Policy briefing

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The Financial Conduct Authority's RDR Post Implementation Review: Phase 1

In 2014, the Financial Conduct Authority published its planned first phase post-implementation review of its changes to the retail investment advice rules. This comprised of both a thematic investigation into Handbook compliance and an externally-commissioned study investigating wider consumer trends.

The findings were as follows:

- there is further evidence of the increasing professionalism of financial advice;
- there has been a material improvement in the way firms disclose the cost of their advice, their scope of service, and the nature of their services to clients. This suggests firms have responded positively to the findings from the second cycle of the review. As a result, clients should be in a better position to understand the nature of firms' services and the charges that apply. However,
- some consumers have limited awareness of the fees they are paying for ongoing services;
- there remains scope for further disclosure improvements. In particular, the FCA highlighted concerns that some firms are failing to provide individual clients with clear disclosure, in cash terms, of the ongoing charges they will be paying for the firm's ongoing service; and
- one firm was found "not to be sufficiently engaged with the changes", and was referred to the Enforcement and Financial Crime Division.

Next Steps: the next phase of the review will be published in 2017, allowing the FCA to draw from at least three years of evidence as firms complete the transitional process, allowing a more complete analysis as to the medium-term impacts of the rule changes.

The regulator will also be carrying out work to improve information disclosure and service labelling, due for publication in Q1-2015.

Background

The Retail Distribution Review (RDR) was undertaken by the predecessor body of the Financial Conduct Authority (FCA), beginning in 2006 and culminating in a series of rule changes on the conduct of retail investment advisers that went into force in January 2013. They raised the minimum level of adviser qualifications, improved the transparency of charges and services and removed commission payments to advisers and platforms from product providers.

Following implementation in 2013, January 2015 marks the two-year point since RDR implementation, the regulator commissioned Europe Economics to independently undertake the first phase of a post-implementation review. This aims to indicate the extent to which the RDR is on course to deliver its original aims and to flag any immediate issues. The regulator points out that this stage of the review is not meant to definitively evaluate whether all of the expected impacts of the RDR have materialised.

The review can be accessed via its main press release: http://www.fca.org.uk/news/early-indications-that-reforms-of-financial-advice-are-working

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About the Post-Implementation Review process

The Post-Implementation Review has been an exercise planned since 2011 when the regulator consulted the market its approach to measuring the success of the RDR. It set out a three-phase plan with the first phase aiming to indicate the extent to which the RDR is on course to deliver its original aims and flag any immediate issues; and the next two phases (undertaken three years after implementation and subsequently) comprising a more detailed analysis of how firms completed the transitional process and assesses the medium- and longer-term impacts of the RDR.

The phase 1 review consisted of two broad elements:

- **Thematic Review TR14-21:** the regulator conducted a detailed thematic review into how firms were complying with the Handbook changes; and
- **Commissioned research into wider consumer trends**: led by Europe Economics and comprising of a quantitative survey undertaken by NMG Consulting on the consumer impact of the RDR on the retail investments market, an advice gap analysis: by Towers Watson on the availability of advice to meet consumer demand; and an overall assessment by Europe Economics.

Overall findings

The overall findings of all the studies were as follows:

- **Implementation**: overall implementation of the amended RDR rules was good, however the FCA highlighted several cases in which this was not adequate. One firm was found "not to be sufficiently engaged with the changes", and was referred to the FCA Enforcement and Financial Crime Division.
- **Product bias:** the removal of commission from providers to advisers/platforms has reduced product bias from adviser recommendations reflected in a decline in the sale of products which paid higher commissions pre-RDR.
- **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 removal of commission also means that providers who sold lower or no-commission products pre-RDR are now competing on a more equal basis.
- **Professional standards:** the vast majority of advisers are now qualified to the new minimum standards and there has been an increase in the number of advisers going beyond these minimum standards. The increase in qualifications, along with greater focus on provision of ongoing advice services, indicate a direction of travel moves towards increasing professionalism in the advice market.
- **Implementation costs:** the costs to firms of complying with the RDR have been in line with or lower than expectations, with ongoing costs largely successfully absorbed into business as usual costs by the industry.
- **Existence of an "advice gap":** according to the independent researcher, there appears little evidence that the availability of advice has reduced significantly as a result of the RDR, with the majority of advisers still willing and able to take on more clients. However there is evidence that transparency of advice cost has led consumers to question its value.
- **Simplified advice**: there are clear opportunities for innovation in the market, particularly in relation to simplified or automated advice. However, there is currently a considerable perception of regulatory risk among potential providers related to both the FCA and the Financial Ombudsman Service (FOS). The FCA has stated that it wants to remove regulatory obstacles to such advice services and will shortly be publishing guidance on this.
- **Improving customer understanding**: the FCA are considering an idea put forward by the Financial Services Practitioner Panel to introduce a simple label that better sets the consumers' expectations by explaining the scope of the

