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Treasury Committee

Retail Distribution Review

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Summary

The FSA's Retail Distribution Review (RDR) is a major reform of the regulation of retail investment advice and is due to come into force on 1 January 2013. It would in particular require advisers to have qualifications equivalent to a Certificate in Higher Education in order to practise, and remove the system of commission paid to advisers and replace it with Consumer Agreed Remuneration.

Some parts of the financial services advice market are not working properly for consumers. But some elements of the FSA's evidence have appeared weak to the Committee, and the FSA itself concedes that its proposals would cause large numbers of Independent Financial Advisers (IFAs) to leave the market. This would reduce competition and choice for consumers, at a time when the savings rate is already too low. A delay of 12 months in the implementation of the RDR in order to allow advisers to satisfy the requirements of the RDR would be likely to increase the number of firms and advisers making the transition to the new system, while recognising the fact that many advisers have already complied with the RDR's requirements.

A higher level of qualification for advisers can help build a stronger professional ethos among advisers and reflect the considerable of responsibility advisers have for the financial welfare of their clients. By asking for a delay of a year to the introduction of the RDR, we hope that advisers will take the opportunity to meet the new qualification requirements. We also recommend the FSA use other means, such as providing for flexibility for advisers on a case by case basis, and allowing supervision of non-qualified advisers.

Customers of financial advisers have tended to see financial advice as 'free' under a commission-based system. The RDR will mean that customers will clearly see what they are being charged for advice. This is a healthy development but will involve a significant change in culture for the industry.

The FSA is to be replaced by the proposed Financial Conduct Authority (FCA). The FCA will have different objectives to the FSA, and the Treasury should state whether it is content that the RDR as currently constituted would be consistent with the objectives, as it currently sees them, of the FCA. The creation of the FCA also provides an opportunity to examine the accountability mechanisms that will apply under the new system of financial regulation. We will therefore instigate an inquiry to form a view on whether they are adequate.

1 Introduction

1. The Financial Services Authority's Retail Distribution Review (RDR) is a major reform of the regulation of retail investment advice. Our inquiry was prompted by significant concerns raised by sections of the industry over key elements of the Review. The RDR as a process has been underway for some time, and several elements of the RDR have now proceeded to final rules.

2. After releasing terms of reference for the inquiry, and in response receiving a significant amount of written evidence, we held a hearing with Mr Hector Sants, Chief Executive, Financial Services Authority, and Ms Sheila Nicoll, Director, Conduct Policy, Financial Services Authority, on 9 March 2011. The Financial Services Authority has also provided several pieces of written evidence, both prior to and after our hearing, which have been published with this report.

3. The scope of the Retail Distribution Review (RDR), undertaken by the Financial Services Authority (FSA) was limited to retail investments. The FSA noted that "Within the definition of retail investments we include, products and services such as pensions, investment funds (unit and investment trusts), life products (endowments, with-profits and unit-linked policies) and exchange-traded funds."[1]

4. There is a temptation to think that the RDR will only apply to Independent Financial Advisers (IFAs). However, as the FSA's evidence points out:

> Our new rules will apply to all advice given in relation to such products and services, regardless of the type of firm for whom any individual adviser works—so advisers within banks, asset managers, life insurers, sole traders, partnerships, stockbrokers, networks, IFAs or financial advice firms will be subject to the same regulatory environment.[2]

5. In our terms of reference, we concentrated on three particular topics: changes brought about by the RDR to the qualifications of advisers; their remuneration; and how their advice can be classified. These topics were raised by Mr Sants in a hearing with us on 23 November 2010.[3] As well as these particular topics, several other issues were raised in the written evidence we received, and we have provided commentary on some of them within this Report.

6. As stated earlier, we have received a great deal of evidence both for and against the measures within the Retail Distribution Review. We thank all those who took time to submit evidence. The evidence we have received is not one-sided, and the Committee has been mindful of the need not only to listen to the concerns and comments of the advisers affected, but also to representatives of the consumers they advise, as well as the regulator.

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1 Ev 23

2 *Ibid.*

3 Treasury Committee, Financial Regulation: a preliminary consideration of the Government's proposals, Seventh Report of Session 2010–11, Volume II, HC 430, Q 738

While our Report does not quote or reference every single piece of evidence submitted, all were taken into account when deciding upon the major themes discussed within this Report. Examples quoted are exactly that, examples of the views we received, and should not be considered the only view on each topic. We felt it would not be appropriate to consider the number of submissions in support of, or against, any measures within the RDR as precisely indicative of the level of support for that measure within the overall adviser community.

2 Qualifications

The upcoming change

7. Under the reforms being brought in under the RDR, the qualification level required for those providing advice on retail investment products will be raised. The current qualification requirements for those providing advice in the investment sphere lies at Level 3. Under the National Qualifications Framework, that equates to A-levels.[4] These new rules, as discussed earlier, will apply to all those wishing to provide advice on investment products. Following the RDR, the requirement will be for Level 4 qualifications, equivalent to a Certificate in Higher Education, or the first year of a degree.[5]

8. The FSA provided the following explanation as to why it had decided to move to this higher level of qualification. It stated that:

> We believe these changes are fundamental to equip the modern adviser to give good quality advice, and many advisers recognise that these skills have great relevance to their role.
>
> The enhanced professionalism requirements will also mean that advisers, on the whole, will be more competent than at any time in the past. As the professionalism and reputation of the adviser community increases, new entrants will be attracted to the sector. We are seeing more learning opportunities for new entrants and some firms are creating graduate recruitment schemes to accommodate some of the demand.[6]

The case for Level 4

9. In a letter to us prior to our hearing with the FSA, Mr Sants provided the following evidence to support the move to Level 4. He referred to the following pieces of evidence:

> —Our data from early 2010 on platforms shows the advice of advisers meeting current qualification standards was deemed to be "suitable" in 11% of cases and 89% of advice was either "unclear" or "unsuitable". The advice of advisers with a similar qualification to the new standard was suitable in 43% of cases, "unclear" in 32% and unsuitable in the remaining 25% of cases. Cases from the few advisers who had attained qualification in excess of the new standards indicated that 71% were classed as "suitable" advice and were "unclear" in 29% of cases.
>
> —A review of the quality of financial planning advice by an expert panel from Australia (ASIC 2003 study) also showed that plans completed by advisers with a

4 http://www.ofqual.gov.uk/qualification-and-assessment-framework/89-articles/250-explaining-the-national-qualifications-framework, Ev 28

5 *Ibid.*

6 Ev 28

> "certified"/qualified status (around QCF [Qualification and Credit Framework] Level 6) scored better than unqualified advisers.

The use of this Australian study brought particular condemnation from others who provided evidence to the Committee. Derek Gair, GDC Associates, wrote to us as follows:

> Numerous studies conclude the proposals fail to match the original intention of RDR and that they will result in the deprivation of mass-market advice. Yet [the] FSA rely on an outdated study (Australian Securities & Investment Commission) of just 124. This study is not representative of the UK market, being filled with inaccuracies—8% of the study group were rated "poor" purely because they failed to provide a general guide to the customer (nothing to do with the advice aspects whatsoever)—15% of the overall score was based on the adviser supplying generic regulatory booklets NOT the quality of the advice. It is also true to say that the advisers were judged on providing a comprehensive financial plan not typical of day to day financial interaction with clients who generally require relatively simple financial advice and products to satisfy those requirements.[7]

10. The FSA in January 2011 provided further evidence as to why the move to Level 4 was justified:

> We based our decision to raise professional standards on recommendations from our initial industry working groups, which were refined and developed by PSAG, throughout which we carried out substantial consultation. This was supported by some focussed research on how higher professional standards might lead to better outcomes. The research we obtained indicated that both in the UK and non-UK markets advisers meeting higher professional standards give more suitable advice. We have summarised this research, and the main findings, in the following paragraphs:
>
> (a) Professional Standards and Consumer Trust. This research found that in the longer term, measures to improve compliance with professional standards may result in improved consumer trust and engagement in markets.
>
> (b) Professional Standards Bodies: Standards, Levels of Compliance and Measuring Success. This research demonstrated that professional bodies operating in markets with potentially similar consumer problems are taking a broadly similar approach to us in standard setting and establishing processes for monitoring and enforcement.
>
> (c) Linking Professional Standards to "Consumer" and Other Outcomes in the Financial Sector. The research presents two case studies showing positive links between standards and outcomes. The first was a review of financial planning advice by the Australian regulator and consumer agency. The evidence suggests that qualification at the level of higher education and engaging in Continuing Professional Development (CPD) contribute to increasing professionalism and

7 Ev w182 *[Note: references to 'Ev wXX' are references to written evidence published in the volume of additional written evidence published on the Committee's website]*

> improving the quality of financial advice. The second study aimed to identify whether qualifications of fund managers could be used to explain differences in the performance of their funds. The research concludes that clients with advisers holding professional membership and/or higher qualifications ought to improve outcomes.
>
> (d) Platforms thematic review. Our data from early 2010 on platforms shows the advice of advisers meeting current qualification standards was deemed to be "suitable" less often than that of advisers with a similar qualification to the new standard.
>
> (e) Major banking group—internal review: The review analysed quality of advice provided by level 4 and level 3 advisers. Analysis of fail rates (a measure of "poor" quality) and risk scores (a blend of Key Performance Indicators including complaints) showed that indicators were better for higher qualified advisers.[8]

11. It was not just the FSA's evidence base for the move to Level 4 that was criticised. Concern was also expressed at how far a qualification could prevent mis-selling and further complaints, especially given the level of complaints in other professions with higher qualification levels. Mr Simon Mansell, Temple Bar IFA Ltd, explained that "Six years of exams and a very restricted complaint definition didn't stem complaints against solicitors!".[9]

12. Other evidence we have received also questioned whether higher qualifications alone would work. RBS noted that "Higher qualifications do not in themselves equate to increased professionalism and must be seen in a wider context of measures that will inspire consumer confidence and trust."[10] Others were more forthright. Mr John Amey, Cavendish Independent Financial Advice, stated that:

> It is a false assumption that passing exams reduces mis-selling. The ability to pass exams is no guarantee of honesty and integrity. The most highly qualified can still be corrupt if they choose. If the FSA seek to control any mis-selling through a better qualifications framework, this must fail. Further, no account has been taken of the fact that mis-selling has decreased year on year in the IFA sector—look at the Ombudsman service figures.[11]

13. When we suggested to Mr Sants that qualifications would not get rid of malicious intent, he acknowledged that "it would be wholly wrong for us to suggest that we are going to eliminate all mis-selling, and I don't think we suggest that".[12] He noted that "the reality of the cost of regulation is such that even if we were the most efficient policeman, for the sort of money and resources we have we will still have mis-selling on top of that. There are

8 Ev 31-32

9 Ev w42

10 Ev w259

11 Ev w91

12 Q 90

certain types of wilful deception that, however good your regulatory policing process is, the cost to detect would not be acceptable”.[13] But he continued:

> The question is, is this a significant improvement in the round on where we were? We believe it to be. We believe we have good, solid evidence to that effect and that is why we should go forward. A number of very useful, sensible points have been made, which I would like to consider on the margin, but on the central thrust of the argument, it still seems to me that the logic is compelling.[14]

14. Others though supported the move to Level 4 qualifications. Which? was adamant that there was a need for higher qualifications. In its evidence, it argued that:

> The current minimum qualification a financial adviser is required to hold before they can give advice is set at Qualifications & Credit Framework (QCF) Level 3. This is equivalent to an A-Level examination. We cannot see how this is remotely appropriate as a minimum standard for an individual whose advice has such an enormous impact on people’s lives. When you compare the level of training necessary with that of an accountant or a solicitor it is hardly surprising the current qualification standards do nothing to support consumer confidence in the industry and the quality of the advice they receive.
>
> As a result we welcome the moves in the RDR to improve the professionalism of those offering financial advice and selling financial products. Many advisers are already qualified at a level above the level required by the new proposals so will not be affected by the change. Many others are taking action to increase their level of qualification and the FSA has taken steps to ensure there are a range of options available so that those advisers who do not wish to sit written exams can take an alternative route.[15]

There were also those in the industry who also supported the move. Nick Bamford, Informed Choice Ltd, was adamant that:

> The RDR introduces a requirement that advisers are qualified to QCF Level 4 by the start of 2013. The current benchmark entry level of formal qualification is QCF Level 3. In the highly technically complex world in which financial advisers operate, Level 4 should be accepted as a minimum qualification level. Level 3 is simply inadequate in ensuring competent advice to the consumer.[16]

15. **The evidence provided by the FSA on the need to move to Level 4 was weak. Nevertheless, the Committee sees some merit in a move to a higher level of qualification, both as an opportunity to build a stronger professional ethos amongst advisers and as a reflection of the high level of responsibility financial advisers have for the financial welfare of clients. Trust in financial services must be key.**

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13 Q 90

14 *Ibid.*

15 Ev w281-282

16 Ev w18

The ‘cliff-edge’ and ‘grandfathering’

16. Some also took exception to how the Level 4 requirement would be implemented. From 1 January 2013, those without Level 4 qualifications will be unable to provide advice on retail investments. There was vociferous criticism of the ‘cliff-edge’ nature of these reforms, and many wanted some form of ‘grandfathering’. Grandfathering in this case would allow certain people to be regulated under the system, without first attaining the new Level 4 qualification requirements.

17. Several of those who provided evidence were close to, on or above, the current state-pension retirement age. These older IFAs felt it unfair that they would have to undergo further qualifications where the benefit to them would be limited, as they might retire soon. As an example, Paul Naylor, A P Financial Services UK Ltd, informed us that, “At age 61 [...], I dispute the need that after 20 yrs as an IFA, without any customer complaints, that after 2012 if I do not take additional exams to bring me up (so called) to the diploma level, that I am deemed no longer competent to advise retail clients”.[17] As APCIMS noted:

> FSA opposition to any form of “grandfathering” for older staff without relevant qualifications effectively means that the experience/expertise that these individuals have acquired over decades of looking after clients count for nothing and may, in many cases, be lost to the industry as advisers choose to retire rather than having to ‘re-qualify’.[18]

18. These were not the only complaints against the cliff-edge approach being followed by the FSA. Many of those who wrote to us also felt that it was unfair to allow those who were both experienced, and complaint free, to be removed from the industry, while others felt that both the cost of the examinations, as well as the time required to study for exams, were of significant concern. Evidence we received from Jason Georgiou raised many of these concerns:

> I have been in the industry for 30 years now, had no complaints and keep my knowledge up from both my experience and ongoing CPD. I have started studying to the level of RDR already but with great reluctance. The cost with my examining body, IFS, is £600 but it is not just the monetary cost which I consider to be excessive but also the time that will be required to complete the studies and examinations. I would expect it will take in the region of 100 hours to study information for an exam which will be nothing more than a test of memory rather than aptitude for the job.
>
> So that means 100 hours at least out of my working time. This is when I am trying to run a business, earn money for that business, keep up to date with compliance issues (of which there seems to be an endless flow), keep staff in a job etc. etc. Just to give you a practical example I received my exam coursebook for the second element (I recently passed the first and feel no more qualified to do my job) at the beginning of

17 Ev w366

18 Ev w263

> November. It was 25 November before I had chance to even look at the first page of the study text as I was so busy actually doing the job which pays the bills.[19]

19. But support for some type of grandfathering was not universal. Some highlighted that there had been several years for those affected to begin to move towards gaining Level 4 qualifications. The IFS School of Finance noted that "In 2008 the Financial Services Authority (FSA) confirmed that new minimum qualification standards at level QCA (now QCF) Level 4 would be introduced. Those advisers who were not appropriately qualified were therefore fully aware that they had four years to obtain the necessary qualifications".[20]

20. Consumer groups were also supportive of the FSA's approach. Which? was firm in its opposition to any 'grandfathering'. It stated that:

> We appreciate the fact that any regulatory change on this scale can be difficult for some of those already in the industry to handle. However it is clear that the current service offered by the industry as a whole is simply not good enough and we would strongly oppose any proposals to introduce grandfathering rights. While in many cases experience does bring wisdom it simply cannot be said that, just because someone has been in the industry for a long time, they provide a good service to consumers. Widespread grandfathering would also result in a significant number of bank advisers and IFAs being automatically upgraded to the required level, which would mean that it would take a generation for the higher standards of professionalism to implement. This would be totally unfair on the significant number of IFAs who have already put significant effort into gaining the new qualification.[21]

21. This unfairness to those who had already gained, or were proceeding towards, Level 4 qualifications was discussed in other submissions we received. Mr Andrew Reeves, The Investment Coach Ltd , argued that "To 'water down' the requirements now would also be inequitable to those that have pursued further qualifications already".[22] Evidence was also provided to show that many had already qualified at the level required, or intended to do so. The FSA informed us that "In March 2010, 49% of all advisers were already appropriately qualified"[23] and that "82% expected to remain as a retail investment adviser".[24]

22. The FSA has consistently taken a firm line on such wide-spread grandfathering. In its further evidence following our hearing with them, the FSA put up the following defence of its cliff-edge approach. It argued that:

19 Ev w7

20 Ev w73

21 Ev w282

22 Ev w53

23 The FSA noted that "Whilst 49% of all advisers were already qualified with an appropriate qualification in March 2010, please note that this table includes 3% of advisers who held a MLIA designation that was incorrectly classed as RDR compliant in the research"; Ev 34

24 Ev 34

> We are concerned about the lack of consumer trust and believe there is a need for a step change for the whole financial advice sector. This explains why the increased professional standards will apply to all advisers, even though we do recognise that there are many advisers who have considerable experience.
>
> This position is supported by our extensive consultation on the RDR, which found broad industry and consumer consensus that higher professional standards are necessary, with the majority of respondents opposed to grandfathering. We also do not see how advisers can evidence their improved professional standing if they do not demonstrate this through an objective measure—a qualification—that tests this. This goes to the heart of restoring consumer confidence and trust.
>
> We consider our changes to be a fair and proportionate step in meeting the consumer protection objective, consistent with our legal obligations. Allowing grandfathering for a proportion of advisers, perhaps based on age, experience, a good track record (as evidenced by no or few complaints), or some combination of these, would create its own problems and would lead to different issues of 'fairness'. Creating conditions under which grandfathering is acceptable would inevitably lead to challenge from those advisers that didn't meet the precise conditions set out. Allowing grandfathering would also be unfair to that majority of advisers who are either already appropriately qualified or who are well on the way to being qualified.[25]

Older advisers

23. Many of those who submitted evidence suggested that the move to a higher qualification level via a cliff-edge approach would lead to a reduction in the number of IFAs in the market, and a subsequent reduction in the amount of advice available. Adviser Alliance provided the following evidence as to the potential scope of the problem:

> The prospect of taking further examinations has persuaded many older advisers, with over 20 or 30-years experience, to leave the industry, albeit unwillingly. A figure of 20% is accepted by the FSA, although numerous independent surveys have placed a figure of between 20% and 50%.
>
> 1. Figures provided exclusively to Financial Adviser by Matrix-Data Solutions showed there were 32,000 advisers in 2008. However, this plunged to 30,198 in 2009 and currently stands at 28,714. A 10.3% reduction as at June 2010.
>
> 2. Robin Stoakley, Head of Intermediary Business at Schroders said, "I do see up to 30% of the IFA market leaving".
>
> 3. TISA Director, Malcolm Small, "How many will leave? Perhaps 40% of the adviser market will go as a result of the RDR".
>
> 4. Deutsch Bank, "There has been industry talk of 30% or even 50% of IFAs exiting the industry post 2012, which is not impossible"

25 Ev 32

> 5. Rachel Vahey, head of pensions development for Aegon, stated, “The way that the RDR is panning out is that it will restrict access to advice”.
>
> 6. Financial Services Skills Council director, Sarah Thwaites, who previously headed the FSA Training Dept, stated, “The danger is that if too few existing advisers meet the new qualifications level or the industry does not find it cost-effective to offer advice to the mass market, the very important aim of achieving good consumer outcomes may be lost.” [26]

24. As the Adviser Alliance evidence makes clear, many who wrote to us were worried that older IFAs were most likely to leave the market on implementation of a cliff-edge approach. Many emphasised the costs involved in gaining further qualifications, compared to the limited period they may wish to work. As Mr Chris Dodd, an Independent Financial Adviser, told us:

> The RDR requirements, as they stand, are extremely unfair on the older IFA. It creates a “cliff edge” scenario whereby someone like myself will be, after 30 years' service, disqualified from practicing on 1 January 2013. I see no reason why someone like me should take a raft of expensive exams for a few more years service.[27]

Others however were less sympathetic to this line of argument. A sceptical Mr Chris Petrie, an owner of an IFA firm, warned us:

> You will be told that financial advisers are highly experienced (particularly the older ones) and that they should not suffer the stress and cost of further higher level qualifications by examination. But the truth is that we provide advice about products that sit in a highly technically complex world. Many financial advisers have out of date qualifications. The experience that they claim is also dated and not necessarily conducive to the delivery of high quality financial advice in today’s world.[28]

25. However, we were concerned by the potential loss of advisers from the market, and therefore asked the FSA to provide further evidence on the age profile of those to be affected by the RDR. The FSA also told us that NMG in March 2010 estimated that there are 48,000 advisers impacted by the RDR.[29] Table 1 shows the age profile of all advisers, which includes IFAs, but also all the other types of advisers impacted by the RDR. The FSA added that “looking only at those working for IFA firms, this shows that IFAs have a slightly older profile with 14% aged 55-59 and 18% aged 60 or more”.[30]

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26 Ev w191

27 Ev w340

28 Ev w171

29 Ev 32

30 *Ibid.*

Table 1: Age profile of all advisers impacted by the RDR

Age-band	All advisers
18-29	4%
30-39	21%
40-49	35%
50-54	16%
55-59	11%
60+	12%
No answer	1%

Source: Financial Services Authority, Ev 33

26. Given the significant proportion of advisers aged over 55, it is also necessary to note that for this age group, the FSA's own data indicated their expectation of leaving the market were higher than the average for all advisers, as shown in Table 2. While as can be expected more of those aged over 55 were retiring as planned than in the entire adviser group, the RDR appears to have also led more of those aged 55 or over retiring earlier than planned, or stopping advising on retail investments, than in the overall adviser group.

