Prof. Roll & Pastuch
MANAGEMENT CONSULTANTS

ConPolicy
Institute for Consumer Policy

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Towards a fairer deal for consumers and the financial industry

Lessons from the Retail Distribution Review and the ban of commissions in the UK

Summary of Conclusions

Study conducted for:
Association of German Fee-Only
Advisers (BVDH) and quirin bank AG
Kurfürstendamm 119
10711 Berlin
Germany

by:
ConPolicy GmbH
Moltkestr. 5
53604 Bad Honnef
Germany
www.conpolicy.de

and

Prof. Roll & Pastuch GmbH
Franz-Lenz-Str. 1a
49084 Osnabrück
Germany
www.roll-pastuch.de

Authors:
Dr. Christian Thorun

Dr. Frank Niemeyer

Summary of Conclusions

Commission payments in financial services will be banned in the United Kingdom (UK), the Netherlands and Australia in the next year. The objective of this study is to shed light on the rationale for such a drastic regulatory overhaul, to analyse the anticipated impacts of the ban on the financial industry and consumers and to draw lessons from this intervention.

In so doing, the UK Retail Distribution Review is analysed in a case study, and experiences from other EU and non-EU countries as well as the academic literature is reviewed.

The conclusions of the study are summarized in eight theses.

Thesis 1: The financial services market does not work properly. As a result, there are severe detrimental impacts for a large number of consumers, the financial industry and the economy as a whole.

"*Some time ago, financial institutions changed their view of consumers from people to serve, to people to sell to.*"[1]

Martin Wheatley, Managing Director of the UK Financial Services Authority

Despite the growing significance of financial services for consumers to save among other things for their retirement, the financial services sector is in a desolate state on a variety of benchmarks: Not only does it continuously rank lowest in the Consumer Markets Scoreboard of the European Commission in terms of consumer trust, satisfaction and consumer complaints, yet again consumers have lost trust in their banks this year (sections 1.1 and 2.1).

This dismal performance has a price. Consumers too often invest in products that are too expensive or not suitable for them. A number of studies show that this mis-investment creates a substantial economic damage for consumers. Some studies estimate that the damage created from insufficient investment advice in Germany alone was 20-30 billion Euro per year (section 2.1). In the UK the mis-selling of Payment Protection Insurance represents the largest financial scandal of all time. It is expected that the UK financial industry will have to pay up to 10 billion Pounds in fines and compensations.[2]

Not only are consumers harmed on a large scale, but evidence suggests that low consumer trust also harms the financial services industry itself. Numerous studies show that a minority of consumers in Germany trust their banks and more than two thirds argue that the advisers are primarily focused on their own interest and that these interests at least partially influence their recommendations (section 2.2.2). British and Dutch banking and insurance associations therefore

[1] Martin Wheatley, 'The incentivisation of sales staff - are consumers getting a fair deal? - Speech', (2012).
[2] http://www.which.co.uk/news/2012/09/fsa-targets-bank-incentives-that-lead-to-mis-selling-294869/

speak out in favour of far-reaching measures to improve consumer protection in financial services. They hope that these measures will rebuild trust and confidence in the sector so that consumers will spend more on financial services.

Taken together addressing the current underperformance and creating a functioning consumer market for financial services creates value for consumers and the financial industry and hence contributes to economic growth at a time in which the economic outlook in the EU is unstable and growth rates are low or even negative.

Thesis 2: The commission-based advice model is broken. It neither serves consumers nor industry, as it creates a conflict of interest that can negatively impact consumers.

"*My contention is that we have a [distribution] system which serves neither the producer of the services nor the consumer of the services. It is doubtful whether it serves the intermediary either.*"[3]

Callum McCarthy, former Chairman of the UK Financial Services Authority

The study suggests that there is ample evidence that the commission-based advice model is broken both for consumers and industry. The commission-bias leads to a focus on sales rather than advice due to a mis-alignment of the interests of consumers and financial advisers. Academic research shows that commissions drive up retail prices for financial products due to a competition between firms to offer high sales commissions. Furthermore, the involvement of commission-paid financial advisers often lowers portfolio returns, worsens risk-return profiles, and encourages return-chasing behaviour and a push for actively managed funds that have higher fees (section 2.2.1).

This analysis is also shared by governments, regulators and consumer organizations in the UK, Netherlands and Australia. All of them make the commission-bias responsible for mis-advice and major mis-selling scandals, a focus on volume rather than quality, low persistency of pension policies and churning (sections 3.1 and 5.2).

Furthermore, there is evidence suggesting that the commission-bias also does not benefit industry. The commission-bias damages the reputation of the entire sector and undermines consumer trust and confidence As an indication of its relevance and importance, the British financial industry itself supports the Retail Distribution Review on the whole (section 4.1). Similarly the Dutch banking and insurance associations have supported their government in banning commissions (section 5.5).

