FCA's response to The Heath Report Two

Introduction

1. At the TSC hearing on 20 January 2016 we were asked to consider The Heath Report Two[1] (THR2) and provide comments on the numbers and methodology used in respect of the impacts arising from the Retail Distribution Review of the market for retail investments.

2. The FCA welcomes the opportunity to provide written evidence to the Committee on the issues raised within the Report.

Executive summary

3. This response sets out our views on the conclusions of THR2. These are set out in detail later in this response. However, in brief, they are as follows:

Conclusion 1: Since RDR was announced 13,500 advisers have left the industry.

4. We recognise that there has been a decline in the number of advisers over recent years. Before the RDR was implemented it was anticipated that there would be a fall since the increased minimum standard of qualification was expected, inter alia, to act as a catalyst for earlier retirement among some older advisers.[2]

5. However, THR2 measures the change in the number of advisers from 2008 whereas the RDR took effect at the end of 2012. Measuring changes from a long time before RDR implementation makes it difficult to isolate the changes due to the RDR as opposed to other market changes. There are a number of reasons why adviser numbers fell in that period including: banks withdrawing from parts of the market for wider commercial and strategic reasons; and the consequences of episodes of mass mis-selling (in terms of redress and reputational damage).

6. Also, it is important to note that adviser numbers on their own do not tell the whole story, since the issue is not solely the number of advisers, but the number of clients

[1] Mr. Garry Heath is the former head of the Independent Financial Advisers Association and in 2015 launched a further trade body called Libertatem aimed at adviser firms.

[2] Page 6, Retail Distribution Review proposals: Impact on market structure and competition, Oxera (2010). http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf

those advisers service which determines capacity in the market. There is evidence that points to advisers having adequate capacity to meet demand. Please see paragraphs 19 to 32 of this note for more detail.

Conclusion 2: Historically 23m consumers have accessed advice via IFAs and banks. Since RDR was announced 16.5m consumers no longer have that access.

7. We have reviewed THR2's analysis and do not recognise the figures which are presented, as the sources of the data are not always referenced. From a methodological perspective, the analysis is likely to significantly overestimate the number of "abandoned consumers". This is because it takes the number of consumers who have received advice *at "some time"* and then subtracts the estimated capacity for advice based on the number of clients THR2 estimates the advisers in the market at a *particular point* in time can service. It would seem unreasonable to expect the stock of advisers at any one point in time to be able to service all individuals who have ever had advice at some time. Equally it would seem unlikely that all of these individuals would want, or need, advice over the same period. Consumers are likely to want advice with different degrees of regularity, depending on their circumstances. Some may seek advice frequently through the year; others may seek advice on a transactional basis, say once every few years.

8. We set out a more detailed analysis of the methodology, and our views in paragraphs 33 to 39.

Conclusion 3: If trail commission is banned in 2016 then the IFA sector will lose between 7,260 advisers and 15,510 advisers with an associated consumer capacity of 1.4m to 3m consumers.

9. We have not banned trail commission to advisers relating to pre-RDR advice on investments. The final rules on trail commission, which were published in November 2011[3], confirmed that commission for pre-RDR advice can continue to be paid and that it can be transferred to a different adviser.

[3] The rule and guidance on continued payment of trail commission are set out in the FCA Conduct of Business sourcebook.

10. There may be some confusion in THR2 between adviser trail commission on pre-RDR business and the sunset clause in relation to payments to investment platforms.[4] Our rules require platforms to stop retaining payments from providers at the latest by 6 April 2016, and to be paid for their platform service only through platform charges agreed with clients. But these rules do not affect commission paid to advisers for advice on pre-RDR business, including pre-RDR advice on investments held on a platform. It is correct that when platforms move clients to 'clean' share classes, there may no longer be a facility for commission to be paid to advisers, but this change is not required by our rules. This is covered in more depth in paragraphs 40 to 46..

Conclusion 4: RDR will cost the consumer £340m pa (with no associated consumer benefit).

11. The estimated costs presented in the Cost Benefit Analysis included high costs to the banks of changing their systems. In reality, however, many of the banks left the market for advice for a range of reasons, many of which were unrelated to the RDR. These costs therefore are unlikely to have been incurred by the industry on this scale.

