisticated and less sophisticated consumers tend to use different channels. For example, if less sophisticated customers tend to use the tied/multi-tied channel and sophisticated customers tend to use IFAs or platforms then providers may be able to set different FGPs for the different channels and charge higher prices to the less sophisticated consumers.

Figure 4.1 Market and charging structure post-RDR



Notes: A = FGP + provider processing charges; B = FGP + platform administration charges. Although not shown in the figure, distributors can also offer products on an execution-only basis. Providers include both pure savings/investment products and combined savings/investment with insurance products.
Source: Oxera.

4.2.5 Validation of mechanisms

In relation to the first mechanism, interviewees indicated that the view from distributors is that FGP will be only one of many factors taken into account by advisers when deciding which product to recommend to their customers. For example, with any product that is invested in the stock market, the (perceived) quality of the investment management team and past performance are very important, and are likely to override small changes in price, although there may be greater price sensitivity in cases where there are marked differences in price for products that are close substitutes.

Since the first element of this mechanism is not validated, there is no need to test whether the second condition would hold. Moreover, since increased price competition is not expected due to the importance of non-price factors, there would be no need for providers to coordinate their behaviour in order to escape competition.

The second mechanism will only work if there are sufficient numbers of sophisticated customers to drive down the FGPs for everyone. FSA research on consumers' financial capabilities would suggest that the proportion of sophisticated consumers is likely to be limited. The mechanism also depends on low FGPs that are available to sophisticated customers also being available to less sophisticated customers. This will not necessarily be the case, for example if the well-known high-street advisers do not offer lower prices but instead rely on customer inertia from less sophisticated consumers.

In summary, there is little evidence that this increase in the degree of price competition between providers will happen in practice.

4.2.6 Supervision

As the arrangements that providers can put in place with distributors are subject to FSA rules on inducements, they can only influence advisers to a limited extent. However, with significant discretion in terms of recommendations and in the absence of close equivalence, the manifestation of product provider influence over intermediaries' choices that are not in the interests of intermediaries' customers may be hard to identify.

4.3 Dimensions of competition

4.3.1 Mechanisms

As discussed above, the RDR proposals may change the factors on which providers compete. Efficiency savings could in future be passed on in terms of better systems and service to advisers and better quality products to consumers. On the other hand, some of the savings could simply be passed to shareholders or be spent on marketing/branding and other methods of product differentiation.

4.3.2 Validation of mechanisms

One interviewee suggested that the introduction of FGPs may lead to savings being passed on to consumers more quickly. This would happen where FGPs are based on underlying costs, and when these costs changed, the FGP would also change. This compares with the current situation, where cost savings may simply be passed on to advisers in the form of higher commissions, with the total price to the consumer remaining unchanged.

The RDR proposals may have the effect of reducing switching between products. At present, advisers have incentives to encourage consumers to switch so that the adviser receives an upfront commission. In most industries, switching is seen as good for competition. However, where the switch is to products that are not necessarily better, switching does not benefit competition and can reduce efficiency. The results of the Deloitte (2009) survey suggest that persistency (the flipside of switching) will either remain the same or increase slightly. The majority of respondents (60%) said that persistency would not change, 21% expected it to increase, with only 3% anticipating that it would decrease.[86]

The RDR proposals could result in providers seeking to influence advisers in new ways. For example, providers could compete to offer the best service to advisers in terms of speed of completion and providing back-office administrative functions. Some of these elements of competition may also benefit consumers, but not necessarily. Furthermore, such benefits to advisers may be given at the expense of better or cheaper products for consumers.

Although Oxera has not seen strong evidence to validate this mechanism one way or the other, it was raised by one of the Oxera interviewees. However, the Deloitte (2009) survey shows that only one-third of firms expect to offer a payment facilitation service (collecting and passing on adviser charges).[87] This is exactly the type of service that providers would be expected to offer to advisers in order to win their business. This evidence suggests that it is too early to draw firm conclusions on whether advisers will maintain their gatekeeper role, and thus whether providers will indeed focus their competitive efforts on winning advisers at the expense of providing benefits to consumers. Larger firms are more likely to offer this service to advisers because of the potential associated economy of scale benefits.

In terms of product quality, providers could directly improve the quality of products for consumers. However, to the extent that advisers maintain their gatekeeper role between providers and consumers, it is expected that an important element of competition between providers will be offering the best service to advisers in terms of responsiveness and efficient handling of requests. Consumers will also benefit indirectly from this in terms of faster response times to their queries that are routed through advisers, and potentially also, for those customers paying by the hour, fewer hours billed by their adviser. If providers start competing more directly for consumers, they will also have incentives to improve their product quality, which would directly benefit consumers. This outcome is more likely to occur when consumers are more active in the decision to choose a particular product and rely less on the recommendation of the adviser.