[3] Callum McCarthy, 'Is the present business model bust? - Speech at the Gleneagles Savings & Pensions Industry Leaders' Summit' (2006).

Thesis 3: Attempts to address the commission-bias with disclosure do not work.

"*[T]he complexity of commission-based remuneration structures, together with low levels of investor financial literacy, mean that the disclosure approach is not working as intended. Rather, the most vulnerable investors - those most in need of good financial advice - are also those most at risk of being sold products that are completely inappropriate for their financial needs.*"[4]

Chris Bowen, Australian Minister for Financial Services, Superannuation and Corporate Law

"*UK experience has [...] been that investors find it difficult to decode labels.*"[5]

Niamh Moloney, Professor at the LSE

Two approaches are put forward to address the commission-bias: mandatory disclosure and a ban of commissions. The first group who proposes mandatory disclosure highlights negative side-effects of a ban, such as raising costs for advice, an unwillingness or inability of consumers to pay for advice and the risk that a ban of commission could lead to a concentration of the market. This group therefore calls for improved disclosure of commissions rather than a ban (section 2.2.3).

Proponents of a ban on commission point to research that demonstrates that the disclosure of commissions does not rectify the commission-bias. They argue that consumers find it difficult to understand how commissions may affect the independence of the service they are being provided; that there was a danger that consumers made worse decisions due to an inadequate framing of the information and due to information-overload which prevents them to digest other payoff-relevant facts; and advisers might feel more justified to give biased advice, since they revealed the conflict of interest (section 2.2.1).

Experiences in the UK, Netherland and Australia all support the stance of the proponents of a ban of commissions. In all countries disclosure was tested and proved to be an inadequate instrument to address the commission-bias. The conclusion in all these countries was that rather than focusing on symptoms, the root cause for mis-advice and mis-selling had to be tackled (commission-bias), that disclosure was an insufficient instrument to address this bias, and that the commission-bias therefore had to be erased (sections 3.1 and 5.3). It is important though, that this ban is made applicable to all financial advisers and not only some - such as the European Commission had proposed in the MiFID II proposal. The UK House of Lords European Union Committee convincingly concluded that: "Restricting the ban on inducements to independent advisers will be unwork-

[4] Chris Bowen, 'The Future of Financial Advice in Australia and Federal Budget Overview - Address to the Association of Financial Advisers', (2010).
[5] Moloney, *How to protect investors: Lessons from the EC and the UK*, p. 268.

able, since advisers will simply take steps to avoid being classified as independent."[6]

Thesis 4: A ban of commissions transforms the industry, offers new opportunities and stirs competition for quality.

Starting next year commissions will be banned in the UK, Netherlands and Australia. Such a ban represents a significant regulatory overhaul. While financial *product providers* will not need to change their core business of asset management fundamentally, they will need to introduce new share classes and instruments to facilitate adviser charging. Furthermore, there will most likely be a shift to passively managed investments and, most importantly, the performance of the products will be more in the spot light in the distribution of financial products. Intermediaries will measure financial products more thoroughly with regard to their performance rather than the associated commissions (section 4.1).

For *intermediaries* a world without commissions will look very different. Intermediaries will need to focus increasingly on the quality of their advice and they need to prove that this service is worth its price. While some intermediaries will not be able to rise to this new task, there are indications, that the drop-out rate will not be high and that new qualified actors will enter the market. These new actors will be better trained and ready to engage in this new competition for advice quality (sections 4.2 and 5.5).

Finally, the way in which *vertically integrated firms* react to the RDR indicates that they will apply different strategies. While some are focusing on more affluent consumers, others will still offer an array of services to all consumer groups, still others will totally withdraw from the advice market, and many will invest in technology to facilitate streamlined advice processes.

In sum, product providers, intermediaries and vertically integrated firms will need to focus less on volume and more on quality - the quality of products and the quality of advice. This study shows that not all current players will be able to cope with this new situation. At the same time, the study shows that this new regulatory environment creates opportunities for those who want to compete on quality and that there are a great number of actors that get ready to seize this opportunity. Furthermore, industry in the UK and the Netherlands hope that by addressing this root cause, there will be less pressure on governments and regulators to continuously introduce new (costly) measures to improve consumer protection. In supporting the ban, they hope to play a more pro-active rather than reactive role.

Thesis 5: Potential negative impacts on consumers can be mitigated.

"*We believe that once consumers begin to understand that the service being provided is one that is worth paying for, the risk [that Adviser Charging could lead consumers withdrawing from the process] will largely fall away.*"[7]

[6] House of Lords - European Union Committee, 'MiFID II: Getting it Right for the City and EU Financial Services Industry', in Hl Paper 28 - 2nd Report of Session 2012-13 (ed.), (2012), p. 32.

UK Financial Services Consumer Panel

Opponents of a ban of commission warn that a ban will have negative impacts on consumers. They highlight that consumers will not be able or willing to pay for advice, that costs for advice will be too high and that particularly low- and middle-income consumers will be left with little to no access to advice, which could aggravate the already existing savings and insurance gaps.

