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Agenda

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Reform of retail financial services: the end of commission payments?

The Financial Services Authority has published its proposed reforms to the market for the provision of financial advice in the UK, calling for an end to the use of provider-paid commissions to advisers who recommend retail financial products. What is the problem with commission payments, and why does the FSA want an end to their use? What does this imply for the market for these products across Europe?

Reform is in the air

The financial advice market in the UK has long been the subject of discussion, debate and reform. Financial advisers represent a major distribution channel for investment products. Traditionally, their remuneration has taken the form of commission payments received from the providers whose products they are recommending. These payments are recovered through the charges paid by consumers for the products. Consumers are thus paying for the advice, but only indirectly. Many may not appreciate that this is the case, and may see the advice as being provided free of charge.

This system of remuneration has led to accusations that advice will be biased towards those products or providers that offer the adviser the highest levels of commission. Although the extent of such bias has been disputed and the evidence to support its existence, across all product categories, has been mixed, there remains a widely held view that it does create a risk of potentially distorted incentives.

Until now, the Financial Services Authority (FSA) has attempted to mitigate this risk by requiring advisers to disclose the commission they receive on products. This was introduced following the move in 2005 to a 'depolarised' regime, under which advisers were also categorised as being either 'independent', 'whole of market', 'single-tied' or 'multi-tied'. To call themselves 'independent', advisers had to offer customers the option of paying a fee for the advice. This was in contrast to the previous 'polarised' regime (introduced in 1987), under which advisers were classified as 'independent' or 'tied'. This polarised regime had in 1999 been criticised by the Director General of Fair Trading as damaging to competition.[1]

However, even after depolarisation there was a continued perception that the changes made had been insufficient to remove the risk of bias completely. Within a year of depolarisation Callum McCarthy, then Chairman of the FSA, commented:

> My contention is that we have a system which serves neither the producer of the services nor the consumer of the services. It is doubtful whether it serves the intermediary either.[2]

Therefore, a new, more radical approach has recently been put forward by the regulator, which could give rise to significant changes in the financial advice sector in the UK.[3] These proposals are not just concerned with the way in which advisers are remunerated, but also aim to ensure that advisers are adequately capitalised and that they exhibit a high level of professional standards.

So far as commission is concerned, the aim is replace all forms of payment from the product provider to the adviser with a system in which consumers pay the adviser directly for the advice they receive. As a result, consumers would now be faced with a clear distinction between the wholesale price of a product (the 'factory gate price', or FGP) and the price of the advice they receive.

The removal of commission is only one part of the total reform package. However, as this aspect is thought likely to engender the most discussion and comment from industry and consumer groups, this article examines the background to the proposed reforms and considers their potential implications for the market for retail financial advice.

This article is based on the Oxera report, 'Retail Distribution Review Proposals: Impact on Market Structure and Competition', prepared for the Financial Services Authority, June 2009. Available at www.oxera.com.

Various aspects of the new proposals are likely to generate further debate and analysis over the next few months. As part of this analytical process, Oxera recently published a report examining the possible impact of the proposals on market structure and competition in retail financial services.[4]

These issues are not confined to the UK alone. The European Commission published its Communication on Packaged Retail Investment Products in April 2009,[5] and is planning to provide a more detailed legislative approach by the end of the year. Although this may differ in some respects from the proposed UK approach, the basic aim—of ensuring that distorted incentives do not cause consumer detriment—remains the same.

Is commission a problem?

Payment by commission is a widespread form of remuneration across a number of other sectors, such as estate agencies, car dealerships and employment agencies. Commission itself need not be detrimental if customers are well informed and if there is sufficient choice of products in the market.

Problems with commission emerge where an agent is used not to facilitate a transaction between a customer and the provider of a good or service, but rather to provide advice and recommendations on which provider and/or product the customer should use. In such cases, incomplete information, and/or the inability of customers to make an informed judgement regarding the quality of the advice they are receiving, may result in consumer detriment. 'Provider bias' may occur if an adviser is incentivised to recommend a product or service which may deliver the highest commission rates, but which may not be the most appropriate solution to a customer's particular needs. Alternatively, 'product bias' may be apparent if specific products (again attracting high levels of commission) are recommended in a situation where they may be inappropriate for the customer. If customers are sophisticated and find it relatively easy to evaluate the quality of the advice being received then the incentive to provide inappropriate advice is more likely to be mitigated.

Although the risks associated with the use of commission are widely accepted, there have been few attempts to quantify, with any degree of rigour, the actual extent of consumer detriment arising from commission bias. Indeed, such quantification is very difficult to undertake in practice.

Adviser remuneration

One of the problems with the use of commissions in retail financial services is the complexity of payment structures and the difficulty many consumers may have in evaluating the rates that are used. Commissions can take a variety of forms.

