The future of financial advice in a post-polarisation marketplace

Stuart Fowler
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field - particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

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The provision of appropriate information and advice to consumers is clearly of the utmost importance in ensuring the provision of appropriate financial services products. Only if the products supplied are appropriate will consumers’ relationship with their financial services providers be built on trust and likely to lead to the purchase of further investments and protection. This ideal ‘trusting’ relationship has been damaged by past experience of mis-selling and poor value, and is further battered by the current market downturn. In addition, in a world of ‘1% creep’ the provision of appropriate information and advice with all products looks prohibitively expensive, leading to a Catch 22 situation where although consumers need to buy, providers cannot afford to sell.

In this environment, and at the time of the publication of CP121 and the Sandler report, it seemed worthwhile to have a wide ranging debate on the future of advice. A very broad group of industry manufacturers, distributors, suppliers, commentators, lobbyists and consultants took part. We thank them for their input, Stuart Fowler for his work to pull together the plethora of ideas generated, and the CSFI for providing the forum in which this debate could take place. We hope that this addition to the debate on how to maintain an honest and symbiotic relationship between consumers and financial services providers and distributors will be thought provoking for its readers.

Pauline Wood
Partner
Accenture
Working group

This paper, although published by the CSFI (with financial support from Accenture), has been written by Stuart Fowler. While it is his paper, for which he takes responsibility, he has endeavoured to reflect the views of the working group that was set up by the CSFI. This group met three times to debate the important issues raised by CP121 and the Sandler Review. Although it did not reach a consensus (not surprising given the breadth of experience represented), it produced a lively debate and many good ideas. Wherever possible, Stuart has tried to incorporate the views of the group and the ideas that were generated.

All members of the group participated in a personal capacity. Though several have indicated a preference to remain anonymous, we are delighted to be able to recognise the following personal contributions:

- Alan Asher  Consumers’ Association
- Nick Baker  Accenture
- Geoffrey Barraclough  BT
- Brandon Davies  Global Association of Risk Professionals (GARP)
- Steve Jackson  Syntegra
- Stan Kirk  Howard & Co
- Adrian Lloyd  Banking Code Standards Board
- David Mapplebeck  Charles Schwab Europe
- Mick McAteer  Consumers’ Association
- John Pattison  Atos KPMG Consulting
- Les Stewart  PA Consulting
The future of financial advice in a post-polarisation marketplace

Stuart Fowler

Foreword

This report, though written by Stuart Fowler (and, in the end, primarily representing his views), is, in an important sense, a joint effort.

Following publication of the FSA’s CP121, the Pickering Report and the Sandler Review (not to mention the earlier report by Paul Myners), there can be no one in the UK’s financial services industry (or government) who is still unaware:

- that the average Brit has made grossly inadequate provision for his/her old age;
- that the (government-sponsored) shift out of SERPS into private pension provision in the late-1980s is a political time bomb which is due to blow up at any time;
- that expectations about what the state is either willing or able to provide are utterly unrealistic; and
- that, of all areas of human experience, one’s financial affairs are by far the most subject to massive self-delusion – even more so than sex.

Unfortunately, while everyone acknowledges the problem, there is no consensus on the solution. Indeed, some of the alternatives that are being canvassed are flatly incompatible.

Having a great deal of sympathy with both Sandler and the message of CP121, and (from earlier work) being well aware of the problem, we at the CSFI felt it might be useful to pull together a small working group to look at what the impact on the industry might be of the growing head of steam in favour of some kind of reform. This is not a trivial issue. After all, there may be as many as 80,000 financial advisers of one sort or another whose jobs could be at risk – not to mention the massive investment that the UK has in active fund management. Thanks to the help of Accenture, we were also able to bring Stuart in as a writer; as many of you will know, he recently published (for the Financial Times) a well-received book on the fund management industry, entitled No monkey business.

A good mix of people participated in the working group, coming from different parts of the UK financial services industry – as well as regulators and journalists. Not surprisingly, some have chosen to remain anonymous, but we thank them all. Although, in the end, the report is Stuart’s, he has, I believe, made a genuine (and successful) effort to incorporate most of the concerns that were raised within the group – and I hope that we bludgeoned out of him some of his starry-eyed preconceptions about the role of technology. I would guess that about 85% of what is in this report would be signed up to by around 90% of the working group members; given where we were all coming from, that is no mean achievement.

Andrew Hilton
Director, CSFI
Summary

1. The political and social leitmotif of financial advice in twenty-first century Britain is personal responsibility: dependency is out and self-provision is in. Primarily a personal benefit, which can be sold as such, financial advice nonetheless calls for a radically different political and regulatory approach.

2. Combining this vision with financial theory and business economics, this paper sets out tough but achievable targets for UK policy-makers and the financial services industry. It recommends both that government and the industry should aim:
   - to spread awareness and generic understanding of the need to save and of the options available;
   - to cut the need for specific advice;
   - to lower the cost of all financial advice;
   - to increase ease of access to advice; and
   - to improve its quality.

3. Reducing total investment costs is vital to increase the product of savings. The high costs of typical brokered products dramatically reduce average outcomes, to the extent of defeating the purpose of the products - particularly relative to deposit-based saving.

4. Increasing the participation rate (the number of households saving and the adequacy of their level of savings) requires other solutions. This involves:
   - convincing people about the reasonableness and sustainability of long-term government policies in this area;
   - promoting consumer ‘awareness of need’, which typically precedes any sales or advice process;
   - promoting information about an extended range of CAT-marked savings and investment vehicles;
   - joined-up policy-making for savings and benefits - at present, serious tax disincentives operate at the income levels politicians are most concerned about;
   - provision of both advice and products by frequent-access consumer agents, such as high street banks, supermarkets and the Post Office - not just low-visibility IFA businesses; and
   - promoting low-risk savings products, as well as higher-risk investment products

5. The dominant commission-based revenue model of today operates as an effective monopoly, keeping financial advice costs high (and opaque), preventing the emergence of a separate ‘market’ in financial advice, concealing the commodity nature of most products and biasing advice. Depolarisation (as proposed in the FSA’s CP121 consultation paper) will kick-start competition from new types of business format and from different revenue models. But, that is not enough. This paper also identifies the potential reforms that are most likely:
   - to remove the bias towards expensive or unnecessarily risky implementation options; and
   - to move education, information and advice into frequent-access, high-visibility, consumer channels.

6. Separating financial advice from sales, and planning from implementation, is a challenge, but (contrary to some current thinking) it does not necessarily require separate agencies, such as independent advisers. Nor is there any particular logic linking agency payments for handling savings to the value of those savings. We believe that competing models based on unit pricing can have a dramatic impact – and indeed can write their own sales pitch. For instance:
   - The difference in total costs for someone contributing £4,000 a year for 20 years into low-cost active funds or equity index trackers, instead of into typical high-cost brokered funds, is between £12,000 and £40,000, after allowing for fixed fees for advice.
   - The chances of making up those cost differences through good portfolio selection, let alone making a clear profit, are small, and the uncertainty will generate its own need for additional advice (and transactions) over time.
   - It is a self-serving industry line, swallowed too easily by Ron Sandler, that you cannot get people to write cheques for £200 (or even £1,000), for advice. We think you can - if you can demonstrate that it will save them £12,000, £40,000 or even six figure sums for wealthier savers.
7. With an economically separate (fee-based) advice market, the need to achieve much lower unit costs for advice will apply right across the wealth spectrum. It is not just about pricing small investors into the market. The drivers and the solutions that, in our opinion, will jointly force costs down are:
   ▪ technology - virtually everything can be designed today to be done by computers, whether behind the scenes or visible to the consumer;
   ▪ pricing - flexible price strategies will make explicit the extra cost of (affordable but avoidable) face-to-face access, leaving the consumer to choose whether he or she needs it;
   ▪ economies of scale - changing the scale of businesses, so as to spread marketing and general business overhead over a larger number of cases, will drive down costs; and
   ▪ buying power - commodity-supplier models for funds will make charges a function of fund size.

8. In our view, the adoption of integrated technology-driven processes - from fact-gathering through personal goal-planning to implementation and progress-reporting - can realistically do more than retraining to raise the quality of advice.

9. Supporting personal responsibility and reducing costs require the FSA to shift the emphasis of regulation from the sales process to product design and description. This need has been underestimated by both the FSA (in CP121) and the Sandler Review. Universal product description standards must focus on much clearer communication of risks. All products should say exactly what they do ‘on the tin’. This will make self-selection easier and safer, whether in conjunction with advice or not.

10. Though we feel that universal product description will reduce the need for product segmentation, the working party supports Sandler’s proposals that a category of tightly-regulated products be sold ‘off-the-shelf’ (with no sales process red tape), including by non-regulated entities. But it disputes Sandler’s idea that these products should all be the outdated ‘everyman’ balanced fund in different wrappers. They should cover different locations on the ‘risk spectrum’, consistent with our belief in personal responsibility for risk choices.

11. Reforms, a bear market and lower expected returns may make industry consolidation inevitable - leading to fewer product providers, fewer IFA firms and far fewer products of each type. But loss of competition by number is less important for consumers than the benefits of competing business models.

12. It is vital that a tough climate for providers, particularly life companies, is not used as an excuse to delay or dilute reforms.

13. The Treasury holds the wild card: simplification of tax, benefits and pension rules would do more to reduce the need for, and cost of, advice at each income level than any of the other changes addressed by this paper.

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1 Medium and long-term retail savings in the UK: A review for the UK Treasury by Ron Sandler, July 9, 2002.
1 What individuals need from the industry

Need – or want?

‘All you need is this, this is all you need’ might be a popular industry refrain, but we did not hear it from our working party of some 20 industry-watchers and practitioners. They were mostly against specifically prescribing the products people need, and in favour of encouraging informed self-selection as part of a general shift towards greater personal responsibility for financial provision.

Advocates of prescription tend to assume that choices are either so boring or so complex that individuals will not want (or be able) to get to grips with them. Supporters of prescription also tend to assume that what people choose may not be what they need, perhaps because they cannot be trusted to make rational choices. ‘The investor’s chief problem – perhaps even his worst enemy – is likely to be himself’, wrote Benjamin Graham, one of the founding fathers of modern investment theory, half a century ago. His words are supported by the subsequent emergence of a ‘science’ of behavioural finance that challenges the assumption of rationality underpinning most investment theory and practice.