The study shows that these opponents are right and wrong at the same time. They are correct in the sense that the market for financial advice will change significantly for consumers, that there might be regions where access to advice will become more difficult and that consumers might find it difficult to accept that they have to pay directly for the advice service.

Opponents are wrong, however, in so far as potential negative effects have to be weighted against the positive ones:

- Higher professional standards and the ban of commissions will contribute to a better quality of advice and it might prevent large scale mis-selling scandals that have happened in the past.
- Fee compensation reduces the risk of churning and the sale of underperforming investments.[8]
- Financial advice will become a value. Advice was never free, but under the new regime the costs become transparent.

Furthermore, mitigation strategies can be introduced. Simplified advice or scaled-advice systems and stakeholder products (which include consumer protections) are ways to ensure that key financial services that should be easily accessible to all consumers will be available even without or with limited advice (sections 3.2.2.3 and 5.5).

Thesis 6: Fee-only advice eradicates the conflict of interest which is inherent in commission-based advice. However, it must be backed with high professional standards.

The study suggests that consumers have a right to know whether the advice they receive is independent (paid by a fee) or dependent (paid by the product provider via commissions). There needs to be a clear distinction between advising and selling, as only fee-only advice eradicates the conflict of interest which is inherent in commission-based advice.

The UK and the Dutch experiences show that the success of the fee-only advice model depends on two factors. First, fee-only advisers need to be competent advisers. It therefore needs to be ensured that the advisers are properly trained, engage in continuous professional development and are accredited to profes-

[7] Financial Services Consumer Panel, 'Simplified Advice - Guidance Consultation', (2011), p. 2.
[8] See also: Finke, 'Financial Advice: Does it Make a Difference?', p. 16.

sional standard bodies that sanction any misbehaviour. In Germany, for example, the Association of Fee-Only Advisers (BVDH) has a codex for its membership which clearly states that fee-only advisers are not allowed to take commissions or any other form of inducements or even to participate at incentive programmes of product providers.[9]

Second, consumers need to know whether the adviser is able to offer recommendations on the whole range of financial products, whether he/she is specialized on particular financial products or tied to products from particular providers. The scope of advice needs to be clearly labelled (sections 3.2.2 and 5.6).

Thesis 7: Changing the financial industry is a journey. While new challenges will arise, the most pressing issues should be addressed in a timely manner.

Particularly the UK case study reveals three key lessons for the implementation of such a fundamental regulatory overhaul. First, while it might not be easy, it is possible to create a common consensus among key stakeholders - such as regulators, banks, intermediaries and consumer organizations - to start a process to address root causes of mis-advice and mis-selling. If such a consensus is achievable in the UK - a country which is more dependent than any other EU country on the financial services sector - such a success should be replicable in other states.

Second, changing the framework for financial advice should be regarded as a journey. This is best exemplified by the fact that new questions and challenges have come up and will continue to arise throughout this endeavour. Examples are issues around platforms and how they fit into the new adviser charging regime (section 3.2.3) or in-house incentives (section 3.2.4). All these questions can be handled in a pragmatic way. It is important, however, to make the first step and address the issues that are most pressing.

Third, by addressing the important issue of the commission-bias, one should not forget that a comprehensive approach is needed to improve the overall performance of the financial services sector. Consumer literacy, accessibility and comparability of reliable and understandable information about financial products, behavioural biases, transaction costs, hurdles to switching and access to and the availability of high quality financial advice all play important roles in improving the functioning of the financial services market from the consumer perspective (section 2.3).

Thesis 8: A system change in the financial industry is needed to protect and empower consumers and restore trust in the financial industry.

"[W]hile public attention has been on the huge rewards on offer to the few, the effect of more modest rewards on the many needs to be dealt with. We need to deal

[9] Berufsverband deutscher Honorarberater, Kodex der Honorarberatung (9. August 2010)

with how incentives and bonuses are used by firms across financial services to drive sales, and the knock-on effect this has on their customers."[10]

Martin Wheatley, Managing Director of the UK Financial Services Authority

Given the large mis-selling scandals and the low quality in financial advice, this study shows that a system change in the financial industry is necessary. Governments, regulators, the financial industry and consumer organizations must work together to create benefits for all stakeholders. A regulatory overhaul is not only necessary, but possible and it could lead to a win-win-situation between consumers and industry. Removing the commission-bias by banning commissions increases competition for quality of products and services and contributes to restoring trust and confidence in a sector with a dismal reputation. The experience in the UK, Netherlands and Australia demonstrate that attempts to address the commission-bias solely with improved disclosure will not solve the conflict of interest inherent in a commission-driven financial service distribution. What is needed is a courageous system change in the financial industry. The industry players should renew their commitment to their most valuable stakeholder: the consumer.

[10] Martin Wheatley, 'The incentivisation of sales staff - are consumers getting a fair deal? - Speech', (2012).