firm's advice. This will form part of the FCA's wider work on the provision of information to consumers, due for publication in Q1 2015.

Thematic investigation

In January 2013, the FCA began a three-cycle thematic review into how firms implemented key changes brought about by the RDR. The FCA requested information from 110 firms, carried out desk-based reviews of this material and undertook a more detailed assessment of the design and delivery of ongoing services in 12 firms. In the first two cycles the FCA focused on compliance with disclosure and scope of service practices:

- **adviser charging and service disclosure requirements:** it found that firms had made progress in implementing the RDR, but identified some areas where they were failing to meet the FCA's requirements, particularly around adviser charging disclosure. In response, the FCA set out what constitutes good and poor practice, the findings from linked consumer research, and a factsheet to help firms; and
- **service delivery practice:** the majority of firms holding themselves out as independent were indeed acting independently in practice. However, the regulator did register concerns about how firms in the sample were disclosing important information about their charges and services.

The failings often related to areas of the disclosure requirements that were fundamental to providing consumers with clear information on the costs of advice. For example, many firms that based their adviser charges on a percentage of the funds invested were failing to disclose the charges in cash terms.

The findings from the FCA's work with firms found that good practice was observed where firms tailored their ongoing service proposition to their customers' needs and amended their offerings accordingly. Disclosure of ongoing services needs to be clear with key phrases explained so that the customer can understand the information. Poor practice was seen where disclosure documents were at a relatively high level and the terms used were not defined. In the main, firms are delivering the ongoing services that are promised to clients and, in doing so, are generally covering the main elements of diary and resource planning, formal review processes, monitoring and management information.

Box 1: FCA suggestions on advice services disclosure

Form and content:

- **Font size:** to allow easy reading and avoids confusion for terms and conditions.
- **Group services/charges information together:** to ease assessment in context. Separated information requires more work to reconcile the various points.
- **Bold/coloured/highlighted text:** to draw out key information such as costs.
- **Length:** aim for up to four pages. Longer documents start to look like hard work and so receive less attention from consumers. However, firms should not sacrifice font size or layout needs just to meet this desire.
- **Avoid dense paragraphs:** of text to share complicated information. Tables/diagrams are preferable, particularly for processing and comparing information such as costs.
- **Avoid cramming information:** particularly where this means changing the layout, font size or the margins of the pages to accommodate additional points.

Delivery of ongoing services:

- **Trust underpins consumer-adviser relationships:** consumers view ongoing services as a relationship with a trusted professional who is acting in their best interest.
- **The key consumer benefit is peace of mind:** stemming from working with someone with expertise and awareness of the market taking care of their investments.
- **Multiple benefits of receiving advice:** aside from achieving better return than self-managed portfolios; consumers see strong emotional drivers such as "security" and "peace of mind".

Consumer demand study

The study into consumer demand comprised two separate reports by NMG Consulting, with one focusing on consumer interaction in the retail investment market, and another an assessment into ongoing advice services.

The main conclusion of the first study was that consumers are not wedded to a particular distribution channel (advised or non-advised) but elect to use different channels depending on their circumstances, amount to invest and complexity of requirements at that point in time (see Figures 1 and 2 below):

- Their survey suggests that £20,000 is the turning point at which advised consumers expect to use an adviser for another investment.
- While at £50,000 the majority of both advised and non-advised consumers would opt for advice over making a decision on their own.