- **Initial commission** is quoted as a percentage of the transaction in question and is paid to the adviser at the time of purchase. It may be:
  - *'non-indemnifi*ed', which means that the commission cannot be reclaimed from the provider if the customer does not pay the future premiums due; or
  - *'indemnified'*, which means that the commission paid can be reclaimed by the provider if the customer fails to meet future premium payments.
- **Renewal commission** is payable on regular premium products whenever a premium is paid by the customer.
- **Trail commission** is an annual commission based on the value of an investment. This is payable on single premium products, and encourages the adviser to maintain a relationship with the customer and to recommend additional products to them.

There are many ways in which commission rates may be structured, with trade-offs between the level of initial commissions and renewals or trail commissions.

Since 2005 advisers have been obliged to provide more information on the rates of commission earned on particular products. The disclosure requirements were simplified in 2007, with the ending of the requirement to produce a 'menu' of rates earned and a market average—although advisers still have to disclose the amount of commission they will earn for recommending a particular product before the sale goes ahead. The situation is further complicated, however, by the fact that many advisers offer what are effectively commission 'rebates' to customers—for example, by supplying them with an increased allocation of product units for the same initial investment value.

The result is a remuneration system that tends to be opaque and difficult for customers to understand, particularly the less financially sophisticated. Previous attempts to improve disclosure on commission charges were deemed by the FSA not to have been successful. Hence, the FSA felt it was necessary to introduce more radical reform in the UK.

The EU dimension

Problems related to the distorted incentives arising from commission payments have also been noted elsewhere in Europe. In October 2007 the European Commission issued a call for evidence in order to consider a number of issues relating to the sale of packaged investment products. This was followed by a Feedback Statement in March 2008, a technical workshop in May 2008, and a high-level Open Hearing in July 2008. Finally, a Communication to the European Parliament and the Council was issued in April 2009.[6]

The effective management of potential commission bias was identified as a priority by the European Commission, but it still appears to be the consensus that this can best be achieved by enhancing disclosure requirements and ensuring that such requirements are in place for as wide a range of retail products as possible. In the minutes to the technical workshop it was stated that:

> The Commission is not questioning [a] commission-based system as a sound business model for [the] future financial services landscape. However, conflicts of interest arise and must be avoided, managed and disclosed.[7]

Any legislation that does emerge is likely to take account of the significant variations between countries in the distribution routes for retail products. Overall, in 2005, around 75% of investment products were distributed by commercial banks and insurance companies in the EU.[8] However, in the UK during April 2009, around 85% of investment fund products were found to be sold through intermediaries.[9] The particular importance of the independent financial adviser in the UK has resulted in an initiative to review UK compensation arrangements. However, the growing importance of such advisers elsewhere in Europe means that the likely effects of the UK proposals are being considered closely elsewhere.

Current state of the UK market

When considering the likely impact on the UK retail investment market of removing commission, it is useful to understand the market structure and the different participants involved.

The structure is characterised by large numbers of providers and advisers, and various types of distribution channels. At present, as identified in Figure 1, the retail investment value chain involves several agents, from the fund manager, who is responsible for managing the underlying assets in a product portfolio, to the product provider, who is responsible for packaging the portfolio in the most suitable form for a wide variety of investors, and the intermediary, who is responsible for advising the ultimate purchaser on the suitability of the product to meet their particular requirements. In addition, recent years have seen the development of 'platforms', which function as portfolio management services, and which may be used by advisers or, directly, by consumers.

Much of a product provider's marketing effort appears to be directed at ensuring that advisers recommend its particular products. Where providers directly target consumers, they appear to compete on the basis of factors such as past performance and reputation, rather than price. There does not appear to be much direct competition between advisers, as it would appear that consumers do not 'shop around' for advice.

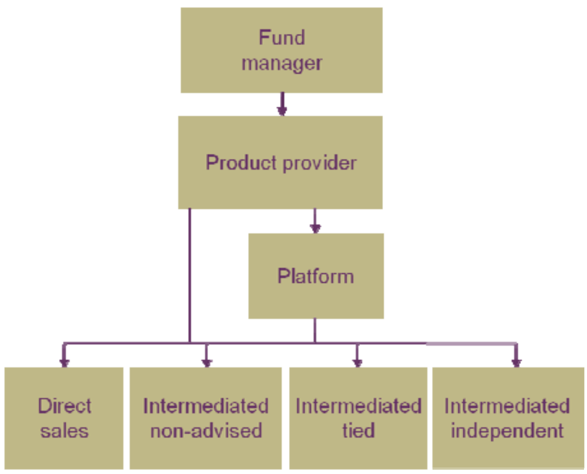
When a consumer purchases a retail financial product (whether through an adviser or otherwise), they pay charges to the provider, which will affect the net return received by the provider on the investment. These charges take the form of an initial charge (expressed as a percentage of the amount invested), followed by annual charges based on the ongoing value of the investment. A proportion of these provider charges reflects the commission that has been paid to the adviser. Thus, the consumer ends up paying, indirectly, for the advice received: something which is often not fully appreciated by the consumer.

