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Joseph Piacentini
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10 February 2014

Our Ref:

Your Ref:

Dear Joe

UK RDR and US Fiduciary Reforms

Following your recent discussions with some of my colleagues about the effects of the Retail Distribution Review (RDR) on the UK market, I thought it would be helpful if I explained the rationale for the changes we made and the effects so far on the market. I also recognise that there are a number of misconceptions regarding the impact of the RDR which I thought it may be helpful to correct.

We introduced the RDR, as a package of measures, in an attempt to address the root causes of some of the problems that had persisted in the retail investment market over the years. Not only did we want to improve the level of professionalism within the intermediary sector and enhance consumers' understanding of the service they were receiving, we also wanted to remove the potential for bias in the advice market where advisers are remunerated by product providers through commission.

The RDR rules introduced a major change for all parts of the market. Thus they impact on Independent Financial Advisers (who are responsible for transacting over 60% of investment business in the UK), advisers tied to product providers, wealth managers and bank advisers. A key concern from the industry had been the rules on qualifications, which require all advisers to reach a higher minimum level of qualification. This was widely expected by many in the industry to lead to many advisers leaving the market, so reducing the availability of advice. In the event, we have not seen the substantial fall in adviser numbers that some commentators forecast.

Research we have carried out shows the number of advisers declined by around 11% - from just over 35,000 to just over 31,000 at the end of 2012 – and this decline was very much in line with our expectations. Since then we have seen the number of advisers in the market rise. It is worth putting this in context – adviser numbers have been falling over the last few years, at least in part as a result of weaker demand for investment advice and products in a world where returns are low and volatile and real personal disposable incomes are falling (that is to say, there is a demand side issue as well as a supply side issue). Moreover, adviser numbers on their own do not tell the whole story, since the issue is not the number of advisers but capacity in the market. If advisers were not previously working at full capacity, then a fall in numbers could be met by the remaining advisers increasing their productivity.

However, a key element of the RDR was removing the influence of product providers over advisers' recommendations by the removal of commission payments. Despite the existence of a best-interest standard (our rules say 'A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule)') and comprehensive rules on the disclosure of commission, we had seen persistent problems with mis-selling over many years.

Further, research found that disclosure was not helping consumers understand that advice was not free and that they were paying through the charges on the product; or how the value of their investment was affected by commission. While there was some recognition that the amount of commission an adviser might receive on different products could affect their recommendation, the trust they placed in their adviser seemed to override this. Commission is a powerful incentive and, with consumers unable to comprehend and make use of information designed to assist them in challenging their advisers, it was clear that disclosure was unlikely to provide a complete solution for dealing with conflicts of interest.

A more direct solution, addressing the cause of the problem, was required. Moreover, removing commission and introducing "adviser charging", where the intermediary charges the consumer directly for the advice they provide, helps consumers understand that advice comes at a cost and what that cost is.

Concerns have been expressed about the opening up of an "advice gap" and it is indeed the case that many of the banks have withdrawn from the advice market for people with lower amounts to invest. It would be wrong to ascribe all of the withdrawals from the market to the RDR – at least one large bank pulled out before the RDR rules came in citing "a decline in commercial viability for such services over recent years." (That bank had also just been fined over £7m for investment mis-selling.) However banks are not the only source of advice for people with smaller amounts to invest. We commissioned research in the IFA market which found that most retail investment advisers would continue to serve clients with savings and investments of between £20,000 and £75,000 and that over a third of advisers surveyed planned to continue servicing clients with less than £20,000. However, we have also seen the emergence of new ways of accessing guidance and advice using on-line technology. These have the potential to offer people with straightforward needs and smaller amounts to invest an efficient and cost-effective route to market.

It is certainly the case that the RDR was controversial and had substantial political scrutiny by the Treasury Committee, whose overall view was that there needed to be more time for advisers to gain the new qualifications but that they were broadly supportive of the banning of commission. However, it is interesting to note that other countries, including the Netherlands and Australia, have also adopted this approach. Importantly, the idea of banning commission for non-tied intermediaries is now included in the text of an EU-wide Directive which will become law in all EU countries in late 2016.

During the development of the new regime, we committed to carry out a Post-Implementation Review of the RDR. The first part of that, involving a thematic supervisory exercise to assess compliance with the rules, has already begun and Phase 1 is complete. Our rules do not specify how advisers should charge for their service so this leaves firms with flexibility over pricing. We found that advisers were using a range of different ways of pricing their advice, for instance as a percentage of funds under management or a cost-per-hour. It is important, however, that firms make clear what their charges are and we have provided guidance to firms on how this can be done. The rest of the review will look at the impact that the RDR has had on the market by capturing data during 2014. However, we recognise that commission is only one form of inducement and have found from our thematic work that product providers have sought to use other inducements to influence intermediaries, using payments for systems, training and other things which have the potential to influence intermediaries' recommendations. As a result we have published guidance to address this type of issue.

I hope this is helpful and we would be happy to talk to you and your colleagues at any time about the developments in the market as the regulations bed in.

Yours faithfully

David Geale

Head of Savings, Investments & Distribution