12. Europe Economics were commissioned by FCA to conduct the first stage of an RDR Post Implementation Review. In their report, they made clear that it was early days since the implementation of the RDR (less than two years) and so definitive evaluation of all of the impacts and benefits was not possible, as some impacts were still to be fully realised. Even so, Europe Economics identified a number of very positive impacts, which are explored in more detail in paragraphs 47 to 54 below.

Financial Advice Market Review (FAMR)

13. We will continue to monitor the impacts of the RDR and developments in the sector. As the Committee is aware, we have been looking, alongside HMT, at ways of increasing access to advice through the Financial Advice Market Review (FAMR). We remain of the view that the RDR is delivering some very positive impacts such as improving adviser professionalism and reducing product bias. FAMR, however, recognises the challenge that those without significant assets or income may have in obtaining appropriate advice or support with their decision.

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[4] See PS 13/1 Payments to platform service providers and cash rebates from providers to consumers. (2013) http://www.fca.org.uk/your-fca/documents/policy-statements/ps-13-01

14. The recommendations from FAMR were published on 14 March 2016.[5] The report sets out a series of recommendations intended to tackle the barriers to consumers accessing advice. .

Background

15. THR2 sets out the views of Garry Heath (Director General of Libertatem, a trade body representing advisers, planners and wealth managers) in relation to the impact of the Retail Distribution Review, along with some wider views on regulation and government policy generally. The Retail Distribution Review (RDR) was introduced by our predecessor (the Financial Services Authority) at the end of 2012 as a package of measures to address the root causes of some of the problems that had persisted in the retail investment market over a number of years. The RDR sought to improve the level of professionalism within the intermediary sector and enhance consumers' understanding of the service they were receiving, and also to remove the potential for bias in the advice market where advisers were remunerated by product providers through commission.

16. The FSA recognised the potential impacts of the very significant changes which were being introduced and so not only set about one of the most wide reaching consultation exercises it had undertaken[6], but also committed to review the impact once the changes had been implemented. As part of this post implementation review (PIR) Europe Economics were commissioned to give an independent, objective and robust assessment of the impacts that the RDR had made as of December 2014 (Phase 1 of the longer term post implementation review project). We continue to believe that it is the most thorough and methodologically robust study into the RDR that currently exists and draw on the evidence it presents in this response.

17. The next phase of the PIR is planned for publication in 2017, allowing us to draw from at least three years of evidence. A subsequent, third phase of the review will consider the longer-term implications.

Purpose of this report

[5] https://www.fca.org.uk/your-fca/documents/financial-advice-market-review-final-report
[6] During the existence of the FSA from 2001 and 2013.

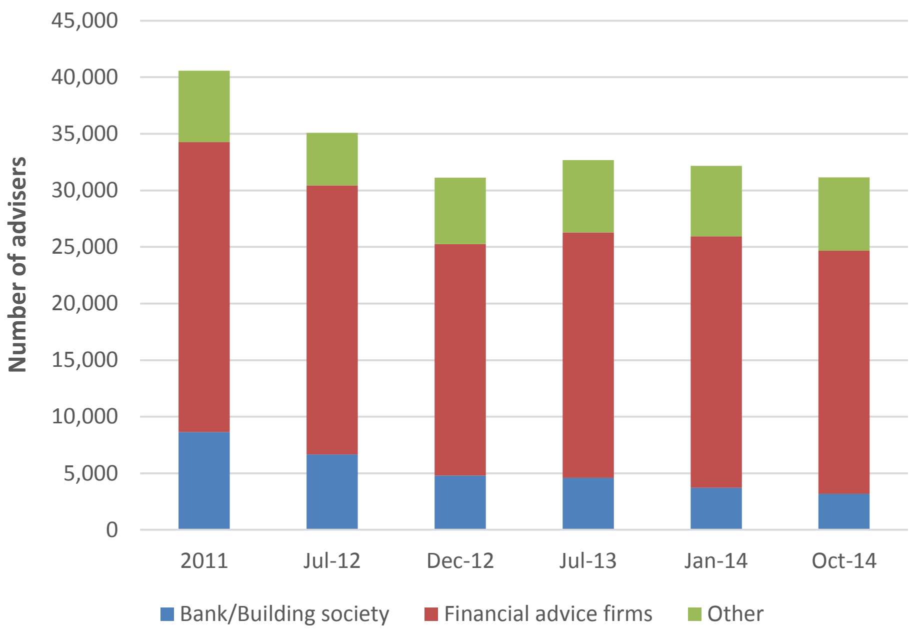
18. This report gives our response to the conclusions of THR2, including our view on both the numbers given and the methodology used. We also provide a summary of the findings from the first stage of the RDR PIR, which found that, although it was early days since implementation, there was evidence of some very positive effects for consumers, such as: greater adviser professionalism; a reduction in product bias; and falling prices in some areas.

