

The Impact of Depolarisation on the UK Retail Financial Services Markets

A paper prepared by John Lawrence for publication by the British Banker's Association

1. Abstract

In this paper, we argue that the depolarisation initiative as represented in CP121 is a potentially good initiative to simplify regulatory processes and reduce costs for an important part of the financial services distribution system to affluent markets, but will not have much immediate impact on the fundamental concerns facing the retail financial services sector, in particular lack of competitiveness, high charges and failure to 'close the savings gap'.

Success will depend critically on the extent to which depolarisation can be a catalyst to more change in the supply side, leading to the introduction of truly novel business models and economic structures.

We consider the near term effect of CP121 on the supply side and how suppliers and distributors strategies might evolve in response, and conclude there will be winners and losers, and that new strategies will be required, but real advantage will come from innovation around the customer proposition and use of technology.

We also comment on the savings gap, which will not be much impacted by depolarisation, and conclude that to empower demand for savings will require investment in integrated policies aimed at influencing consumer knowledge, attitudes and behaviour.

2. Introduction and context

The FSA issued a second stage consultation paper CP121 in March 2002 to stimulate a public debate on the issue of 'depolarisation' in the sale of certain financial services products. The polarisation regime, introduced by the SIB in 1987 established a binary status for distributors of investment products – either a tied agent of one supplier, or an independent financial adviser dealing with all suppliers. Polarisation has long been recognised as anti-competitive by the DGFT in 1987 and 1999 but its introduction and maintenance was endorsed in the name of consumer protection.

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The main suggestions put forward in CP121 for public debate were, in a nutshell, to:

- abolish polarisation, with the expectation that more varieties of distribution business would emerge, some tied, some multi-tied, some entirely independent;
- establish a fee-based remuneration for the delivery of advice, instead of commissions;
- allow product provider investment in IFA firms;
- streamline the advisory process;
- introduce a two-tier qualification structure for the sale of 'low risk products'; and,
- unbundle the cost of advice delivery and marketing from the product cost.

Clearly, these proposals are still being discussed, but CP121 is likely to lead to practical initiatives in 2003. CP166 emerged in January with the first set of rules for the industry.

The CP121 paper noted that there were a number of indications of market failure in the retail financial services markets and that it would not be sufficient to propose changes in the way products are distributed, but that changes to regulation on a broader front were also required.

It is worth reviewing, briefly, the various facets of 'market failure' referred to by the FSA and others.

- **High charges.** This has been well documented by the FSA and the Sandler report. Current charges are justified by the industry on the basis of the costs of distribution, particularly prospecting.
- **Commission-driven bias in advice offered to clients,** documented at length in both recent initiatives, leading to claims that the adviser is not the client's agent.
- **Over emphasis on active equity based products,** which are not necessarily suited to certain retail investors who do not appreciate the risks involved, and who pay for active management but get index-tracking.
- **Manufacturing revenues based on a percentage of assets held/managed,** has long been a tradition of the asset management industry, but is perhaps less-justified in the context of highly automated, STP environments with little incremental cost.

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- **Failure to address the savings gap.** This has been asserted as representing £27bn shortfall in savings, although some observers disagree.

Underlying these criticisms is the sense that **the industry is maintaining an uncompetitive status quo, by its adherence to a limited range of business models, viz. commission-based distribution, active equity-based product forms and AUM-based remuneration structures, that serve the industry but apparently not the consumer.**

This is the theme developed in this paper.

3. Proposed Structure

In the interests of brevity, we have addressed three questions:

- **Will depolarisation improve the functioning of the retail financial sector? (Section 4)**
- **Who will be advantaged or disadvantaged in the near term, and how should they respond? (Section 5)**
- **Will it have much impact on the savings gap? (Section 6)**

In the rest of this paper, we set out some views, which have been derived from experience built from consulting to several major players, and carrying out original market research with customers in these markets since before 'polarisation' was first introduced.

4. Will depolarisation improve the functioning of the retail financial sector?

Depolarisation is likely to have a modest impact on improving the functioning of the retail sector, but is an important first step.

- It will protect the provision of generic advice, for the time being
- It could help to streamline IFAs' sales process and associated costs
- It could act as a catalyst for more competitive behaviours

However, it could distort the market if the level of investment in IFAs is allowed to increase.

4.1 Depolarisation can help protect generic and brand advice pro tem

Depolarisation is likely to help to maintain one of the few sources of approximately independent financial advice, and therefore can be considered a good thing. Otherwise, the IFA sector could be destroyed by interventions that are inappropriate.