Table 2: Advisers' future intentions

Age-band	Aged over 55	All advisers
Likely / definitely remain as a retail investment adviser	59%	82%
Retire as planned	17%	5%
Retire earlier than planned	8%	3%
Stop advising on retail investments	5%	2%
Leave the industry	3%	3%
Other / don't know	7%	5%

Source: Financial Services Authority, Ev 34

27. Given the potential for older advisers to leave the market, 'grandfathering' by age or experience has been discussed. When dealing with the question of whether there could be grandfathering for older advisers, the FSA noted its need to act within existing equality legislation. It told us that:

> The Equality Act 2010 requires us to have due regard to the need to eliminate unlawful discrimination in the exercise of our functions. This includes discrimination on the basis of age. Given our consumer protection statutory objective, any grandfathering rights would need to be granted on the basis of a certain number of years' experience rather than upon age alone. This is because an

adviser who is, for example, 60 years old will not necessarily have worked in the financial services industry for a significant number of years.

Allowing grandfathering on the basis of a certain number of years' experience would indirectly discriminate against younger advisers. Therefore, in order to comply with our obligations under the Equality Act, we would have to be able to justify this indirect discrimination on the grounds that it is a proportionate means of achieving a legitimate aim. We do not consider granting grandfathering rights for more experienced advisers to be proportionate on the basis that more experienced advisers will need to invest significantly less time acquiring the necessary knowledge to pass the qualifications and granting such rights would not be consistent with our statutory duty to achieve an appropriate degree of protection for consumers.[31]

28. **We are concerned at any potential loss of competent and experienced advisers from the market. Any restriction of any trade must be carried out with due consideration for the livelihoods of those affected. However, the FSA has argued that it cannot because of the provisions of the Equality Act provide a blanket grandfathering process either on the grounds of age or experience. In an effort to achieve the legitimate aim of maintaining competition and choice in the advice market, we recommend that the FSA consider instituting a process whereby it provides for flexibility for advisers on a case-by-case basis.**

Less of a cliff-edge, more of a slope

29. Not all those advocating a move by the FSA away from a cliff-edge approach advocated a simple pass-through to the new regime with no need for further qualification. We received several suggestions of ways in which a more gentle approach into the new regime could be provided. While rejecting a mass grandfathering approach, AIFA made the following comments:

> we are concerned that a fixed deadline for all advisers will cause unnecessary hardship for some advisers and their clients when greater flexibility would not undermine the effect of the reform. We therefore call on FSA to take a more flexible and pragmatic approach with regard to the deadline for those advisers who are demonstrating commitment in attaining Level 4 as the deadline approaches. The objective must be to ensure that the maximum number of advisers are able to trade at the higher level of competence and this is not best served by simplistic lines in the sand. We believe that FSA should make it clear the basis on which they would entertain dispensation requests from firms for an extension of the timescale to complete their qualifications.[32]

The Financial Services Skills Council suggested another route to prevent a 'cliff-edge' type approach. They suggested a supervision approach as follows:

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31 Ev 32

32 Ev w228

> We are not in favour of grandfathering if this just means a tick box approach which allows you to carry on in the industry. However it might to be possible to introduce a transitional process used by a previous regulator the Personal Investment Authority (PIA). It allowed a period of transition, if the new standards were not achieved within two years, advisers were allowed to continue working under the supervision of an appropriately qualified supervisor, whilst they continued to gain the qualifications.[33]

30. In its evidence to us however, the FSA resisted attempts to provide further leeway to advisers that would not make the cut-off of RDR implementation. It argued that it had already been lenient enough, and that a supervisory approach would not work. They stated that:

> We also considered a working group recommendation in 2008 to permit existing advisers a grace period of two further years (to end-2014) under supervision to allow them longer to get qualified. However, we had serious concerns about the supervision of these advisers being effective. At its most unacceptable supervision carried out within firms is a form of remote file checking with no coaching, mentoring or training of the individual. Instead, we found an acceptable compromise and said that those who are on course to complete, or already hold, an appropriate qualification can continue with this. This meant that from November 2008, existing advisers could continue or begin their studies using existing higher level qualifications, without having to wait for the new qualifications to be made available. Overall, our view is that, by the end of 2012, established advisers will have had enough time to meet the new standards.[34]

31. **Later in this Report we recommend that implementation of all aspects of the RDR be delayed by twelve months, in order to maintain choice and competition in the advice market. We recommend that the FSA temper the 'cliff-edge' nature of the current reforms. A system of proper supervision, along with the additional year, would provide some leeway, while maintaining the Level 4 requirement.**

Legality

32. Some of those who wrote to us doubted the legality of the FSA's action in preventing grandfathering.[35] When we questioned the FSA representatives on this, Ms Nicoll replied:

> Yes, we have taken legal advice on this. There have also been challenges in the context of human rights law and we have satisfied ourselves that the powers that we have are sufficient, that it is legal and that we are doing this within the law.[36]

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33 Ev w139

34 Ev w29-30

35 Ev w238

36 Q 16

Beyond Level 4

33. Several of those providing evidence suggested that Level 6 (equivalent to a degree) should be the minimum level of qualification.[37] And in its evidence to us, the FSA also noted that there had been pressure for this level of qualification. It stated that:

> In developing our policy and rules, we consulted on a proposal from our industry groups that advisers wanting to provide a wholly independent service should have to achieve qualifications at graduate level. While many advisers tell us that they want to become more professional, feedback was that this level was too high for the market at the moment. We therefore settled on the vocational equivalent to the first year of an academic degree as this level requires more relevant skills than is required by the current standards.[38]

When we questioned Mr Sants on whether there were plans to move to Level 6, he replied:

> I wouldn't take it as a formal plan. I recall a discussion in an earlier Committee here where it was questioned whether we had set the qualification at a high enough level, and I think we responded at the time that this is something we would keep under review. However, we don’t have a formal intention to do this at this point in time.[39]

34. **It is conceivable that in the future the FSA may require Level 6 qualifications for advisers. We would expect there initially to be a full study undertaken by the FSA (or its successor) before any move to Level 6, using a large sample of UK based advisers, looking at the merits of such a move. Should implementation then be proposed, we would expect, in view of the significant difference between Level 4 and Level 6, there to be a far longer lead time to implementation, with a wide-range of potential routes available to those wishing to upgrade their skills and qualify under any new regime.**

37 For example: Ev w103, w279

38 Ev 28

39 Q 20

3 Commission

Introduction

35. One of the ways in which IFAs are currently paid for the advice they provide is via commission on the products bought by some of their clients. This commission is agreed between the product provider and the IFA, but is fully disclosed to the client. Some IFAs rebate part of that commission to their client.[40] However, the FSA noted potential reasons why such a system of remuneration was inappropriate. It told us that several biases existed in a commission based remuneration environment:

- Provider bias—advisers recommending a provider's products on the basis of commission payments;
- Product bias—some products carrying higher commission payments than others, biasing advisers' recommendations to those products paying higher commission; and
- Sales bias—generation of income is contingent on a sale being made due to the advisory firm's business model being dependent on payments of commission. This can lead to an incentive to "churn" the client's investment in order to generate income.[41]

Consumer Agreed Remuneration

36. Given the potential biases it argues are ingrained by a commission-based system, the FSA has decided, as part of the RDR, to move to a system of Consumer Agreed Remuneration. The essential purpose of the move to Consumer Agreed Remuneration is to ensure that the client and IFA agree the amount of remuneration to be paid to the IFA, rather than the IFA and the product provider agreeing the amount. Commission in its present form will no longer be an option. In his letter to the Committee, Mr Sants provided this description of the new system:

> The new rules require advisers to discuss and agree with their customers how they will pay for advice, and there are a number of different charging structures that might be adopted. Payment could be a fixed charge, it could be based on an hourly rate, reflecting the time taken by the adviser to perform the service, it could be based on a % of the amount invested or through some combination of these methods. Some customers with a lump sum to invest may wish to pay for advice upfront. Others may wish to invest a regular amount each month and so be unable or unwilling to pay for advice at the outset. In such cases there are a number of different charging structures that can be adopted, for example, spreading the payment over a period of time. This might be by means of a regular payment to the adviser, or if the

40 Ev w165

41 Ev 24

product provider agrees, customers would also be able to ask for their adviser's charges to be paid out of their investments. The difference between this and the present system of payment by commission is that it would be for the customer and adviser to agree how much should be paid. The product provider's role is simply to collect and pay the agreed amount.[42]

37. Much of the evidence we received was critical of this move. One of the arguments raised was that it removed a payment choice from the consumer. Mr Maurice Manasseh told us:

> There is already a choice available to consumers between fees and commissions. By removing the option of commissions it means that most of middle England will not pay a fee for consultation about insurance, investments or savings for either short or long term needs. The RDR is trying to change a century of habit in one day. Why can't the consumer continue to have a choice?[43]

38. Others argued that a fee-only approach would make advice the preserve of the wealthy, who may already be paying for their advice by fees anyway. SimplyBiz told us that:

> It is vitally important to note that independent advice is not at present the preserve of the wealthy with currently around 60% of IFA clients being C1 or below. If consumers are forced to pay a fee for advice it is inevitable that many who would benefit from independent advice will not seek it. Recent surveys have shown that across all groups only between 4% and 10% of clients would prefer to pay for their advice by way of a fee. It is claimed that the radical market intervention of banning commission is necessary because of the extreme bias and consumer detriment caused by the present system. This claim is not supported by the FSA's research.[44]

39. Some however were supportive of the FSA's approach on commission. Alan Smith, of Capital Asset Management Plc told us that:

> [...] the removal of payment from a third party (ie commission) significantly improves the integrity of the advice offered—in simple terms if the only way I can be paid is to sell a commission bearing product (rather than, for example, pay off debts or buy NS&I products) then the advice is highly likely to be swayed towards the sale of the product. By asking the client to pay—for true, impartial advice, I am free to give fully considered opinion of the "what would I do if I were him" style—the advice is truly unhindered by conflict of remuneration.[45]

42 Ev 22

43 Ev w164

44 Ev w148

45 Ev w58

Will consumers pay fees?

40. One of the core concerns expressed to the Committee is over the seeming reluctance of consumers to pay for financial advice via a fee based system.[46] Terry Collins, of Terry Collins Associates, outlined the problem as follows:

> The majority of clients within my practice are every day people on ordinary and average incomes. When they have a sum of money which they wish to invest, or when they are looking for advice to take retirement they simply will not be willing to part with hard earned cash for the type of advice which they have in the past received for free. Of course the advice has not really been free and the cost of adviser remuneration is reflected in the charging structure, however clients perceive it to be free. The clients are made fully aware of the product provider charges and are perfectly happy to pay these charges but I assure you they will not be inclined to pay anywhere near the same levels when the fee is to be paid directly.[47]

Many others also emphasised the reluctance of consumers to pay fees. For instance, John Amey, of Cavendish Independent Financial Advice, noted that:

> The proposed ban on commission and fee charging will prevent clients from seeking advice because they cannot or will not pay a fee for advice. Why should my clients lose the right to pay via commission if they wish? Commission is disclosed and is no secret. I choose products that are the best for my clients and that is why, along with so many IFAs, we have solid, honourable businesses. Charging fees for advice will have a negative impact—look at what happened when Opticians and Dentists charged for checkups.[48]

When we questioned Mr Sants on the reluctance of consumers to pay fees, and whether this would restrict take-up of advice, especially for those on lower incomes, he told us:

> There is reasonably good evidence of the willingness of potential investors to pay fees, but that does correlate with the available amount of money for the investment and clearly at the lower end [...] there is a risk that they would not want to pay, which is why we are encouraging the development of the other advice channels and it takes us back to our simplified advice point earlier. So, we do absolutely acknowledge that moving to more of a fee-based environment in terms of the overall marketplace working requires simplified advice and other services to also be available.[49]

46 It should be noted that Consumer Agreed Commission does allow the fee to be taken by the product provider from the initial investment or early payments. However, the amount must be agreed between the customer and the adviser beforehand.

47 Ev w85

48 Ev w91-92

49 Q77

Disclosure

41. Many of those who wrote to us felt that there was already adequate disclosure within the market, and that further reform towards Consumer Agreed Remuneration was not necessary. Terry Collins, Terry Collins Associates, told us that "Advisers and product providers are required to be compliant and existing legislation dictates that every minute detail of the charges and costs are highlighted and brought to the attention of the customer, it really cannot become any more transparent than it already is".[50] This point was reiterated by John Amey, of Cavendish Independent Financial Advice, who described the disclosure process already in force:

> Currently, an IFA has to tell clients how he is paid. He has to offer a fee basis, but can choose (as most IFAs do), to offer additionally the option of payment via commission. My clients choose. I explain the commission comes out of the product and in the illustration of the product, the commission is shown. The key facts documents tell the client what commissions are payable for various types of product.[51]

Creative Benefit Solutions felt that given this level of disclosure the problems with the current remuneration system stemmed from the FSA's inability to police their own systems. They told us:

> The ban on commission and indemnity terms (factoring) does not act in investors' best interests and removes investor choice. We believe that the FSA already has all the powers it needs in its existing rules and under their Treating Customers Fairly (TCF) initiative to protect investors against commission biased advice and abuse. Any failure in the present regulatory system reflects a failure of the FSA to properly enforce its own rules.[52]

42. The FSA itself acknowledged that there had been a system of disclosure in place. The main point it put to us was that such disclosure was not sufficient, if it was seemingly not acted upon or absorbed by the consumer. Ms Nicoll told us that the FSA "have a disclosure rule now and [...]. The evidence from our consumer research is that consumers don't listen to that disclosure; they don't understand the effect."[53] In their written evidence, the FSA provided further detail on how they thought commission led the public to undervalue financial advice. They noted that:

> The role of the intermediary is to provide advice to the consumer. However, advisers' remuneration structures are such that the cost of advice (commission) is often built into the product charges. Our consumer research shows that only around half of respondents understood how the long-term value of their product would be affected by commission. Consumers are left with the impression that advice is free. The

50 Ev w85

51 Ev w91

52 Ev w133

53 Qq 79-80

> adviser's interests are often aligned with the provider, not the customer. Competition between product providers tends to focus on encouraging the adviser to recommend a particular product. As a result, product features, including charges and commission, provide incentives to attract the adviser rather than focusing on product features which are attractive to the consumer (such as delivery of good performance and long term growth or income).[54]

43. **There is already full disclosure to customers of the cost of the advice they receive, whether paid for via commission or fees. However, as both advisers and the FSA have told us, many consumers appear to see financial advice as being 'free' under a commission based system, despite adviser disclosure of its actual cost. The introduction of consumer agreed remuneration under the RDR will potentially create a market price for advice. Given that some consumers will have seen advice as 'free' beforehand, it must be assumed that the setting of this price will lead to a reduction in the consumption of advice, just as would be the case in any normal market where the price of a good rises. But this rise in the price of advice may also lead to consumers undertaking greater scrutiny of the advice they are paying for, and who is providing it. Given the past mis-selling episodes of the industry, this must be a welcome development. However, we do not underestimate the scale of the change in culture that this will involve for an industry based so heavily on individual relationships.**

Removal of trail commission

44. In its evidence to us, the FSA noted that "The new rules will also prevent advisers from receiving ongoing commission ('trail' commission) where they are not providing the customer with an ongoing service".[55] Consumer Focus were concerned that the need for trail commission appeared confused. They explained that:

> Trail commission is paid on the fund value until the policy is either transferred to another provider or used to purchase an annuity/drawn down. The purpose of trail commission is far from clear. Many IFAs see it as compensation for the on-going servicing of their clients. This sentiment is echoed on the trade association's own website. It says: "there may be annual commission payments to cover ongoing advice from your adviser over the lifetime of your products". Others see it solely as deferred initial commission. A number of pension providers require IFAs to continue to act on behalf of their client to receive trail commission and will cease to pay trail commission if they believe the IFA is no longer servicing the client.[56]

45. Trail commission is however an important part of the remuneration system for financial advice, especially to IFAs, as the future stream of income from trail commission allows a current value to be attributed to an IFA firm. As Consumer Focus noted "many IFAs are leaving the industry in the near future and they will often want to develop an on-

54 Ev 24

55 Ev 28

56 Ev w257

going stream of income, which adds value to their business before it is sold".[57] Evidence received from Mr Roger Parkes, Ovenden Parkes Ltd, shows how some advisers charged trail commission, and felt it to be a perfectly fair part of their remuneration. He noted that:

> As a small company and an individual IFA, I have spent the last 25 years building up my business. I always took 3% plus 0.5% trail on all business. I believed this to be entirely fair.[58]

Consumer Focus provided evidence on the charging structure for pensions, noting that:

> The initial commission might be 30% to 50% of the first year's premium for a regular pension plan, or 4% to 6% of a one-off transfer. Trail commission is typically 0.5% of the fund value. (Some pension providers pay IFAs renewal commission based on regular payments into the pension instead of trail commission.)[59]

46. However, Consumer Focus warned that "The existing charging structure for advice is poorly understood. Most (56%) personal pension holders who took their last personal pension with an adviser have heard of trail commission. Of these, only 46% are aware of whether their adviser received trail commission".[60] This corresponded with evidence from the Financial Consumer Services Panel, who stated that:

> GfK research found that while most consumers were aware that financial advisers were paid by way of commission from providers, the majority were unaware of the existence of trail commission at all. Often, they did not know specifically how they were paying and sometimes "the absence of a visible payment means that advice feels free".[61]

47. Even fund providers were concerned about the impact of trail commission on the advice provided by advisers. Robert Davies, Fundamental Tracker Investment Management Ltd, told us that:

> Traditionally new entrants break into a market by offering lower prices. However, this route is more difficult for collective funds because of the widespread use of trail commission. Typically a fund will have an annual management charge of 1.5% and 0.5% of that will go to the IFA. In effect this is a distribution cost. Offering a low cost fund at 0.5%, as we do, means that there is no, or very little, scope to provide a trail commission to the IFA. He or she therefore has no incentive to sell a low cost product whatever the benefits for the client.[62]