THR2 Conclusion 1: Since RDR was announced 13,500 advisers have left the industry

19. THR2 states that since the RDR was announced in 2008, 13,500 advisers have left the industry, made up of 7,750 bank advisers and 5,750 IFAs.

20. As previously set out in the RDR Post Implementation Review, there has indeed been a fall in the numbers of advisers in the sector. This is shown in the diagram below[7]:

Change in the number of advisers between 2011 and 2014 by type of advisory firm



Sources: RS Consulting and FCA Professional Standards Data

21. This chart shows that there were approximately 40,000 advisers in 2011, falling to 35,000 in the summer before the RDR came into force. In November 2015 the total number of advisers stood at 30,600. This has remained stable since 2013.

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[7] Pg 54, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics http://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics

Baseline for measuring RDR impact

22. The THR2 baseline against which it measures the number of IFAs leaving the industry is 2008. We do not believe the impact of the RDR should be measured from this point. The changes were not finalised until 2010 and did not actually come into force until 31st December 2012, and so while there may have been some departures in anticipation of the RDR, not all of the exits will have been directly as a result. The number of advisers had been falling steadily for many years against a backdrop of falling demand for advice which predated the RDR – not just advice on investments but in respect of all financial products. FCA data shows the proportion of the population[8] who had sought advice across all products (not just investments) fell from 25% in 2008 to 13% in 2012. [9]

23. We consider that it is more appropriate to take the total number of advisers in the market in the year before RDR implementation (35,000 in Summer 2012) as a more relevant baseline from which to measure the changes caused by the RDR. By going back further in time it becomes more and more difficult to identify the changes directly attributable to the RDR as opposed to other changes happening in the market.

Factors contributing to a fall in adviser numbers

24. The RDR is not the only reason for a fall in adviser numbers. It is important to look behind the numbers to understand all the drivers of any reduction:

Demographics of adviser population

25. A decline in the number of advisers was expected before the implementation of the RDR,[10] since the requirement for a higher level of qualification and professionalism would mean that advisers who were not able or willing to meet those standards would naturally leave, particularly those close to retirement.

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[7]The survey was representative of the British population in terms of known population data on age, sex, social class and region.

[9] FSA Consumer awareness of the FSA and financial regulation' reports from 2009 – 2012.

[10] Page 6, Retail Distribution Review proposals: Impact on market structure and competition, Oxera. http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf

26. Similarly, in 2011, 8% of Retail Investment Advisers stated that they expected to cease being an adviser after 31 December 2012 because of non RDR reasons, including planned or early retirement or a switch to another role within the industry.[11]

Majority of fall due to exit of bank advisers

27. The majority of this decline in adviser numbers (58 per cent of the advisers who left the industry in the period 2011-2014)[12] can be attributed to banks withdrawing from some parts of the market for advice. While the requirements of the RDR may have played a part, there were a range of other important factors at play. These include the commercial realities of maintaining a viable advice model based around geographically disparate, 'bricks and mortar' branches in the face of growing competition online and the impact of a number of significant misselling episodes. [13]

Growth of non-advised market

28. At the same time we have seen a growth of the non-advised market, particularly now that the cost of advice is made clear to clients. As an example of the costs, a typical pre RDR commission taken on a £100,000 investment into an Investment Bond was 3% of the investment upfront with a 0.5% trail commission payable each year. This meant that the total amount received by the adviser over the first ten years was approaching £9,000 or 9%.