That wasn’t really how our working group saw the problem: individual investors are not doomed to choose the wrong products, or even to ignore the need for saving and/or financial advice. With support from the industry and from government, they can act in their own individual and collective self-interest. After all, financial markets (nothing more than the collective behaviour of individuals) are fundamentally rational, whilst exhibiting non-rational behaviour much of the time. This explains quite well, for instance, the observed differences between the short and long-run behaviour of financial markets. True, individual behaviour is skittish and emotional, and our thought processes are heavily biased. Yet quite complex trade-offs, in conditions of uncertainty or risk, are part of our formula for surviving the game of life: we need to harness that talent for survival and use it to encourage longer-term financial planning. To do so, however, is going to require new thinking and a different attitude from the industry (particularly with regard to trust and integrity) and from government.

Trusting the industry

Even proponents of self-protection who exhibit a healthy cynicism about agency risks accept that it is highly inefficient to have consumer markets where all trust is absent. Some core level of trust in the moral integrity of financial service firms is vital to efficient relationships. As a result, society has every right to demand certain standards from the financial market, in the same way we expect them from health professionals or teachers.

What technical integrity should individuals be able to count on?

But standards are not just ethical. As long as financial markets are not just a casino, investment practice should be built on some ‘science base’. (Even if they were a casino, subject only to randomness, there would still be a version of a science base: the laws of probability.) The
combination of practice, the techniques it relies on and the basis of those techniques in accepted theories makes up the concept of ‘technical integrity’ referred to at various points in this paper.

The science base needs to support a wide range of personal decisions involving money, from laying off or bearing the risks of adverse events through choices about how much investment risk is appropriate. That wide remit covers utility, finance and portfolio theories, out of which have developed a number of ‘best practice’ techniques for planning and selecting in conditions of uncertainty. These mostly involve quantifying uncertainty about the future, even if it is only a reasonable approximation.

In a healthy market for financial advice, there will always be a science base. But there will also be a degree of competition between assumptions about how markets and investors behave and between techniques of assessing uncertainty. Diversity is to be expected, but the absence of a science base is not. In its absence, the vacuum will just suck in the same behavioral biases that consumers, left to their own devices, exhibit.

Technical integrity also involves education and language: the way in which science is used to communicate choices to individuals and inform their selection. It is the equivalent in the casino (where randomness rules) or in a bookmaker’s (where chances are not equal) of ‘quoting odds’. If the odds are known to the professionals but not disclosed to the punters, integrity will be lacking. If the professionals do not know the odds, they cannot advise with integrity.

If the role of advice is to support personal responsibility for financial decisions, it follows that the provider of the advice needs a business model that is relatively indifferent to the customer’s informed choice. This means an advice or planning function that is separate from distribution or implementation, or a retailing function similar to supermarkets. Either way, it is hard to reconcile this with the agenda of an agent who is dependent on a product manufacturer for his or her remuneration.

What help do we need from regulation?

In this country, we expect to have legal protection from the worst effects of agency risk, at least beyond some limit of caveat emptor. Where the line is drawn is a moot point. Generally, we have no right to protection from market risk unless it is explicitly offered and guaranteed. But deliberate misrepresentation and the sale of products unsuitable for their purpose should be beyond limits of acceptability.

This is fairly well captured already by common law in the UK, but it is chancy and expensive to bring a prosecution. Indeed, one reason for bringing in statutory regulation (in the form of the 1986 Financial Services Act and the 2000 Financial Services and Markets Act) was to remove the chance (and expense) of litigation.

There is clearly a middle ground to be sought between:

- protecting consumers and providing them with the right of redress; and
- so tying the hands of the financial services industry that products and services no longer become worthwhile for the agent (in terms of potential liability) or the customer (in terms of passed on cost).

Crossing this line will tend to reduce access for some individuals and reduce choice and increase cost for all. This paper reflects the view of the working party that this line has already been
crossed. That it has been crossed is also implicitly recognised in a series of recent proposals for reform – including the FSA’s own consultation paper (CP121) on ‘polarisation’ and the Sandler Review of medium and long term savings.

What instruments do we need?

Individuals need to be able to choose from a spectrum of financial market risks, from near certainty of outcome to greatest uncertainty of outcome, and to have access to a range of securities, instruments or products that allow them to place their money somewhere on that ‘risk spectrum’.

Firms perform this function for their clients either as agents (like a broker or unit trust group) or as principals (such as deposit-takers or ‘with-profits’ life insurance companies). Either way, they are likely to want to package products for their clients that combine instruments which individually lie at different points on the risk spectrum (such as bonds or equities), to create an overall ‘portfolio’ that gives them an expected location on the spectrum.

We know from the approximation typically used in the science base that the location of both single asset classes and composite portfolios is actually fuzzy, rather than precise. However, this should not stop a fair attempt being made to identify and describe the absolute and relative risk. Individuals can then form a realistic set of expectations about outcomes – and use them to match their portfolio to their own risk tolerance, whether they are working on their own or with the help of professionals.

We also know that location on the risk spectrum is affected by the investor’s time horizon and by whether outcomes are measured in real or nominal terms. So, whilst individuals need products for different purposes, matching them may need to be dynamic rather than totally static. The industry has to make this clear, and make the facility available.

In this view of the industry, there should be no particular bias towards products or instruments that lie in one location rather than another on the risk spectrum. Clustering may emerge, but that should be because of common individual selection, based on purpose, time horizon and attitudes to risk, rather than biases in their availability or in the manner of their distribution. In the next section, we will see that significant systematic biases have in fact arisen – and are probably also affecting total savings levels.

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2 The risk spectrum can be thought of as a one-dimensional array on one axis of assets with different volatility – a measure which might further distinguish between short term uncertainty (the path) and long term uncertainty (the outcome). The spectrum is similar in concept to the ‘capital markets line’ in investment theory: in two-dimensional space defined by return on one axis as well as risk on the other, it connects a risk-free asset with a risky asset or portfolio of risky assets. Each of these concepts rejects an assumption that there is a single perfect or most efficient asset or portfolio. Instead, each requires personal preferences (or ‘utility’) to be expressed to select a location on the spectrum, line or frontier (depending on which specific application of the same general approach is being used).
What is healthy competition?

For a marketplace to function efficiently, there needs to be competition. Healthy competition has several characteristics, including:

- good benchmarks for value;
- ease of access;
- innovation in products and business models; and
- diversity in cost and value propositions.

By conventional analysis, we should expect to find all these in retail investment services. After all, there are thousands more products than we need, far too many product manufacturers and too many broker firms distributing them. Yet we do not see them. This point has already been made, more or less explicitly, in reviews of the retail investment industry conducted by the Office of Fair Trading in 1999, CP121 and Sandler. But these reviews have not really addressed the key question: how can we change things to ensure that consumers are actually getting the competition they need?

What do we actually understand by advice?

People seem to have an intuitive notion of the type of support they expect when buying products or services from anyone – and they do not obviously differentiate between financial services firms and firms in other industries. Though many insist that products and services (and contract natures) in the financial area are genuinely more complicated, consumers don’t really seem to agree. This means that we need to look at the market for financial advice rather as we do for other goods and services – concentrating on provision of:

- a degree of education (to improve the context for choices);
- point-of-sale information (to support or confirm choices); and
- after-sales service.

Amongst the expectations carried across from other purchases is the notion that the cost (or value) of pre- and post-sale support should be part of the price (or value) of the product bought. By ‘bundling’ product and advice, the industry has met this expectations – and hence has tended to confirm it. In doing so, however, bundling has created problems for the industry that it is now under pressure to resolve.

2 What individuals get from the industry

Industry agents

The UK savings and investment market has three characteristics that are important and unusual.

Savings and investment divide: There is a significant difference between (riskless) cash on the one hand and all risky assets on the other – represented as a big gap in the risk spectrum for individual asset classes that can only be filled by mixing risky and riskless. This category divide is replicated in the marketplace as between deposit-takers on the one hand and investment product providers and brokers on the other.
The UK market for retail investment is unusual...

You do not need a broker or adviser to find a home for cash, although you might compare rates in a specialist magazine or, more recently, on a financial website. It is easy for the people who are most able to save money to find deposit-based vehicles. In practice, long periods of similar rates for these vehicles may have encouraged indifference to the initial choice of banking relationship (and subsequent inertia), but that is not really down to the system’s inefficiency.

People find it much more daunting and confusing when they consider moving out along the risk spectrum - as they might expect to for ISAs or for personal pension plans. They then have a choice between going directly to providers of products (which may include their bank or an insurance company) or going to brokers of products. Even that decision has been made more complicated, however. Since the 1986 Financial Services Act, broking has been ‘polarised’ between tied agents and independent financial advisers. This means that the effective choice today is between product providers (including their tied agents) and IFAs.

*Historical bias to insurance companies:* Five factors have led to a concentration of packaged product-investing in the life insurance sector:

- the rules for packaging pension contracts;
- the unusually dominant position of ‘with-profits’ investing in the UK;
- the packaging of investment contracts as life assurance to obtain tax relief;
- the ability to use insurance brokers for distribution of both protection and investment policies - a benefit fully taken advantage of when IFAs were created mainly out of (or on the model of) insurance brokers; and
- the ability of the life insurers to remove or conceal explicit choices about the risk spectrum

Much of a consumer’s confusion about investment arrangements stems from the role of life companies.

Combining insurance and investment led naturally to complexity and opaqueness, but the industry then exploited this to encourage dependent relationships. Product complexity was built up both by successive tax changes to encourage saving and by this desire to offer products with sufficient complexity to justify, or at least disguise, high margins. This complexity is today the curse of the industry as product manufacturers struggle with rationalising legacy books with high inbuilt costs, and as insurance distributors suffer withdrawal from the ‘drug’ of high-margin with-profits policies. At the same time, regulators are trying to remove margin from products that can be sold in future, while doing nothing to help bring down the cost of complexity that is built in to the industry’s existing book.