48. We also questioned the FSA on concerns that trail commission in another form would continue after the implementation of the RDR, Ms Nicoll told us that:

57 *Ibid.*

58 Ev w62

59 Ev w257

60 *Ibid.*

61 Ev w215

62 Ev w46

> we are certainly saying, and our rules very clearly say, that if post the RDR, a firm is taking trail commission, then individuals will still be able to pay for the product through the product, but if trail commission is going to be paid going forward that has to be clearly against the provision of a continuing service and that the individual should be able to say, "I don't want that service any longer and therefore I want you to stop receiving trail commission".[63]

49. **Trail commission where advice is not offered is very difficult to justify. However, we note the initial impact its removal may have on the value of IFA firms, and recommend that the FSA analyse the impact of this measure on the market for advice, and especially on the small-firm IFA market. We discuss later in this Report concerns expressed to us about an increase in trail commission being awarded in the run-up to the implementation of the RDR.**

Removal of factoring

50. One of the changes brought in by the RDR concerns the use of factoring (indemnity commission). The FSA provided the following explanation of both the change being brought in, and the original remuneration set-up:

> Under our new rules product providers will be allowed to offer consumers the choice to have adviser charges paid out of their investments. In particular, consumers who contribute to their investments on a regular basis will be able to spread the cost of initial advice fees, thus helping to maintain access to the market.
>
> However, unlike the current indemnity commission, providers will not be allowed to advance this money to advisers before it has been collected (a practice sometimes referred to as factoring). Effectively this means that providers cannot use their own funds to advance this money to advisers before it has been collected from regular premium insurance products (such as endowments), as they currently can by using indemnity commission—where a future stream of commission payments is rolled up and paid in a (discounted) lump sum when the product is sold. It should be noted this is only a feature of the insurance market and does not feature in other product markets such as mutual funds.[64]

51. AIFA provided the following defence of the need for factoring of regular premium products:

> Factoring is the cost-effective way that consumers can receive advice at outset, with the cost spread over a period. It is not practical for an IFA to charge hundreds of pounds up front when the savings plan may be only tens per month, and if the adviser can only recover the cost of his advice over a long period the focus is likely to shift away from serving customers who are seeking regular savings.[65]

63 Q 76

64 Ev 31

65 Ev w228

Justice for Financial Services were clear as to the impact they considered the ban on factoring would have. They told us that:

> The economics of advising on regular pension contributions have already become doubtful for IFAs. The RDR will make giving such advice very unattractive—the ban on factoring will stop IFAs capitalising a future income stream based on a small annual charge. They will have to levy an upfront charge, which will be a high proportion of the first year's payments. IFAs will largely withdraw from this segment of the market.[66]

AIFA warned against under-estimating the impact that the ban on factoring might have. They explained that:

> we are extremely concerned by FSA's decision to ban the practice of "provider factoring", which we believe is critical for preserving and encouraging a much-needed regular savings culture. Whilst some would have us believe regular savings are inconsequential, ABI figures suggest otherwise. In Q3 2010, new regular premium investment savings and individual pensions together amounted to 14% of the entire amount invested in investment savings and individual pensions.[67]

52. The FSA were again robust in the defence of their proposals, and provided us with the following arguments for their ban on factoring:

> First, there is no evidence that the current indemnity commission, which proposals for factoring by product providers would replace, has led to any substantial increase in new saving. In fact, there is some evidence that it has encouraged churn in the market, adding to its lack of sustainability. Second, the discount rate in factoring offered by product providers would have the potential to bias the recommendations of adviser firms, as different discount rates would generate different "factored" amounts for the adviser. Product providers could compete not on the price of the product to the consumer, but on the discount rate that generates income for the adviser. We have discussed a single factoring rate with OFT and their view is that this would be anti-competitive. During pre-consultation and consultation, we asked the industry for reasons to allow product provider factoring but no compelling arguments were provided.[68]

53. **Consumer agreed remuneration will allow advisers to deduct their fees from regular payments made by customers for their products. Advisers would like product providers to be able to use factoring to create a single payment at the start of a product's life from this future stream of income. However, the FSA's concern is that the discount rate used in the factoring process by product providers can be used to influence advisers' decisions in a way consumers may find difficult to understand. We therefore agree with**

66 Ev w211-212

67 Ev w228

68 Ev 31

the FSA that allowing factoring by product providers would provide a potential bias in the market at odds with the overall transparency aims of the RDR.

Ensuring a level playing field

54. As we noted earlier, the RDR does not just apply to IFAs, but all advisers in the market. One concern expressed by IFAs was that the ban on commission could not be enforced against vertically integrated institutions (firms that include a product provider and a sales force), such as banks. AIFA explained the problem, and the need for policing, as follows:

> we call on FSA to be absolutely clear and public about how it will police its commitment to ensure a level playing field between IFAs and vertically-integrated firms on Adviser Charging. If they are not highly vigilant about attempts to cross-subsidise advice costs from product manufacturing, vertically-integrated firms may disguise the advice costs and so undermine the foundations of the RDR.[69]

Others were more strident in their remarks, concerned that IFAs rather than bank staff would be more closely monitored. Paul Raseta made the following remarks:

> The FSA is approaching this issue from entirely the wrong direction. Firstly, if the customer is to receive the correct advice, every adviser in the UK should be independent; be suitably qualified and authorised to provide recommendations across all need areas, having access to whole of market solutions from all product providers. Secondly, the FSA should then be required (by Act of Parliament) to apply identical scrutiny and rigour to monitoring the Banks' IFAs as they currently do with the present IFA individuals. Without being flippant, Hell will freeze over first.[70]

However, the FSA appeared aware of these criticisms, telling us that:

> We acknowledge concerns from some IFAs that despite these changes there is still potential for certain reward structures for in-house sales staff in banks and other advisory firms to cause the types of bias we have described. We are scrutinising those reward structures for in-house sales staff across the advisory sector.[71]

55. **The RDR concerns not just IFAs, but advisers in banks as well. We would be extremely concerned if banks found ways round the rules that will cover all aspects of remuneration. We recommend that the FSA (or its successor the FCA) report after one year, and then yearly, on the impact of the RDR on vertically integrated firms' remuneration structures, indicating breaches that have been found and what remedies the regulator has asked for. Only with such transparency will the IFA community be persuadable that it has not been unfairly impacted by the implementation of the RDR.**

69 Ev w228

70 Ev w310

71 Ev 28

VAT

56. Another concern expressed about the change to a fees based system for investment advice was that it might attract a VAT charge, and that this might lead to price differentials between different types of advice. Mr Stuart Jefferies, of Cerberus Financial Planning Ltd, noted that:

> The recent "clarification" of how [VAT] should be charged in respect of financial advice is a potential bombshell. It is clearly being interpreted differently by different product providers and already I am being approached by some with novel ways of avoiding having to charge clients VAT. The current proposals may avoid commission bias but could substitute them with a tax bias in its place. For the majority of advice given today, VAT has not historically been charged because the advice has been hidden around a policy sale. Now with customer agreed remuneration the issue of whether advice is related to a sale or advice is more open and those that are actively seeking unbiased advice where there is no product sale recommended because this is the right thing to do for the client is likely to result in an increased charge. To some extent this appears to undermine the original objectives of better consumer access to advice and ensuring the quality of advice is as good as it can be.[72]

57. Some however were not sympathetic to the concerns expressed about VAT. Jon Lowson, IFA Research and Reports Ltd, argued that:

> the Anti RDR brigade continue to peddle the lie that moving to a fee charging structure will mean VAT on adviser remuneration and therefore higher costs for consumers. Whether adviser remuneration is exempt from VAT or not has nothing to do with whether the adviser charges a fee or is paid commission. Commission is exempt, because the IFA gives "free" advice and gets paid for arranging the product (intermediation, which is exempt). If the same adviser took the same commission, but told the client they were taking it as payment for "advice" then that would be VATable. Commission is only exempt if advisers keep up the pretence that they give free advice. If a Fee charging IFA charges only for arranging a product, then it will be exempt too. Personally, it appals me that IFAs give away free advice (their most valuable service) and charge for arranging a product (which requires no special skill whatsoever), even if it does makes the charge VAT exempt. In any case, VAT on fees does not necessarily mean higher overall cost. For example, if an IFA charges £100 per hour plus VAT, that would work out far, far less overall than our friend above who takes £35,000 commission.[73]

58. **The evidence we have received suggests that there is some confusion on both when VAT will be payable, and how much it will raise. We recommend that HMRC, in conjunction with the FSA if necessary, report to us as soon as possible with clear guidance on when VAT will be payable for financial advice under the RDR, why it has**

72 Ev w78

73 Ev w278

not been payable in the past, along with any expected additional revenues from the change, and whether further reform of VAT rules in the area will be needed. The FSA should report to us on whether this imposition of VAT will have an impact on the provision of advice, and whether an unfair tax advantage between different advice models will result from the move to the RDR.

4 Types of advice

Introduction

59. There have been several attempts by the FSA to classify the type of advice received by consumers. The following extract provides a history of such efforts:

> Until May 2005, [the] risks to consumer protection were dealt with by the regulators through requirements that financial advisers should either act as an agent of the consumer and recommend products from across the market, or act as an agent of the provider and recommend only the provider's products. The former group were known as independent financial advisers and the latter were known as tied agents. The requirement to be either an independent financial adviser or a tied agent was known as polarisation. Under **polarisation**, there was a requirement to safeguard against conflicts of interest by means of the 'better than best' rule. This placed additional requirements on independent financial advisers to prove a product was the most suitable from the market if the product provider had a financial stake in their business.
>
> In June 2005, the market was 'depolarised', and these restrictions were removed along with the 'better than best' rule.
>
> Under **depolarisation**, options in the advice market are likely to be harder for consumers to understand than in the polarised advice market. Following depolarisation, advice can be:
>
> • Independent—the adviser considers products from across the whole market and offers the consumer the choice to pay by fee; or
>
> • Whole of market—the adviser considers products from across the whole market but does not offer an option to pay entirely by fee and is remunerated, at least in part, by commission payments from product providers; or
>
> • Multi-tied—the adviser has a range of products from different product providers that they advise on, but this range will be less than the whole of market and could be as little as products from two product providers; or
>
> • Tied—the adviser sells the products of one company only.[74]

60. The RDR seeks to once again change the classification of the type of advice available. The Consumer Finance Education Body set out the following overview of the different advice type arrangements that will be present under the RDR:

> The RDR proposes that firms that advise on retail investment products must clearly describe their services as either "independent" or "restricted".

74 Financial Services Authority, *Depolarisation Disclosure*, Research report prepared for the Financial Services Authority by GfK NOP, February 2008

> To qualify as independent, firms must make recommendations based on a comprehensive and fair analysis of the relevant market, and to provide unbiased, unrestricted advice.
>
> If advice is not independent, then it must be described as restricted. This covers firms that advise on their own products or on a limited range of products, such as bank advisers and other single-tied and multi-tied adviser firms. Restricted advice also covers:
>
> — Basic advice—regulated advice on "Stakeholder" savings and investment products using a process that involves using pre-scripted questions. It was designed to deliver simple products to people with straightforward needs.
>
> —Simplified advice—an industry-designed advice process to help people whose needs are relatively straightforward access the market for investment products.
>
> Also worth noting are non–advised services, or execution-only sales. These are where a customer buys a product but no advice or recommendation is given.
>
> The final part of the landscape is generic advice—advice that is not regulated but helps people to understand and manage their money and take the right decisions based on their needs.[75]

Confusing to consumers?

61. Some of those who submitted evidence felt the new system of advice definitions would be confusing to the consumer. One of the most regularly cited concerns was that "restricted advice" could actually mean two different things. It could be restricted by provider (for example, a bank only offering its own products), or it could be restricted by type of product (for example, only providing advice on a particular type of retail investment product, such as pensions). Some were concerned that this may dissuade some consumers from seeking advice at all. Standard Life set out one of the problems it foresees as follows:

> It is important that consumers are given information that goes beyond simple high level labels such as "independent" and "restricted". While Standard Life understands the rationale for these labels, we think there needs to be some flexibility within the "restricted" category to capture the clear difference between advisers that advise only on their own products (ie tied) and those that essentially advise in a whole of market manner but on a limited number of products. The risk with the current labels is that consumers are discouraged from seeking advice from a "restricted" adviser, when in reality this may be beneficial for consumers without complex needs.[76]

However, the FSA again strongly defended its position. Ms Nicoll stated that:

75 Ev w301-302

76 Ev w225

> On restricted, again this is an area where we have listened to comments that we have had in the sense that we do recognise there will be different types of restricted advice, so we recognise that there will be some advice that will be restricted, for example, to the products of a single provider. There might be other areas where their advice is restricted to a particular range, so the firm may not, for example, give advice on life products and only on collectives.[77]

But she felt that firms would be able to provided descriptions to the consumer, to help them in understanding the restriction. She noted that "We are not being prescriptive in terms of what is meant by restricted and we are not being prescriptive in terms of how a firm describes its services, so it will be able to say, 'I am restricted but I specialise in a particular area of activity'."[78]

62. **We note the concerns raised by some about change in how advice will be described, especially around the 'restricted' label. We recommend that the FSA and other relevant bodies provide significant resources to explaining to the public the change, and in particular that 'restricted' may mean restricted by product, or by firm.**

Simplified advice

63. We had several submissions emphasising the need for a simplified advice regime if the RDR were to proceed as currently envisaged. In their written evidence, Cazenove Capital Management explained why such a regime would be needed:

> The removal of commission and factoring for regular premium savers and lower income earners will mean it [is] no longer economically viable for advisers to sell regular savings plans or pensions to these individuals. If the FSA wishes to continue with this approach, it must give a stronger lead on Simplified Advice, or a large tranche of society will be left without financial advice. This will be to the detriment of promoting a savings culture in the UK.[79]

The British Bankers' Association set out for us in their written evidence the essential design features of such a service as they saw them:

> We believe that "Simplified Advice" services have potential to fill the advice gap for less affluent consumers which we believe will result under the RDR.
>
> This view is informed by the following features of Simplified Advice:
>
> —the service would satisfy straightforward savings and investment needs and deliver extended customer access with respect to these needs more cost effectively than full advice services;

77 Q 26

78 *Ibid.*

79 Ev w132

—average transaction size would be expected to be lower than that for full advice services given the target market;

—the service would be highly automated and comprise a safe process for delivery of suitable, personal recommendations of packaged retail investment, deposit or protection products to customers with acceptable risks and safeguards, including recourse to the Financial Ombudsman Service;

—service automation would help to keep costs down for customers and as a result enable wider distribution than we envisage under the new full advice model;

—Internet-based Simplified Advice offerings could be accompanied by face to face and telephone services, where staff would act as "facilitators" and have no discretion to impact the personal recommendations generated by the model, ensuring that consumer protections would be built into the model;

—professional qualification and training and competence requirements for Simplified Advice facilitators should be appropriate to the nature of the role; and

—service providers would ensure the appropriateness of the products recommended in line with the FSA's guidance on the responsibilities of providers and distributors for the fair treatment of customers.[80]

64. There were however some notes of caution over such a regime. Some were concerned that the simplified advice regime would not be an adequate replacement for the loss of any IFA capacity following the implementation of the RDR. Written evidence submitted by J P Loveland, of Hanover de Broke Private Clients LLP, noted that "It is not clear how consumers would benefit from a simplified "mass market" approach to advice and personal recommendations based only on a limited assessment of a customer's financial circumstances generated by Banks if that were to be the outcome of RDR".[81]

65. Despite support for simplified advice in some quarters, AXA noted that "little progress has so far been made".[82] When we asked the FSA whether simplified advice would be available by 2013, Mr Sants told us that:

> To the general point, the answer is yes, we hope so. We intend to make sure that certainly there aren't any regulatory barriers to doing that. At the end of the day, it is the firms that have to offer the service, not us, so that ultimately determines whether the service is available. We completely agree, as you have said, that this is a really important part of the overall savings architecture.
>
> We also agree, and are working with industry at the moment on the point, that industry haven't yet got themselves to a point of sufficient comfort in the regulatory environment to be absolutely sure they can launch services that comply with our

80 Ev w234

81 Ev w151

82 Ev w199

> rules. So we recognise we haven't completed that dialogue. We have therefore accelerated our efforts in the last few months to do that. We were literally having meetings as recently as last week on the subject.
>
> We committed recently, as you know, in response to some of the earlier concerns, which this Committee is aware of, to publishing a further paper in the summer—indeed, if we can publish it a bit earlier, we will do so—in which we would hope to give the firms, or we intend to give the firms, there the necessary certainty they need in respect of the regulatory questions to enable them to deliver the advice.
>
> Assuming we are successful in that goal, and we think we can be by the summer, then there would be enough time, we believe, for the firms to get those services in the marketplace by the deadline. So absolutely, the key priority for us at the moment.[83]

66. **We note the concerns held by some that simplified advice may simply replace the advice of IFAs with an inferior advice system. Without a fully developed system to allow analysis, it is not possible to know. We urge the FSA to maintain the pace of its work towards a simplified advice regime so that a competitive market can begin to operate. We recommend that the FSA (and its successor the FCA) report to us both on progress towards a simplified advice regime and, when such a regime is put in place, update us on how implementation has affected consumer outcomes.**

83 Ev 29

5 Transition

67. The industry is now in a period of transition before the implementation of certain aspects of the RDR on 1 January 2013. Some of those writing to the Committee expressed concern over practices that have emerged before the move to the new rules, and what may then develop after the implementation deadline. Evidence we received from Rensburg Sheppards Investment Management Ltd noted the following disturbing pattern in this run-up to the RDR being implemented:

> One of the consequences of transition of remuneration structures to fee rather than commission based remuneration that we are currently witnessing is firms moving to place business pre-transition to secure as much income as possible through trail commission while the facility is still available. Furthermore, as "product providers" in some areas (where we provide clients of IFAs with discretionary investment management services), we are being requested to increase trail commission payments. We believe that there is no reason to do this other than to secure a larger income flow pre-RDR and protect their business.[84]

Further evidence on the rise of trail commission prior to RDR implementation was provided by Consumer Focus. They told us that:

> We believe there has been growth in the payments of trail commission by some providers, to some IFAs in advance of RDR coming into force. Consumer Focus has used its information gathering powers to require pension providers to disclose how much trail, renewal and initial commission they pay IFAs for personal pension sales. In one case the company's payment of trail commission has grown by 80% between 2007 and 2009. This amounted to almost £250 per client. In other words customers have been locked into paying trail commission a few years before this practice is banned. The other company that provided us separate data for trail and renewal commission paid out between £11 million and £13 million in trail commission and £5 million in renewal commission over the last three years. This company has a large back book of policies, but has written relatively little new business over the last decade. This shows the long persistence of trail commission.[85]

Following implementation of the RDR, Rensburg Sheppards Investment Management Ltd expressed concern that trail commission would influence the advice of some advisers. They told us that "We are also concerned that clients will be discouraged by advisers from moving their pre-RDR investments into a different product post-RDR, as the ongoing income stream it generates for the adviser will cease".[86]

68. The FSA assured us that they were aware of the risk of inappropriate sales in the transition period before implementation. Ms Nicoll told us : "It is one of the risks that we

84 Ev w348

85 Ev w257

86 Ev w348

have very specifically identified in the lead-up to the RDR and is one of the areas that we are very specifically looking to in our supervisory activity".[87] When asked what action the FSA were taking, she warned "We will stop firms carrying on—if we do find that they are flouting the rules by taking trail commission inappropriately, we will take action against them".[88] She then provided the following information on how inappropriate behaviours would be identified:

> we do that now on the basis of file reviews and so on, whether advice is suitable and, for example, we can look at trends among particular advisers, compare particular advisers against other advisers. Particularly the way that we supervise smaller firms is by looking at trends and looking at returns data and we will continue to do that in the lead-up to the RDR.[89]

When asked about the possibility of firms then holding on to clients post-RDR implementation, to prevent the loss of the continuing trail commission the firm received, she noted:

> there may be an immediate effect, but I think if individuals are being given suitable advice then our approach would be exactly the same post-RDR as it is pre-RDR, in that we would take judgments about the suitability of advice. There are suggestions at the moment that there is too much churn in the market because of initial commission and so therefore a certain amount of less activity may be appropriate, depending on the circumstance of the particular individual.[90]

69. **We take the concerns expressed about the adverse incentives towards poor advice that have arisen in the transition to the RDR very seriously. We therefore recommend that the FSA, and its successor, use all available tools to search either for pre-implementation churn, or post-implementation holding of clients, where that is not the best solution for the client. We expect to see the results of any regulatory findings.**

87 Q 72

88 Q 73

89 Q 74

90 Q 75

6 Overall costs and benefits

Introduction

70. As we have already seen, several of the proposals contained within the RDR have caused controversy within the industry, while those especially concerned have been Independent Financial Advisers. In particular, complaints have been raised against the changes to the qualification levels and the systems of remuneration, and there has been suggestion both of advisers leaving the market, and advice becoming unavailable to certain groups of people, especially those on lower incomes. It is unsurprising that given this impact on advisers within the market, the costs and benefits of the RDR are also contested by some.