29. These costs, coupled with an increasingly computer literate society, have meant that consumers use and transact on the internet more often than before and are more willing to by-pass advisers with self-directed investing via web-based services to save time and money.[14] NMG Consulting consumer research found that a significant

[11] Page 30, RDR adviser population & Professionalism research, April 2013 https://www.fca.org.uk/static/documents/rdr-survey-2012-rs-consulting.pdf
[12] Page 55, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics http://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics
[13]Page,56 , Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics. http://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics
[14] Deloitte (2013), "Recognising RDR reality" and pg 56 Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics http://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics

proportion of consumers, particularly when investing smaller amounts, were happy to direct their investments themselves.[15]

30. These impacts are summarised in a Cass Business School Report which states that "even without the RDR, the landscape for the advisor sector would have begun to change; technological advances have been making the creation and delivery of investment products more accessible and cheaper to a wider audience, whether guided by an advisor or not," and that "the industry was already shrinking pre-RDR".[16] This is supported by data showing that the demand for advice in respect of *all* financial products (not just investments) has been falling since before the introduction of the RDR.[17]

Advice Capacity

31. As THR2 suggests, adviser numbers on their own do not tell the whole story, since the issue is not solely the number of advisers but also the number of clients those advisers service which determine capacity in the market. The fall in adviser numbers does not mean a corresponding decrease in the capacity for advice. In fact, the evidence points to advisers having adequate capacity to meet demand:

- Existing advisers in the market have taken on more clients — research by NMG Consulting shows that each adviser took on, on average, a net increase of 26 clients in Q2 2014.[18]
- There is also evidence that advisers are making greater use of technology (e.g. adviser — i.e. B2B — platforms and social networking sites) and paraplanners to grow their businesses and increase efficiency.[19]
- Towers Watson's model estimates that the aggregate supply of full regulated advice outstrips demand. [20]

[15] NMG Consulting (2014), "Impact of the Retail Distribution Review on consumer interaction with the retail investment market", September 2014, p.37-38. NB: this research was conducted amongst consumers with a minimum of £5000 investable assets who were joint or sole financial decision makers.
[16] Page 8 Challenge and Opportunity: The Impact of the RDR on the UK's Market for Financial Advice," June, 2013. Cass Business School
[17] The proportion of the population who sought advice fell from 25% in 2008 to 13% in 2012. FSA "Consumer awareness of the FSA and financial regulation' reports from 2009 – 2012".
[18] Page 56, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics.
[19] Page 57 Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics.
[20] Towers Watson (2014), "Advice Gap Analysis: Report to FCA", December 2014. http://www.fca.org.uk/your-fca/documents/research/advice-gap-analysis-report.

- THR2 reports that in their survey firms felt they could take on an additional 54 clients on average in the next 12 months without compromising the services received by existing clients.[21]

32. In summary, there has been much comment on the absolute number of advisers in the market, which have fallen for a number of reasons, but capacity in the market is not determined by the number of advisers alone. The evidence suggests that there is still adequate capacity in the market to meet demand for full regulated advice.

Conclusion 2: Historically 23m consumers have accessed advice via IFAs and banks. Since RDR was announced 16.5m consumers no longer have that access.

33. We have reviewed THR2's analysis in this area and do not recognise the figures presented as the sources of the data are not always referenced. However, we have made some observations on the methodology as follows:

34. THR2 suggests that 23m consumers have historically accessed advice via financial advisers and banks. This suggests a greater number than corresponding data from the Personal Finance Society (PFS), which has consistently found that around 34% of the population had received financial advice at some time, equivalent to 16.5 million people. [22]

35. Similarly, the size of the group of consumers "abandoned" appears high. This is because it is calculated by taking the figure for consumers who have received advice historically (23m) and then subtracting the estimated capacity for advice based on the number of clients THR2 estimates the advisers in the market *at a particular point in time* can service. Methodologically, it is not comparing like with like. Regardless of the RDR, it would seem unlikely that the stock of advisers at any one point in time would be able to service (even on an infrequent basis) all individuals who have ever had advice. It is also unlikely that they would need or seek advice at the same time. THR2 figures seem particularly high when one considers that in the 12 months to

[21] We have assumed this is an average figure. Page 18 The Heath Report Two, March 2015.
[22] PFS: The RDR and Consumers (2014) http://www.cii.co.uk/media/5139793/pfs_rdr_consumer_report_feb2014.pdf

summer 2012, research estimates that investment advisers gave advice to 2.65m people[23].