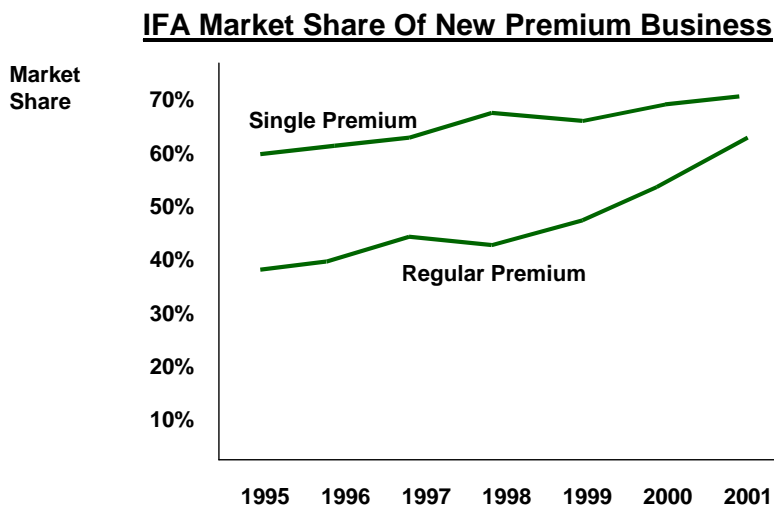
Our research and experience suggests that much of the generic advice on offer from tied distributors is compromised for two reasons:

- First, because sales people are either dealing with a limited product range, and therefore will seek to divert clients into that product range, and
- Second, because sales people are tied to one supplier, and can only deal with the products of that supplier.

Some have argued that it is better for people to save whatever the instrument they use, rather than not save at all, but that is a recipe for a new scandal.

At present, IFAs are one of the few sources of generic advice, and the value that is placed on this by the mass affluent/affluent market, is indicated by the strong market share IFAs have of investment business. (See Figure 1)

Fig. 1 IFAs continue to grow their market share



Source:ABI

This is not to imply that there is not bias in the advice that IFAs give – the research carried out for the CP121 paper implied that there was bias, but to the extent that their advice is biased by commissions, they share this with the tied channels.

The withdrawal of the defined fee proposal in CP121 is a good thing in the short term, as it could have been damaging to the IFA sector. IFAs have moved towards fees, but there is resistance amongst clients, and it is reasonable that IFAs migrate their clients rather than attempt to shift their business model overnight. Nevertheless, the proposal should be followed up with other ideas to encourage fee for service and to stimulate demand.

There is a need to stimulate a market for good generic financial advice for a fee, but the emphasis should be on **market** stimulation, i.e. on the demand side, as well as on the delivery. Streamlining current delivery processes e.g. transportable fact finds, and on line tools are a good thing, as well as sales stories on the implicit costs over the lifetime of an investment, of the current model, but **until there is widespread public education and empowerment, there may not be the desired take-up of products which are currently “sold” rather than “bought”**.

4.2 Depolarisation is likely to have some positive effects on the processes and costs of IFAs

The costs of being an IFA are high relative to being a tied agent because of the more extensive regulatory process for approving individuals able to act as advisers, for vetting supplier selection processes and for controlling client needs analysis.

Given that depolarisation reflects sensible processes evolved by IFAs to ensure best advice and to be cost effective, the regulatory burden on IFAs could be reduced somewhat. However, this is not likely to have much effect on the costs of compliance

IFAs could become more effective if their sales processes were simplified, as suggested in CP121:

- Use of portable, tool driven fact finds which could speed up the pre-sale process

- Ability to offer second-tier products through less qualified salespeople to customers with lower risk profiles or those wanting a particular product.

4.3 CP121 could stimulate more competition and fresh business models

Both the Sandler report and CP121 refer to various business models that might be used to manufacture and distribute investment products, but in fact these are all of a common theme as noted above.

There is a belief, in the industry, that sales processes must be well funded to promote the distribution of “sold” products such as investments and pensions. This is a vicious circle that the industry is locked in and it will require action on a number of levels to shift the market.

Our work on strategy with providers and distributors across the market has shown that one central theme which dominates the clients’ thinking has been where to play on the regulatory bifurcation, and whether any innovation would be ‘allowed’. Thinking has therefore been constrained and innovation curtailed. Allowing the incursion of more variation in the distribution models and the relationship between distributors and manufacturers is a good thing **if it stimulates more radical approaches to evolving competitive business models.**

By this we mean implementing more options around:

- the adviser as the **client’s agent**;
- fee and reward based remuneration ;
- more specialisation along the value chain e.g. more commodity supply, services provision and outsourcing to get economies of scale; and
- deployment of newer, cheaper technologies to achieve straight through processing, and low cost manufacture and administration.