Benefits of the RDR

71. Before turning to the potential detriment of the RDR, which has been the focus of many of the submissions we have received, it is important to examine why the FSA has decided to continue with the RDR while faced with continued criticism from some quarters. In its evidence to us, the FSA outlined why it felt intervention in the market was necessary:

> The RDR was launched in response to both our, and market participants' observation of significant problems in the UK market for retail investments. In deciding whether to invest, consumers are being asked to make decisions about markets which are, by their very nature, uncertain and which can be complex. When they decide to invest they are also being asked to take risks which can often be quite difficult to assess and they may not crystallise until a long time after the decision to invest was taken. This is one of the main reasons why consumers seek advice; it is also why consumers need advisers they can trust, why advisers need demonstrably to behave in a professional way and why the interests of advisers need to be clearly aligned with those of their clients. These are not characteristics of the retail investment market.[91]

72. It should be noted that the FSA is not the only body supportive of the measures contained within the RDR. Which? told us that:

> Which?, the UK's largest consumer organisation, is strongly supportive of the measures contained within the Retail Distribution review (RDR). Consumers need access to good quality financial advice and Which? firmly believes that the Independent Financial Adviser (IFA) industry is best placed to offer this advice. However it is clear that the current model does not deliver for consumers and we would argue that change is essential. We believe the RDR contains necessary and

91 Ev 24

commendable proposals that will deliver benefits for those seeking access to good quality financial advice and we hope MPs will give it their support.[92]

The Financial Services Consumer Panel was also supportive, and provided us with examples of how they felt the RDR would improve the market:

> The Panel has taken a close and active interest in the development of the RDR and we continue to support both its objectives and how the FSA proposes to achieve them. In our view the RDR presents great opportunities to the industry as well as challenges, but with consumers being the true beneficiaries of the RDR—the advice market is currently weighted in favour of industry and the RDR will establish much needed equilibrium.
>
> How will this be achieved? By:
>
> —Eliminating bias in the market.
>
> —Changing the relationship between the independent adviser and their client to one where the adviser is the agent of the client, not the product provider.
>
> —Providing clarity about the nature of the advice service being offered, how it is to be paid for and by whom. As the FSA has said, "it cannot be right to hide the cost of advice from consumers, with the intention that they neither see the cost involved nor value the services they receive. We cannot both support structures that conceal the cost of advice and complain about consumers not being prepared to pay for it. A paradigm shift is needed".
>
> —Ensuring that financial advisers are appropriately qualified, complying with standards of ethical conduct and aware of developments and innovations in the market.[93]

The FSA also provided us with data on the detriment they felt was suffered by consumers from mis-selling. In the following tables, they provided information on the cost of recent problems within the market (Table 3), and then estimated potential annual detriment in the market for retail investment product new business (Table 4).

92 Ev w280

93 EV w213-214

Table 3: Examples of previous mis-selling

Examples	% of unsuitable sales	Illustration of annual consumer detriment
Pensions being transferred inappropriately	16%	£43 million
Unit Trusts sold outside an ISA where a tax benefited equity ISA was more suitable	12–20%	£70 million
Investment bonds sold outside an ISA where a tax benefited equity ISA was more suitable	12–20%	£92 million
Personal pensions	A 1% increase in commission leads to an increase in personal pension market share of 1.4%	Up to £18 million

Source: Financial Services Authority, Ev 25

The examples provided by the FSA in Table 3 suggest "approximately £223 million of detriment arising only from those sales that were unsuitable", as well as adding that "Research on mis-selling is not available for all products in the market, and therefore this figure of £223 million is likely to underestimate total consumer detriment".[94] Table 4 provides some scoping of potential mis-selling annual in the market for retail investment product new business, which the FSA estimates to be around £0.4-0.6 billion per year.

Table 4: Potential mis-selling

Total annual market (£ bn)	Average unsuitable sales	Level of consumer detriment	Total annual detriment (£ bn)
109	12%	3%	0.4
109	20%	3%	0.6

Source: Financial Services Authority, Ev 25

73. Not all took the FSA's figures as an accurate reflection of the benefits to be had from the RDR reforms. SimplyBiz noted that:

> The benefits of the RDR are wholly uncertain and whilst we note Hector Sants' letter regarding the cost of consumer detriment from mis-selling, such comparisons as are quoted by the FSA relate to circumstances and conditions which in the main are no longer applicable or include other channels which make the figures unreliable in relation to IFAs.[95]

Alongside this, written evidence by Roger Heath, an IFA, who drew our attention to other work:

94 Ev 25

95 Ev w149

Paul Mcmillan (in the 06/01/2011 issue of MoneyMarketing) points out that the table purporting to show an annualised consumer detriment total of £223 million for mis-selling contains data which is:

—out-of-date;

—skewed by the inclusion of tied and multi-tied advisers (eg a large retail bank); and

—takes no account of subsequent developments such as falls in upfront commission levels, behavioural changes by advisers and the decline in the sales of investment bonds.[96]

Trust in advisers

74. One of the aims of the RDR is to increase the levels of trust in advisers. As the FSA noted:

> The number of people currently seeking advice, as a proportion of the population, is small. If more people are to seek advice in the future, then they must both trust the advice and view the service as good value for money. Our proposals address both these issues by improving the likelihood of there being trust and confidence in the market and by making clear to consumers the cost of advice and the nature of the service they are going to receive.[97]

This was reaffirmed during the hearing with the FSA. Ms Nicoll, when asked whether the RDR was going to achieve an increase in trust levels, replied:

> We hope so and we intend so, and we intend to monitor that fact. Once the RDR is in place, we will have a programme of continual monitoring of achieving what it is that we are seeking. One of them will be in this particular area in consumer research and the confidence and trust that they have in this market.[98]

Mr Sants was also keen to stress that trust was "an absolute key yardstick by which the success of the RDR should be judged and we do believe that it will improve trust".[99] He went on to note that:

> It is not just that 40% figure. You have the other 70% of people not seeking investment advice at all. So we have 70% of people who don't seek advice at all and 40% of people who do don't trust the advice they get. That, I think we would all recognise, is a problem to be solved and this, we hope, will make a significant contribution to improving those statistics.[100]

96 Ev w109

97 Ev32

98 Q28

99 *Ibid.*

100 *Ibid.*

The FSA also provided us with further detailed information on the statistics on trust used by them during our hearing. As Table 5 shows, even when financial advice is taken, people may not trust that advice. 39% of people who use any type of adviser do not trust financial advice, showing the need to increase trust levels.

Table 5: Levels of trust of financial advice

	% of adults	% trusting financial advice	% not trusting financial advice
All		45.0	48.0
Using any adviser	30.6	60.0	39.0
Not using a financial adviser	69.4		

Source: Financial Services Authority, Ev 34

However, Table 6 shows that those who seek advice from IFAs are more trusting of financial advice than those who use a Bank adviser or an accountant or solicitor:

Table 6: Trust of financial advice by type of adviser

Received professional advice from:	% of all adults	% trusting financial advice
IFA	18%	63%
Bank or building society adviser	11%	55%
Accountant or solicitor	3%	53%

Source: Financial Services Authority, Ev 35

And finally Table 7 shows the distribution of those who do and do not trust financial advice by age, with those between 30 and 49 showing the most mistrust of financial advice.

Table 7: Trust of financial advice by age

Age band	Trust financial advice (45% of all adults)	Don't trust financial advice (48% of all adults)
Under 30 years old	25%	14%
30–49 years old	39%	36%
50–64 years old	20%	27%
65 years plus	16%	23%
	100%	100%

Source: Financial Services Authority, Ev 35

Costs

75. Of course, the implementation of such a complex system of regulation is not without direct cost to the firms involved, and in the case of the RDR, it is considerable. The FSA provided us with the following details of the costs they expected firms to have to carry:

> We used data provided to us by firms to estimate that costs for the first five years of the RDR would range from £1.4 billion to £1.7 billion; an increase from our earlier estimate of £0.6 billion (also based on estimates provided by firms). The difference arises because the draft rules we published gave firms a better understanding of the changes they will need to make and the costs they are likely to incur. Consequently, firms' responses to our second CBA survey are materially different in some areas from the responses to our first survey on estimating compliance costs. The main changes in the cost estimates are increases in the costs of introducing the move away from commission to "fees".[101]

Not all were sure that the FSA had completely captured the cost of the RDR. SimplyBiz told us that "The FSA has consistently underestimated the cost of the RDR and most experts agree that their latest estimates are still woefully inadequate".[102] Others were just not convinced that the RDR was a useful use of resources. Mr Laurence Frazer told us that "The actual cost of the RDR which is well in excess of one billion pounds is a profligate waste. The IFA system is not broken, people are happy with its proposition of choice in remuneration, but it may well be if this is implemented".[103]

Access to advice and closing the savings gap

76. Independent Financial Advisers play an extremely important part in our financial advice system. When Mr Martin Lewis of Moneysavingexpert.com gave evidence to us on reforms to financial regulation, we asked him whether IFAs were being fairly treated by the RDR, he told us that:

> I'm rather worried. Funnily enough, many financial journalists are very pro-fees, when it comes to IFAs, and think that IFAs should charge fees. Probably, by the nature of what I do, I deal with a wide spread of the public. The websites have 10 million unique users a month. It's a very wide range of people. I worry that if you ask people to pay for financial advice they will not pay. Now, I'm not the greatest fan of IFAs, but I certainly think they're far better than tied agents and are well worth people going to on issues like protection, pension and investments especially for somebody who doesn't have a clue. I sometimes worry about which is the worst evil: having some IFAs who are paid commission and who have limited levels of commission bias, which should be regulated very stringently to try and reduce the commission bias, or not having people go at all.
>
> So I'm not 100% convinced of the idea that fees solve everything. I think, to an extent, what we're going to end up having is tied agents who are getting commission, going in selling hard. It's very difficult for the public to understand the concept of tied agents—multi-tied IFAs—going in selling hard. People go into their bank and think the salesperson, who is commission incentivised, selling them payment protection insurance, is a financial adviser. That's difficult enough. To tie IFAs'

101 Ev 31

102 Ev w149

103 Ev w339

hands by not allowing commission, certainly in environments where people would prefer them, seems to be a problem for me.[104]

77. Since IFAs are an important part of the financial advice mix, in the same earlier inquiry into financial regulation we asked the FSA about the potential loss of IFAs from the market:

> ***Mr Sants:*** Well we obviously have looked closely at this issue. We have some data that suggested more like a 10 to 20% reduction in capacity could flow from the RDR measures. We've obviously deemed that to be acceptable or we wouldn't be going ahead. But in my experience in the lobbying process you tend to get fairly extreme statements made, which don't necessarily always come about in practice.
>
> ***Lord Turner:*** But we shouldn't exclude the possibility that some exit of capacity from the industry, which is therefore also an exit of administrative costs, may be in the interest of consumers. That's a cost that is being absorbed, isn't it?
>
> ***Mark Garnier:*** I put on the record I disagree with that.[105]

78. Mr Sants remarks were met with considerable disquiet by the adviser community. Adviser Alliance made the following remarks to us:

> Hector Sants believes a 20% adviser exodus a price worth paying, a display of insouciance which has inspired industry outrage. Given the current economic climate we consider this view contemptible—it will leave millions of consumers without access to advice. FSA research, carried out by Oxera, indicates that most of the orphan consumers will not seek any further advice. So, far from encouraging consumers to engage with the industry, the RDR will disenfranchise millions of consumers and exacerbate the current pensions gap of £318 billion (Aviva estimate, September 2010).[106]

The Association of Independent Financial Advisers was similarly concerned by his comments:

> There are a wide range of predictions as to the number of IFAs who will exit the industry post-2012 as a result of the RDR, but AIFA categorically believes that FSA is wrong to say that a 20% drop is acceptable. It is incompatible with the original RDR objective of improved consumer access to accept a significant reduction in the number of places that consumers can go for independent financial advice.[107]

In its written evidence, the FSA told us it did not think that the RDR would lead to less advice being available. As well as providing detailed statistics, it explained that:

104 Treasury Committee, *Financial Regulation: a preliminary consideration of the Government's proposals*, Seventh Report of Session 2010–12, Volume II, HC 430, Q 277

105 Treasury Committee, *Financial Regulation: a preliminary consideration of the Government's proposals*, Seventh Report of Session 2010–12, Volume II, HC 430, Q 742

106 Ev w191

107 Ev w228

> Some in the industry believe that the RDR will reduce access to advice for the less well off. We do not agree. We have said that changes from the RDR are significant and there will indeed be changes within the market; however, the impact on market capacity and structure is likely to be limited. For example, Oxera reported that around 14% of firms that currently provide independent advice indicated that they are likely to provide restricted advice post-RDR. This market impact will, in some cases, simply be a shift in the service description of the firm from independent to restricted advice because of the new definition of independence.[108]

The FSA went on to explain that:

> As we have said, we will be monitoring the changes in the market, including exits during and after the transition. Even if demand for advice outstrips supply, entry barriers are low. In the longer term, new entry or expansion by existing players is likely to fill the gap. Some customers may question whether they need advice when they understand how much it costs them (a cost which is currently opaque because of commission) but that is a personal decision based on how much individuals actually value the service they receive.[109]

79. Many of those who provided evidence were more concerned than the FSA appeared to be by the loss of these advisers. Mr Keith Lewis explained that:

> In the current form the implications of RDR could mean a loss of 30% of small to medium IFA's and important issues, such as Pensions and Life Assurance always have to be sold, and unless people have access to advice and services, and only have a deteriorating effect on the level of pension provision and life cover, and is a time bomb for any Government, in terms of the public relying more and more on benefits. Also, the closures of many small businesses could result in the loss of some 10's of thousands of jobs, as well having an impact on larger organisations, such as major life offices having to close call centres.[110]

Mr Preston Anderson, a financial adviser, highlighted a potential impact on the state if amendments to the proposals were not made:

> I believe that examinations should apply to new entrants of the industry and perhaps to anyone under the age of say 55. Advisers above that age should surely be able to continue practicing with strict CPD under what is referred to as “Grandfathering”. If this amendment to RDR is not considered there will a great loss of many long term experienced advisers, again to the great disadvantage of the majority of the UK client base. Their financial affairs/protection will not be looked after in the way it is now. This may mean they would need to lean even more heavily on the state when they need financial support.[111]

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108 Ev 27

109 *Ibid.*

110 Ev w85

111 Ev w131

We note that Lloyds Banking Group announced on 30 June in the outcome of its strategic review that:

> Bancassurance will be a core part of our proposition, through our multi-brand retail strategy. We aim to maximise the conversion of our retail banking customers to Bancassurance through offering them affordable and relevant advice, taking advantage of the advice and distribution gap we see as being created by the Retail Distribution Review.[112]

The evidence suggests that there will be a loss of market capacity, as some advisers decide not to comply with the new requirements. However, the FSA state that barriers to entry in the market are low. We are concerned that the loss of advisers, particularly individuals and those in small firms, will disadvantage smaller savers by reducing choice and competition.

Savings Gap

80. Given the potential loss of advisers to the market, some who wrote to the Committee feared that the RDR would not help improve the level of savings within the economy (sometimes referred to as the savings gap). The Financial Services Consumer Panel outlined the nature of the savings gap problem:

> the Panel accepts that there is likely to be some shrinkage in the traditional advice market as a result of the RDR. We are conscious too of the savings gap that exists at the moment, and which has existed for some years, and the general need for consumers to save more. Figures vary, but Aviva's November 2010 research revealed a European annual “pensions gap” of €1.9trillion of which the UK accounted for €379 billion. According to the recent YouGov survey on behalf of the Institute of Financial Planning and National Savings and Investments, eight out of ten people in the UK say they would be more likely to save if financial products were more flexible and made easier to understand. Fewer individuals are planning ahead—the same research found that only 14% had goals they were working towards (compared to 26% in 2008), yet 59% of those surveyed were worried about their finances.[113]

Given the scale of the problem outlined above, many were concerned that the RDR would not aid in closing this gap, especially given the loss of advisers. Charles Stuart Financial Services Ltd explained that:

> The appalling savings gap in the UK has been well documented and it makes no sense for the government through its appointed regulators to be setting in motion a situation which will see the main providers of quality advice decimated. That is the reality of losing 30% of IFAs.[114]

And Barclays told us that:

112 Lloyds Banking Group, Outcome of Strategic Review, 30 June 2011, page 8

113 Ev w217-218

114 Ev w267

> We expect that there will be an unmet demand for advice post-RDR (due to both a supply and a demand effect), which conflicts with the wider policy objective of plugging the savings gap and ensuring retail investors can access the investment services they require, especially in a world moving from defined benefit to defined contribution pension systems.[115]

81. When we pressed Mr Sants on whether the RDR would combat the savings gap, he replied:

> May I first of all say that the issue of reducing the savings gap, encouraging savings, is a central concern, I am sure, to Government and to you here in this Committee. It is very right that you should be focusing on this key issue. It is vital to the long term prosperity of the country. I don't think, however, that we see the RDR as specifically designed to address that issue. Obviously, we hope, that if we have a marketplace that is working better and is trusted more by consumers, that this would have an influence on that issue but we are not specifically targeting the savings gap problem as a measurable, immediate consequence of the RDR.[116]

82. **Personal savings in the UK are unacceptably and unsustainably low. We were therefore concerned about the impact that loss of advisers might have on saving. The FSA seeks to reassure us in its evidence, but we recommend that regular reports on the impact of the RDR on adviser levels, and savings through independent financial advice, should be compiled by the FSA and its successor.**

83. **Implementation of the RDR must be to the benefit of consumers. Consumers will not benefit if it results in a reduction in choice and competition through a substantial loss of advisers and firms. Some advisers have already complied with the requirements of the RDR. We have no wish to alter those requirements, but do wish to allow more time for advisers to reach the required standards. Therefore we recommend that the FSA defer the introduction of the RDR by 12 months, alongside our earlier recommendation to temper the 'cliff-edge' nature of the reforms to the required qualifications.**

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115 Ev w316

116 Q4

7 European and international issues

Introduction

84. Some of the regulatory decisions affecting the UK financial system are now being taken at an EU level, rather than being the sole preserve of the UK authorities. As Mr Richard Saunders, Chief Executive, Investment Management Association, told us in October 2010, “A large part of the regulation which the industry now has to deal with comes from Europe, and that is simply a fact”.[117] This point was also reiterated to us by Mr Sants, who noted that:

> Rulemaking authority is broadly gradually moving to the European architecture, as you know, and also that consumer issues are rising to the fore of that European agenda over the coming years. Both are statements of truth.[118]

85. As well as the European dimension, not all those customers of advisers within the UK are necessarily firmly fixed here. High Net Worth individuals can look across a range of potential domiciles for both investment opportunities and where they may wish to buy financial advice. The measures in the RDR must be considered both from the context of ongoing work in Europe, and with internationally mobile High Net Worth consumers in mind.