36. The banking example in THR2 illustrates this point. The average stated client base for a bank adviser is calculated by taking the total number of people who have received advice via a bank at any time (7m) and dividing by the number of advisers in November 2010 (8,750). This gives an average client base for a bank adviser of 800, however research[24] from 2012 shows that the mean number of clients advised by bank and building society advisers per year was 110, so an active client bank of 800 appears on the high side. The report then goes on to assume that the number of advisers has fallen by 7,750 (in the report bank advisers are estimated at less than 1,000 when there were actually approximately 3,700 in November 2015 - and in addition several of the banks have announced that they are re-entering the advice market). The report concludes that the number of bank customers left without advice are 7,750 bank advisers x 800 customers = 6.2 million. This would appear to us to be a high estimate..

37. It also assumes that clients of advisers (both financial advisers and bank advisers) who have exited the market are completely excluded from the market. In reality the exiting adviser might sell their bank of clients to another firm or the client may look for a different adviser. Similarly, those advisers who left the banks may have joined an independent or restricted financial adviser firm.

38. Europe Economics point to NMG Consulting's research[25] which implies that 820,000 clients were gained by advisers in the twelve months to Q1 2014 (some of whom would have been previously serviced by advisers who had since left the market). Even taking account of some advisers stopping servicing some existing clients because they might be unprofitable (about 310,000 in the year to Q1 2014) and advisers refusing to take on clients for reasons of insufficient profitability (about 60,000) the positive net increase in customers serviced suggests that consumers looking around for an alternative adviser were largely successful. Europe Economics concluded that "we

[23] Page 34 RDR adviser population and professionalism research 2012 survey, published April 2013
[24] Page 78 RDR adviser population and professionalism research 2012 survey, published April 2013
[25] Page 63, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics.

cannot rule out the existence of a residual group of consumers denied service in this way. However these data do not speak to a significant issue here. "

39. This said, the recently published FAMR report sets out our belief that steps need to be taken to make the provision of advice and guidance to the mass market more cost-effective, particularly for those seeking help in relation to smaller amounts of money or with simpler needs. The report finds that there are a number of consumers who would be willing to pay something for financial advice but not the cost of full face to face advice. FAMR therefore makes a number of recommendations intended to deliver real improvement in the affordability and accessibility of advice and guidance to people at all stages of their lives.

THR2 Conclusion 3: If trail commission is banned in 2016 then the IFA sector will lose between 7,260 advisers and 15,510 advisers with an associated consumer capacity of 1.4m to 3m consumers.

40. It appears that much of the concern behind THR2 stems from a belief that trail commission on contracts set up pre RDR will be banned this year (April 2016). The concern expressed in THR2 is rooted in the impact on the advice community and a potential negative effect on the value of IFA businesses rather than on the outcomes for consumers.

41. We welcome the opportunity to clarify the situation We have not banned continued payment of trail commission to advisers in relation to pre-RDR advice on investments provided that the conditions in_Section 6.1A of our Conduct of Business sourcebook are met.

42. The final rules on trail commission, which were published in November 2011, confirmed that commission for pre-RDR advice can continue to be paid and that it can be transferred to a different adviser if appropriate. This can take place either through a bulk transfer of business (e.g. on retirement of the original adviser) or where the client chooses to move to a new adviser, and the new adviser decides to seek transfer of commission payable in relation to the client's existing products. In the latter case (but not in the case of bulk transfers), the new adviser must make certain disclosures to the client and provide an ongoing service to the client.

43. Separately, there has been some confusion between commission payable to advisers and the 'sunset clause', which relates to payments received by *investment platforms* from product providers. Under the sunset clause referred to in THR2, platforms must stop retaining payments for their service from product providers by 6 April 2016. Platforms are already banned from keeping such payments for new business, and will also have to stop retaining them for product transactions executed on or before 5 April 2014 (when the rules came into force). Instead, they can only be remunerated through platform charges agreed with clients. The ban on keeping payments from product providers can be implemented either by the platform moving clients to 'clean' share classes or by the full amount of the payments being rebated to clients in the form of small cash rebates or unit rebates.