These initiatives will only benefit the consumer if they result in lower charges, better risk management or the delivery of fresh service propositions to a wider audience, and not merely in higher margins for firms.

Although we are advocating new business models, and this could include new relationships between suppliers and distributors, there are potential risks for the customer, if suppliers are able to buy their way into IFA firms and restrict their behaviours related to meeting client needs. It is proposed that institutions may invest in IFA firms, ostensibly to provide capital for their development, although

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more likely, to provide capital at the coal face in the event of further claims for mis-selling. The ownership will be restricted to 10%, but there is some concern that this will act to reduce IFA's independence of action over time, and this initiative could be the thin end of the wedge.

5. Who will be advantaged or disadvantaged in the near term?

There will be winners and losers on the supply side, and whatever is proposed, there are therefore likely to be those in the industry who will dissent.

If CP121 leads to more diversity of sales channels, depolarisation will have a knock-on effect across the sector, beyond the IFA community, because existing distribution models have been framed to reflect the current high level of sales costs and the need to make a binary choice about the role and function of each sales channel under the polarisation regime.

The following comments reflect the initial impact likely on some of the players concerned.

5.1 Initial winners

- **Distribution businesses** in general are likely to be the main beneficiaries, with new options open to them for tailoring their services to market segments.
 - Existing IFAs will benefit as outlined above if they have the managerial capability, although the networks may need to adjust their services to members as the compliance processes are simplified. Larger IFAs with some capital can establish 'non-regulated' businesses for low risk products and low ticket clients, which can be fed leads from the IFA business, and vice versa.
 - Tied branch based businesses could benefit by moving to a multi-tie status, if they wish to offer both better generic advice to customers, and products from a broader range of suppliers without the costs of becoming a full blown IFA
 - The larger branch-based organisations will not benefit per se, but are likely to be able to persist with a tied proposition since they will be able to generate large numbers of leads from their retail base, at lower cost than from open market prospecting.

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In the longer run, distribution businesses will need to explore not only lower cost ways of prospecting and selling, but also fee-based remuneration, in order to build competitive advantage. There is also the opportunity to build scale to exert buying power over manufacturers and to deploy intelligent CRM technologies.

- **Client-oriented manufacturers with competitive products** could benefit if they are able to position themselves more effectively for the multi-tied channels, or if they are able to innovate with new segment/channel/product-service combinations. These firms will already be selling through IFAs, but if multi-tie leads to consolidation in supply, the leading companies will benefit – their success then will depend on the overall share won by the IFA/multi-tied channels versus tied channels.
- **Private client managers/banks** will potentially be beneficiaries if they will be able to source products from a wider range of suppliers, including those from their own group, rather than being constrained to operate under a single ‘marketing’ platform. Asset managers, however will be vulnerable if they levy high charges for closet index tracking, and may experience pressure from clients. **These firms need to revisit their relationships with clients and decide whether they wish to offer advice or sell equity portfolios.**
- **Consumers** are likely to be only **marginal beneficiaries** for the near to medium term because they can shop around now if they so choose.
 - Affluent customers, who use IFAs will have their preferred channel preserved, and so will suffer no loss
 - Mass affluent customers, and/or those who use branch-based tied facilities could receive better generic advice from their suppliers, and more product range, but they can access this now
 - Mass market customers who do not have access to advice could benefit from better educational and generic advisory services, but the bulk of the benefits of this will not be apparent for many years.

In the longer run, the winners will be those that combine low cost supply/sourcing with excellence in customer needs analysis and customer management, and that will require innovation.

5.2 Initial losers/those at risk

- **Non-bank manufacturers with tied distribution** (life and pensions and fund managers) are likely to suffer some erosion in volumes if their channels decide to multi tie, and this effect will be exacerbated if the tied arrangements had been protecting a weak or expensive product range. **These firms need**

to overhaul their product range and cost structures if they are not to lose their sales teams.