Ongoing work

86. One fear of those who wrote to us was that current pieces of legislation now working their way through Europe would unravel parts of the RDR, leading to uncertainty, and unnecessary costs for firms, both large and small, should further changes then be needed. In their evidence, Killik & Co requested that “The Government should defer implementation of the RDR, whilst a fundamental review is undertaken, particularly in the light of the European Commission’s PRIPs [Packaged Retail Investment Products] project, which has the same objectives as RDR, but is seeking to achieve them by different means”.[119] They provided more detail of their concerns as follows:

> A serious weakness of the RDR is that the FSA is “front running” Brussels, with no guarantee that Brussels will follow. This is particularly in the area of PRIPs, which are central to the RDR, but which have yet to be defined by the European Commission, and which it may never define.
>
> Indeed the Commission published a consultation paper on 26 November 2010 that stated it favoured merging the PRIPs project into the on-going work taking place on

117 Treasury Committee, *Financial Regulation: a preliminary consideration of the Government’s proposals*, Seventh Report of Session 2010–11, Volume II, HC 430,, Q243

118 Q 68

119 Ev w24

> the reform of the Markets in Financial Instruments Directive and the Insurance Mediation Directive.
>
> Therefore, at the very least, the PRIPS project will be subject to some delay and yet the FSA is carrying on regardless. Indeed one possible consequence of this is that it will be theoretically possible that a financial services business registered in another European country could be passported into the UK and be outside the RDR.
>
> Moreover, the Commission's consultation paper went on to say that a new disclosure instrument was necessary but that further consultation would be needed to determine how charges and performance history should be presented. It added that the responsibility for disclosure should rest with the product provider rather than the distributor.
>
> This, on top of RDR will make for a complex and burdensome regime with consumers receiving information about charges from both the product provider and the adviser. This seems likely to add to consumers' confusion rather than improve clarity.
>
> PRIPs and RDR are ostensibly seeking to achieve similar outcomes for consumers in terms of removing product provider bias and increasing transparency over charges, but are approaching these aims in totally different ways. This should be reason alone for RDR to be delayed and reconsidered in light of the PRIPs' consultation.[120]

87. When we tackled Mr Sants on the potential mismatch of the EU and RDR processes, he outlined the problem the FSA faced as follows:

> There is evidence—in our judgment, very good evidence—of significant current consumer detriment. So, yes, we have to make a judgment between seeking to address that problem now and the possibility—I take your point that we are not responsible for the final determination that Europe makes, that is absolutely correct—that at some point in the future, a number of years hence, the European regime might come out with an outcome that is somewhat different to our proposal. That is possible. The question is what if we make the judgment in the round, and we judge on the basis of the data we have, that that is a reasonable judgment to make?[121]

Mr Sants also emphasised that the FSA was engaged with the European agenda, and was attempting to ensure alignment between the UK model as outlined in the RDR, and what may eventually appear in Europe. He told us that:

> I am saying that we are, as you would expect, in dialogue with the Commission, which I believe is our role to try to influence the European agenda, and I know it is very important to you that we do seek to influence the European agenda. We are comfortable with the model we are introducing here in the UK and we are proposing

120 Ev w26

121 Q 70

> that as a way forward in Europe, and that is what you would expect us to do. I am certainly not saying that I know what the Commission is going to do.[122]

Ms Nicoll also felt that the European legislation would not take effect until some time after the RDR implementation date in January 2013. She told us that "We don't yet have legislation in the context of PRIPS and we are not expecting that until the end of this year. [...] most European legislation then has a lead-in period and a transitional period. We think that would take us well beyond the RDR deadline date".[123]

88. In written evidence to the Committee, the FSA provided further assurances on how forthcoming EU legislation would dovetail with the FSA's proposals under the RDR. It stated that:

> The Committee also asked whether our new rules should take account of the timing of proposed draft EU legislation. We support the European Commission's Packaged Retail Investment Products (PRIPs) initiative, which has the potential to be an important step forward in delivering consistent consumer protection. We believe our rules will be compatible with the outcome of the Commission's recent consultation, and we keep closely in touch with the Commission on both our developments and theirs.[124]
>
> We are confident that, rather than waiting for any new EU rules to come into force, we should move to strengthen protection for UK consumers now. It is worth noting that rules about specific professional standards, including qualification levels, are not covered by the PRIPs initiative and our rules on professional standards would not be affected by the current Commission consultations.[125]

89. **The FSA and its successor bodies will always be faced with difficult decisions over whether to proceed with UK specific legislation quickly, or wait until things have cleared at a European level. The FSA though should act wherever possible to remove consumer detriment in financial services, as it has in this case.**

Passporting

90. One of the concerns raised by those giving evidence to us was that EU firms outside the UK would able to passport their operations into the UK, and by doing so, would circumvent the requirements of the RDR. The FSA noted that:

> The activity of providing services on a cross-border basis is usually described as "passporting". Firms can passport into the UK either by:
>
> —setting up an establishment here, usually described as a branch; or

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122 Q 69

123 Q 70

124 Ev 36

125 *Ibid.*

—by providing services with no physical presence in the UK, such as by telephone or internet.[126]

In additional evidence provided by Simon Mansell, of Temple Bar, he raised the following concerns about passporting, and the implementation of the RDR:

> The FSA have confirmed that passporting is possible and EU firms will only be subject to certain rules. In response to my letter the European Commission confirms passporting firms will not subject to the RDR. An FSA spokesperson also confirmed this.
>
> EU advisers will only have to comply with the FSA's Conduct of Business rules, which cover adviser remuneration, but will not have to comply with the RDR's rules in relation to qualifications.
>
> The revelation could leave the market open for European adviser firms, wishing to take advantage of more lax rules in their home countries, to enter the UK market. It is also possible that some UK-based firms may wish to move jurisdiction in a bid to avoid some of the harsher rules due to be implemented with the RDR in January 2013.[127]

91. The FSA however provided the following evidence on passporting, and noted several requirements and restrictions of those that may wish to passport their operations into the United Kingdom:

> There are currently 2,030 firms authorised to passport into the UK. Between them, these firms have 195 establishments around the UK. The precise requirements vary between different EU directives, but in general for the investment advice sector the following additional points are relevant:
>
> —the UK's conduct of business requirements (including the RDR rules on describing services and adviser charging) would apply to branches set up in the UK for business conducted with UK clients. The FSA would have responsibility for supervising the conduct of business, including, for example, assessing whether advice given was suitable;
>
> —if a firm passports into the UK without having a branch here (ie, provides cross-border services), then it will have to comply with its home member state conduct of business rules;
>
> —a firm may not conduct its business on a cross-border basis if it is doing so to evade the host state standards. An indicator of this might be where a disproportionate volume of business is being conducted in the host state compared to the home state, particularly if the firm had previously been authorised in the host state; and

126 Ev 35

127 Ev w295

—the competence of individuals is the home state regulator's responsibility. Firms passporting into the UK are not subject to the FSA's training and competence requirements, which includes requirements for individuals to hold a relevant qualification or carry out continuing professional development. Individuals operating in branches established in the UK will need to be approved by the FSA, if, for example, they are advising retail customers.[128]

As well as this, the FSA also told us that:

> It is important to note that EU directives do not currently include all investment products. For example, UK personal pensions are outside the scope of these directives. This means that if a firm passports into the UK and wants to advise on pensions the firm will typically require an additional permission from the FSA (a "topup"). Under the top-up permission, the firm will be subject to the host state requirements, so in this example the firm would be subject to the RDR requirements for their advice on pensions. [129]

92. **We recognise that passporting (where firms from other countries within the EU conduct business in the UK) may seem to present an opportunity to some advisers to counter the implementation of the RDR. However the evidence provided to us by the FSA repays careful study. It makes it clear that passporting will only be possible in some areas, and cannot be used by UK operators as a device: "a firm may not conduct its business on a cross-border basis if it is doing so to evade the host state standards". We recommend that the FSA (and its successor the FCA) undertake regular scrutiny of operations passporting into the UK within the area of activity covered by the RDR, and report on action it has taken to limit this type of activity.**

High Net Worth individuals

93. Several firms who provided written evidence suggested that the implementation of the RDR might particularly impact those who provide advice to High Net Worth individuals, especially those such individuals who are internationally mobile. The British Bankers Association outlined for us just how mobile the market actually was, both in terms of customers, and the firms servicing them:

> High Net Worth clients of the UK wealth management sector are commonly internationally mobile and can just as easily access services in Switzerland or other offshore jurisdictions as they can in the UK. Further, offshore firms are generally able to come to the UK and carry on business with High Net Worth clients without having to comply with the FSA's rules, whether under an EU financial services passport or in reliance on exemptions under the UK regulatory regime.[130]

128 Ev 35

129 *Ibid.*

130 Ev w232

Given the international mobility of their High Net Worth customers, JP Morgan then highlighted the problem London based banks may now face given the implementation of the rules governing adviser charging under the RDR, including potentially either higher costs for UK based customers, or a restriction of the products available. JP Morgan suggested that:

> Under the proposed changes to the adviser charging rules, regulated firms will no longer be able to accept trail fees from funds, even if they are appropriately disclosed to clients. If RDR has the effect that the global funds industry moves to develop RDR compliant products, then we can see that a key step forward will have been achieved in terms of fees transparency. However, we believe that there is a considerable risk that the majority of non-UK funds will not restructure their products in line with RDR and clients are unable to invest in such funds. This will have the effect of limiting the range of products available to UK-based investors. Alternatively, the funds could retain such fees in relation to UK clients, thus making the funds more expensive for a UK client than a non-UK client. As this regulation will affect UK clients only, UK based private banks will need to apply different fee charging schedules to UK clients to those outside the UK.[131]

94. One of the suggested remedies was to exclude High Net Worth individuals from the requirements of the RDR. Barclays made the following point:

> We have not seen convincing evidence of the FSA's claim that "the landscape of retail investment advice is broken" applying to our HNW individuals, despite the FSA extending these rules to cover private wealth management; nor do we believe some of the measures being introduced via the RDR are appropriate for the specificities of the HNW market which is highly competitive, and involves internationally mobile clients who are often more financially sophisticated than retail clients.[132]

JP Morgan also had a similar recommendation, and provided further evidence on how the FSA were dealing with this issue:

> As a potential solution, an exemption from the adviser charging elements of RDR should be applied in relation to HNW clients as those clients are able to understand more complex products and charging structures. These clients should be given the freedom to elect to stand outside the new regulations.
>
> The RDR is designed to protect UK consumers. The HNW client base that we service wants a full range of products and therefore should be permitted to opt out of the RDR protections in order have these available to them. We have attached a letter from Freshfields to the FSA on this point. We note that the FSA responded with the view that firms could "Opt Up" such clients to "Professional" status, thus eliminating the need to apply the RDR standards. However, this is not always possible, as the

131 Ev w344

132 Ev w316

> MiFID standards require a number of quantitative tests to be passed that do not necessarily apply even to extremely wealthy clients, for example, the requirement to transact more than 10 trades in a specific product per quarter, which is extremely rare in the case of Private Equity and Hedge Funds. The FSA is free, if it chooses, to apply a different standard, as RDR does not derive from EU regulation.[133]

95. However, when asked whether the RDR might lead to such customers leaving London, Ms Nicoll replied:

> I would be very surprised by that because I think in many ways the RDR is going in the direction of the sort of ways that high net worth individuals expect to interact with their advisers in the sense that I think you would find that the high net worth individuals—there is more fee business, for example, and, therefore, I think it would be going with the grain of the way that high net worth individuals already operate in the market.[134]

When we asked what research the FSA had done in this area, Ms Nicoll noted that "The research that we have done has covered the whole area. The consumer research that we have undertaken has been across a cross-section of types of consumer".[135] Following on from Ms Nicoll's comments, Mr Sants however told us that:

> It is not obvious to us—and again when you come to make your report if you want to spell something out here we can take a look at it—how the high net worth model would be adversely affected by the RDR. There are various different types of models, but they don't seem to be particularly at variance to the RDR. So no, we haven't specifically done research in that area, being absolutely open about it. If there were grounds for so doing again, we could take a look at that.[136]

96. **We note the concerns of certain firms that the RDR may have a deleterious impact on their ability to provide a full service to High Net Worth individuals from their London offices. The FSA has not done specific research on the RDR's impact on this specialised area of business. We ask that the FSA as a matter of urgency review the evidence we have received related to these matters, and the proposed remedies, and report back to us on both the potential scale of the issue, and whether modification of the RDR might be possible to mitigate those concerns. We recommend that the FSA examines how to allow High Net Worth individuals, as determined by the FSA, the opportunity to opt out of the requirements of the RDR should they wish. This should also mean they opt-out of most or all protections that retail customers receive.**

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133 Ev w345

134 Q 49

135 Q 50

136 *Ibid.*

8 The Financial Conduct Authority

Continuity

97. The Government is currently undertaking a significant restructuring of the system of financial regulation in the UK. This has culminated in the publication of a white paper by the Treasury entitled *A new approach to financial regulation: the blueprint for reform.*[137] As part of those reforms, as we have noted earlier, the responsibilities of the FSA will be divided, with those relating to the RDR being moved to the proposed Financial Conduct Authority (FCA).

98. Several of those who wrote to us felt that the implementation of the RDR should be halted while this reorganisation was ongoing. For instance, the Financial Services Smaller Practitioner Panel told us that:

> The RDR is being implemented at a time when the objectives of the regulation of retail conduct are to be changed with the creation of the CPMA. We believe it would be much better if the new CPMA [now renamed the FCA] objectives could be set and checked with the RDR before the requirements of the RDR are finalised.[138]

Aviva was also concerned about how the change to the new regulatory system would impact on the RDR. It noted that:

> Finally, we are concerned at the two year gap before the reviewing the RDR, given that the market is undergoing such profound structural changes. It is essential that the Consumer Protection and Markets Authority (CPMA) [now renamed the FCA] which will replace the FSA in 2012 supports and actively engages in this process. There is concern about whether the CPMA will also be measured on its success in implementing the RDR. This is necessary to ensure that accountability is maintained in the new regulatory body, and that the RDR will not be subject to significant changes once the CPMA is in charge.[139]

99. However, when we questioned the FSA on whether the move to the FCA should stop implementation of the RDR, Mr Sants seemed certain it should not. He told us that:

> I think from our point of view we feel that this is a thoughtfully constructed, vital reform to the market. We don't believe there is any suggestion in the thrust of Government policy that the FSA should be stepping back from continuing to deliver needed reform and improvements to the financial market. The FCA obviously will be a successor body to the FSA. I think it is right and proper that it will carry forward those initiatives that have been properly assessed and have been through a full approval and consultation process. The RDR is one of those. We have had some discussion with Martin Wheatley [Chief Executive designate of the Financial

137 HM Treasury, *A new approach to financial regulation: the blueprint for reform*, June 2011, Cm8083

138 Ev w292

139 Ev w317

> Conduct Authority], who obviously is not yet in post, but he is very content with that approach.[140]

100. **We note the assurances of Mr Sants that the Financial Conduct Authority will be content with the RDR. However, the FCA will have different objectives to the FSA, and we therefore recommend that the Treasury, in response to this Report, state whether it is content that the RDR as currently constituted would be consistent with the objectives of the FCA as it currently sees them.**

Accountability

101. The FSA was deliberately created as an independent regulator. Some of those who provided written evidence, though, were concerned about the accountability of the FSA. Professional Investment Management Services told us that "We appreciate that our industry is still far from perfect and that the FSA has been successful, in part, in dealing with some of its worst excesses, but it is not right that it should only be accountable to itself, and not even to Parliament, although you can of course exert very considerable influence behind the scenes".[141] Paul Raseta noted that:

> I find it quite unbelievable that the FSA is accountable to no-one, not even Parliament. I watched the recent Back Bench debate, and whilst lifted by the cross party support, I and thousands more were amazed that unless the FSA listened (there was, and is no indication of that ever happening), then little or nothing would be done. I therefore welcome this opportunity to offer my views, in the faint hope that common sense and reality might ultimately prevail.[142]

102. When we raised these concerns over the accountability of the FSA with Mr Sants, he did note that there were already accountability mechanisms for the FSA:

> I don't think we are immune from public accountability. I am an extremely strong supporter of accountability. I hope I have always given that impression and I, on a personal basis, will always make maximum effort to make sure that any questions and challenges put to us are answered in an open and transparent way. I demonstrated that, I believe, in the post-crisis period in a number of different ways. We clearly are accountable to Parliament through a number of mechanisms, including this Committee, which, as you know, I take extremely seriously.[143]

He also noted that "We can, of course, be judicially reviewed" and he also pointed out the FSA has its "own complaints commissioner process that is available for people who feel the FSA's process has not delivered as it should. We have a review process and we have an

140 Q 3

141 Ev w38

142 Ev w309

143 Q 34

accountability process in Parliament”. [144] The FSA also noted that in formulating the RDR, a significant amount of consultation had been undertaken. They highlighted that:

> We have held an open debate about industry-led solutions, wherever possible, in what has been the FSA’s most extensive and far-reaching consultation process to date. This involved some two and a half years of discussion and a further two years of formal consultation, during which we have received nearly 2,000 formal responses and proactively contacted around 2,500 firms, in addition to considerable additional correspondence and discussion.
>
> We used industry working groups, as well as considering the views of individuals, consumer representatives, a wide range of firms, and their representatives, to develop our proposals. Often debate has arisen around detailed points of the proposals. We have listened to the arguments and evidence presented, amending several proposals in response to this debate, where appropriate. For instance, we have amended our professionalism proposals to allow alternative assessment methodologies to be used in light of concerns about written exam-only qualifications, and we have also allowed for an additional transitional year for our capital requirements proposals, to take account of difficult trading conditions. [...]
>
> This extensive consultation has enabled us to listen and respond to market participants concerns and so develop, with industry, a package of reforms that we believe is necessary to address the problems in the market, improve consumer outcomes and confidence, as well as support the long-term viability of the retail investment market.[145]

However, Mr Sants was keen to emphasise potential reforms for the future, and seemed receptive to further suggestions. He told us that:

> As I say, I am supportive of an additional layer of accountability when major regulatory failures occur. I am also supportive of the NAO being a review authority for the FSA. If you have other accountability mechanisms you would like to suggest, I am sure you will do so during the Bill period and we are certainly are happy to take them into account.[146]

103. **The creation of the FCA provides an opportunity to examine the accountability mechanisms that will apply under the new system of financial regulation. We will therefore instigate an inquiry into this including the mechanisms proposed by the Government, as well as the concerns raised within the evidence attached to this Report, to decide whether they are adequate.**

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144 Qq 34-35

145 Ev 26

146 Q 35

The long-stop

104. Many of those who wrote to us were concerned about the lack of a limitation on the amount of time an adviser may be liable for mis-selling a product. The Association of Independent Financial Advisers outlined the problem faced by the industry owing to a lack of a long-stop as follows:

> If RDR is about making the industry work better, and enabling better outcomes for consumers, then the introduction of a 15 year long stop is an issue that needs to be addressed. The lack of a long stop means that businesses have the burden of making provision within their accounts for the increasing risk of complaints, the cost of maintaining records over a long period, as well as the proposed increases to capital-adequacy provisions. Furthermore, the uncertainty generated by open-ended liabilities makes it difficult for firms to be sold and also hinders their ability to attract new sources of capital.[147]

In line with many other submissions, they suggested that "Introducing a 15 year long stop would address these issues while bringing financial services into line with the Statute of Limitations".[148] They noted that consumers were not averse to this change. AIFA told us that "research we carried out with YouGov showed that the majority of consumers were actually in favour of a time limit for responsibility, with 75% of clients questioned agreeing there should be some time limit for IFAs to be legally responsible for advice given".[149]

105. Which? however was "strongly opposed" to the implementation of a 15 year 'long stop'.[150] It noted that "there are already time limits in place covering when consumers are allowed to refer complaints to the FOS" and that "these rules require consumers to complain within six years after the event complained about occurred or (if later) within three years from the date on which the consumer became aware (or ought reasonably to have become aware) that he or she had cause for complaint".[151] It made the following points in defence of the current lack of a long-stop in financial services:

> Many financial services products are long-term in nature and it can be many years before problems arise. Their complex nature, combined with poor information from companies can make it difficult for consumers to know when they have made a loss and if they have grounds for complaint. A key example would be endowment mortgages. As a result a long-stop could restrict access to justice for many consumers.
>
> It would be difficult to apply a 15 year long-stop if the magnitude of the loss was unknown and there was no way for the consumer to crystallise the loss—for example in the case of contracting out of the State Second Pension, if a consumer was mis-

147 Ev w230

148 *Ibid.*

149 *Ibid.*

150 Ev w350

151 *Ibid.*

> sold there is currently no way for them to crystallise the loss until retirement as the Government does not allow people to buy back into the State scheme.
>
> The introduction of a long-stop could weaken the incentive for financial services companies to prompt valid complaints and inform consumers of the magnitude of their loss. Under the current rules, the company has to inform the consumer that they have cause for complaint for the clock to start. If a long-stop was in place there would be a strong incentive for the company to take no action and wait for the consumer to run out of time. This is likely to further damage consumer confidence in financial services.[152]

106. In its written evidence, the FSA provided the following description of the previous work it had undertaken looking at whether a long-stop would be useful or not:

> Some advisers express frustration at the absence of a long-stop time limit on the period within which complaints must be brought or the application of the statute of limitations because they want to limit their liabilities. This strength of feeling, particularly amongst IFAs, was made clear to us when we first consulted on long-stop in 2007. To justify the introduction of a long-stop we need to identify benefits to firms or consumers beyond the savings for firms in compensation payments. These benefits would need to exceed the consumer detriment from time-barred complaints.
>
> Responses to our consultation focused on "fairness" arguments around the statute of limitations and concerns about handling "stale" claims—particularly into retirement. We were unable to convert these arguments into a persuasive analysis that it would be reasonable to impose responsibility on consumers to identify any and all issues with advice within a given period.
>
> Other respondents highlighted the consumer detriment and reputational damage that a long-stop could cause. Due to the strength of feeling on the issue we made a further call for evidence in 2008 but only three firms responded with further evidence. This prompted us to seek further evidence to see if we could build a persuasive argument. We could not and we had to conclude that we should not introduce a long-stop because we were unable to demonstrate that it would bring additional benefits to consumers and firms (for example from greater investment in the sector).[153]

107. When we then questioned the FSA on whether or not there should be a long-stop, Mr Sants seemed open to the FSA looking at this issue again:

> This was looked at in 2007 and at that time there was not compelling evidence to change the situation—that is, to bring in a longstop. But I have to say that I have some sympathy with the argument that says if people are still concerned, 2007 now is

152 Ev w350

153 Ev 29

> a number of years away, and possibly if this Committee was to recommend to us that we should take another look at it, I think that is something we might usefully do.[154]

He then suggested an alternative way of looking at the issue that may merit further investigation by those considering the forthcoming legislation in this area:

> It is a little bit of a question of what is the framework that you use to reach the determination, to be fair, in the sense that the way that it was looked at in 2007 was: what is the consumer benefit that would be brought by bringing in a longstop? There was no particularly compelling evidence presented; that was the backdrop. But you could be asking the question the other way round, which is there are other industries that do have a longstop, so why wouldn't this one have one? So, it depends on the framework, and I must admit when I looked at the question I thought there is an argument that says perhaps we should look at it again.[155]

108. **We note the FSA's acceptance that there may be a need to look at whether a long-stop on potential liabilities should be instituted within financial services. We recommend that the Committee on the Draft Financial Services Bill, which would create the Financial Conduct Authority, consider whether there is a compelling case for a long-stop. Our view is that any long-stop would need to be shown to be clearly in the interest of consumers.**

154 Q 103

155 *Ibid.*

Conclusions and recommendations

Qualifications

1. The evidence provided by the FSA on the need to move to Level 4 was weak. Nevertheless, the Committee sees some merit in a move to a higher level of qualification, both as an opportunity to build a stronger professional ethos amongst advisers and as a reflection of the high level of responsibility financial advisers have for the financial welfare of clients. Trust in financial services must be key. (Paragraph 15)

2. We are concerned at any potential loss of competent and experienced advisers from the market. Any restriction of any trade must be carried out with due consideration for the livelihoods of those affected. However, the FSA has argued that it cannot because of the provisions of the Equality Act provide a blanket grandfathering process either on the grounds of age or experience. In an effort to achieve the legitimate aim of maintaining competition and choice in the advice market, we recommend that the FSA consider instituting a process whereby it provides for flexibility for advisers on a case-by-case basis. (Paragraph 28)

3. Later in this Report we recommend that implementation of all aspects of the RDR be delayed by twelve months, in order to maintain choice and competition in the advice market. We recommend that the FSA temper the 'cliff-edge' nature of the current reforms. A system of proper supervision, along with the additional year, would provide some leeway, while maintaining the Level 4 requirement. (Paragraph 31)

4. It is conceivable that in the future the FSA may require Level 6 qualifications for advisers. We would expect there initially to be a full study undertaken by the FSA (or its successor) before any move to Level 6, using a large sample of UK based advisers, looking at the merits of such a move. Should implementation then be proposed, we would expect, in view of the significant difference between Level 4 and Level 6, there to be a far longer lead time to implementation, with a wide-range of potential routes available to those wishing to upgrade their skills and qualify under any new regime. (Paragraph 34)

Commission

5. There is already full disclosure to customers of the cost of the advice they receive, whether paid for via commission or fees. However, as both advisers and the FSA have told us, many consumers appear to see financial advice as being 'free' under a commission based system, despite adviser disclosure of its actual cost. The introduction of consumer agreed remuneration under the RDR will potentially create a market price for advice. Given that some consumers will have seen advice as 'free' beforehand, it must be assumed that the setting of this price will lead to a reduction in the consumption of advice, just as would be the case in any normal market where the price of a good rises. But this rise in the price of advice may also lead to consumers undertaking greater scrutiny of the advice they are paying for, and who is providing it. Given the past mis-selling episodes of the industry, this must be

a welcome development. However, we do not underestimate the scale of the change in culture that this will involve for an industry based so heavily on individual relationships. (Paragraph 43)

6. Trail commission where advice is not offered is very difficult to justify. However, we note the initial impact its removal may have on the value of IFA firms, and recommend that the FSA analyse the impact of this measure on the market for advice, and especially on the small-firm IFA market. We discuss later in this Report concerns expressed to us about an increase in trail commission being awarded in the run-up to the implementation of the RDR. (Paragraph 49)

7. Consumer agreed remuneration will allow advisers to deduct their fees from regular payments made by customers for their products. Advisers would like product providers to be able to use factoring to create a single payment at the start of a product's life from this future stream of income. However, the FSA's concern is that the discount rate used in the factoring process by product providers can be used to influence advisers' decisions in a way consumers may find difficult to understand. We therefore agree with the FSA that allowing factoring by product providers would provide a potential bias in the market at odds with the overall transparency aims of the RDR. (Paragraph 53)

8. The RDR concerns not just IFAs, but advisers in banks as well. We would be extremely concerned if banks found ways round the rules that will cover all aspects of remuneration. We recommend that the FSA (or its successor the FCA) report after one year, and then yearly, on the impact of the RDR on vertically integrated firms' remuneration structures, indicating breaches that have been found and what remedies the regulator has asked for. Only with such transparency will the IFA community be persuadable that it has not been unfairly impacted by the implementation of the RDR. (Paragraph 55)

9. The evidence we have received suggests that there is some confusion on both when VAT will be payable, and how much it will raise. We recommend that HMRC, in conjunction with the FSA if necessary, report to us as soon as possible with clear guidance on when VAT will be payable for financial advice under the RDR, why it has not been payable in the past, along with any expected additional revenues from the change, and whether further reform of VAT rules in the area will be needed. The FSA should report to us on whether this imposition of VAT will have an impact on the provision of advice, and whether an unfair tax advantage between different advice models will result from the move to the RDR. (Paragraph 58)

Types of advice

10. We note the concerns raised by some about change in how advice will be described, especially around the 'restricted' label. We recommend that the FSA and other relevant bodies provide significant resources to explaining to the public the change, and in particular that 'restricted' may mean restricted by product, or by firm. (Paragraph 62)

11. We note the concerns held by some that simplified advice may simply replace the advice of IFAs with an inferior advice system. Without a fully developed system to allow analysis, it is not possible to know. We urge the FSA to maintain the pace of its work towards a simplified advice regime so that a competitive market can begin to operate. We recommend that the FSA (and its successor the FCA) report to us both on progress towards a simplified advice regime and, when such a regime is put in place, update us on how implementation has affected consumer outcomes. (Paragraph 66)

Transition

12. We take the concerns expressed about the adverse incentives towards poor advice that have arisen in the transition to the RDR very seriously. We therefore recommend that the FSA, and its successor, use all available tools to search either for pre-implementation churn, or post-implementation holding of clients, where that is not the best solution for the client. We expect to see the results of any regulatory findings. (Paragraph 70)

Overall costs and benefits

13. The evidence suggests that there will be a loss of market capacity, as some advisers decide not to comply with the new requirements. However, the FSA state that barriers to entry in the market are low. We are concerned that the loss of advisers, particularly individuals and those in small firms, will disadvantage smaller savers by reducing choice and competition. (Paragraph 80)

14. Personal savings in the UK are unacceptably and unsustainably low. We were therefore concerned about the impact that loss of advisers might have on saving. The FSA seeks to reassure us in its evidence, but we recommend that regular reports on the impact of the RDR on adviser levels, and savings through independent financial advice, should be compiled by the FSA and its successor. (Paragraph 83)

15. Implementation of the RDR must be to the benefit of consumers. Consumers will not benefit if it results in a reduction in choice and competition through a substantial loss of advisers and firms. Some advisers have already complied with the requirements of the RDR. We have no wish to alter those requirements, but do wish to allow more time for advisers to reach the required standards. Therefore we recommend that the FSA defer the introduction of the RDR by 12 months, alongside our earlier recommendation to temper the ‘cliff-edge’ nature of the reforms to the required qualifications. (Paragraph 84)

European and international issues

16. The FSA and its successor bodies will always be faced with difficult decisions over whether to proceed with UK specific legislation quickly, or wait until things have cleared at a European level. The FSA though should act wherever possible to remove consumer detriment in financial services, as it has in this case. (Paragraph 90)

17. We recognise that passporting (where firms from other countries within the EU conduct business in the UK) may seem to present an opportunity to some advisers to counter the implementation of the RDR. However the evidence provided to us by the FSA repays careful study. It makes it clear that passporting will only be possible in some areas, and cannot be used by UK operators as a device: "a firm may not conduct its business on a cross-border basis if it is doing so to evade the host state standards". We recommend that the FSA (and its successor the FCA) undertake regular scrutiny of operations passporting into the UK within the area of activity covered by the RDR, and report on action it has taken to limit this type of activity. (Paragraph 93)

18. We note the concerns of certain firms that the RDR may have a deleterious impact on their ability to provide a full service to High Net Worth individuals from their London offices. The FSA has not done specific research on the RDR's impact on this specialised area of business. We ask that the FSA as a matter of urgency review the evidence we have received related to these matters, and the proposed remedies, and report back to us on both the potential scale of the issue, and whether modification of the RDR might be possible to mitigate those concerns. We recommend that the FSA examines how to allow High Net Worth individuals, as determined by the FSA, the opportunity to opt out of the requirements of the RDR should they wish. This should also mean they opt-out of most or all protections that retail customers receive. (Paragraph 97)

The Financial Conduct Authority

19. We note the assurances of Mr Sants that the Financial Conduct Authority will be content with the RDR. However, the FCA will have different objectives to the FSA, and we therefore recommend that the Treasury, in response to this Report, state whether it is content that the RDR as currently constituted would be consistent with the objectives of the FCA as it currently sees them. (Paragraph 101)

20. The creation of the FCA provides an opportunity to examine the accountability mechanisms that will apply under the new system of financial regulation. We will therefore instigate an inquiry into this including the mechanisms proposed by the Government, as well as the concerns raised within the evidence attached to this Report, to decide whether they are adequate. (Paragraph 104)

21. We note the FSA's acceptance that there may be a need to look at whether a long-stop on potential liabilities should be instituted within financial services. We recommend that the Committee on the Draft Financial Services Bill, which would create the Financial Conduct Authority, consider whether there is a compelling case for a long-stop. Our view is that any long-stop would need to be shown to be clearly in the interest of consumers. (Paragraph 109)

Formal Minutes

Wednesday 6 July 2011

Members present:

Mr Andrew Tyrie, in the Chair

Michael Fallon
Mr Andrew Love
John Mann
David Ruffley
Tom Blenkinsop

Draft Report (*Retail Distribution Review*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 108 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Fifteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publishing with the Report (in addition to that ordered to be reported for publishing on 2 February 2011).

[Adjourned till Tuesday 12 July at 9.45 a.m.

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Oral evidence

Taken before the Treasury Committee

on Wednesday 9 March 2011

Members present:

Mr Andrew Tyrie (Chair)

John Cryer
Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman

Examination of Witnesses

Witnesses: **Hector Sants**, Chief Executive, Financial Services Authority, and **Sheila Nicoll**, Director, Conduct Policy, Financial Services Authority, gave evidence.

Q1 Chair: Good afternoon. Thank you very much for agreeing to give evidence to us on this sensitive subject, on which there has been a good deal of correspondence to the Committee and to you over a run of years.
Mr Sants, can I begin by asking you about the sense of priorities we can discern from your consultation paper, compared to the oral evidence you gave to us last time you saw us when this was discussed in response to a question from Mark Garnier? In your written evidence, one of the objectives of the RDR was that there should be, and I quote, "A market which allows more consumers to have their needs and wants addressed", but in your oral evidence you made no reference to consumers at all, even though you were invited to do so. Was that an oversight?
Hector Sants: I think broadly, yes, in the way you are putting it. I think the general point about consumers we feel underlies many of our initiatives so I was, for brevity, just trying to focus in on the specifics of the RDR, but I think in terms of clarity for the Committee we would say that was an oversight. Our basic objectives of the RDR have not changed, so sustainability and access remain in there. They are basic objectives that underlie, as I say, pretty much everything we do in the consumer sector, so I didn't choose to highlight them for brevity.

Q2 Chair: In which case when you said in your oral evidence about the RDR that it had become, and I quote, "More focused and more realistic in its intent", you were not then referring to the downgrading of consumers but to something else. What was it you were referring to?
Hector Sants: Yes, correct. I had in mind the speech that the then Chairman, Callum McCarthy, had given—I think at Gleneagles, from memory; I don't have my notes with me on that point—where he made some rather more general comments about the savings market being broken and therefore had set out what I would describe as a more ambitious agenda in respect of improving the savings market in a more holistic way. I was contrasting what I hope are focused, measurable objectives that we have for the RDR to the original speech that commenced the piece of work. My reference point was the inaugural speech that led the FSA to commence the RDR study, not earlier pieces of RDR material.

Q3 Chair: You have been working on the RDR for a long time. We have been inundated by those telling us that, with the creation of the FCA imminent, we should at least wait to give them an opportunity to form a view about this before implementing it. What is your response to that?
Hector Sants: I am not quite sure who "them" is, other than Martin Wheatley, obviously, who is due to join us in September, but—
Chair: Do you want me to read them out? I have a string of them here: the Financial Services Small Practitioner Panel, the Financial Services Practitioner Panel, Aviva. I could go on.
Hector Sants: Oh I see, you meant people making the suggestion; I thought you meant "them" in the FCA. I beg your pardon, a misunderstanding of your question. I thought you meant there were some other FCA people who we could consult with. But leaving that aside, I think from our point of view we feel that this is a thoughtfully constructed, vital reform to the market. We don't believe there is any suggestion in the thrust of Government policy that the FSA should be stepping back from continuing to deliver needed reform and improvements to the financial market.
The FCA obviously will be a successor body to the FSA. I think it is right and proper that it will carry forward those initiatives that have been properly assessed and have been through a full approval and consultation process. The RDR is one of those. We have had some discussion with Martin Wheatley, who obviously is not yet in post, but he is very content with that approach.

Q4 Chair: How far do you think the RDR can go towards encouraging a reduction in the savings gap?
Hector Sants: May I first of all say that the issue of reducing the savings gap, encouraging savings, is a central concern, I am sure, to Government and to you here in this Committee. It is very right that you should be focusing on this key issue. It is vital to the long term prosperity of the country. I don't think, however,

that we see the RDR as specifically designed to address that issue. Obviously, we hope, that if we have a marketplace that is working better and is trusted more by consumers, that this would have an influence on that issue but we are not specifically targeting the savings gap problem as a measurable, immediate consequence of the RDR. Sheila, do you want to expand on that?
Sheila Nicoll: Yes, I think that is right. It is clear that there are a lot of consumers who don't seek investment advice now. The figures are that 70% of consumers don't seek such advice, and even of those who have sought the advice, 40% have said that they don't necessarily trust it. I think a vital part of the initiative is to make sure we enhance the trust and confidence that consumers have in the market.

Q5 Chair: What about the view that savings need to be sold rather than merely bought, and that what we are going to do with RDR is reduce the number of people trying to sell it?
Sheila Nicoll: I think even if you do continue to say that it needs to be sold, it would be clearly easier to sell in the context of a consumer who feels they can trust the person who is selling it to them. I am not sure that the RDR necessarily specifically tackles an imbalance between the consumer buying or the consumer selling, but I certainly think the intention is that consumers would be more willing to participate in the market.

Q6 Chair: You are basing that view on research that the overwhelming majority or a large number of people don't trust the people who are selling?
Sheila Nicoll: Yes, we are.
Chair: I see.
Hector Sants: I am sure you will probably come on to ask us questions about the specifics of this in a moment, but just to add on, in terms of ensuring that there are the maximum number of available channels for consumers to access savings products, we do believe that an effective simplified advice service would be a very useful component to that architecture. I am sure you will come on in a moment to ask us how we feel the industry is progressing in developing those channels. We do see there are other elements of the jigsaw that we need to solve too, in order to improve the overall environment for consumers in respect of savings.

Q7 Michael Fallon: There was considerable anger, Mr Sants, among IFAs in my constituency at your admission to this Committee in November that a removal of 10% to 20% capacity would be acceptable. Do you now regret that? Don't you think that you were being a bit blasé with people's livelihoods?
Hector Sants: I am certainly happy to say I am sorry if we have caused offence and distress. It is never our intention to cause distress in the language we use and if you would like me to apologise for that, I am more than happy so to do. I try to be a mild-mannered individual and I am certainly not trying to make any remarks for effect or to cause distress.
What I was trying to do—which I am sure you appreciate I was—quite properly, in answer to a question, to lay out the assumptions that lay behind our statutory obligations, to carry out cost-benefit analysis in respect of any regulatory actions we take. I was laying out the facts that lie behind the cost-benefit analysis that underlies the RDR. I was reasonably being asked what those figures were. You would have found it odd if I hadn't been able to answer the question.

Q8 Michael Fallon: Is there a loss of IFA capacity that you would think was unacceptable?
Hector Sants: I think what we are talking about of course is improving the marketplace. Clearly, there is a level of capacity that we might judge then leads to the marketplace deteriorating in terms of the benefits it brings to society and, at that level, that would have to be taken into account in the calculation.

Q9 Michael Fallon: What is that level?
Hector Sants: I think it is very difficult to judge. One of the key aspects of the way we take forward the RDR has to be to constantly monitor how the marketplace evolves. We are in the process of developing some performance metrics, which we can no doubt give you a flavour of now. We will be publishing, however, a more lengthy paper on that in the autumn, and we will need to look at that as it progresses.
It is an interaction, of course, between the total capacity in the market, not just that of IFAs but all the selling channels; the costs that consumers are paying for access to a product and the ease with which they can access a product. In itself, I don't think there is a single number for specifically the IFA channel. What we need is a marketplace that works in the round for consumers.