Figure 1: Customer expected channels for future investment, by investment amount

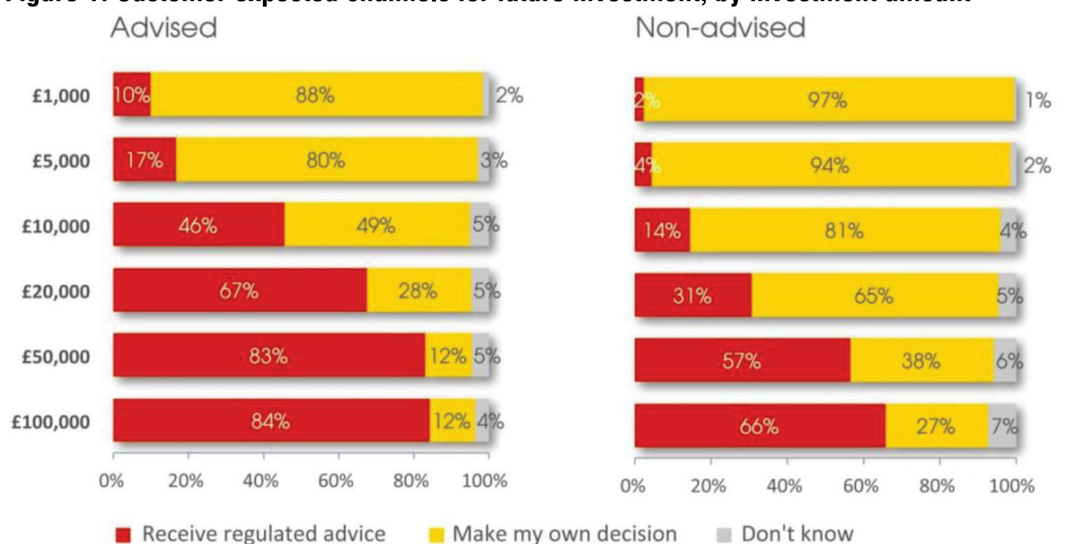
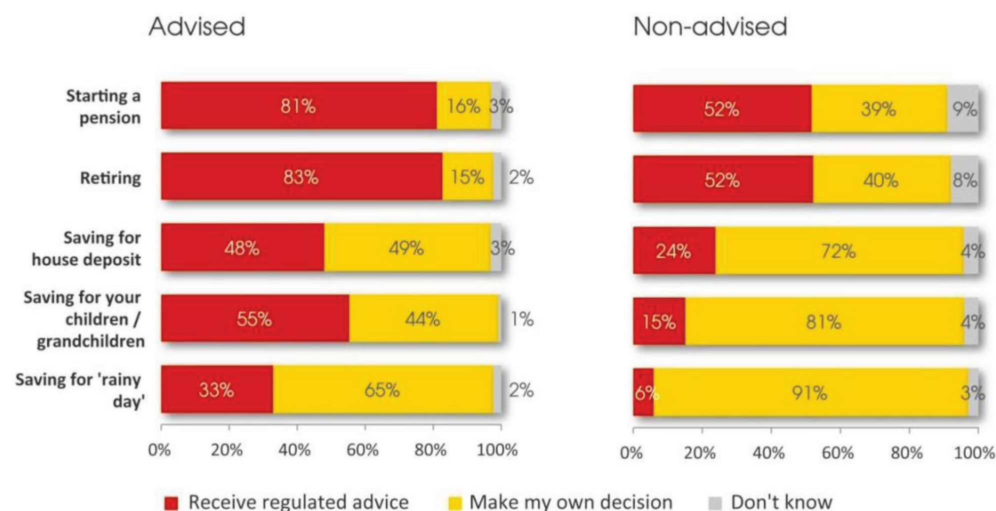


Figure 2: Customer expected channels for future investment, by type of investment



Source: NMG Consulting, Impact of the RDR on Consumer Interaction, Sep 2014

The second study investigated the advice process post-RDR and the finding was that of has not deterred a significant proportion of consumers from seeking advice:

- Of those who received advice prior to the RDR, 14% had shifted to a non-advised channel post-RDR. When the reasons behind this were explored, 42% stated that the reason for choosing to make their own decision was that the activity, product or investment value did not justify receiving advice.
- When the reasons for all consumers investing on a non-advised basis were explored (including those who invested on a non-advised basis pre-RDR) only 7% of these cited advice not being value for money as a reason.
- This means that, now consumers are in a position to judge the value of the advice received, this is not in itself significant in driving those consumers away from advisers.
- The study also considered whether consumers had chosen to no longer invest as a result of the RDR's implementation. It concluded that although a considerable proportion of respondents had not completed any investment activity since the RDR was implemented (40%), this was more likely to reflect them not having any investment needs rather than a direct result of RDR.
- One of the most important changes resulting from the RDR was the ban on commission payments from providers to advisers for advice given on retail investment products. This key change to adviser remuneration, along with other important changes, such as the need for advisers to either be 'independent' or 'restricted', and the need to raise professionalism standards, drove a more general examination of business models in preparation for the RDR.
- NMG fieldwork indicates that firms generally took the opportunity of the changes implied by the RDR to define and clarify their service offerings and the profitability of the business, and this included reassessing their client base and the needs of different segments of clients.
- For example, an experiment by Decision Technology found that a significant minority of people may be averse to paying an up-front fee for advice. 20–30% of the online subjects displayed evidence of "narrow framing" and loss aversion making them excessively averse to paying for advice which is not contingent on investment.
- However, when one considers that the majority of advisory firms have been adopting charging structures with contingent fees as a percentage of investments rather than upfront lump-sum fees, as discussed below, it is less surprising that consumers could be less sensitive to the switch to explicit adviser charging.
- Also, the fieldwork did not highlight any concern among advisers of customers being unwilling to continue receiving advice due to cost.

Advice gap analysis

Towers Watson was commissioned by the FCA to explore the possible existence and size of an advice gap in the UK retail investments market. Specifically the project had three main objectives to assess:

- demand for retail investment financial advice;
- the amount of adviser capacity required to meet that demand; and
- possible gaps in advice provision (the advice gap) in the UK retail investments market.

Scope and approach

The study's approach sets advice in 2014 as the sum of modelled initial advice demand in that year and modelled ongoing advice demand which follows from initial advice cycles in previous years (referred to in this document as "Legacy Ongoing Advice"). Advice demand is expressed as the number of initial and legacy ongoing advice transactions:

- Demand for initial advice in the 12 month period is modelled by estimating the probability of consumers seeking initial advice and multiplying by the number of people; and

- Demand for legacy ongoing advice is calculated by estimating the probability of the current holders of investment products having (a) sought initial advice in any of the prior ten years; (b) opted for ongoing advice at the time; and then (c) continued to use ongoing advice until the current period.

The research project defined three groups of customers that could use financial advice:

- **The unengaged:** Those consumers who have the financial means to invest but are not engaged in the investment markets.
- **The unwilling to pay:** Those consumers who have the means to invest, are engaged in the investments market but are not willing to pay for full regulated advice at true cost or prefer to self-direct. Some may however be willing to pay for a cheaper alternative source of advice. This group may also include some consumers making a somewhat forced choice, as we explain below.
- **The unserved:** Those consumers have the means to invest, are engaged in the market, are willing to pay for full regulated advice at true cost but are unable to find an adviser willing to advise them.

Results

The unengaged: this group, though important, does not constitute an 'advice gap' in that the affected consumers are not actively looking for investment advice (they might, of course, benefit from unregulated, generic advice).

- The bank exit may have increased the size of this group as evidence suggests bank-based advisers were effective in prompting a decision to invest from unengaged consumers.
- It is debatable whether this is an RDR effect, as bank exit appears driven by a combination of factors, including wider strategic considerations.

The unwilling to pay: this is driven by consumer choice about value for money and existed to a degree prior to the RDR. To the extent that this is a choice by consumers as to whether they are willing to pay for advice, whether this group is a 'gap' is arguable.

- By revealing the true cost of advice the RDR is likely to have increased the size of this group, although the evidence suggests the size of this increase has been limited by the move by the majority of firms to adopt contingent charging structure rather than up-front fees.
- This group includes consumers who we expect would pay for cheaper forms than the full advice model — the absence of these cheaper models therefore creates a 'forced choice for this group.
- There are signs that in time the market will adjust to address at least part of this gap by developing cheaper advice offerings that these consumers may consider value for money.