- **Tied, non-branch distribution businesses** (working for the above), which have no option of sourcing from other suppliers, perhaps because the major shareholder does not wish to dilute the channel, are likely to gradually lose effectiveness because the best sales people will migrate towards multi-tied models in order to give their clients a better service.
- **Small life and unit trust companies selling through IFAs** will continue to decline unless they can secure a role in the multi-tied constellation. It is likely that multi-tying will reduce the number of suppliers dealt with, and there is likely to be commonality in the bases of choice, so many firms will lose out, unless they are able to differentiate in a product category, or invent a new category. Small players will also lose out if larger institutions succeed in buying IFA firms in anticipation of multi-tying. Smaller institutions may not be able to buy their own distribution and therefore will not secure market access and not participate in downstream profits. **These firms have an opportunity to innovate around product, service or segment, in order to secure a niche.**

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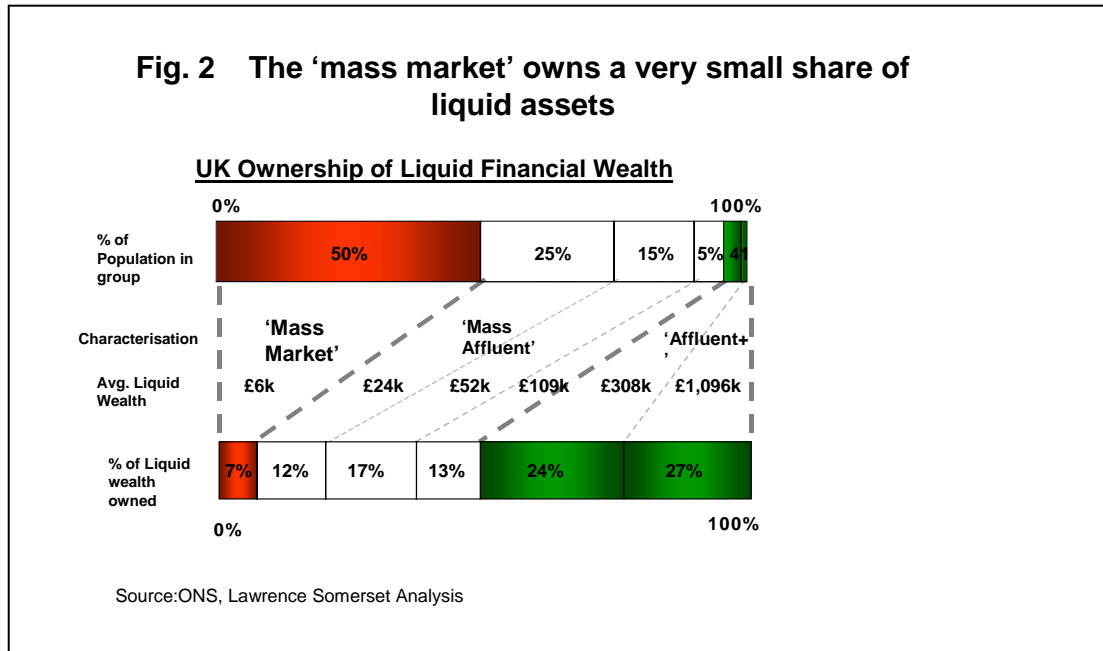
None of this is set in stone, of course, as each company has the option of revising its strategy and taking advantage of the new regime.

6. Depolarisation will only have a limited impact on the savings gap and uptake of second tier pensions

The real issue with the savings gap of £27bn p.a. is that, however large it is, **the gap is more pronounced for the less well-off**. The over-35s earning over £35,000 do not have an appreciable savings gap, and that the gap increases with decreasing income, and decreasing age.

The mass market represents the bulk of **people**, if not money, however, since wealth and earnings are very concentrated. (See Figure 2)

Fig. 2 The 'mass market' owns a very small share of liquid assets

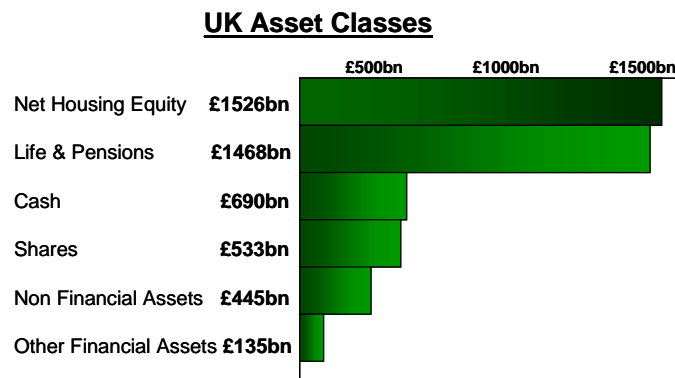


The top 5% of people either own the bulk of assets, of all classes, or, they receive the bulk of earnings. In fact, some observers believe it is this disparity, and the fact that it is widening, that is the real issue with savings, and that the broad brush assertions which lead to the conclusion about a £27bn shortfall are erroneous.