*Historical bias to equities:* The investment products sold by banks, insurance companies and unit trust groups, or brokered by IFAs, have become heavily equity-based. This primarily reflects the UK’s bad experience of inflation in the 1970s and 1980s, which seriously damaged products closer to cash. Casualties included gilts and National Savings. Both short-dated gilts and National Savings instruments used to be widely seen as having very little additional risk relative to cash, and they were often rolled over to turn short term savings into long term savings. The public’s understanding of the relative risks, compared with cash and equities, was good and required little educational effort. The Post Office was widely used as the easiest place to buy them. That, however, is in the past.

Today, pushing investors out along the risk spectrum has made it harder for them to know what to expect. This has increased their need for advice. Pushing some of the products themselves, such as with-profits and managed funds, into greater equity exposure, to the point where they
were no longer really ‘balanced’, has also confused people’s grasp of relative risk and suitability. Attaching equity return elements to fixed income or deposit instruments, using option strategies but without illustrating the distribution of likely payoffs, has really confused people - probably deliberately.

One structural change resulting from the shift to equities has been the faster growth of the UK unit trust industry relative to insurance companies, because their equity management skills have tended to be seen as superior to the life companies. Even so, the historical bias in favour of with-profits and pensions continues, with the UK life industry still holding about £950 billion of assets versus £250 billion in unit trusts.

A business model monopoly

The OFT, the FSA and Sandler have each determined that the UK retail investment industry’s structure is damaging to the consumer. When they analyse the market structures that do the damage, they identify a particular approach to the distribution of investment products that depends on commission incentives. From this perspective, what is being described is a single model. There are different versions, as between incentivising a direct sales force or IFAs; but they really are versions, not different models.

Sandler deals with this by referring to the ‘different business models’ for providers as direct sales forces, bancassurance and tied agencies. However, all three use commissions to pay for their distribution costs. The Sandler Review says IFAs also operate ‘different types of structure’- national, regional, local and networks. But how different is not so clear. About advisers, Sandler says: ‘irrespective of whether tied or independent, in the overwhelming majority of transactions, advisers are remunerated on the basis of commission’. The Review also says ‘the commission system of adviser remuneration is of fundamental significance to the operation of the retail savings market’. It goes on to acknowledge that, ‘in practice, a wide range of variants on the pure commission theme are observable… however, the incentives created by such arrangements are broadly the same as those generated by commission’. Variants include trading off front-loaded commissions against trail commissions – a timing difference that offers different net present values for the broker but which, with realistic assumptions about customer retention, might not actually be so different.

In this paper, the common commission-based approach to distribution is referred to as a ‘business model’ rather than a ‘revenue model’. Though commissions are a form of revenue, ‘business model’ better captures the broader impact - which is:

- to deprive consumers of a separate market for advice; and
- to reproduce in the advised product market the same product biases as in the non-advised product market.

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3 In the 1990s, for instance, the average standard deviation of balanced retail funds was about 14% pa compared with 16% pa for equity unit trusts – probably not as much risk reduction as was expected (source: Lipper Hindsight). Policy payouts for with-profits, far from being smoothed downwards at a time of high market returns, were often higher than for the life companies’ own managed unit trusts.

4 These take the form of a rebate to the broker, not the customer, of part of the manager’s annual management charge. They have been a device for restoring commission incentives when they started to be eroded by consumer resistance to front-end loads, and explain a general rise in the level of annual management charges.
It should be clear to readers that the use of the term ‘business model’ is specific to this argument.

Though overwhelmingly dominant, this model is obviously not a complete monopoly because there are products that can be bought without commissions, notably:
- stakeholder pensions;
- other CAT-marked products; and
- funds bought through discount brokers, who rebate all or part of the providers’ front-loaded sales commissions - though they do take the providers’ ‘trail’ commissions.

The key point is that the impact of these products on the market has so far has been marginal, largely because there are so few economically viable alternatives to the distribution of products using commission. Thus:
- only 10% of IFA revenues are currently fee-based, rather than commission-based (and much of this also relies on commission offset); and
- most use of the internet to date exploits the offline revenue model (retrocession of commissions for access to transaction platforms and commission-discounting), while direct consumer payments (fees for service or subscriptions for information) are a tiny part of the online market.

A single dominant distribution model is not necessarily a competition issue, if competition comes from the diversity of products brokered and the diversity of value propositions. But, in the UK, the single model does tend to smother diversity.

Surprisingly, the fact that providers rebate to brokers, but not to customers buying direct (which Sandler picks up as a market distortion), did not greatly excite the OFT or the FSA. They have decided there are other competition issues resulting from the current polarisation rules, notably:
- ‘Adoption’: Polarisation currently restricts providers to marketing their own products. One intention of CP121’s proposals for depolarisation is that it should allow banks and insurance companies with limited product ranges or products of perceived poor quality to improve the competitiveness of their offerings by selling other providers’ products alongside their own. The term used in CP121 to cover this is ‘adoption’. It sounds good, but some have argued that it was always possible through ‘white-labelling’.
- ‘Multi-ties’: The binary world of tied or independent, equivalent to access to one company or the entire market, is viewed as inherently anti-competitive by the FSA. Polarisation prevents brokers forming agency agreements with a few companies to represent exclusively their products. The industry refers to these currently excluded arrangements as ‘multi-ties’. CP121 anticipates categorising them with ‘distributors’.

Distortions to advice

Whatever the problem of polarisation, it is the other detrimental effects of the dominant business model that are the real meat of CP121 and Sandler. These can be loosely described as the distortions arising from a commission-driven model. The significance for this paper is that they

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* Under a commission-offset arrangement, commissions are collected from the provider, offset against the fee due based on the fee schedule and any balance (after a reasonably long statement period) rebated to, or collected from, the client.
particularly impact the functioning of the market for advice: its cost, quality and accessibility. This paper also argues that these distortions act as a bias towards, instead of against, irrational choices by individuals. In these important respects, we extend the logic of Sandler’s observations about the business model.

### The active management monopoly

People were generally surprised that the Sandler Review focused so much on the connection between the UK’s distribution model and the bias towards active management. But the argument has been made before.

The real point is that the active management industry *needs commissions* to distribute actively managed products. The reason it that there are so many of them. Unfortunately, the effect of having more of them is to drive up the cost of distributing them – instead of reducing it, as over-supply of most commodities would. Once a high-cost distribution system based on commissions is in place, it *needs active management* and equity-based products since these are the only ones whose hoped–for returns can possibly support the commission structure. This is clear from the poor sales of CAT-marked products and the low sales of trackers through brokers.

Sandler suggests that systematic bias against the retail investor is evidenced by the fact that, in the institutional market, passive investment or tracking represents some 25% of assets versus just 7% for individuals. In reality, the difference is even more marked than he suggests, since the institutional market pays much less for active management – in most cases, less than the retail investor pays for trackers! If institutions were confronted with the same active costs as retail investors, and if trackers were the only way to avoid them, the proportion in trackers would be vastly higher than 25% (or even the 40% in the US).

### The cost effects

The choice between active and passively managed investments is inherent in an efficient product market offering diversity, rather than prescribing what is or is not rational. The bias built into the distribution system is inefficient because it impedes that diversity. That much Sandler recognized. But the impact is actually more significant than the mere distortion of competition.

In terms of an individual’s need to be able to rely on the industry’s technical integrity, it is the cost, not the theoretical debate about market efficiency, which is the key issue the industry needs to deal with. The high cost resulting from the dominant business model causes an investor’s choice to become irrational. And, at the same time, the ‘true odds’ are not being presented to individuals, even when they are advised. If they were, we can safely assume that most would make a different choice.

When assessing the impact of cost on consumer choice, it makes little difference if we are talking about product cost or the cost of advice. Separate or bundled, the value of the advice, like the value of the product itself, cannot be divorced from its cost – and there is a feedback loop between cost and suitability. Since any active manager would accept that there must be a cost at which a product defeats its own purpose, this is essentially a practical argument, not a theoretical one.
The Sandler Review implies that typical industry costs for actively managed equity funds have passed the self-defeating point. Relying on FSA estimates of all-in costs of 3% pa, it says:

‘A recent study\(^7\) estimates that the future annualized equity risk premium, relative to bonds, is not far from 3%. The authors note that with 3% annual cost and performance drag, an equity mutual fund might give a final value no greater than direct ownership of government bonds.’

In other words, ‘the individual takes the risk and the industry takes the reward’. But this pithy re-write of Sandler only captures the relationship between costs and the mean expected risk premium. This could still be a gamble that investors want to make. To decide whether there is actually a reasonable chance of getting over the cost hurdle, to produce a net gain relative to a conventional gilt (or cash or an index-linked gilt\(^8\)), or to get over the additional costs relative to a tracker, we need to understand the probability distribution of active managers’ relative returns before costs.

Quantifying probabilities

Research in this area is surprisingly limited. Whilst we have plenty of data for returns after costs and know the current explicit costs of funds, we do not know the hidden costs, including market trading costs, or the history of the changing explicit and hidden costs. One piece of research\(^9\), based on 36 exempt (personal pension) UK equity funds, has adjusted for explicit costs to produce a probability distribution for cost-adjusted returns, with the intention of showing the chance of making up cost differences between funds, over different holding periods. Logically, this can be extended to estimate the chance of making up any other set of assumed return differences of the same size and over the same holding periods, such as a given margin relative to a tracker or a margin relative to a risk premium.

It also allows us to replace the 3% all-in cost average by a range of possible costs. Actual all-in costs will vary with the particular combination of annual management charge, front-loaded commission and market trading activity. Most active funds probably lie in a band of 2% to 3%, but some of the most popular, with high charges, high trading and at least 5% sales commissions, are higher than 3%. Most funds-of-funds, or multi-manager funds, with two sets of charges, are also above 3%. In Figure 1, the cost differences are presented as a ‘wedge’, with the lowest-cost index trackers as its thin end.

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\(^6\) James, The costs of retail investing in the UK, FSA Occasional Paper No 6, 2000
\(^7\) Dimson, Marsh, Staunton, Triumph of the Optimists, 2002
\(^8\) For most investment tasks conventional gilts are not the best comparison with equities, as they both have wide degrees of uncertainty about real outcomes (as a function of both market and inflation uncertainty)
\(^9\) Chapman, The charge of the pension brigade, Money Management, 1998
Fig. 1: Range of Fund Costs

Based on Chapman’s findings, we should assume the following approximate probabilities of making up cost differences over a ten year holding period:

- Making up a 1 percentage point margin : 1 in 4
- Making up 2 percentage point pa : 1 in 10
- Making up 3 percentage point pa : 1 in 20

In terms of the customer’s choices, a one percentage point margin could be the extra cost (versus a tracker) of a low cost, no load, active product at the lower end of the wedge (eg 1.6% versus 0.6%)\(^\text{10}\).

