

Anticipating the Retail Distribution Review

Insights from a firm that knows about alternative (consumer-friendly) business models

Key points

- The background to the RDR is economic. There is a 'market failure' in the distribution of long-term savings products (FSA, Treasury, HOC Treasury Committee, Myners, Sandler). Three aspects: i) the business model for firms involved is not sustainable – returns on capital not economic ii) consumer-access thresholds rise with costs, creating service gaps iii) consumers' savings outcomes reduced by wasteful 'cost wedge' – *we estimate (compared with realistic alternatives) at least 25% down the drain, equivalent to 50% increase in savings rate!*
- There is effectively a monopoly of a single commission-fuelled business model. Because of the way competition works where selection is based on performance of active funds, increasing supply has perverse effect that it drives cost *up* not down (the key Sandler insight)
- Technically a market failure is outside the FSA's remit and its hands are now also tied by MiFID. Hence RDR positioned as 'call to collective action', recognizing change has to work with the market and be market-based in its economics. Hence don't expect another attempt at a magic bullet like depolarization or the menu
- Though not ultimately sustainable, the dominant model is also resistant to change. *The key to interpreting the RDR Discussion Paper is whether any market-based solutions emerge that look like they have a chance of disrupting the dominant model*
- Some of the key initiatives have a life outside the RDR and have been hinted at by the FSA as a 'segmented' approach: generic advice at the bottom, versions of 'basic advice' in the mass market and full, face-to-face, advice-based distribution at the high end
- The middle segment is the key to disruption. Lowering perceived regulatory risk can help, so can technology enablers (our own contribution to the review team). But ultimately you don't stake millions on a disruptive approach unless you think consumers will value it. *We get the business model we deserve: consumer indifference in money matters invites more of the same not a risky new model*
- We think the FSA buys the idea that the best way to engage customers is to reposition the product as a 'service experience' that is personally relevant. For most saving purposes this is a 'journey' which is planned, has outcomes and whose progress is reported in terms of those planning outcomes. Service-based alternatives, if valued by customers, could emerge in any part of the market: product manufacturers, banks and building societies, advisers, platforms, non-financial retailers
- We agree with the FSA that most savings purposes only need simple sales and advice processes implemented using low-cost 'commodity' products. This is true at quite high levels of wealth

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(For those interested in more background to these suggestions, we develop the main points below.)

Distribution economics

Competition should ensure that flawed business models are driven out by more successful ones. This has not happened in the long-term savings market. Why not?

Labour-intensive direct sales by manufacturers (mainly insurance companies) have been largely driven out of the market by high costs. Both competition and regulation did at least work to prevent these high costs being passed on to consumers. The effect has been dependence by product manufacturers on distributors. Distributors are effectively the customer. This is not itself unusual: it arises where products are 'brokered'. However, it has unique effects where the product being brokered competes on a false basis of selection, as it prevents the normal basis of comparative advantage from working. In long-term savings products, selection is based on performance. The only performance that matters is future performance, which cannot be known, so the proxy relied on is past performance. This quantum is not related to economic factors such as size and efficiency and only weakly to fund-management costs. This is to be expected if performance variability is essentially a random process (or cannot be exploited cost-effectively), as much theoretical and empirical literature has demonstrated.

Packaged products hold diversified portfolios of many securities (whether bonds or equities). We have more products packaging actively-managed securities than there are securities in the market! It requires only a small number of actively-managed funds to ensure efficient markets so this extra supply brings no benefit to society. In fact, it destroys savings by increasing costs at the same time as raising the barriers to entry by new products, except those that endorse the same version of the competitive game.

The active-management game is seen to be best played by maximizing assets under management when performance is good (even if it only randomly good) and keeping fees up across all funds. Since cost reduction does not prevent asset loss when performance is bad (even if only randomly bad) it still pays to keep fees up. These effects are well-documented in the academic literature.

To the extent fighting for market share calls for competitive initiatives, this has increasingly taken the form of agreeing to pay trail commissions, rather than bidding up initial commissions. Since trails are met by the provider (unlike initial commissions which are met by the buyer), annual fund charges have increased to pay for this. As the Sandler Review pointed out, in a contest gamed this way, increasing supply tends to drive the costs of distribution higher and as long as both agents and customers continue to select on performance these will be passed on to the end investor.