That said, it is unlikely that depolarisation per se will have any material effect on closing the 'gap', since IFAs are unlikely to become radically more effective than they have been, and the problem lies outside their core market, which in the main is the mass affluent/affluent, rather than the mass market. The secondary proposals in CP121 to enable a second-tier sales channel to emerge, could make some difference, if they stimulate growth in the mass market, but this channel will have similar economic drivers to the existing channels, unless a solution can be found to the expensive prospection problem. There are several interrelated practical, attitudinal and behavioural factors that inhibit the mass market from saving into financial assets, and these must be taken into account to make any material effect on the savings gap.

- Lack of interest in financial services.**
 Strange as it may seem to many people in the industry, many people are not interested in financial services, and see the whole area as complex, rather boring and a chore rather than a pleasure. Moreover, the decline in state and corporate paternalism has led to anger not self-empowerment. **Product simplification, and a product-focussed regulatory regime could help.**
- Unfavourable trade-off with consumption**
 We estimate that the lower income groups will need to save 15%-20% of their income to provide for their retirement, and to do this, would need to make a deliberate trade-off between consumption and savings. Most of the products in question, pensions, long-term contracts, long-term care insurance etc., offer **deferred** gratification and often cannot compete with the benefits from more immediate, tangible goods and services.
- Over-promotion of credit**
 The widespread promotion of credit by the financial services industry can be seen to be a factor in widening the savings gap, not only because it is inherently costly of financial resources, but **because it erodes those attitudes most necessary to build the self-sufficiency required to save for the future. More joined-up thinking is required on economic policy, because, at present, management of consumption is not related to the savings issue.**
- The perception that housing equity is a substitute for more liquid savings.** The UK has a high level of home ownership compared with other developed economies, house purchase is the most significant financial transaction that most people engage in, and net housing equity is on a par with liquid and invested financial assets. (See Figure 3)

Fig 3. Net Housing Equity is the largest single store of value for individuals



Source: 2002 Blue Book, Lawrence Somerset Analysis

Despite periodic collapses in the housing market, and periods of ‘negative equity, the belief persists that the purchase of a home is an investment and a store of value, both for the owners and their descendants. This market has had its own share of scandals, and **more work is required here to develop a wider range of instruments to facilitate access to housing equity.**

- **Concern about means testing.**
For the very low-income groups, there is concern, amongst advisers if not potential customers, that there is little point building up modest pools of savings or assets because the individual will lose out in any means testing process for a pension or for nursing care. It may seem better to cast one’s self on the state rather than be disadvantaged for a life of frugality. **This requires State intervention.**
- **Lack of compulsion**
It is clear that most people who have a car or a mortgage have motor, structure insurance and life assurance because these are compulsory products. Pensions are not compulsory, and ultimately, **compulsion is the one tactic that will be effective.**
- **Prevailing media culture**
More broadly, the media driven culture does little to encourage parsimony. Reality TV shows encourage a blind faith in finding an easy route to fame and fortune whilst the lottery encourages a similar reliance on the view that ‘something will turn up’. **This should be one of the prime foci for any educational programme.**

These factors contribute to a set of attributes, which exacerbate the problem that certain products must be sold because demand is not overt or empowered. The move towards kite marked products makes sense in this context as one move to provide viable alternatives to existing products. **However, it will not be enough to stimulate demand on its own, witness stakeholder pensions, and action will be needed on a number of other fronts.**

7. Coda

In conclusion, we consider depolarisation it self to be a potentially good thing, but success will depend on the role it plays in facilitating and catalysing other changes to the economic structure of the retail financial services sector. The

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broader agenda of rectifying 'market failures' and empowering the public and encouraging them to save will depend on three things.

- A much better understanding of consumer behaviour with respect to financial services products in particular, and to the management of assets and liabilities in general, throughout the sector.
- More creativity on the part of the regulators and the sector participants to generate truly alternative business models, which survive with lower costs, and to encourage real competition. A precursor to this will be honesty about current practice.
- A more coherent approach to public policy formulation with respect to demand management, education, taxation, means testing for benefits and sector regulation.

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The views set out in this paper have been derived from experience built from consulting to several major players, and carrying out original market research with customers in these markets since before 'polarisation' was first introduced.

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