In addition, there is, to some extent, a lack of transparency surrounding the actual charges that consumers must pay for products. Rebating and discounting are common, particularly where a product is purchased through a fund supermarket or discount broker. This reflects the fact that the consumer will not have received advice from these distributors prior to the purchase.

Implications of the changes

Removing the payment of commission by providers to advisers clearly removes the risk that advisers' product recommendations are biased by the levels of commission they receive. However, a number of key questions remain over the likely impact of the proposals.

Figure 1 The UK retail investment market



Source: Oxera.

If providers are unable to influence the choice of products by advisers through the use of commission, how will they ensure that their products are purchased by consumers? It seems likely that they will continue to try to influence advisers' decisions to some extent. However, they may also engage in more vertical integration, by acquiring firms of advisers, to ensure a direct distribution route for their products.

What form will advisers' income actually take? With the ending of commission, the adviser will now receive income directly from the consumer. At present it is still not clear how these remuneration packages will be structured. A number of alternative fee structures could be envisaged—eg, flat rate, hourly fees, or rates based on value of potential investment. Advisers will need to assess the most appropriate form of remuneration, taking into account their own business strategy models and the characteristics of their client base.

Will reform change the way in which advisers treat different types of customers? At present, advisers appear to cross-subsidise small investors through the higher income they can generate from larger investors—for whom more suitable products may be associated with higher commissions. Under the new regime, some small clients may now face charges for advice, which may make them more reluctant to use an independent adviser.

Will reform give rise to greater competition on the basis of product 'price'? Under the current regime, the FGP may be thought of as 'the product charge less the cost of commission'. Under the new regime, it is anticipated that these FGPs will become more transparent as advisers use them to attract clients. Greater transparency would enable consumers to compare products and prices within and across distribution channels, although this would require consumers to be proactive in this regard. However, it would also require a degree of financial capability on the part of consumers to enable them to make such comparisons effectively.

What will happen to product prices? Arguably, advisers' incentives to impose competitive pressure on providers to reduce FGPs will be weaker than their current incentive to negotiate high commissions (which currently ensure competitive FGPs). This is because, under the current regime, higher commissions lead immediately to higher adviser incomes; whereas, under the new regime, a lower FGP will not, directly, result in increased revenue to advisers, or will do so only to the extent that a lower FGP gives rise to increased sales volumes.

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. On the other hand, if FGPs become the focal point of competition between advisers, or if consumers adopt the direct sales route, end-customers may reassert this competitive pressure. However this would, again, require a degree of financial sophistication on the part of consumers. For these reasons, significant downward pressure on prices seems unlikely in the short term, although this could change in the long run.

Will consumers be willing to pay for advice? This is really the key question, but without further research into consumer attitudes and behaviour it is difficult to answer. Many consumers who currently use an adviser do so following a recommendation from another professional services adviser, for example a lawyer or accountant. A significant proportion of these consumers will have large sums of money to invest—perhaps as a result of a legacy or other windfall. Such individuals may still be prepared to pay for advice. However, it is important for advisers to ensure that the scale of charges is such that smaller investors are not deterred from seeking advice for reasons of cost, particularly since a key objective of the reforms is to encourage higher levels of investment.

In conclusion, it is clear that many questions remain regarding the likely impact of the reforms—whether the objective is seen to be enhanced disclosure requirements (or an extension of their scope), or the more radical step of a completely altered basis for the remuneration of advisers. Further research is necessary to determine and quantify the actual benefits of financial advice, to identify and quantify the willingness of consumers to pay for such advice, and to determine the factors that underpin consumer decision-making in the purchase of financial products.

The recent Oxera report highlighted the importance of identifying the precise mechanisms through which the proposals may have an impact on the affected parties. Likewise, any further research must also identify the mechanisms which might give rise to the required outcome and then test them, to ensure that unexpected consequences do not arise and that the desired policy objectives are met.

[1] Director General of Fair Trading (1999), 'The Rules on the Polarisation of Investment Advice', August.
[2] McCarthy, C. (2006), 'Is the Present Business Model Bust?', speech given at the Gleneagles Savings & Pensions Industry Leaders' Summit, September 16th.
[3] Financial Services Authority (2009), 'Distribution of Retail Investments: Delivering the RDR', CP09/18, June.
[4] Oxera (2009), 'Retail Distribution Review Proposals: Impact on Market Structure and Competition', prepared for the Financial Services Authority, June.
[5] European Commission (2009), 'Communication from the Commission to the European Parliament and the Council: Packaged Retail Investment Products' (Communication) COM (2009) 204 Final, April 30th.
[6] Ibid.
[7] European Commission (2008), 'Minutes of the Industry Workshop on Retail Investment Products', May 22nd, p.12.
[8] European Commission (2009), op. cit.
[9] Ibid.

**If you have any questions regarding the issues raised in this article, please contact the editor,
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