Any analysis of the distribution business also needs to focus on the health of structured products. The key structure, with-profits, has failed. The structural features that mattered were the claimed transformation of risk, through pooling – a principle at the heart of insurance funds. This transformation required fine judgement about the allocation of earned returns to the payouts of different maturities of policyholder ('smoothing') and about the investment risk undertaken in the presence of guarantees. We believe judgement was bound at some stage to be humbled by markets but also that prudent reserves are too tempting a target to be used for a different purpose: securing competitive marketing advantage by bidding up policy payouts. Both happened. The industry effects have been:

- to weaken the competitiveness of insurance companies by absorbing capital
- to increase the market hold of brokered unit trusts and OEICs.

Finally, the broking of long-term savings is efficient in terms of one attribute the consumer likes: face-to-face contact with an adviser. In economic terms this is hopelessly inefficient, so even high commissions have not produced sustainable models for financial advice businesses. Most lose money.

Segmented services

This comes from the FSA's latest public statements on the RDR:

Although full details of the issues arising from the review will be presented in a FSA Discussion Paper in June, some common views are emerging about the future shape of the market and the changes needed. Overall, there seems to be some preference for a move away from the focus on products towards the range of services that reflect consumer needs.

Other recent FSA statements have hinted at different service needs in different population segments. We expect the service formats to be segmented around three categories:

- the bottom end of the market: generic advice
- the middle market: simple advice formats using simple products (moving on from 'Basic Advice')
- the high end where advice looks more like a profession.

Generic advice is already the topic of a review team headed by Otto Thoresen of Aegon and he chaired one of the working parties. Generic advice is poorly understood. Most of the time (and cost) of financial planning is generic: discovery and development (mainly educative), leading to decisions. Where deployment of those decisions uses simple products, that stage of the process is almost trivial. Generic advice is personal and customized: it just does not lead on to a specific product or deployment.

Generic advice at the bottom end of the market will go hand-in-hand with personal accounts. It will have to focus on the complexities (and trade-offs) arising from the interaction of savings and benefits. For background on generic advice, we recommend Clive Cowdery's philanthropic initiative: go to www.resolutionfoundation.org.

Variations on the theme of basic advice are effectively generic advice that leads on to a product – a simple one that gets the job done. Simple products are best understood as commodities: they are sufficiently homogenous that selection between them is trivial. Low-cost index trackers are the obvious example. The discovery and development focus is different in this segment: the need may be more focused and also more obvious to both parties.

Simple products with simple advice processes are the solution the FSA will want to see replacing the failed IFA model in the mass market (see Huertas speech 06/06/07).

To attract firms like high street banks or non-financial retailers as well as insurance firms, there will need to be a significant reduction in compliance risk, *notwithstanding that the necessary condition is that consumers value the proposition*. Look for indications about the trade off between simplification and lighter regulation but remember this is part of a much bigger project: the move to principles-based regulation (and the reduction in the amount of prescriptive rules). Basic advice is also in the middle of a review not expected to report before mid-2008. But we may get some industry feedback in the paper as to why the take-up has been so poor (and therefore what has to change).

At the high end of the market, there seems no end to the inexorable upwards movement of the entry level for expensive face-to-face advice. We believe much of the frustrated demand would in fact be satisfied if simplified services are developed below this segment, as many needs do not call for full holistic financial planning.

Realistically, the FSA should worry less about consumer protection at the high end of the IFA or stock-broker market segment. Not only are these customers who are better able to protect themselves but

they already have a choice about what how they select and work with agents. These are the very people who do not value what they could get when they write a cheque for service and so make themselves easy victims of the distribution game. Their '25% down the drain' is measured in hundreds of thousands of pounds over a long period of investing.

Technology

Technology adoption was a key emphasis in our meeting with the FSA review team leader and senior colleagues. (This reflects this firm's experience applying technology but also Stuart Fowler's previous consultancy work.) If technology makes it to the Discussion Paper it is likely to be in connection with new mass-market solutions.

We believe technology is critical to successful delivery of high-quality but low-cost advice or decision support in the mass market. This applies to the delivery channel itself (mainly telephone rather than online but still relying on computer-based processes) and also to sales and advice processes.

