
Commissions: what's not on the 'menu'

By Stuart Fowler

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Two weeks ago the last piece of the FSA's reform of financial advice was put in place: the 'menu' agents will have to give customers which sets out what advice will cost them and how they can pay. It was the one piece capable of bringing about a sea change in the culture of the financial services industry. In a spirit of misplaced compromise, the FSA has blown it. Instead of a compromise, product manufacturers and distributors think they have won a total victory against a frontal onslaught on the dominant commission system for distributing packaged financial products.

The original premise of the FSA's reforms was simple and intuitive: if financial advisers wished to call themselves 'independent' they had to be financially independent of product manufacturers, paid by the customer direct and not by manufacturers. The purpose of the reform was to deal with commission bias. This remains the benchmark against which we should judge the new regulations, even if the FSA has lost sight of it itself.

True, commission bias was not the primary focus of the original Office of Fair Trading report that ruled that the bipolar world of 'tied' agents and 'independent' agents was anti-competitive. The fee versus commission condition was a surprise element of the FSA's 'depolarisation' consultation paper, CP121, but it was one applauded by the OFT.

The FSA was always exposed because it relied on a report on commission bias it ordered from economic analysts Charles River Associates which was deeply flawed. The report demonstrated some bias between different commission-paying

products but never analysed the systematic biases which all of those competing versions of commission-paying products share. Charles River justified this, with logic worthy of Lewis Carroll, on the basis that 'there is a 'dance ticket' – a minimum level of commissions that is required to remunerate the level of effort put in by advisers, without which advice could not be given at all', so evidence that commission-based IFAs rarely sell products that do not pay a commission does not prove there is commission bias – 'instead it reflects the way all commission-based distribution systems work'.

It was left to the commonsense Sandler Review to spell out the system-wide sources of commission bias:

- against courses of action that do not involve a product sale
- to actively managed investment funds and against cost-effective index trackers
- to riskier investments because it requires some hope of higher return to justify the product charges
- to taking on irrational levels of risk because the size and chance of likely

payoffs after commission costs are too small.

Though Mr Sandler strengthened the FSA's hand, the regulator was promptly trumped by Charles River producing for two opposition groups, the Association of Independent Financial Advisers and IFA Promotion, an economic justification for an extreme and then entirely speculative view that, if the FSA stuck to its guns, there would be virtually no independent advisers for consumers to choose. They also confirmed the FSA's consumer research showing that people prefer commissions to writing a cheque for advice. This prepared the ground for the menu as a compromise.

The FSA bought the deal: financial advisers would not have to be commission-free to be 'independent', but in common with all distributors they would have to give customers more information about how they could pay, fees or commissions or some mix, and about levels of each. Since commission disclosure had already been required since 1995, the real test of the deal was whether the changes in the form of commission disclosure would counter bias as effectively (or as cost-effectively) as would new and absolute distinctions in a firm's status.

For all investment related products, the menu was doomed from the start. There is a set of information which, if disclosed by an agent and if read and understood by a customer, would make the impact of bias so apparent that the customer would reject the agent's recommendation or select a different agent. But it would require complete information about alternative courses of action and for products would require assumptions about fee frequency

and holding periods to illustrate differences between outcomes for commission-free and commission-paying products, which would also need to be based on return probabilities. To measure possible bias, these illustrations would have to pick up all the cost differences, not just the payments going to the agent which is all the menu does. Examples of such illustrations, using the FSA-prescribed rates for both inflation and real investment returns, formed part of the report of a working party on depolarisation organised by the Centre for the Study of Financial Innovation. They showed, for instance, that for a regular contribution of £2,000 pa in today's money, such as for a modest personal pension, the full likely cost of attaching a typical sales commission for 20 years is about £12,000 and of trail commissions of 0.5% pa for an active fund is a further £17,000, equivalent together to over 10 years of contributions. Fee-paid advice over the full period would be measured in hundreds of pounds, not thousands.

The FSA knows consumers very well: the form of comparative disclosure that would make true costs evident and allow people to distinguish between a fair bet and a bad bet is 'information overload' - they will never give it the time of day so it will never change their behaviour. But this is precisely why they need simple, absolute distinctions, such as commission-free independent advice or the 'stakeholder' label for consumer-friendly products.

Like any botched attempt at consumer protection, this one carries the risk it will make a bad situation worse by lowering the consumer's guard. For a start the menu implies that both a fee schedule and a product commission schedule tell the consumer about the cost

of advice. They do not. A commission contingent on the purchase of a product is not a charge for advice, as is demonstrated by the fact that a customer could take the advice and implement it elsewhere at no cost. The advice is free. Or, in other words, the advice is a loss leader which industry experience has proved leads to product sales. Instead of forcing consumers to think about the implications if advice and products are actually separate but get linked artificially by a firm's business model, the menu has the opposite effect, implying they are the same things.

But neither does an hourly fee rate spell out the cost of advice. As the FSA's consumer testing of the menu revealed, without the number of hours it takes for a piece of advice, 'it left respondents unable to draw meaningful comparisons between the fee and

commission options'. What these respondents took from this gap in the fee information will delight commission firms: 'it was not as useful as the commission information'. So the difference the menu makes is that an irrational choice now looks rational.

It is too late to get the FSA back on track. Without regulation providing a marketing reward for doing business untainted by commissions, all we can hope is that a few firms in the industry will decide that, if they make enough noise about it, staking out the moral high ground should bring its own reward.