A two percentage point margin could be thought of as a mid-wedge fund relative to a tracker. However, it could also be the same low cost fund but with a target margin of outperformance of 100 basis points, per annum, on the basis that a rational investor requires a risk premium to compensate for the additional uncertainty of the active manager’s relative returns. Either way, a one in 10 chance, though it ought to be alarming considering the small target net payoff of one percentage point per annum for ten years, does fit the choices that many individuals actually make – even when they are consciously avoiding the most expensive funds. Though cost-conscious, they undoubtedly assume the odds are much lower, or else the likely payoff much larger.

The three percentage point margin is equivalent to high-cost funds where activity is high, charges are front-loaded and the annual management charge is also at the top end. It is typical of insurance-based funds, with every regular premium bearing a front-loaded charge and high internal management costs. It is also equivalent to the mid-range fund. Thus we can assume that the majority of IFA-promoted plans and funds and the most popular funds bought ‘off-the-page’ carry implausibly long odds.

\(^{10}\) The impact on final values additional costs relative to a tracker, assuming no offsetting active manager gains, is illustrated in the Appendix.
Transaction impact

The bias towards active management has another impact. It increases the frequency with which individuals change their fund positions — equivalent to a shortening of holding periods. As Sandler suggests, high costs relative to the expected risk premium mean we should favour a buy-and-hold strategy. He did not discuss why this is discouraged by the dominant distribution model.

Remarkably, there is no industry data source for individuals’ holding periods for unit trusts. Mutual fund industry data in the US suggests three years — staggeringly short. Here, as in America, the increasing focus on performance has made investors, and their agents, much more conscious of a manager’s relative returns, changing rank orders (or positions in the league table), changing ratings (such as Micropal stars) and also changes in personnel in the management firms. All increase transaction frequency. This often starts with an anxious client asking for advice on what to do with a poor-performing fund. Advisers — who generally hold the view that poor performance does not tend (even randomly) to improve11 — are strongly biased to recommend a switch. Changing adviser, also a natural response, has the same effect.

The frequency of this effect can be estimated from a statistical observation. Given the typical size of the bets that active managers have made in the past, there is a roughly 50% chance that an ex post star fund (with the benefit of say 10 years’ hindsight to fit the intended holding period) will be indistinguishable from a dog somewhere during the 10-year period.

The industry is not blind to this problem. The general effect might be for managers to tighten up tracking error, so that the 50% probability is significantly reduced, even if funds then have less chance of emerging as a star. This gives the investor a different problem as it pushes most of the likely net return distribution into self-defeating territory. Managers who do this, dubbed ‘closet indexers’, are increasingly recognized as an irrational choice.

But going for managers with higher tracking error is only superficially more rational. True, the bigger the bets, the better the chance they can clear the cost hurdle. But the bigger the bets, the more likely the path and outcome will be outside the investor’s risk tolerance12.

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11 Past changes in relative return (over periods of three or more years) are essentially indistinguishable from random changes, according to the large body of empirical evidence for UK funds. Any weak non-random biases (including the one popular with IFAs that ‘dogs stay dogs’) are difficult to exploit in practice since they are based on averages for a sample (perhaps 10%) out of a large population (possibly several hundred). The fund the individual is concerned about is just one.

12 Performance analysis does not support the theory that bigger bets predict better performance, as a reward for that additional risk. Research by The WM Company found a weak contrary tendency: bigger bets have a greater than random chance of being losing bets. This has been disputed by the Investment Management Association. Like many performance effects, this appears to be period-specific. Note that the same ‘capturing’ problem applies as with persistency for dogs.
Economic impact

Another recent CSFI paper\(^1\) has estimated the total cost of the active management bias on retail investment in the UK at £20 billion each year. The scale of this is compared with the one-off £13 billion cost to the industry of making good pension mis-selling. (The impact would be several billion greater but for the paper’s assumption that actual costs should be compared with an assumed minimum cost of active management, rather than with the lower cost of trackers.) Quite apart from the detriment, this means that the current industry model looks like a giant waste of human and capital resources. If we could only redirect lots of these clever people from the lottery of active fund management to financial planning, advice and education, what a difference it would make!

Asset allocation

Active management focuses too much of the advice process on implementation at the expense of strategy. Sandler refers to the body of evidence which shows that exposure to market returns, rather than to active managers’ gains or losses relative to their benchmark, explains some 90% of the variance of returns. It might be argued that the statistical basis of what is called ‘attribution analysis’ arbitrarily skews the observed attribution towards asset allocation at the expense of security selection. Even so, it is only asset allocation that offers the customer a practical lever for controlling \textit{ex ante} risk, through exposure proportions. That, as well as theory, is why asset allocation is the basis of customer responsibility for risk choices in the institutional market.

Financial planning

The poor development of asset allocation skills in the advisory market, including the relatively infrequent use of software solutions, is part of a general underdevelopment of financial planning skills in the UK. In that sense, the industry is failing the test of technical integrity set in the first section of the paper.

It seems likely that this failure is also partly a function of the dominant distribution model, because this model links rewards to implementation, not good planning. The ‘holistic’ planning model, complete in all aspects of a client’s balance sheet and cash flow, prevails only where the basis of the adviser’s remuneration is a non-commission based fee schedule. In the US, better financial planning goes hand in hand with a stronger market position for fee-based advice.

Financial planning must include debt decisions, as well as asset or saving decisions. Many commission-earning IFAs in the UK will argue that they provide this anyway. But it is implausible to assume that there is no significant bias in advice in respect of a course of action that carries no commission (and that may even bring existing renewal commissions to an end) as against another that offers incremental income to the agent.

\(^1\) K James, \textit{Waiting for Ariadne}, CSFI, 2002. When at the FSA he did the most detailed research on UK retail fund costs. His assumptions in this new paper about hidden costs are at the top end of my ‘wedge’, but that is perhaps balanced by optimistically assuming that front-loaded costs can effectively be ignored because they are only incurred once, and by assuming that a relatively high activity cost is a necessary contribution to market efficiency (‘the efficient markets tax’). His assumptions about the mean real return on equities is 6% pa, which is the same as I have assumed to demonstrate cost effects.
Financial planning does not have to be a continuous process, generating continuous fees or commissions. It breaks down naturally into two components:
- strategic planning; and
- implementation.

The dominant business model ties the two together, but they can be separated. The first lends itself to a ‘surgery’ approach: identifying insurance, saving and investment needs, communicating options, and making strategic plans. These plans can include a programme for the automatic investment of contributions, so that new money is used to rebalance the asset mix to the strategic mix. The strategic mix can also be dynamic, reflecting shortening time horizons with the passage of time. Many occupational pension plans use this approach, and it is widely followed by individual investors in the US. This model quite clearly supports the use of low-cost stakeholder or off-the-shelf products, requiring no further implementation advice. Providers themselves, or execution services, can then manage the collection and investment.

There should also be services offering continuous and dynamic stewardship of implementation, with a value worth its fee-based price. These services could as easily use low-cost products.

Resource planning

The fundamental underpinning of sound financial planning is a realistic estimate of the resources required to meet targets defined by the customer at a level of risk the customer is happy with. Direct sales forces, tied agents and IFAs are generally not equipped to help their clients by showing the dynamic effects of changing resources, or target or risk. In most IFA practices, the growth of investment planning demands (driven by greater self-provision for pensions and higher levels of wealth) has not been met by additional technical skills. Technology has focused on the back office, and is rarely used to inform the interaction between customer and adviser. Given that individuals have a poor sense of probabilities, this is a serious shortcoming at the heart of the advice function.

The FSA and its predecessor organisations have not helped by prescribing the growth rates used to project outcomes for packaged investment products. These projections also contain serious technical flaws. In particular:
- they are limited to nominal, rather than real, terms;
- the lower and upper limits are not related to actual modelled probabilities;
- there is no dynamic linking to changing market conditions;
- large changes in assumptions are made at irregular intervals to reflect past changes in inflation;
- there is no differentiation for products at different parts of the risk spectrum; and
- there is no differentiation for products with and without active manager risk.

Rightly or wrongly, IFAs claim that using different assumptions from those prescribed when recommending a product invites confusion, and probably compliance risk too. Whatever the reason, the gulf between the technical skills and investment technology used in the retail market and those routinely relied on in the institutional market is not acceptable.
Access to advice

The FSA and Sandler claim that access to advice is effectively restricted - a claim that is worth looking at.

Since the cost basis of such advice is rarely fees, particularly at the bottom end of the market, it seems unlikely that the hidden costs discussed above are what restrict access - if access is indeed restricted. Since socio-economic groups C1 and C2 currently account for some 75% of the IFA sector’s customer base, it is also not obvious that a large section of the population able to save, even modestly, is shut out of advice. However, it is true that IFAs are constantly trying to move up-market, both to AB customers and to companies; so there could be market gaps forming at the lower end which, without new competitive offerings, could get worse.

The real access problem is for much lower income households, where bank access may also be a problem and credit records may be impaired. The need for advice and general education about money is greater in these households. But the content is also quite different: budgeting, debt management, precautionary savings, benefit claiming and the interaction between savings and benefits. This is not what IFAs or banks offer. So another solution is needed.

The working group felt that there is no obvious way to provide this on a commercial basis, and believed that if the government is serious about closing the savings gap for those who can make some savings (and would not have these savings taken away from them in the future by loss of benefits), it should be prepared to invest public money in this area.

The representation of risk

Consumers don’t understand risk...

*Past experience:* Most of the problems the consumer has had with the financial services industry have partly or largely involved the poor communication of risk:

- **Endowment mortgages:**
  - unsuitability of with-profits for meeting a fixed nominal target; and
  - setting premiums to make them competitive with the repayment alternative, instead of the funding required to match the desired certainty of meeting the target.