Where a service (or underlying product structure) incorporates journey attributes of planning and progress reporting on the way to long-horizon outcomes, technology can handle the planning of the journey parameters in a way that builds education about the principles of a choice into the sales process. Long-term asset models are also critical to the mass-customisation of dynamic asset allocation which the journey management requires.

Skills

Our input to the review team emphasized another role for technology. As a means of distributing top-level skills *down*, it is far more realistic than driving individual skills *up* for the tens of thousands of people who currently interact with FS customers. Skill improvement will be a key focus of the paper, however, as it was one of the five working groups. We expect the suggested solutions to vary as between the middle market segment and a more professional model for IFAs in the top segment. Money Marketing (<http://www.moneymarketing.co.uk/cgi-bin/item.cgi?id=144334>) quotes 'well-informed sources' on how qualifications will be used to underscore this distinction. This sounds sensible although the overall skill level will also be addressed indirectly if the bottom end of the IFA market is lost to new distribution methods, as these are the mom and pop operations that drag the average skill level down.

Caveat emptor

The tide has subtly turned at the FSA from consumer protection at any price to reasonable self-protection, as a perfectly valid part of the overarching public-policy goal of personal responsibility. The involvement of industry firms in the review will hopefully have reinforced the message that consumers that have been properly informed (under the principle of treating customers fairly) do not have grounds for a complaint.

Expect to see some lip-service to caveat emptor in the paper. But the real tests are outside the scope of the paper and relate to how the FSA manages the change to principles-based regulation. It needs to meet industry fears about predictability of interpretation by the FSA and (as important) consistency between the FSA and the FOS. The recent CSFI working-party publication *Principles in Practice* is an excellent source of practical wisdom (and healthy doubt) on this (CSFI: 020 7493 0173).

Commissions

If there were to be a big idea, this is what it would have to address, because commissions are the root cause of the failure of the existing distribution model. Unfortunately, whatever its logic in the UK as a last-ditch solution, an outright ban is surely a measure too far for MiFID.

There is a new FSA position on commissions which arises as a consequence of what MiFID has to say about 'inducements'.

- Commissions paid to advisers *are* an inducement
- Commissions must be designed to 'enhance the quality of the service to the client'
- Advice 'that is not biased as a result of the receipt of a commission' should be considered as having met that condition.

That should be simple: the entire commission-based model biases the general design and nature of products and services (mainly via that obsession with active management)! Though this interpretation of structural bias is intellectually and practically defensible, we accept that it would never command the support within and between countries that MiFID requires. This is because it is a failure of competitive diversity in the UK market, not a failure of commissions by their nature. America has healthy diversity in which fees and commissions share market space and it shows up as a wide dispersion of product costs with a much lower mean than the UK. See Morningstar article comparing mutual fund costs at: <http://www.morningstar.co.uk/UK/Funds/article.aspx?lang=en-GB&articleID=49411&categoryID=13>.

Expect to see something on the ABI's proposal that consumers agree advice charges with their adviser and mandate the product provider to pay the adviser on their behalf. This 'factory-gate pricing' idea is a version of the 'alternative defined payment system' favoured by Sandler – which was rejected. It may have appealing integrity as an explanation of the economic relationship between adviser and consumer but it does not address the need for a market-based solution for the economic relationship between providers and distributors. Either this is the daftest proposal ever made by the ABI or there is a hidden agenda. IFAs think it is to steal the customer relationships from them. Their outraged reaction suggests the ABI did not get the FSA's message about market-based solutions!

Lastly, it is fun to speculate about wildcards. HMRC could constructively disturb the cosy arrangements between providers and IFAs for paying for advice or portfolio management out of commissions and so avoiding VAT. This would unquestionably encourage fees for advice.

No Monkey Business Limited is a wealth management and financial planning firm working with families with around £2-20m in financial assets. Formed in 2004, it puts into practice the principles in Stuart Fowler's book, *No Monkey Business; what Investors need to know and why* (FT Prentice Hall 2002). Clients pay fixed fees as a function of their fair share of the costs of the 'family office'. Two portfolio approaches are used: fully quantitative goal-based portfolios (using trackers and a risk free asset) and diversified wealth management combining mainstream and alternative assets.

Previously Stuart Fowler ran a consultancy focused on business model change and technology adoption in retail financial services. Clients included BT Syntegra, Egg and IFA practices. Stuart's career has mostly been spent in institutional fund management and Philip's in financial advice for wealthy individuals.