Finally, on product suitability, the incentive trade-off between commission payments and suitability will be removed post-RDR. All else equal, this is expected to improve the suitability of products sold. This is beyond the scope of this study and has been assessed in more detail by the FSA.[88]

4.4 Impact on competition in market for advice

4.4.1 The relationship between advisers and consumers

Mechanisms

In most markets where products and prices are standardised, less well-informed consumers tend to free-ride on the efforts and choices made by well-informed consumers. As long as a sufficient proportion of consumers shop around and make well-informed choices, this will put sufficient pressure on firms to keep prices low (from which less-well informed consumers also benefit). However, this may not necessarily be the case in the market for advice. The new regime envisages some degree of negotiation between adviser and consumers about the fees charged for advice. The FSA's expectation is that the adviser will prepare a menu, and that negotiation will take place based on the prices in the menu. There is a concern that this may result in the adviser applying price discrimination. Although this does not necessarily harm consumer welfare, there may be a concern that some people run the risk of paying excessive charges.

[86] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 25.
[87] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 22.
[88] Oxera (2007), 'Assessment of the benefits of the FSA suitability letter', a report prepared for the FSA, April.

Validation of mechanisms
Although it is difficult to draw firm conclusions about whether this mechanism is likely to occur, the following observations can be made on the basis of Oxera's analysis and interviews conducted with firms.

– Some price discrimination can already be observed in the form of intermediaries agreeing different levels of commission rebate with clients. There is no data on the exact degree to which this occurs, but the impression is that, typically, more-informed consumers (and those with larger investments) currently benefit (more) from rebating.

– The current regime means that no one will be charged more for advice than the level of commissions the intermediary receives from the provider. Assuming that commissions are subject to certain constraints (eg, very high commissions would make it difficult for advisers to justify their recommendations to the regulator and would result in high product charges which are subject to some competitive pressure), even uninformed consumers are to some extent protected against excessive charges. Under the new regime, they would potentially lose this form of protection. However, this may be replaced by alternative regulatory action along the lines of intermediaries having to justify the level of charges for their advice against its potential value to the consumer.

  Another way to look at this is as a 'double-marginalisation' problem.[89] Under the current regime, providers set the price of their own product and the maximum adviser charge (by setting the commission). They set the total price so as to maximise their profits. Post-RDR, providers would set the price of their product, with advisers adding this to the price of their advice when setting the final consumer price. Since neither the provider nor the adviser takes into account the other's profit, this will result in a price above the profit-maximising price being charged.

– However, interviews with firms indicate that, at least in short term, the current level of commissions is likely to form an anchor point for fees for advice. From the consumers' perspective, in the short term—and in particular at the bottom end of the market where consumers are not used to getting commissions rebated—consumers are unlikely to perceive a significant difference compared with the current regime. The charging system may look like the commission-based system they are used to; they will simply be asked to authorise the provider to pay the adviser a fee at the prevailing commission rate.

– In the longer term, there may be some unwinding of cross-subsidies (between customers with more and less money to invest). To some extent, this will result in higher fees for 'low-value' clients. This resulting degree of 'price discrimination' is likely to reflect costs, and so will not distort competition.

– Consumers who are less informed may be protected by firms setting standard fees for advice. However, it is not clear whether firms will publish their fees on their websites, for example, nor to what extent advisers would adhere to these fees in practice.

In the longer term, there may be some unwinding of cross-subsidies, which will result in higher fees for 'low-value' clients. Consequently, some will no longer have a realistic option of receiving independent advice. Some may switch to non-independent advice, others to bancassurance, while some may not purchase at all. The result will be a loss of choice for these customers, which may be perceived as harming competition. Nevertheless, since it is removing a cross-subsidy, it will have the effect of improving competition in the sense of increasing efficiency. This is because, in the cross-subsidised model, 'low-value' consumers

[89] Double marginalisation is a long-established problem identified in the economic literature relating to vertical agreements and mergers. It arises because the two products in question—in this case, the financial product and the provision of advice—are complements. A decrease in the price of one product therefore leads to an increase in demand for the other. Where prices for the two products are set independently, this pricing externality is not taken into account. However, if a single party sets both prices, it can internalise the effect and the prices of both products will be lower.

were charged prices below cost, which led to inefficient over-use of IFAs by this group, and 'higher-value' consumers were served at prices significantly above cost, which led to inefficient under-use of IFAs.

Potentially, transparency could lead to an increase in price competition in the market for advice, with IFA firms publishing their prices on the Internet, and with the FSA or other facilitators setting up comparison tables. IFAs could offer special deals, such as standard fixed prices for a 'financial review'. All these outcomes are possible. Some firms emphasised that a well-functioning market for advice requires consumers to be financially confident and aware; otherwise, there will be no benefit to advisers from competing on price.

4.4.2 Competition between IFAs and non-independent advisers, including bancassurers

Increased competitive pressure on IFAs
Post-RDR, non-independent advisers will be required to have the same minimum level of qualification as IFAs. This includes advisers working for firms or networks of non-independent advisers and those working for bancassurers. Therefore, it could be argued that these advisers will provide a stronger competitive constraint on IFAs in terms of the expertise they offer.