44. This sunset clause does not stop advisers continuing to receive commission in relation to pre-RDR advice, even where the advice related to assets held on platforms.

45. However, we are aware that some platforms/providers have chosen to move to 'clean' share classes which remove commission payments to advisers as well as payments by providers to platforms. This is a consequence of the platform/provider's own commercial decisions, not a requirement of FCA rules. Interestingly, we have noted that the annual management charge to the consumer has been reduced by up to 50% or even more in some cases.

46. Moreover, as we have seen above (paragraph 28) trail commission can hide the true cost of advice from the consumer. The example in that paragraph shows that the adviser received a total of 9% in commission payments over the life of the product in essence for providing the initial advice, since pre-RDR there was no requirement to provide any ongoing service funded by trail commission.

THR2 Conclusion 4: RDR will cost the consumer £340m pa with no consumer benefit

47. The estimated costs contained in the Cost Benefit Analysis of complying with the RDR were revised (as highlighted in THR2) with the present value of the first five years' costs ranging from £1.4bn-£1.7bn. THR2 obtains the £340m pa cost figure by taking the upper end of this range and averaging over five years. However, the increase in estimated cost was as a result of the banks revising their estimates of the costs of the required systems changes significantly upwards during the period of

consultation. In reality, many of the banks left the market for advice, for a range of reasons, many of which were unrelated to the RDR. These costs therefore will not have been incurred by the industry on this scale.

48. As part of the Post Implementation Review (PIR) of the RDR, we asked Europe Economics to examine how the compliance costs that were incurred by firms compared with what we originally expected. They found that "compliance costs to firms of complying with the RDR are likely to have been as expected or lower than originally estimated"[26].

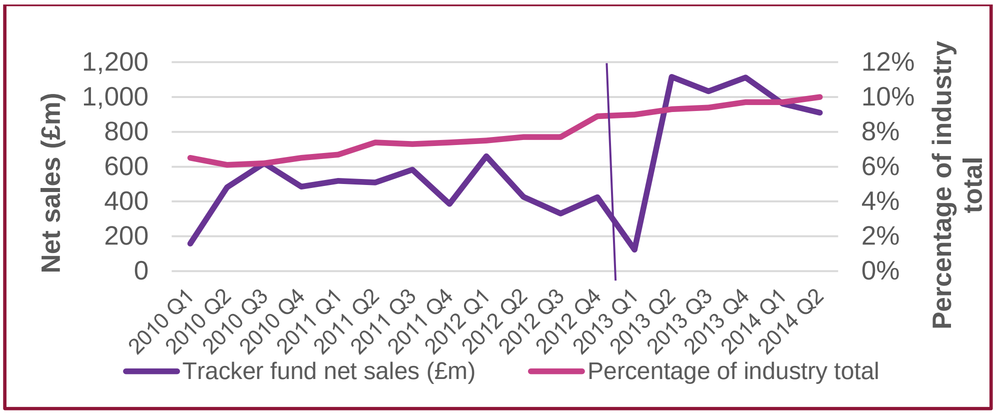
49. THR2 states that "the Europe Economics report clearly opined there was no evidence of consumer benefit". However, from the outset of the report, Europe Economics made clear that it was early days since the implementation of the RDR (less than two years) and so definitive evaluation of all of the impacts was not possible, as some impacts were still to be fully realised. It has always been our expectation that it will take time for the changes to feed through to demonstrably better quality of advice. Even so, Europe Economics identified a number of very positive impacts, which are explored in more detail below.

What were the findings from the RDR PIR?