- **With-profits:**
  - guarantees – loose sales talk leading to excessive expectations about how much was guaranteed;
  - annual bonuses – confusion about what they are and why they should fall when markets are going up;
  - terminal bonuses – how large falls can be consistent with smoothing;
  - surrender penalties – no reference point for fairness of the proceeds;
  - MVAs – effect is that you can easily lose (maturity values may be less than asset share if the smoothed value is lower), but you are unlikely to win (maturity values are cut back to asset share if the smoothed value is higher); and
  - sold as closer to cash on the risk spectrum but actually closer to underlying balanced or managed fund.

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14 Berkeley Independent Advisers, quoted in Sandler, figure 4.1, page 76
...but they are also misled

- **Zero dividend preference shares:**
  - sold as generic and homogenous, but specific portfolio risks and capital structure risks are more important; and
  - some outcomes involve a significant loss when the class is expected to behave like a deposit.

- **Fixed income products:**
  - high yields are partly taken from capital; and
  - some have outcomes determined by strategies using equity-related derivatives, such as ‘precipice bonds’ – also leading to losses outside expected possibilities.

Some recurring characteristics in this list of problems are:

- ‘technical integrity’ issues that investment professionals in the provider firms should have been aware of;
- the absence of control systems in the provider firms to check senior managers’ enthusiasm for selling high risk, high margin products;
- inconsistent incentives arising from the commission model;
- sellers playing to the behavioural weaknesses of buyers;
- sellers offering more than they can deliver – ‘free lunches’ only happen in sales pitches;
- genuine difficulties placing the product on the right part of the risk spectrum (for agents as well as their customers); and
- buyers relying on generic risk descriptions when specific risks may dominate.

Sales process regulations may prevent recurrences of the most blatant abuses, but they do not adequately address the more typical problems. In particular:

- product risk descriptions are, by themselves, not enough to permit self-assessment of suitability on the part of potential purchasers, particularly as a counter to selling pressure, agency conflict or poor agency skills;
- the volume of additional information is not helping – research for the FSA shows that few people currently read the Key Features document, which contains most of the prescribed disclosures;
- too many products are being offered where return distributions are complex and the likelihood of poor risk communication is very high, including with-profits and products using derivatives; and
- the possible irrationality of the choice of actively-managed products at prevailing costs is not brought home to potential buyers.

**Public policy effects**

**Risk preferences:** In a number of areas, government policy appears to see savings in terms that favor equity investing rather than deposits or securities (including gilts, whose supply the government itself influences). This is a bias that it could have picked up from conventional industry funding preferences after a period of high inflation. It could also reflect the Treasury’s supply-side interest in equity as the underpinning for corporate investment and private/public partnership at a time when it has little need to sell government debt.\(^{13}\)

\(^{13}\) It is worth noting that the insight that prompted the Sandler Review came from the Myners Report on institutional investment (to the effect that ‘if you think there are structural problems in the institutional market they are nothing compared with the retail area’). The Treasury insight that prompted Myners was that institutions should be investing more in private equity!
Consistent with its emphasis on personal responsibility, the working party tended to view the trade-off that individuals need to make between saving and consumption as one best made independently of any particular home for the saving. For instance, it would be better for people to pile up cash or roll over short-dated savings instruments than make no provision because they mistrust equities or the agencies that give access to equities.

**Tax simplification is crucial...**

*Tax:* Sandler, the Pickering report on pensions and this working party (and probably all other sane observers) see the UK’s tax code as complicating financial decisions, raising the cost of errors and increasing the need for advice - and, therefore, raising investors’ costs. Though savings taxes could be simplified, rule simplification is also needed to deal with the plethora of different vehicles for pension accumulation (and the options for drawing pensions).

The key point is that, whilst pension tax benefits are based on the assumption that contributions will be pretty regular, the typical pattern of household borrowing and saving at different stages of family life is subject to all sorts of interruptions that make planning difficult or impossible\(^{18}\). Recent changes have reduced funding flexibility but what is needed is more. There is an overwhelming case for a life-time limit for tax-subsidised contributions that can be met at any time and frequency. If the government is concerned about wealthy people taking too much advantage of flexibility, it should find other ways to cap those benefits.

*Housing:* The working party noted that much of the shortfall in retirement provision will, in the end, have to be met from reductions in housing equity, by sale or capital extraction. Concern was expressed that the market is currently not offering instruments or agents that can safely provide this on a large scale or at a reasonable cost. Earlier products were the cause of considerable detriment, so this is an important public policy area.

### 3 How can we narrow the gap?

**Three priorities**

This analysis of consumer behaviour and industry failure in the financial services sector points to three key elements for both public policy and commercial strategies:

- encouraging informed personal responsibility for saving and investment choices;
- supporting it with advice and information that has greater technical integrity; and
- cutting the individual’s cost of investing.

Since public awareness of cost is a powerful agent for forcing the industry to lower costs, the goals are compatible from a consumer viewpoint. Businesses, though, will protest that the goals point in different directions. Supporting better education and well-informed choice threatens to increase industry cost, at the same time as the all-in cost to investors is being lowered. It may also mismatch the products the industry wants to sell and those consumers want to choose. Reconciling this clearly requires a change in the business model — particularly with regard to how firms relate to customers, what products and services they offer, and how they charge. These are not trivial changes.

What should public policy focus on?

Increasing personal responsibility requires a clear statement of public policy about state provision. At present, for many who are not currently saving, relying on the state may still look like a rational choice, either because of the way they assess the trade-offs or because they mistrust the message and expect policies to change.

If we believe that, as a result, many individuals will be condemned by their own behaviour to regret their level of provision, then the only protection politicians can offer is compulsion. However, to some extent, the low level of public awareness about financial provision is itself the product of compulsion - via National Insurance and via historical dependence on employer-provided pensions. In the vacuum of personal responsibility created by various forms of compulsion, people have been slow to pick up messages about falling third party provision. So there is no guarantee that increasing the level of saving by compulsion will lead to higher than minimum prescribed levels – or that those minimum levels will avoid widespread regret about outcomes.

The role of consumer education

Sandler called for a substantial increase in public resources devoted to adult education, envisaging the FSA as the prime provider. There are basic forms this can take that the FSA is well-qualified to provide, such as generic literature and illustrative examples (such as what x, saved over y years, might produce as outcomes, or what a debt of x will cost to repay after interest of y). This kind of information could be widely distributed through schools, universities, banks, estate agents, car dealers, registry offices, hospitals – wherever the lifetime events that call for decisions about money are likely to occur. But it is not enough.

Learning about finance, of course, starts in schools, but the key personal trade-offs involving money are really relevant to adults: trade-offs between income and work satisfaction, owning a home and renting, career and child-raising, spending and saving, flexibility versus contractual commitment, short versus long-term. Ideally, adult conversations about financial provision would not exist in a narrow framework, dictated by government or the financial services industry, but rather a broader context which is all about the role of money in our lives - and in our heads. Personal responsibility is after all a way of being, not just a way of dealing with money. Some of the many contexts potentially relevant to these trade-offs are the workplace, parent groups, doctors, friends, family and any other support groups.

The media might also consider whether its approach to financial coverage is focused on too narrow a framework – news-based, product-focused and often negative. In contract, coverage of other subjects succeeds better because its style is broader, multi-focused, surprising, even idiosyncratic.

Creative businesses involved in education, programming, media and branding are likely to respond positively to commercial opportunities to help make personal financial planning more interesting, more relevant to people’s lives, more positive and ‘aspirational’. Much of this should be commissioned by the industry itself, responding to a consumer appetite it is presently ill-equipped to feed. This should shape both point-of-sale support and after-sales service, and is part of a fundamental shift in customer relationship management from selling to serving.
Delivery

For businesses to meet this demand, they will need to deal with three failures we have identified:
- unequal access to products at different points on the risk spectrum;
- the vested interests of providers and advisors in a customer’s choice of location on the risk spectrum; and
- chronically poor description of products and poor communication of risks.

There are two potentially large-scale, sustainable business models for retail financial services that can correct these failures. They are:
- the retailing model; and
- a model based on fees for advice.

Both require a kick-start from regulation or public policy to:
- encourage competing business models;
- clarify the proper distinction between consumer protection and caveat emptor;
- enforce clearer description of all products; and
- ease the promotion of highly-regulated products (stakeholder or CAT-marked).

These are necessary both to achieve valid consumer goals and to encourage industry take-up by reducing regulatory hazard and business costs.

Some of these changes were also identified in CP121 and Sandler, but the distinction we have made between individual responsibility and prescription leads to different conclusions about:
- product regulation versus sales process regulation; and
- the reforms that are most likely to break the effective monopoly of the distribution model.

Product regulation

*Segmentation*: CP121 proposed an undefined product segmentation enabling certain simple and/or ‘safe’ products to be sold by less than fully qualified staff in regulated firms. Sandler suggested that regulated products could be sold off-the-shelf by non-regulated firms. Sandler’s proposals do more than the FSA’s to increase access and reduce consumers’ costs, but they do less to ensure that products are accompanied by appropriate advice.

The idea that it is actually practical to distinguish products in some way, assumed by both Sandler and CP121, was generally accepted by the working party. For the working party, the notion of ‘safety’ that justifies segmentation is strongly related to ‘clarity’, consistent with its preference for informed self-selection. The analogy was made of on- or off-prescription drugs: even off-prescription drugs can be dangerous, but only if commonsense self-protection is not observed.
In the context of technical integrity and the risk spectrum idea, we can anticipate that ‘off-prescription’ products might share a number of characteristics:

- simplicity of concept – eg, giving exposure to the UK equity market return as cheaply as possible;
- clarity of location on the risk spectrum – eg cash fund, gilt fund, balanced fund, equity fund (but not with-profits or products using derivatives);
- generic risk characteristics dominate as opposed to specific risks – eg a tracker fund (or an active fund with tight tracking error controls);
- no principal risk – eg return being dependent on markets, not an agent (therefore excluding smoothing);
- no requirement to diversify exposure to provider; and
- CAT-marked terms.

CP121 was silent as to which products would be safe, or whether safety was a risk or clarity function. Sandler (apparently personally) plumped for a single prescribed location on the risk spectrum, rather than a range of products at clear points along the risk spectrum. In his view, ‘safety’ seems to mean:

- a managed or balanced unit trust;
- a balanced fund with smoothing of the investment risk (to replace with-profits); and/or
- a balanced pension fund.