For example, consumers may view advisers working within the bancassurance model as cheaper than independent advisers. Given that these advisers must be trained to the same qualification level as IFAs, genuine difference in the price of advice is likely to come from reduced product search costs, for example. If bancassurers are able to sell themselves as the cheaper alternative to IFAs, this may lead to some increased competitive pressure on IFAs. However, some of those interviewed by Oxera commented that consumers place a high value on the 'independent' tag, which would suggest that the extent to which non-independent advisers will be able to compete directly with IFAs for the same groups of customers may be limited. The way that the different forms of advice are labelled may also have a significant impact on the degree of competition between different types of adviser. However, as noted above, the issue of labelling is beyond the scope of this report.

Overall, it is possible that the non-independent sector, including bancassurance, will put greater competitive pressure on IFAs post-RDR. However, this depends on the level of importance that current consumers of independent advice place on the advice they receive being independent. It also depends on the extent to which consumers will be willing to shop around for advice. Section 2.5.9 concludes that there is currently little evidence of a large number of advisers directly competing with each other for consumers, and so it may be inferred that strong competition between independent and non-independent advisers is unlikely under the current regime. The RDR proposals may change this, leading ultimately to a market for advice. However, there is currently no evidence to suggest whether or not this will be the case. Firms interviewed by Oxera were generally sceptical about the development of market for advice.

Increased competitive pressure on non-independent advisers and bancassurers
It is expected that some IFAs will switch to the non-independent sector post-RDR (as described in section 3). IFAs moving into this sector, in some cases with a low cost model of operation, will increase competitive pressures on existing large non-independent firms. The Deloitte (2009) survey finds that 9% of directly authorised firms said that it was 'likely' or 'very likely' that they would move to the non-independent sector as a result of the RDR changes.[90]

As the size of the non-independent sector varies by product type, it is difficult to estimate its overall size post-RDR. However, taking as an example the new life and pensions business, as shown Table 2.1 above, IFAs currently account for around half of sales, with non-independent firms, including bancassurance, making up the other half. Therefore, a 9%

[90] Deloitte (2009), 'Firm behaviour and incremental compliance costs', research for the FSA, May 14th, p. 39.

switch of IFA firms to the non-independent sector would lead to post-RDR shares of supply of just under 45% for IFAs and just over 55% for non-independent firms, including bancassurance.

Overall, existing IFAs changing their status to become non-independent may lead to increased competitive pressure on existing non-independent firms. However, two effects militate against this. First, in some cases IFAs will not simply change their status, but, as described in section 3, will choose to join large non-independent firms or networks. As such they would not be providing an additional competitive force. Second, as described above, increased competition depends on consumers starting to shop around for advice, and it is not yet clear whether such a market for advice will develop in the short term.

4.5 Other impacts on competition

4.5.1 Potential impact on competition between products

A number of financial products will not be subject to the new remuneration model, but may be sold by advisers:

– group personal pensions, where the advice is provided to the employer rather than the employee. Sales of these pensions account for around 10–20% of the average IFA's turnover;[91]

– protection products that do not contain an investment element, such as payment protection insurance or critical illness insurance;

– all non-packaged retail investment products, such as cash ISAs or exchange-traded funds. Although advisers typically do not sell these products and providers do not currently offer commissions on them, under the new independence requirements IFAs will have to consider these products when advising customers.

The fact that commissions are offered on some of these products means that IFAs may have an incentive to sell these rather than retail investment products covered by the RDR. Although this behaviour would be constrained to some extent by FSA rules on suitability and ongoing supervision of compliance with these rules, it may result in a distortion of competition. There could also be potential harm to consumers if, as a result, they are not recommended a suitable product (or, indeed, the most suitable product). Assessing the exact implications would require a more detailed analysis and is beyond the scope of this study.

Similarly, some of the non-packaged products (such as cash ISAs) are typically not sold through IFAs, and would therefore not come with provider facilitation of payment to the adviser. This may give IFAs an incentive not to recommend these products, distorting competition and potentially harming consumers if they are not recommended a suitable product.

IFAs may, for example, also have an incentive to split a protection product that comes with an investment element into a pure protection product (for which a commission could be received) and a pure investment product (for which adviser remuneration would need to be agreed), thereby avoiding some of the pressure on revenue streams as a result of the RDR proposals. This would have two consequences: the benefits of RDR in terms of removing bias would not affect the protection element; and some inefficiency may be created (eg, extra administration) as a result of selling two products rather than one.

As noted in section 3, a concern was raised during the Oxera interviews regarding problems with provider facilitation of adviser payments in certain products, such as collective investments. It was explained to Oxera that, owing to the nature of these investments, it

[91] Based on Datamonitor (2008), 'UK IFAs 2008', and Oxera analysis. The figure is approximate.

would be difficult to have a situation in which the provider facilitates different levels of payment from each investor to their adviser. In order to do this with ongoing payments, new share classes would need to be created, which is costly. The risk to competition could be that these issues would introduce a new type of product bias, away from those products that are not able to facilitate payments from consumers to advisers. The FSA will take this into account in designing its supervision strategy.

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