50. *Reduction in product bias* - the removal of commission paid by providers to advisers and platforms has reduced product bias from adviser recommendations. This is reflected in a decline in the sale of products which paid higher commissions pre-RDR and a move towards lower cost products and those which did not attract high commissions pre RDR. As an example of how product bias has reduced, the chart below shows sales of low-cost index tracker funds rising almost threefold post RDR.[27]

Chart 1

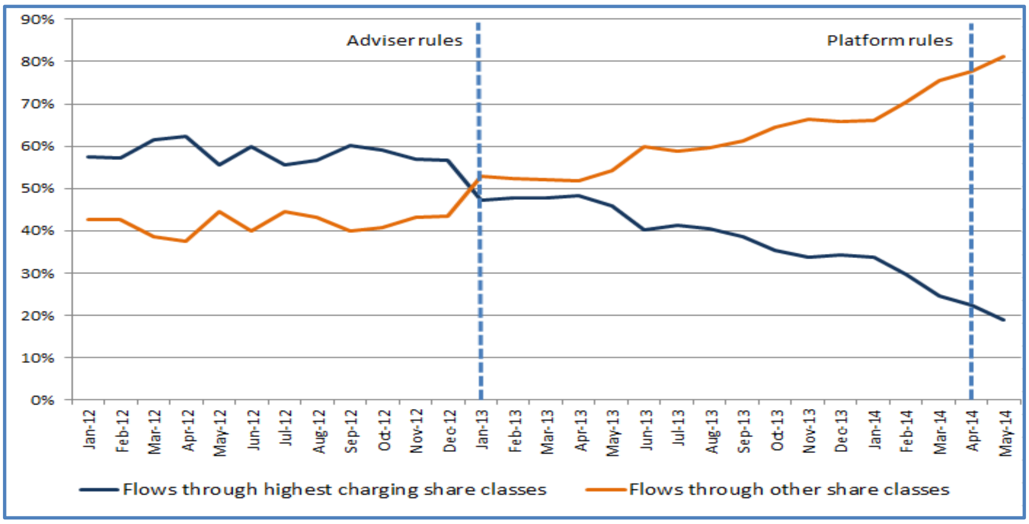
[26] Pg 97, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics
[27] Page 75, Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics



Source: IMA data

51. In the same vein, the chart below shows how the introduction of the RDR at the end of December 2012 saw a move towards the use of share classes that were not the highest charging. The adoption of lower charging share classes has gathered pace ever since. By the end of May 2014, over 80% of flows were being directed into lower charging share classes as opposed to the highest.

Chart 2



Source: IMA Asset Management Survey Report 2013.[28]

52. *Greater adviser professionalism* - the vast majority of advisers are now qualified to the new minimum standards (with the remainder being new entrants undergoing training) and there has been an increase in the number of advisers going beyond these minimum

[28] Pg 74 Retail Distribution Review: Post Implementation Review, December 2014, Europe Economics http://www.fca.org.uk/your-fca/documents/research/rdr-post-implementation-review-europe-economics

standards. The increase in qualifications, along with greater focus on provision of ongoing advice services, indicates positive moves towards increasing professionalism in the advice market.

53. *Firm sustainability* - among advisory firms, average revenues have been increasing over the past few years, with average profits also up by about 20% between 2011 and 2013. At the same time, the percentage of firms posting a loss has decreased. Capital and reserve levels have remained stable or increased for the majority of those firms with a retail investment focus. This indicates an industry where advisory firms are better placed to meet their long-term commitments, provided they continue to build up capital reserves from greater profits.

54. *Falling prices in some areas* - product prices have fallen by at least the amounts paid in commission pre-RDR, and there is evidence some product prices may have fallen even further. This is due in part to the introduction of simpler products and funds which have a lower charge and advisers and platforms exerting more competitive pressure on providers, with platforms increasingly able to negotiate lower product costs. The RDR has also made it easier for consumers and advisers to compare platforms, increasing competitive pressure and leading to a significant reduction in Direct-to-Consumer (D2C) platform charges.

Looking forward

55. It should be noted that key concepts contained within the RDR, in particular banning payments from providers to advisers, have been adopted by regulators around the world, for example in Australia, Canada, South Africa and several European member states. In fact MiFID II, due for implementation in 2018, will prohibit commission payments for independent advisers and portfolio managers across Europe.

56. We will continue to monitor the impacts of the RDR and developments in the sector and have been looking at ways of increasing access to advice alongside HMT via the Financial Advice Market Review (FAMR). The recommendations from FAMR were published on 14 March 2016 and are intended to tackle the barriers to consumers accessing advice. The recommendations are, in part, directed at the FCA and the Government, but, consistent with our belief that this issue can only be tackled through a

multi-faceted approach, we also make recommendations directed towards employers, service providers and consumers.