The unserved: this third group is firm-driven. This group of consumers is likely to have increased under the RDR as a result of firms moving to target higher wealth, higher margin consumers. Some firms are segmenting their client books and focusing on wealthier customers.

- Where this is the case, the evidence suggests the number of consumers affected is generally small and that these consumers are likely to have been picked up by other adviser firms.
- Advisers have capacity and have been taking on new clients. There is little evidence that consumers perceive themselves to have been abandoned by advisers.
- As this gap is likely to be small, to the extent there are firms willing to provide advice to lower wealth consumers, the market should be able to resolve this in time.

Wider findings analysis

The ban on commission has led the majority of firms to fundamentally consider their business model and, where necessary, make key changes.

- Firms are increasingly segmenting their customers and considering the service they provide to different groups of consumers, with some focusing on services to those with higher levels of investible assets.
- Some firms have also moved to increase ongoing charges, in part coincidental with the provision of more extensive ongoing service offerings.
- Lastly firms are trying to become more operationally efficient, for example through their increased use of B2B platforms or of paraplanners.
- Notwithstanding these changes there is little evidence that the availability of advice has reduced significantly, with the majority of advisers still willing and able to take on more clients.

Independent versus restricted

Prior to the RDR coming into effect many anticipated that advisers' need to cover the full range of investment products to remain 'independent' would increase the costs and the resources required to operate. This was expected to incentivise the adoption of the restricted model, with more advisers specialising in advising on particular products.

- Survey data on advisers from NMG Consulting indicate there has been a gradual increase in the proportion of restricted advisers, and this share is expected to continue to rise. Most advisers, however, remain independent and are expected to do so into 2015.

Table 1: Typical charging structures for advisers

Initial charges by firm size	% of firms in group typically applying charging approach	Ongoing charges by firm size	% of firms in group typically applying charging approach
Per hour (£)		*Per hour (£)*	
1	41%	1	32%
2-5	42%	2-5	35%
6-20	40%	6-20	30%
21-50	44%	21-50	33%
51-200	27%	51-200	18%
201+	55%	201+	33%
As a % of investment		*As a % of investment*	
1	90%	1	94%
2-5	91%	2-5	95%
6-20	91%	6-20	96%
21-50	88%	21-50	94%
51-200	86%	51-200	90%
201+	88%	201+	100%
Fixed fee (£)		*Fixed fee (£)*	
1	46%	1	30%
2-5	46%	2-5	30%
6-20	40%	6-20	26%
21-50	46%	21-50	29%
51-200	39%	51-200	41%
201+	67%	201+	44%
Combined charging structure (£)		*Combined charging structure (£)*	
1	23%	1	21%
2-5	23%	2-5	21%
6-20	19%	6-20	18%
21-50	30%	21-50	17%
51-200	25%	51-200	24%
201+	53%	201+	35%

Source: Europe Economics analysis of RMAR (2013 data)

- The same research also indicates that most revenue is expected to be derived from independent rather than restricted advice.
- The fieldwork does support the view that some advisers are moving towards a restricted model, for example through joining restricted networks.
- One reason given for this is advisers' desire to avoid any regulatory risk associated with operating too widely and in areas where they are not fully confident or skilled. Indeed at least part of the industry expects this trend towards restricted advice to become even more significant.
- Research by KPMG for the FCA Practitioner Panel expects the restricted model to make up in time 50–75% of advised business.

Next Steps

The next phase of the post-implementation review will be published in 2017 followed by a subsequent third phase of the review which will consider the longer-term implications. In the meantime the FCA will continue to monitor trends throughout the post-implementation review period. The regulator will also take action in the following areas:

- **Consumer understanding of advice offered**: the FCA will gather ideas for better ways to present information to consumers on the nature of advice services offered and advice charges. This work will form part of the FCA's wider work on the provision of information to consumers, due for publication in Q1-2015.
- **Innovation in advice models:** to remove unnecessary regulatory obstacles that may stand in the way of innovations in advice models. The FCA will in January publish guidance in relation to sales that do or do not involve a personal recommendation. It has also recently launched Project Innovate, an opportunity for businesses wishing to develop new simplified advice or other innovation which benefits consumers.

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