This approach says little about informed self-selection. It also confuses suitability with a fixed risk exposure; in fact, a balanced fund could be too risky for some people and not enough for others. Consistent with its emphasis on personal responsibility, this paper rejects the prescriptive approach in favour of a more complete range of simple low-cost products.

Focusing on delivery rather than the products themselves, some on the working party felt that lowering consumer protection and increasing access to products whilst reducing access to advice, is not acceptable. Others felt that, in a far from ideal world, advice and consumer protection beyond a reasonable interpretation of caveat emptor are becoming so uneconomic a luxury as to threaten their eventual loss anyway.

*Product description:* This paper offers a way of reconciling these differences: clearer product description for *all* products, not just the regulated off-the-shelf products.

We believe that buyers are entitled to expect every product to carry a prominent and simple explanation ‘on the tin’ of what it is, what it does, how it can be expected to behave and what the risks are associated with it. These descriptions would reflect a product’s generic features and any specific features that further differentiate it. Though the description should allow an investor to place a product on the risk spectrum specific to the task for which he or she might want to use it, it should not use risk grades or codes as proxies since these would be task-specific.\(^\text{17}\) This descriptive information is as important as the information about cost and contract risks already required. Both sets of information need to be so prominent, whatever the sales channel, as to be unmissable – ‘on the tin’ does not mean buried in a separate and lengthy Key Features document.

\(^\text{17}\) For example, understanding what range of outcomes can arise investing in equity-based products allows an investor to decide whether that is suitable for say a pension, perhaps yielding a very different answer to say mortgage repayment. Likewise, investors need to know that if they invest in an index-linked gilt fund their outcomes in real terms are near certain, but the value of the investment in money terms will still fluctuate (like equities) day-to-day.
Compliance impact: The working party was conscious that a switch to requiring the comprehensive description of products is an extension of selling regulations that might significantly increase an already heavy burden of regulation, without any easing of sales red tape or common law liability. This is a risk; but the statutory process for rule book changes should prevent an arbitrary outcome.

A number of practitioners felt that the real problem of regulation does not stem from the rule book itself (which actually prescribes less standard process than the industry has chosen to adopt) than the way regulators have used hindsight in judging past errors and quantifying redress. So also might the courts. Either way, the risk should be less with mandatory product description, particularly for advisers.

Status reforms: defining independence

CP121 and Sandler both try to break the dominance of a commission-based distribution model.

CP121 sets out the basis: a marketing reward associated with the term ‘independent’, as in IFA. It suggests that the term be reserved for firms charging on a ‘defined payment basis’, such as time-based fees or portfolio-based fees⁴⁸, not contingent on a product purchase. The IFA industry has raised objections to this approach, claiming that no more than 15% of firms would end up opting for fee-based tariffs (bearing in mind that 10% of revenues and a smaller percentage of firms are already fee-based). However, IFA research by Datamonitor suggests that the proportion remaining ‘independent’ might be as high as 50%, though most of those will deal mainly with wealthier customers.

Sandler proposes an alternative that would probably increase the take-up of the independence option by existing IFAs, both by increasing the marketing reward associated with independence and by offering greater flexibility over the method of payment. He would reserve both the term ‘independent’ and the term ‘adviser’, hoping thereby to alter the consumer’s response to the distinction between advice and broking in a way that polarisation failed to achieve. Sandler would also allow advisers to charge commissions, collected by the provider in the normal way on behalf of the adviser, provided that the part of the provider’s commission that benefits the adviser was separately negotiated by the adviser with his or her customer⁴⁹. Sandler suggests a distinction between a provider’s ‘wholesale’ price, with a front-loaded commission that it takes for itself, and a ‘retail’ price, uplifted by the adviser’s customer-agreed commission. Brokers who are not advisers would deal at the provider’s retail price. The Review team felt that this model would also allow advisers to offer contingent charges: ‘no sale, no fee’.

The expected increase in IFA take-up relates in no small measure to Sandler’s acceptance of the conventional thinking about the consumer’s reluctance to write separate cheques for advice. This argument, quoted by Sandler, is based on consumer research as well as first hand experience of IFAs. However, our working group felt that Sandler may underestimate actual customer response if the cost difference is both explicit and large. We put some numbers on this later.

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⁴⁸ The proposed change did not rule out taking commissions and offsetting them against fees.

⁴⁹ This is in fact a model that already operates – for instance some discretionary portfolio managers require their clients to tell them what fee retrocession should go to a referring IFA to avoid any potential conflict.
Technical integrity

Raising the quality and removing the biases of financial advice can come in two ways:

- retraining; and/or
- better use of behind-the-scenes systems.

Sandler was scathing about the training and skill levels of the nearly 80,000 people who interact with the buying public, either as sales staff or qualified IFAs. The working party agreed, but also felt that it is unrealistic to expect retraining to be the answer when the problem is so large. However, there are many ways in which the advice or sales process can be simplified and improved by standardized templates or expert systems. Spreading the use of technology behind the scenes assumes that technology access is now, or should be, standard – whether through call centres, in-branch PCs or on-the-road laptops. Increasingly, customers accept that the visible use by practitioners of computer software in the sales or advice process is not demeaning but professional.

Reducing investors’ costs

Considering that, without cost reduction, most other industry changes are of little value it is fortunate that there is plenty of scope for cost-cutting.

Reducing the need for advice: Here, the main contribution would come form what we have already proposed: comprehensive product descriptions, cutting the red-tape for off-the-shelf product sales. In addition, simplification of the tax code would have a big impact.

New revenue models: The key change is cutting the automatic link between charges and the amount of customer’s money being handled. Most of the industry depends on this model: gathering assets and attaching an ad valorem fee. It is illogical because most of the costs of managing a fund are not themselves sensitive to changing asset prices or to the size of the fund. It is this link that leads to all-in charges for active management, with bundled advice, being irrational for the consumer at all but very low levels of capital. We suggest three new approaches:

a) Manufacturing: Depolarization should encourage a commodity-supplier model amongst firms who see their strength as manufacturing rather than distribution. At the moment, a manager’s largest funds (with high margins) are used to subsidise a huge number of small unit trusts with very low margins – part of the active management model whereby small funds are tolerated in the hope they will perform well enough to grow large. The cost-effectiveness of this business strategy is rightly being questioned.

b) Retailing: Strong retailers in other industries use volumes to bring pressure to bear on manufacturers to improve quality and reduce unit costs, as well as using volume leverage to reduce their wholesale price. A strong retailing function in financial services could come from:
- banks selling third party products;
- other distributors (including brokers) strong enough to exert the same pressure; and
- non-financial service retailers.

c) Advice: In the advisory market, the link between the product price and the advice price can be broken by separate negotiation of commissions received by the adviser – the Sandler
CP121 makes sense on fees...

model. But it is only if the commission is capped that the linkage at all sizes of capital is broken.

The growth of the fee-based sector may also change the revenue model. The easiest way to justify charging a client a fee for service is to show clients what they are saving. This particularly applies to fees requiring direct payment by separate cheque, where consumer reluctance needs to be overcome by a strong new value proposition.

The advisory model works best when cutting the total industry take – but increasing the advisory share of it. This model is being successfully adopted by some planners and advisers in the marketplace today, using both index trackers and no-load active funds to cut the implementation cost. It has also been adopted successfully in the institutional market.

The impact of separating planning advice and implementation and of breaking the link between the cost of advice and the value of contributions is illustrated below in Figs. 2 and 3 as differences in mean expected final values over time. The detailed assumptions are set out in the Appendix.

The tariff-based advice cost targets used in these examples - £250 for the ISA and £500 per session repeated at about six-yearly intervals for the regular contribution plan - are considered in the next section.

Two examples are shown:

- an active fund brokered at 5% commission and with industry-average total fund management costs; and
- a lower-cost actively-managed fund sold without any sales commission or trail commission.

Bear in mind when interpreting these cost differences the observation earlier that the chance of making up the assumed cost difference of the lower-cost active fund is still between one in 4 and one in 10, and for the higher-cost brokered fund it is between one in 10 and one in 20. (The chances are smaller with regular contributions because each one bears a sales commission.) The chance of earning a clear profit equal, say, to the amount of the cost difference is negligible for both. Though both sets of probabilities illustrate the advantage of a tracker, the cost difference for the advised product is still worth having if an active product is to be preferred in spite of those odds.

The difference in the value of the investment is symmetrical to the amount invested, so for a regular contribution plan of £2,000 pa (escalating in line with inflation), instead of the £4,000 assumed in Fig.3, the mean expected additional cost for a high-cost fund sold by a broker on commissions would be about £22,000 after 20 years, versus the value shown of around £44,000. Was the work shown in fig. 3 twice as much for the broker or the value twice as much for a wealthier customer?
Fig. 2: Cost differences for a single investment of £7,000

![Cumulative Cost Differences versus Tracker for Single £7,000 ISA](image)

Fig. 3: Cost differences for regular contributions of £4,000 pa

![Cumulative Cost Differences versus Tracker for £4,000 pa (real) Regular Contribution Plan](image)

**Regulatory disclosure changes**

The FSA can help spread awareness of cost by making changes to the form of disclosure (some of which are likely to have been suggested in CP121 responses). It should:

- adopt Sandler’s recommendation to split the Key Features document into a shorter sheet with the essential product description, charges and illustrations of the impact of charges, leaving the combination of detail and marketing descriptions to the longer version;
- adopt sensible and more frequently updated projected growth rates;
- show growth in real terms, together with an explanation of why this is being done;
- because research shows poor familiarity with percentages, relate the cost impact to outcomes in pounds using a prescribed general example as well as percentages; and
- require cost comparators – such as prescribed ranges (or quartile breaks) for generically similar products.
Adopting behind-the-scenes technology

Technology consultants and suppliers were well represented on the working party and provided insights into the way technology can reduce business costs.

One insight was that the initiative to improve technology, both for manufacturing investment products and for supporting the distribution and advisory processes, may actually come from technology firms themselves. They are in a position to design, build and manage shared technology platforms. It was pointed out that the same platform could be used by different channels without customers being aware of it – by a bank as the basis of its in-branch face-to-face support for the retailing of financial products, by a non-financial service retailer, by a manufacturer as a new distribution channel, by a broker, by a group of brokers looking for scale economies, or by a fee-based financial planner.