Q10 Michael Fallon: So there is not a specific impact study of the loss of 20% of IFA capacity?
Hector Sants: There is a judgment by us that the loss of that capacity will not undermine achieving our objective. I have to say that we need to differentiate, we would need to get into detail here between numbers of advisers and numbers of the firms. We are estimating that the central number of advisers is a somewhat lower number than the number of firms; 10% to 20% covers a spectrum of advisers and firms. I think the number of advisers we have are more like 10%.
Sheila Nicoll: 8% to 13%.
Hector Sants: 8% to 13%, and 10% is the mid-point in that. In making the judgment, we are saying we believe that, with the loss of 10% of the advisers, the consumer experience is not adversely affected—that is correct.

Q11 Michael Fallon: Okay. The evidence that you have presented for the effectiveness of qualifications seems to depend on an Australian study that you conducted. It was conducted on a sample of 124 different financial plans. Why was there not a significantly larger sampler done inside the United Kingdom?
Hector Sants: We should, of course, recognise that there is, I think, widespread support in the

consultation process for qualification standards. I recognise that that is not the same as a specific study, but I would like to make the point that in the widespread consultation for the RDR—which, as you know, involved 2,500 or so firms being proactively contacted—there is strong support in the round, including from industry associations, for the qualification initiative. But on the detail of technical evidence, Sheila, would you like to—

Sheila Nicoll: I just wanted to say any conclusions that we reached are not based on any one piece of research. There has been extensive research, both of consumers and across the industry, in all the thinking that we have done around this and probably the most unprecedented consultation that we have ever had. We haven't just based our conclusions on one piece of research.

Q12 Michael Fallon: If there is such widespread support for all this, why are so many people unhappy?

Hector Sants: It is not clear to me, and this includes looking at our understanding of the submissions the Committee has received, that the majority of stakeholders are unhappy but obviously we look forward to receiving the Committee's report and we will take into account your conclusions. But it is not clear to me that we would say that in the round that this initiative is not supported. Our sense in the round is that this initiative is supported.. There are certainly, however, points where there are significant minorities of the relevant affected communities who have expressed concerns.

I am not aware of any particular initiative where you would say the majority of all respondents, both in terms of consumers and investors, as well as professional participants, are against it. If you would like to highlight any area where you think there is widespread opposition across the full spectrum of those who are affected, that would be a point we absolutely and rightly should take into very serious consideration. If this Committee reaches a view that you can identify something that passes those criteria, then we would listen very carefully to what you have to say.

Q13 Michael Fallon: I hope you would. You argue in your submissions strongly against grandfathering, but many IFAs have written to us asking how it is that one day they are fit to advise and the next day they are not.

Hector Sants: As you rightly point out, quite a number are concerned about grandfathering, I understand why individuals in those circumstances might take the view you have just described. It is not that we are not appreciative of why they would hold that view but there is an obligation on us to make judgments. Some of those judgments are difficult judgments where we have to weigh all sides of the argument.

We do have the majority of the respondents to our consultation favouring not having a grandfathering proposition. We do have concerns raised by a number of participants in the market that that would then not be a level playing field and we do have the consumer bodies clearly wishing not to have grandfathering, believing that we need to move to a position where people can have absolute trust that they are dealing with advisers who are properly qualified.

I recognise that you could have some sort of tagging or kind of kite-marking system but as we previously discussed, there are limitations to the degree to which consumers absorb risk information at the point of sale—a general point that you are all familiar with. Sheila, do you want to elaborate at all on that point?

Sheila Nicoll: Yes. I would also say that we have been conscious of the need to give advisers time in the build-up to gain the necessary qualifications, and they have known for some four years of the requirements to qualify to the next level up. We do feel that we have been reasonable in giving plenty of time for preparation in advance of the deadline.

Hector Sants: Again, I know you are familiar with this data because we have presented it to the Committee. Market research, which was conducted back in April 2010, had 49% or so of the advisers already qualified, 40% studying and expecting to qualify. So we effectively have, in round numbers—just for the record, round numbers—90% of the community back in April last year indicating that they expect to be qualified. We do need to put this understandable concern in the perspective of that type of information.

Q14 Chair: When you said that you were inviting us to find an issue on which there was widespread opposition, that was not necessarily the right criterion by which to assess where to look, was it, to see what might be right or wrong with these proposals. After all, many regulatory changes are likely to benefit some in the market at the expense of others, so some may be supportive of those changes. Large institutions may benefit at the expense of small IFAs, might they not?

Hector Sants: Quite so. I think I was hoping to respond in a helpful way to the particular observation that there was dissent about a particular measure and making the point that that would be a basis for us looking at the issue. It would not automatically lead to us changing our position but certainly widespread concern would be an absolute legitimate reason for us taking a look at the question again, so I think I was just responding—

Q15 Chair: I hope you have been looking at these things even where the concern has been small but nonetheless strongly felt.

Hector Sants: Quite so, we have indeed. Quite so, absolutely, yes.

Q16 Andrea Leadsom: Specifically on the point of grandfathering, we did have a submission from a barrister who thought that potentially refusing to allow grandfathering might in fact be illegal. I wonder if you have taken advice on whether there might be an application for a judicial review.

Sheila Nicoll: Yes, we have taken legal advice on this. There have also been challenges in the context of human rights law and we have satisfied ourselves that the powers that we have are sufficient, that it is legal and that we are doing this within the law.

Q17 Andrea Leadsom: Moving on to work-based assessments, because you have introduced the possibility of a work-based assessment as an alternative to an exam, may I ask why is that such a late entry and why was that not something that was considered early on, because obviously that might have removed some of the specific objections? In particular, why is the take-up so low? Have those types of assessments not been well marketed? What is your assessment of that?
Hector Sants: To the general point, it was always our intention to try to find some alternative mechanisms to pure formal, exam-based assessments. Again, back to some of the earlier points, I have quite some sympathy with why people who have been in the business for some time might feel uncomfortable as individuals being in a formal examination hall. We do recognise that point. As you rightly pointed out, it has taken some time to bring forward proposals, longer than certainly I would have liked and there are reasons for that. Sheila, would you perhaps like to—
Sheila Nicoll: Yes. I think it is something that we responded to comments that had been made to us, so it is an example of us having listened to the concerns of IFAs in this area. Some of them have been relatively slow in developing, but I would hope and expect that, now that they are on the market, we will see increasing take-up.

Q18 Andrea Leadsom: So you are promoting the work-based assessments?
Hector Sants: Yes, but the trouble is obviously that we needed to find a credible work-based solution that was not one that was seen as entirely self-assessed within the firm itself. I know some firms have said, "Why would that not be reasonable?" but equally I have sat with consumer bodies who have made very clear that they would find that a very uncomfortable position. It has been difficult, and we are recognising that, to work out how we could develop some of these workplace non-formal assessments without turning them entirely into a self-assessment process that we felt uncomfortable with.
Sheila Nicoll: And to make sure that they were as rigorous as more traditional methods. I think the fact that they have been approved suggests that we have satisfied ourselves that they are as rigorous as traditional methods.
Hector Sants: We are looking at this 10% I referred to earlier, who appear to be not actively pursuing qualifications at the moment. If that data I referred to earlier is correct, then we would certainly encourage them to look at this type of assessment process if their reasoning for not getting themselves qualified was their concern around the exam process. We certainly think there is still time to do that.
Sheila Nicoll: Yes, definitely.

Q19 Andrea Leadsom: You will be pressing people who have not applied for the qualification to consider this alternative route, proactively or just reactively?
Sheila Nicoll: We are certainly doing a lot of road shows with IFAs and others. We have got 1,500 IFAs who have signed up to road shows that are taking place over the next few months. This is certainly something that will be part of what we are telling them about in where their options lie.
Hector Sants: We would certainly encourage IFAs to continue to sign up. I am sure there is close interest in what we are saying here, so we can perhaps use it as another opportunity to say that we would really like people to come to our road shows.

Q20 Andrea Leadsom: One last question: on the level of qualifications, there is a significant minority of IFAs who have already gone to the full degree level 6 and there is a concern that obviously this is just the tip of the iceberg and within a couple of years we will be requiring a level 6 qualification. Is that your plan? Is there an intention to continually increase the level that IFAs are required to achieve?
Hector Sants: I wouldn't take it as a formal plan. I recall a discussion in an earlier Committee here where it was questioned whether we had set the qualification at a high enough level, and I think we responded at the time that this is something we would keep under review. However, we don't have a formal intention to do this at this point in time.

Q21 Stewart Hosie: Mr Sants, the fundamental flaw the FSA identified was that customers believed they were getting free advice when charges for advice were being added to the cost of the product and the product provider paid the adviser a commission, and that advisers may have been biased towards products that provided them with the greatest commission. That was in your letter. You have proceeded down the RDR process. Does that not simply confirm that the FSA were unable to police the previous regime properly?
Hector Sants: Two points. First of all, I think that the previous regime was probably not amenable to the type of policing that the FSA is resourced to or set up to do, so, in that sense, you are right. However, it would not be a realistic goal to have asked that type of regime to be effectively policed by us.
Secondly, I think we are saying that, in respect of the inherent payment structure that you referred to, evidence shows that it works against customers' interests. Surely it is right for us then to look at every possible tool to address that failing. Putting in place a transparent and more easy-to-understand system works both from the point of view of making an easier—to use your terminology—police system and also hopefully leads to changed behaviour patterns that work to the benefit of the consumer.
Sheila Nicoll: I think it is fair to say that we have explored and used a range of tools, as Hector has said, and we do recognise that the RDR requires substantial change. We have never made any secret of the fact that there is substantial change, and that is simply because of the extent of detriment that we found in the market.

Q22 Stewart Hosie: The change you are suggesting is the removal of the influence of commission by banning product providers from selling commissions, with advisers agreeing a charge on the basis of a fixed charge, an hourly rate or a percentage of the amount invested. That is kind of where we are, but practitioners are telling us that that still might not be

transparent or necessarily fair because consumers may still not be able to compare the cost of advice because the charging regimes will be different.

The RDR adviser charging regimes, as drafted, don't adequately reflect the way in which advice may be given by a business whose advice on financial instruments is not wholly based on retail products and because even where there is a fixed charge an adviser may be drawn towards a product with a high rate of commission than on a low rate of commission. Practitioners are telling us that even though you have put this new charging regime in place, it may still not yet be transparent and fair. How will you police that?

Hector Sants: I think it certainly will be transparent. If you are making the point—and I apologise if I haven't quite grasped the point, so please do come back if I haven't—that obviously they can charge different rates for different products, therefore that might still potentially bias their advice. You might argue that, in the sense that if they sell one product with a commission over another then that bias potentially could still be there, but at the end of the day I think we would make the statement that in the round that is still a much improved system over where we were. As for the policing point, Sheila, do you want—

Sheila Nicoll: Yes. I think on the policing point we do have an extensive programme, both in the lead up to the RDR and post the RDR, of supervising firms. We will be seeking data from firms and one of the areas on which we will be seeking data will be charges for advice, so that is an area that we will intend to monitor going forwards. I think one of your questions was also around the fact that commission will continue to be paid on other retail products. Was that also one of your areas of concern?

Q23 Stewart Hosie: Yes. The question was effectively in relation to the charging requirements. They don't adequately reflect the way in which advice may be given by a business where the advice is not wholly based on retail investment products, where there is a mix of things.

Sheila Nicoll: We are taking a targeted approach to this and for different types of retail products we are using the RDR as a benchmark and then asking ourselves the question whether we should apply the same rules to this other area—for example, general insurance—as we apply to the RDR. We are studying the detriment that exists in that particular market, so we are focusing our efforts.

For example, in the general insurance market we have concluded that the important aspect there is the nature of the cover, for example, and that is where consumers should be focusing. But we have very clearly said that if a broker is offering advice on investment products alongside insurance products, they should make very clear the commission that they are receiving, so that the total cost is visible to the consumer.

Q24 Stewart Hosie: I have just one final question. To go back to the fundamental flaw you identified, you said, "Advisers may be biased towards products that provide them with the greatest commission"; those were your words. In your answer, Mr Sants, you said that there may still be bias in the system. One of the concerns I have is that lots and lots of IFAs have contacted me and others, deeply concerned about this process. I think we all understand there are reasonable objectives behind it, but it is a little odd to be this far down the line and to have a concession that there may still be bias in the system, which is all this pain they are supposed to get rid of.

Hector Sants: I think that reflects the fact that I am afraid I am a cautious regulator. I am never one to claim we are going to have 100% success with anything. I am also conscious that we are in the world of the interaction between behaviour and economics and that that linkage is an imprecise linkage. It would be nice to say, "Of course this solves all the problems" but, to be honest, it is almost axiomatically true that we never solve all the problems with 100% probability when we are going into a change process. I am afraid it just reflects my natural caution in responding to your question.

Q25 Mr Love: Can I turn to classification of advice? A number of the submissions made to us have described the new categories, particularly restricted but also independent advice, as creating a muddle that confuses the consumer. The argument they have used is that it is confusing the industry, so what will happen to the poor consumer with these new categories? How do you respond to that?

Hector Sants: I think there are a couple of general points. First of all, I believe there is a strong body of support to try to differentiate between those two types of advice, two types of sales process. When it comes then to determining what was the right tag, nomenclature, to make that distinction, again I go back to my earlier comment of recognising that it is very difficult in the job to be certain of achieving perfection.

We have tried hard here to work out both what the terminology is we can use, and there were some limitations on the terminology in respect of European rules, and what works best. We have conducted some market research and so forth, which Sheila can elaborate on in a moment, to try to choose a terminology that achieves the goal that people are looking for, which is clarity around those two types of service. I recognise that in choosing terminology, we are in a world where we can't get perfection, and there will always be some who feel that a different terminology might have been better. But we have done market research to try and choose the one that has the most widespread support.

Q26 Mr Love: Perhaps you could tell me about restricted, because that appears to be the most difficult area.

Sheila Nicoll: Very briefly on the consumer research point, yes, we did considerable research with consumers and restricted / independent was where we ended up as a result of that.

On restricted, again this is an area where we have listened to comments that we have had in the sense that we do recognise there will be different types of restricted advice, so we recognise that there will be some advice that will be restricted, for example, to the

products of a single provider. There might be other areas where their advice is restricted to a particular range, so the firm may not, for example, give advice on life products and only on collectives. We are not being prescriptive in terms of what is meant by restricted and we are not being prescriptive in terms of how a firm describes its services, so it will be able to say, "I am restricted but I specialise in a particular area of activity".

Q27 Mr Love: But doesn't that put at a disadvantage someone who advises only on pensions but is otherwise independent, and others that are tied but only advise on pensions being in the same restricted category? I do accept the point Mr Sants made that you will never get a perfect solution to this, but that would confuse me. Didn't it confuse the panel of consumers?
Sheila Nicoll: No. We tried to keep it simple. We try to keep it as simple as we possibly can and we will require firms to describe the nature of the restriction on their advice.

Q28 Mr Love: I want to come on to simplified, because you mentioned it earlier at the beginning and I think it is an important consideration. Let me just ask, and correct me if I'm wrong, but you seem to be placing a lot of emphasis on the improvement and trust that will be created by the new regime to overcome any bias that may be lost from this whole issue that the Chairman raised about selling products and the commission-inspired sales process. Are you convinced, from your research, that this new regime will lead to an increase in trust? After all, I think you mentioned earlier that 40% of those who accept advice don't trust it, so we have got a major job to do here. Is this going to achieve it?
Sheila Nicoll: We hope so and we intend so, and we intend to monitor that fact. Once the RDR is in place, we will have a programme of continual monitoring of achieving what it is that we are seeking. One of them will be in this particular area in consumer research and the confidence and trust that they have in this market.
Hector Sants: But you are right, this is an absolute key yardstick by which the success of the RDR should be judged and we do believe that it will improve trust. It is not just that 40% figure. You have the other 70% of people not seeking investment advice at all. So we have 70% of people who don't seek advice at all and 40% of people who do don't trust the advice they get. That, I think we would all recognise, is a problem to be solved and this, we hope, will make a significant contribution to improving those statistics.

Q29 Mr Love: Which brings me to simplified advice, because clearly this is an area where both the industry and the regulator seem to be singing from the same song sheet. Are there difficulties? Will you be able to introduce simplified by the 2013 deadline? Presumably there are definitional issues at the heart of the difficulty in getting to a simplified regime.
Hector Sants: To the general point, the answer is yes, we hope so. We intend to make sure that certainly there aren't any regulatory barriers to doing that. At the end of the day, it is the firms that have to offer the service, not us, so that ultimately determines whether the service is available. We completely agree, as you have said, that this is a really important part of the overall savings architecture.
We also agree, and are working with industry at the moment on the point, that industry haven't yet got themselves to a point of sufficient comfort in the regulatory environment to be absolutely sure they can launch services that comply with our rules. So we recognise we haven't completed that dialogue. We have therefore accelerated our efforts in the last few months to do that. We were literally having meetings as recently as last week on the subject.
We committed recently, as you know, in response to some of the earlier concerns, which this Committee is aware of, to publishing a further paper in the summer—indeed, if we can publish it a bit earlier, we will do so—in which we would hope to give the firms, or we intend to give the firms, there the necessary certainty they need in respect of the regulatory questions to enable them to deliver the advice. Assuming we are successful in that goal, and we think we can be by the summer, then there would be enough time, we believe, for the firms to get those services in the marketplace by the deadline. So absolutely, the key priority for us at the moment.

Q30 Mr Love: Let me just ask you, Sheila. I am happy for you to answer that, but let me add a question. If there is any difficulty with the simplified regime, either in terms of constructing it or in terms of the industry getting up to speed on it, will that delay the introduction of RDR? Is it that critical?
Sheila Nicoll: No, I don't think it is that critical.
Hector Sants: We believe that the other measures in the RDR package are justified by the particular issues they address. I think the key importance of the simplified advice service is that it is a key component of helping to address the wider savings issue that was mentioned by the Chairman in the opening remarks. Having said that, we are pretty optimistic that we will address the regulatory issues, so hopefully that question won't occur.

Q31 Mr Love: Let me ask this, because the other side of that is if there is a two-speed, if RDR comes in and then simplified advice comes in, will that add to the confusion for the consumer?
Sheila Nicoll: I don't think it should add to the confusion. As Hector suggested, I think we would wish to make sure that any regulatory issues were solved well in advance, so if we do it in the summer, that will be 18 months in advance, so there should be plenty of time to bring it in. If it is a matter of a few months after the RDR deadline, I don't think that would be the end of the world.

Q32 Mr Love: A final question: we are in the process of changing regulators with all the attendant difficulties, and I know you are dealing with this on a daily basis, but do you perceive any difficulties from the smooth transition to the new regulatory structure?
Sheila Nicoll: No.
Hector Sants: There shouldn't be because, as I mentioned before in the opening comments, the FCA

is the successor organisation to the FSA and the specialist conduct staff under Sheila are clearly intending to work in that new organisation; they know that. That is a pretty seamless process. There is no movement needed, not even any physical movement needed, so they should be able to stay focused on their task, I hope.

Sheila Nicoll: We do remain very focused on our task.

Q33 Jesse Norman: Mr Sants, I wrote to Lord Turner a few weeks ago about the situation of my constituents, Alistair and Terry Hinton. They ran a successful local IFA firm that bought in compliance and other services from Berkeley Independent Advisers as an appointed representative for several years until 2004. During that period, their firm sold no products of BIAL and offered no advice relating to BIAL.

BIAL was later severely censured by the FSA. As a result, an entry was made by the FSA against the Hintons on the FSA register, which gives the quite false impression that they were directors of this firm, BIAL. As far as I am aware, there has never been any suggestion that the Hintons acted improperly and their existing clients, who are some 80 in number, have stayed with the firm notwithstanding the FSA's decision. The entry on the register has blighted their business, which has all but ceased to attract new clients ever since, and it has cost them huge stress and financial expense.

They made a complaint to the FSA, which upheld their claim that the entry is misleading. They have been continually stonewalled by officials at the FSA who have refused to remove the entry even so, while other agencies have deferred to the FSA. The situation, therefore, is that they, as far as I can see, have been declared guilty purely by association. This has impugned their reputations and cost them hundreds of thousands of pounds in lost revenue and additional legal charges. My question is this: do you think this is appropriate behaviour by the FSA towards an IFA?