Shared systems are also likely to include expert systems that streamline front and back office processes, reduce costs and increase consistency. This is vital to reduce the cost of advice. Expert systems are already widely used in banks (credit appraisal, risk models), fund managers (quantitative techniques) and institutional pension consultants (asset/liability modelling), but are notably absent in retail financial advice.

A shared technology platform can effectively host an entire business format, rather like a franchise. This is very important in terms of ability to scale a firm up cheaply, ensuring quality and consistency as well as management training and compliance. Dependence on externally-managed, reputable processes may be critical to reducing compliance risks and costs, including PI insurance. It also allows maximum use of distributed staff – such as those working in call centres and in branches. Again, the customer is not necessarily aware of the location of the personnel if access is by phone.

Internet and telephone access: The working party was generally sceptical about the visible role of technology where potential cost reductions require face-to-face access to be replaced by internet or telephone access. This scepticism may be a reaction to the poor current standard of many call centres and the insubstantial nature of much of the early web-based investment offerings. In any event, it will be up to firms to demonstrate that there are tangible benefits. These might be expected in several areas:

- keener pricing – the price of service may be differentiated according to the means of access;
- linking personal balance sheet components (going beyond the deposit/mortgage interest offsetting model);
- faster response times;
- more intelligent responses; and
- richer reporting.

Two key technology breakthroughs are aggregation and expert systems.

This combination is much more powerful than the early versions of web-based services relying on aggregation already seen in the US. There is little evidence that consumer behaviour is transformed simply by bringing together a lot of information previously dispersed. What is most likely to transform behaviour is the ‘intelligence’ that allows individuals to do something with the information – and which, by placing individual decisions into a meaningful context,
makes sense of a process hitherto irrelevant or confusing. The obvious context is a ‘personal balance sheet’, be it for an individual or a household, that extends to include projection of assets, liabilities and cash flow.

The practical impact of expert systems on the consumer relationship is that power passes to the consumer via the education and information fed back through interaction with the system. This is an important element of informed self-selection.

This is taken to an extreme in ‘open finance’: a model in which manufacturing, advising and execution functions combine in a process that offers little control over the customers’ choices. Fundamentally anarchical from the viewpoint of its industry promoters, it requires a huge leap in thinking about customer relationship management.

Portable fact-finds: CP121’s proposal for portable fact-finds met universal approval from the working party, as from Sandler. This would make it acceptable for customers’ information about themselves, their circumstances, their insurance policies and the products they hold to be ‘transferred’ from one agent to another. The information would replicate much of what now constitutes a fact-find. Falling short of a personal balance sheet, it may nonetheless be the basis for determining suitability under the rules – and also for identifying gaps to fill with a product recommendation. This information-gathering process is currently so time-consuming and dreaded by customers as to have become a real deterrent to shopping around or changing relationships.

The fact-find process, usually paper-based, can take up much of the time required for a face-to-face advice session leading to simple action, such as filling a gap in insurance protection or taking out a pension. This first session cost is often estimated at around £200 per case. Simplifying fact-gathering and needs analysis makes a big difference to advisers’ ability to lower the minimum cost of advice.

If data is to be portable and electronic, it is desirable that it should be limited to standard factual information that will interface with other systems. That includes dates and amounts and policy numbers, for instance. It should not include self-diagnosed ‘risk tolerance’ as the questions should be specific to the sales or advice process of an individual firm, and the tick in a box should always be specific to a customer’s particular requirements.

Economies of scale: Industry analysts are united in pointing to excessive fragmentation at several levels:
- the number of products of each type that are available;
- the number of product manufacturers; and
- the number of IFA firms (though not the number of advisers).

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20 Commonality between the UK format and the US format, which is not shaped by regulations (see Rowland, Best Practices for Financial Advisors, Bloomberg 1997), suggests that good practice and sales techniques lead to much of the fact-gathering template: it is not just red tape.

21 These estimates may not allow for an adequate contribution to general overhead, but all estimates of unit costs in the IFA business are distorted by fragmentation – spreading fixed overheads over far too few cases.
This reflects the dominant distribution model. It has been successful for a long time in keeping at bay normal Darwinian economics: good products should force out bad, strong firms should force out weak firms, fragmentation should lose out to scale economies. Nevertheless, Darwin has been increasingly making his presence felt and, with a return to more normal market conditions, the poor core profitability of many areas of financial services is being exposed. The combination of a bear market, polarisation reform and the need for technology investment is widely expected to lead to a reduction in this fragmentation.

There was some concern in the working party that the effect of consolidation or market concentration will be to reduce effective competition and raise product prices to the consumer, rather than lower them. Considering that oversupply in the UK distribution model has actually kept prices up, there must be doubt about applying a general rule that reducing oversupply will raise prices. If this is a numbers game, it is not the number of providers or distributors that counts but the number of business models – which has been effectively one.

4 Getting from here to there

The reform time-table

In this final section we speculate about what will actually happen. Regulatory reform is probably the key; so most, but not all, of the changes we expect will wait on the lengthy process of reform. In particular, the tax and pension changes proposed by Pickering and Sandler depend on the government and its normal budget process.

The CP121 process envisages imminent publication of the basis of the ‘defined payments’ for advisers who wish to use the term ‘independent’ – but that may be affected by Sandler’s alternative approach. In December 2002, the FSA is due to publish draft rules covering that and the rest of CP121. It has said that it will set up working groups to study Sandler, but realistically it is hard to see how Sandler can be woven into the CP121 process. This means that some changes will probably not come back for consultation until some time in 2003.

Regardless, the Treasury could proceed to consult with the industry immediately on product regulation, directly or via the FSA. Since this is the key to much else that can improve the efficiency of the market, it should.

The economic context

Whatever happens, reform will take place against a difficult economic background as businesses and investors adjust to harsher realities after a long boom. Three blessings:

- the tougher environment will mean that managements are less complacent about old business formats;
- the awkward truth about the damage of high costs is more likely to resonate; and
- latent risks in financial products will become more apparent.
**Unit trusts groups:** Mergers are already occurring in the unit trust sector, largely because overcapacity is finally leading to poor core margins. Exceptionally good stock market conditions over the last decade or so never translated into high industry margins\(^{22}\) – which is alarming for the sector’s profitability prospects during what is bound to be a much tougher time.

**Life insurance companies:** Contraction in the life sector is a likely consequence of the declining appeal of with-profits investing, which not even reform can save. In this area, greater enlightenment is counter-productive: policyholders see they can lose out from smoothing, but that they can hardly expect to win. Free capital has been depleted ‘at the top of the market’ both by management strategies to extract capital supposedly not required to support bonus policies and by excessively generous bonus declarations. For shareholder-owned offices, there is a potential call on shareholders’ capital to boost fund strength which will tend to weigh on investment intentions either for IT or buying distribution.

The FSA is already on record that most of the smaller funds will simply close their books to new business and run off gradually - as indeed a number have already, quietly, started to do. But the problem may become so general and high-profile that many larger offices will also be forced either to put up more capital or close to new business.

The health of the life sector is a concern for the reform agenda primarily because of the way life companies and IFAs are so inter-dependent. The working party felt the authorities need to be mindful of the uncertain near-term impact, but that this should not be used as an excuse for delaying or diluting reforms whose long term benefits are more certain.

### Industry responses to reforms

**Attracting institutions back to direct selling:** The key CP121 goal of improving access to financial services involves tempting more big institutions with large customer bases back into direct sales. Will they be tempted? And, if so, how?

After decades of withdrawal from expensive door-to-door sales and premium collection, there are now only three large-scale channels for distribution other than through IFAs\(^{23}\):

- web or phone;
- tied agents; and
- branches.

Many on the working party felt that the internet and call centres are increasingly viable ways for insurance companies to sell direct, particularly if supported by a full range of off-the-shelf products. Who would have thought a few years ago that mortgages would be sold on the phone? Sandler agrees. But it may only be a viable strategy for a handful of leading brands, and it will never be the heart of their distribution strategy.

\(^{22}\) Apparent from the PricewaterhouseCoopers annual surveys of investment industry profitability.

\(^{23}\) There is an alternative that has not really been considered in this paper (or by the working group). That is the Primerica model, as successfully marketed by Citigroup in the US. Based on the ‘Avon lady’ (or Tupperware party) of legend, it involves the selling of simple financial products over the kitchen table by a part-time workforce that is legally self-employed. The model is really franchising, since salespeople are themselves encouraged to hire new salespeople. There are lots of questions to be answered about this model. However, it has worked well with lower income groups in the US, and Citigroup is about to market the concept here (under the CitiSolutions label). AH
Branches, though, can be the heart of a distribution strategy. But they are only an existing option for banks and building societies. It seems likely that CP121 will have a big impact on banks’ plans for the branch of the future and for the role of the branch in a multi-channel technology push. A successful branch strategy to provide both savings and investment products is likely to benefit from being integrated with call centres, so that the mix of remote versus face-to-face is customer-driven and tends to lower the overall cost.

If banks’ financial retailing strategy is shaping up to be different from the classical bancassurance model, we really need to know whether it will include fixing a tariff-based fee for advice or ‘surgeries’. We note good reasons for banks to go this route:

- it makes the most of their appeal to commodity suppliers, such as stakeholder suppliers;
- they have plenty of experience of unbundling charges; and
- it plays to their strengths - particularly relative to life companies who are stuck with the commission model because they depend on IFAs who in turn depend on commissions.

Buying distribution: For insurance companies, the change proposed in CP121 that makes a big difference is the freedom to buy IFA businesses to secure tied agencies – or, perhaps, to develop separately regulated distribution firms able to broker products from the entire market or a limited range. The latter approach may be appealing given poor prospects for their core manufacturing businesses. Unfortunately, particularly in the current market, they may not have access to the capital needed to make a difference.

Multi-ties: This is a big focus of speculation within the industry. Because multi-ties, by themselves, will probably not alter the business format or revenue model, guessing the uptake is primarily important as an indicator of the competitiveness of providers.

Providers, particularly insurance companies, are evidently eager to tie IFA firms into multi-tie arrangements as the low-cost route to strengthening distribution otherwise weakened by depolarisation. What they can offer in return is commission and service - but both are in jeopardy from deteriorating profitability and systems-handicapped service quality. The strategy itself is not even a clear winner. It is a tricky judgement between securing a few strong distributors and alienating large numbers of weaker distributors and independent advisers.

For brokers, too, it is not a clear-cut strategy choice. Used to the marketing advantage of independence, they are being seduced by business administration arguments, not marketing arguments. The providers who will most value their tie are those with the most exposed value propositions: weaker brands who dare not risk differentiation by past performance. These are not the IFAs’ favourite providers. Technology may therefore need to be the decisive factor: straight-through processing and fast and accurate access to shared-customer information. IFA business is already moving to the twenty or so firms able to offer electronic access. Will these firms withdraw this support from independents? It seems unlikely all will, so there will still be a counter to the multi-tie incentive. Many IFAs will want to wait till they know the new ‘independence’ rules so they know what they are giving up by accepting the multi-tie chalice.

Technology-sharing networks, such as those owned by Misys, offer a potential ready-made multi-tie solution. But forcing network members to accept a business strategy is fraught with danger. Some Misys network members have already threatened to quit over hefty PI insurance premium increases, let alone changing status from independent to multi-tied!
Multi-tied brokers will be separately regulated, unlike single-tied. This still leaves providers with reputation risk – and practical problems managing it. There is also an issue over quotas: how much of one provider’s products the broker sells relative to another’s.24

Competing business formats

*New independents:* The proportion of IFAs who decide to remain independent, however defined, is far more important in terms of competing business formats. If the FSA goes with Sandler’s vision of separately-negotiated commissions, as an alternative to fee-based advise, the key objective of cutting the cost link with money amounts may not be widely met.

*Creating a separate market for advice:* Depolarisation itself may be less important than wide availability of off-the-shelf products because the latter effectively separates the product from advice about it. Off-the-shelf products, therefore, help reveal the need for a truly separate and easily accessible market for advice. If there is a demand for this, there will be a supply response – though it requires advisers to get their minimum fixed costs of delivery as low as possible so they can safely use a non-contingent, fixed-fee tariff.

Product segmentation will also spawn online advisory businesses tailored to tie in with these products. Some of these are likely to adopt the asset-gathering model, offering a combination of investment planning and management based on portfolio-related fees. But we should also anticipate subscription-based models similar to those operating successfully in the 401(k) defined contribution pension market in the US, indifferent to the size of the customer’s wealth. The technology that drives this process, which merely uses the internet for delivery, is identical to the technology that online businesses can use. Several suppliers in the UK have already designed ‘engines’ to drive such models, and US engines are also likely to be adapted to the UK.

The internet is an obvious enabler of a business model tailor-made for the ‘buying agent’ element of the retailing model – providing easy access to quality products at a competitive price with clear comparators and point of sale support, and constantly working to reinforce the perception that it is on the customer’s side. The financial services infomediary has a real advantage: the customer is more likely to value the message that the agent is on the client’s side, exploiting the industry instead of exploited by it.

There are also suggestions that caring employers will be motivated to provide internet-based infomediary-type workplace access: it is cheap enough for small subsidies to make a big difference, and such employers would run less reputation risk than they would by exposing employees to brokers or sales staff from a single provider.

At the top end of the market, CP121 will undoubtedly encourage growth in fee-based models. Ironically, the more the CP121 independence criteria are watered down, the more it creates an incentive to distinguish a robustly unbiased advice model, even if it requires collective effort to promote consumer awareness. In the US, for instance, the National Association of Personal Financial Advisers was formed (with great fanfare) to make that distinction with commission-based brokers. Although it had to do it without regulatory assistance, it was successful in

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24 It has been suggested that multi-ties also lead to a conflict under the common law of agency as between duties to customers and duties to the provider. The statutory power of the rule book, which currently demands equal duties of care to customers of both independent and tied brokers, and which overrides common law, ought to deal with most conflicts arising from the agency role, but does that really extend to quotas?
winning a growing market share. Perhaps the Institute of Financial Planning in the UK, which also only represents fee-based firms, could make a similar splash if it had better resources.

**Achieving cost reductions in advice:** Any IFA business strategy that does not rely on tying or an asset-gathering model needs its own solution for economies of scale. This applies whether it is aiming at the middle market or above and whether it is offering a value proposition based on planning alone, on planning plus implementation via low-cost products, or just trying to make the old commission-model more consumer-friendly. Getting from here to there is not easy, but it can be done.

If the target fee for a basic surgery is to fall to (say) £150, and the cost of processing implementation is to fall to (say) £50, this requires a reduction in charges of about 60% \(^2\). Though technology can help both parts of the process, it is mainly by spreading fixed costs across a larger number of cases processed that this reduction can be achieved. What has prevented IFAs from achieving economies to date is the high marginal cost of adding new business; it is far cheaper to sell more products to existing clients.

IFAs can escape this trap by promoting a new value proposition, such as low-cost fixed tariff services aimed at the middle market (which might also attract a lot of ‘smart wealth’ too).

Both for old and new advisory models, scale can make a big contribution. What is really needed is to scale up business management, marketing and IT functions. This is likely to involve a lot of merger activity – and perhaps new business formation.

We anticipate a new alternative to networks in the shape of non-regulated service companies, to provide IT, marketing support, compliance support and commission negotiation for several firms, and also to control referral traffic between them. These are likely to be smaller and more tightly managed groupings than networks, probably limited to one geographical area.

**New agencies:** The working party considered the call for a National Network of Financial Advisers, an extension of the Citizens Advice Bureaux idea to financial advice. Since banks and IFAs are not likely to cover the right content, let alone have the right pricing model, for people barely able to save, it is an appealing concept \(^2\). For the same reason, it needs public money. Since people using the service are bound to focus on benefits, the government needs to think about whether it first needs to align savings and benefits policies.

**The Post Office:** The working party felt a revived profile for the Post Office could make a big difference as soon as off-the-shelf products are available. An early experiment selling Standard Life’s stakeholder pension has been a flop, but both parties have blamed the lack of government promotion.

**National Savings:** The Treasury should note that, with the reduction in its need to borrow, it has allowed National Savings to become poorly competitive and unimaginative. If it is really serious about access (and alert to the reality that saving is not just about equity) it will try to revive the popularity of National Savings. It could even take up a suggestion from one of the working party that a new long term instrument be offered, combining a core index-linked gilt return with a lottery prize.

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\(^2\) The estimate of existing unit cost of around £500 is based on the much-quoted £200 for the fact find process and £300 per case of general business overhead and compliance for smaller practices (source Phil Billingham Associates Ltd, compliance service provider). Without face to face access and with more data provision done by customers, the target surgery fee could be set lower than £150 without cross-subsidy.

\(^2\) We understand it is being looked at by at least one centre-left think-tank.
Technology’s role

Technology, whether visible to the customer or not, is an important element of most strategies that aim to lower the cost of doing business. This is a dynamic area, and providers (and consultants) are looking hard for financial services applications at a time of reduced spending in many other sectors. Key areas that we expect the focus to be on include:

- the replacement of legacy systems, particularly as the issue of EU compliance looms;
- straight-through processing between brokers and providers (tied or not);
- growth of open finance platforms for multiple types of business;
- new call centre uptake, prompted by computer-telephony advances and large unit cost falls;
- expert systems to provide front office business formats for advisers and sales staff;
- integration of back office and front office systems;
- more powerful (but more user-friendly) software applications to aid planning and selection decisions on investment websites;
- quantitative fund management solutions for new stakeholder products; and
- risk management software for securities and product portfolios.

Education

The groundwork may have started, but the real impact of education initiatives that encourage personal responsibility probably depends on introducing regulated off-the-shelf products and our proposed universal product descriptions.

Before that, the government needs to be thinking about the consistency of messages about savings. It will be ‘talking the talk’ of higher savings. But, in a bad economy, it will be all too tempting to ‘walk the walk’ of past administrations and promote higher consumption. In a modest way, we hope this paper will give encouragement to politicians to stick to a longer term strategy for savings, to give consistent messages and to accept that what individuals actually choose to do with their money is beyond the Treasury’s capacity for micro-management.
Appendix: Cost Differences with Different Business Models

Option 1: Tracker with fixed-fee advice
Option 2: Low-cost actively managed fund with fixed-fee advice
Option 3: Higher-cost actively managed fund brokered with ad valorem commissions

Cumulative additional cost = difference in final value, Option 2 or 3 minus Option 1

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Assumptions:
Equity market mean return in real terms (pre costs): 6% pa
Mean expected active-manager return: zero
Inflation: 2.5% pa
Regular contributions escalate in line with inflation
Tracker costs: 0.6% pa (including full implicit costs)
Advice ‘surgeries’ occur at start and, for regular contribution plans, at 6-year intervals

Notes:
- Actual final value differences are dependent on path of market return and inflation as well as mean value for each
- Calculations assume no contribution to value of active fund from active-manager relative return. Final value differences will also be affected by path of active-manager relative return even if mean value is zero
- Differences for larger contributions than £2,000 pa are proportional

<table>
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<th>Regular Contributions of £2,000 pa Escalating</th>
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Stuart has worked in the investment industry since leaving Oxford in 1969, first as a stockbroker and then as a money manager. He held senior management positions in two mainstream firms - Touche Remnant and Hill Samuel. In 1990, he set up a successful new business with former Touche Remnant colleague Peter Millar. Valu-Trac Investment Management pioneered in the US an approach to investing combining dynamic, computer-based asset allocation with the use of index-tracking funds.

During his career he has worked with institutional investment clients all over the world, including foreign government funds and some of the world’s largest pension funds, as well as with wealthy families. The focus of his personal expertise has been investment strategy and the application of computer-based investment-decision tools.

Through his own company, Investment By Design, Stuart has acted since 1996 as a business consultant within the industry, working with investment managers, IFAs and technology providers. Through a separate joint venture company, Fifth Freedom, he has also developed expert systems for investment advice and portfolio management.

In February 2002, his book ‘No Monkey Business’ was published. Highly critical of the retail investment industry, this and its accompanying website, www.nomonkey.biz, add a role in investor education and consumer activism to his consulting work.

He lives in London with his wife, Mindy, and their two sons.
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