Hector Sants: I hope you don't feel this is an unreasonable answer but I will be absolutely honest and say I am not familiar with the details of the particular case you have raised. I think for me to suggest otherwise would be misleading. I can see from the comments you have made why your constituent would feel upset. Experience tells me, of course, it is always important to evaluate all sides of the story.

If you, through the office, pass me that material immediately, or if you prefer to write to me, I undertake to respond to you immediately and, I hope, in a totally satisfactory manner, and I'm happy to share that with the rest of the Committee. I think for me to suggest otherwise at this stage would not be fair to either my staff or your constituent. I can see from the points you have raised publicly why you feel that is a reasonable question to pose to me.

Q34 Jesse Norman: I am very grateful for that; thank you. A further question is do you think it is right that the FSA should be almost immune from public accountability on these kinds of issues?

Hector Sants: I don't think we are immune from public accountability. I am an extremely strong supporter of accountability. I hope I have always given that impression and I, on a personal basis, will always make maximum effort to make sure that any questions and challenges put to us are answered in an open and transparent way. I demonstrated that, I believe, in the post-crisis period in a number of different ways.

We clearly are accountable to Parliament through a number of mechanisms, including this Committee, which, as you know, I take extremely seriously. I am also a strong supporter in the new legislation of ensuring we have maximum accountability. In particular, I personally have been very supportive of, and indeed I believe, with Government, were instrumental in making the suggestion, that in the event that we have regulatory failures, either in the FCA or in the PRA, there is some clear mechanism to avoid confusion in the future and that we account for those in a clear and transparent mechanism without constraint from our supervisory powers, which as you know, cause problems in terms of revealing information.

I think we are accountable. We can, of course, be judicially reviewed but, nevertheless, I do think in the new legislation that we should be looking to improve that accountability framework. I am a strong supporter of that particular suggestion, which is already in the consultation document.

Q35 Jesse Norman: The difficulty is that these complaints can reach you via the Treasury Select Committee or otherwise via a law suit, and there doesn't seem to be anything in between. The question is whether that kind of immediate accountability—

Hector Sants: We have a complaints commissioner specifically for those. Many consumers, of course—and I'm sure you will appreciate, which is not the nature of the complaint that you have raised—do write to us thinking we handle individual consumer complaints in relation to firms, which of course, as you realise, is a matter for FOS, but we have our own complaints commissioner process that is available for people who feel the FSA's process has not delivered as it should. We have a review process and we have an accountability process in Parliament.

As I say, I am supportive of an additional layer of accountability when major regulatory failures occur. I am also supportive of the NAO being a review authority for the FSA. If you have other accountability mechanisms you would like to suggest, I am sure you will do so during the Bill period and we are certainly are happy to take them into account.

Q36 Jesse Norman: Thank you for that. The RDR is principally about improving the standard and the quality of retail investment advice, but it is very striking that a large portion—maybe as high as 70% or 80%, or maybe more—of a typical financial adviser's work does not involve offering investment advice as defined by MiFID. How would you react if firms de-authorised most of their advisers?

Sheila Nicoll: I think our reaction would be that we would need to make sure they were no longer giving investment advice.

Q37 Jesse Norman: But provided that the investment advice is given by authorised advisers, you are happy, in principle, for the FSA to allow large numbers of members of its firms to be de-authorised?
Hector Sants: I think you then come back to the opening point about the point at which you make a judgment that the market is no longer working efficiently for investors. So we wouldn't be happy if that then damages the efficiency and effectiveness of the market in servicing investors. It is true, perhaps I can state what I think is obvious but in the light of that question it might be worth doing that, namely that the FSA and the FCA going forward, our obligation is to get an efficient, effective and fair market for society as a whole, for investors. So the judgment is: is it working for investors? We are in the consumer protection business.

Q38 Jesse Norman: But the consequence of that approach might be to lower the cost of access to financial advice that was not regulated or authorised.
Sheila Nicoll: I think we would be conscious that quite a lot of IFAs give advice that doesn't go towards the RDR. Indeed, a lot of lower-income individuals may not need investment advice. They may need advice on protection, they may need advice on investing cash, and to the extent to which advisers are not giving investment advice but are giving that kind of advice, then we would have no problem, provided that they weren't giving investment advice.

Q39 Chair: To go back to this accountability question for a moment, and you were asking for suggestions from us a moment ago on how accountability might be buttressed; it is correct, isn't it, that you are immune from redress in the courts for negligence?
Hector Sants: Yes.

Q40 Chair: It is also correct, is it not, to say that you are immune in the courts for gross negligence—that is, reckless behaviour?
Hector Sants: I think that is correct.
Sheila Nicoll: I think we need to check that.
Hector Sants: I think that is correct, yes.

Q41 Chair: I'm 99.9% sure it is correct. Reckless behaviour was defined for me when I asked exactly this question when FSMA was going through Parliament. Recklessness was described as doing something really stupid knowing it's really stupid. Do you think that you should retain immunity from redress in the courts for doing something really stupid knowing it's really stupid?
Hector Sants: Of course, presumably the question is: who would pay? Would you then be suggesting, given our only revenue raising capacity is the firms, that in the event that you judge that the officials had breached the requirements you outline, we would then retrieve the money from the firms, or if you felt we should be paying, you probably would find you would have an issue as to who would want to work in regulation?

Q42 Chair: That is not an answer to the question at all, is it? Of course, the fact that you may be subject to action in the courts will alter your behaviour. If you know that you might be held culpable for reckless behaviour—that is, doing something really stupid knowing it's really stupid—you are going to be extremely careful not to do something really stupid knowing it's extremely stupid.
Incidentally, an example of such recklessness was given, as I recall, in Committee, which is looking at something that you know has a very deleterious effect, has a negative bearing on the reputational risk of a firm, looking at it, knowing that it probably needs action, putting it in your pending tray and going on holiday for a fortnight. You are immune, as an organisation, from redress for action of that type, are you not?
Hector Sants: I believe so, yes.

Q43 Chair: Do you think this is something we ought to visit? You asked for a suggestion and I have now given you one.
Hector Sants: I think it is a very complicated question and I think it is an interesting question I would be happy to pursue the conversation or write back. Even the example you give, of course, demonstrates why this is a very complicated question because the action you have described is an action that would require somebody to make a judgment as to whether that was truly reckless—that is, was that really something that couldn't wait until point X in the future.
If you want to have more judgment-based regulation, which of course is a phrase Government policy is asking for, and less box-tick regulation, then you need the individuals willing to exercise these judgments. You are raising a set of questions about their willingness to engage in the right sort of brave judgments that you are looking for. I think it is an interesting question; I invited a debate, and you have rightly picked up on that, which I appreciate. I am happy to come back to you but I think even the example you have used shows this is not a straightforward question.

Q44 Chair: I agree with your view that it is not straightforward and I am not now trying to persuade the Committee to recommend to you that we do this. This is something that may need to be examined. I recognise, too, that you need protection from vexatious action by counterparties with extremely deep pockets, which can also be prejudicial to the good conduct of regulation. Nonetheless, the fact that you are only liable for acts of bad faith in law, which are extremely difficult to prove, may be something that needs to be looked at again in the context of this legislation. By the sounds of it, you are happy to consider it.
Hector Sants: I am certainly happy to look at it. I think it is a good question. I would maybe make one further passing observation. I think there are accountability mechanisms as such, including this Committee, for when people feel that individuals have

made poor judgments. We are already held to account in a way that makes us give very careful consideration to the judgments we make as individuals, but this is a slightly different point.

Q45 Jesse Norman: A follow-up point on this issue of accountability. I think it is fair to say that many other people in private companies operate as directors on a basis that involves the discharge of fiduciary responsibilities dealing with customers, without any concern as to whether they are being held on a gross negligence-free basis or not. They may have D&O insurance, but in many companies they won't even have that. So it is not clear that the deterrent you describe would necessarily apply. That may just be needlessly alarmist.
Hector Sants: I take the point you are making and, as I have already indicated to the Chair, I think it is a fruitful area for discussion. I would certainly expect, when the new legislation goes through Parliament, that this whole question of accountability is one that should be properly considered. I also recognise that the climate around the accountability question has changed considerably, and indeed around the transparency question, since the original FSMA legislation. I see it as a very important point to recognise that society's views on what is appropriate now, with respect to transparency and accountability have changed dramatically.

Q46 Chair: It has a heavy bearing on issues where great reputational risk attaches to any action.
Hector Sants: I think it is a complicated subject and we do need to think carefully so that we do not end up with the situation in which people don't want to be regulators—that wouldn't really help us—but there is a very meaningful debate to be had here.

Q47 John Cryer: I just want to return briefly to the question of commissions, which Stewart Hosie raised with you. In your answer, you said—and this isn't an exact quote, but this is more or less what you said—they can still charge different rates for different products. That worries me quite a bit because in the 1980s and 1990s we had various scandals involving the payment of commission. It was very often in industrial areas where you had widespread payments of large redundancy cheques. That made those areas a target for certain individuals who, in pursuit of commission, misled people by what they were selling them. Is the system going to be sufficiently transparent to ensure that sort of scandal doesn't happen in the future?
Hector Sants: We hope so, plus again, back to the earlier point, we are putting in systems to monitor commissions in a way that previously the regulators were not.
Sheila Nicoll: I think the regulatory system has moved on quite a lot since then anyway, regardless of the RDR. I think the important point about different costs for different services is also about consumer choice and it is about consumers understanding how much they are paying and them being in control of how much they are paying, and that is precisely what the RDR is about.

Q48 John Cryer: But to make those choices they have to have the information at their fingertips. Is the industry going to be in a position where it has to provide the sort of information, full information, that is going to be required for consumers to make choices?
Sheila Nicoll: They will have to explain the service that they will be offering and how much they will be charging for that service. Yes, they will. I think the issue is that under the commission arrangements, the individuals just don't know how much they are paying and they don't know that they are paying for advice and, therefore, have no control over it. So the intention is that they have a lot more control and that, because they know how much they are paying for that advice, they also value that advice.

Q49 John Cryer: Yes, all right. Just moving on. We have had a number of submissions from private banks stating that high net worth individuals might be tempted not to use London as a base because of the RDR. Would you agree with that?
Sheila Nicoll: I would be very surprised by that because I think in many ways the RDR is going in the direction of the sort of ways that high net worth individuals expect to interact with their advisers in the sense that I think you would find that the high net worth individuals—there is more fee business, for example, and, therefore, I think it would be going with the grain of the way that high net worth individuals already operate in the market.

Q50 John Cryer: Has the FSA done any work on this particular area? Is there any research?
Sheila Nicoll: The research that we have done has covered the whole area. The consumer research that we have undertaken has been across a cross-section of types of consumer.
Hector Sants: On the point you have just made, Sheila, it is not obvious to us—and again when you come to make your report if you want to spell something out here we can take a look at it—how the high net worth model would be adversely affected by the RDR. There are various different types of models, but they don't seem to be particularly at variance to the RDR. So no, we haven't specifically done research in that area, being absolutely open about it. If there were grounds for so doing again, we could take a look at that.

Q51 Mr Mudie: Hector, are these proposals final?
Hector Sants: Yes, is the short answer in the sense that our rules are broadly made and we are moving towards implementation.

Q52 Mr Mudie: Hector, I am just asking: are they final?
Hector Sants: They are final, yes, except—it is reasonable for me to put an "except" on this—insofar as we are a regulator that needs to constantly monitor the market, constantly determine whether the model we have in place works and to take into account new information. Yes, they are final, but if new information came to light you would expect us to sensibly look at it.

Q53 Mr Mudie: Let's just go to a different point if they are final. In a reply to Michael Fallon, you said, "Obviously, we'll take into account your proceedings". How on earth do you take into account our proceedings if they are final? You have said, quite rightly, "Well, we'll revisit them when we see how they're working", but we are having the hearing now and we are going to produce a report. What is the point of this report if they are final?
Hector Sants: I think I just answered that in my last comment, which was if you give us new information then we should quite properly take a look again at the issue generated by any new information that you give us. We have studied carefully the information that we have seen that has been submitted to the Committee so far. I am not sure we felt there was anything that it was telling us that we hadn't already taken into account. However, we are very respectful of this Committee and if you lay out to us new information that means we should take another look, we will do.

Q54 Mr Mudie: Why, Hector, should you dictate the terms under which we ask you to look at something afresh? We are talking about accountability and we have agreed, as a Committee, to look at the bank and the new arrangements because we are concerned about the accountability of you and the bank to Parliament and this is a key forum. You tell us here the criteria will be that we produce more information for you. What if we say to you, "We don't think you're right and we're representing the people. We've been elected and you're going to harm, by these acts, a lot of innocent people"? Would that meet your criteria? It doesn't seem to.
Hector Sants: If the evidence you presented to us led to—
Mr Mudie: You are interviewing us now.
Hector Sants: But, if I may, I think the way we work is we are accountable to the framework that Parliament places us in. We are currently operating to our FSMA framework and I'm not aware that the FSMA framework, which Parliament set up, vested powers in this Committee of direction over the FSA as an independent regulator; I believe Parliament was setting up an independent regulator.
We are completely accountable to Parliament. If you, through the parliamentary process, want to change our accountability mechanisms and the way in which we take direction from Parliament, then I will completely respect that. If I am told by Parliament that direction from this Committee is one that we are meant to take then of course I will take it. I am sure you understand the point. I am not trying in any way to be difficult. I am trying to take forward this initiative within the accountability framework Parliament has given us.

Q55 Mr Mudie: No, I think you are making a very valid point, and it is good that you say that bluntly to the Committee because we are concerned about your accountability. You are saying, "Unless you change the law, I'm not accountable to you. I might listen to you and if you put a strong enough case on I might consider it, but I'm the final word". I just find that a very strange position in a democracy when the elected member will say to an official, "We think you should have another look at that. I want evidence, Mr Mudie or Mr Tyrie. I want evidence and I might consider it". Let me just move on.
Hector Sants: Can I just make one point for the record? I would appreciate it, which I am sure was not your intention, that given the importance of this issue to a large number of individuals, it is not a personalised point. I am sure you recognise I am trying to represent the FSA in a professional way, so it is not me saying that.

Q56 Mr Mudie: It is very much a personalised point. Let's move on. You describe yourself as a cautious regulator and I find you a cautious regulator when it comes to the banks, but not individuals. Do you have in the FSA an age profile of IFAs?
Hector Sants: I think we have. I'm not sure if I have it immediately to hand, but I believe we have, yes.

Q57 Mr Mudie: How many are over 60?
Sheila Nicoll: We don't have that information immediately here but I think we can provide it to you.

Q58 Mr Mudie: But you should have had it and it should be in the back of your minds because you have taken an action that affects over-60s.
Sheila Nicoll: We do know that there are quite a considerable number of IFAs in the older—

Q59 Mr Mudie: How many are over 60? You could be forcing five or 50 or 500 over-60s to spend very valuable money on something that will take effect in two years—well, maybe one year, but two years—and they will retire within three.
Hector Sants: We do have the statistics—I am afraid I don't have them at hand—of those within five years of retirement age, don't we? We do have that statistic.

Q60 Mr Mudie: How many, Hector?
Hector Sants: I am trying to look through my brief here. If you accept it as a provisional figure, I thought it was something like 10%. We have about 8% of advisers leave the industry a year. I would have to clarify that.

Q61 Mr Mudie: Do you have a length-of-service profile that matches the 60-year-olds?
Hector Sants: A length of service of how many—

Q62 Mr Mudie: I could be 30 years in the trade. I could be reaching retirement age and you are saying you won't give me grandfather rights. Why would that be so bad under those stated circumstances?
Hector Sants: I come back to my earlier answer to the question. I think these grandfather rights basically—
Mr Mudie: No, I heard your earlier answer.
Hector Sants: It is a finely balanced argument, but the question is in the round which way do we—

Q63 Mr Mudie: Hector, with the greatest deal of respect, you did not address an individual point about a man or a woman over 60—55 onwards, even. It would be for you to put some proposals on the table to say, "This is where I think it is reasonable or unreasonable". You didn't consider age and you didn't

consider length of service. You can't tell me how many over-60s have been in over 20 years, and then I would say even then how many with a trouble-free record? You can't tell us.

So you took a decision, a blanket decision. Don't you think that was unfair and don't you think that is a reason for revisiting grandfather rights? Not opening the floodgates. Grandfather rights are like that; they're not dispensed freely but they're dispensed with a view of the harm that you are doing somebody who has given a given industry years of good service and approaching retirement. You don't think that is something you should look at?

Hector Sants: I certainly think that it is absolutely good justification for us to write you a carefully constructed letter with those statistics in and do what exactly you have asked us to do, which is give consideration to that point. I am happy to do that because you have made a number of reasonable points. I, however, still continue to make the general point that we are primarily focused on a level playing field and the majority of our respondents wanted a level playing field, including—

Q64 Mr Mudie: Hector, none of the pieces of evidence said that at the aim for perfection you knock out the good. At the aim for getting a perfect situation, you are prepared to destroy an individual. I don't think that is acceptable and I don't think anybody reasonable would think it was acceptable. Besides, I put another point to you. Have you considered—

Hector Sants: They can take the qualification if they want to. We're not—

Mr Mudie: No. Have you considered, at the same time to be fair to the FSA, saying, "Look, under those circumstances, we might have to regulate you a bit more closely, so we might have to charge you a bit more money"? You could build up a package that is fair to the FSA and fair to a certain group of people.

Can I just raise the question of Europe? Is it not true that passporting will allow someone to come in here from Europe, or someone from here to go to Europe—maybe hired or affiliated to a firm over there—and come back and carry out the job without the RDR regulations?

Hector Sants: In respect of some of the RDR regulations on passporting, yes.

Q65 Mr Mudie: I have noticed that in your press releases you don't indicate which ones work, but clearly you are going to spell them out.

Sheila Nicoll: If somebody is operating from a branch here in the UK, they will be subject to the RDR requirements. If they are providing services on a cross-border basis without a place of business here in the UK, they won't be subject to the RDR. But they would need to be authorised in their home Member State, and some of the authorisation requirements are more stringent in other Member States than they are here. Also, if it was clear that they were doing it specifically to avoid the RDR, we would be able to apply the RDR to them.

Q66 Mr Mudie: Yes, but you would have to prove they were doing it and that is as bad as proving Hector is doing something deliberately to harm someone; it is very difficult. Passporting will knock some holes in the RDR facade that it affects everyone. It doesn't. If you come from Europe, you will be able to do the job in here and not be covered by a fair bit of the RDR. You will give us details of which bits don't affect that. But the more important thing is—and I know Mr Garnier is going to go into this, but just for the sake of my last point—what is the cost to the industry, as we sit, of the RDR proposals?

Hector Sants: The cost to the industry? The estimates are the same estimates as we gave you the last time, which is including the one-off implementation cost, the £1.4 billion to the £1.7 billion, which was the figure we discussed, over five years. The statistics are the ones you are familiar with.

Q67 Mr Mudie: You have written evidence and we have written evidence from one firm that says, "Why on earth are you putting us through this when Europe is in the process of dealing with the same regulations and their regulations will overcome our regulations?" So, Hector, why are you putting firms through the costs of £1.7 billion when, within a couple of years, they can be overtaken by Europe? The firm will never forgive me for not mentioning their name, but I cannot find it on this. I'll get it before the end if you challenge it. They are a big firm and they say they put the additional cost at €500 million for PRIPS. Why are we in such a rush? Do you find that amusing, Mrs Nicoll? The industry doesn't.

Hector Sants: I very much doubt they would be in a position to accurately price out PRIPS at the moment. We are very conscious—

Q68 Mr Mudie: Is that the point, Hector?

Hector Sants: No. I was going to answer the point. We are very conscious of the general point that is being made, which is a very important general point. Undoubtedly, we don't disagree—I have said this, again, many times to this Committee—that rule-making authority is broadly gradually moving to the European architecture, as you know, and also that consumer issues are rising to the fore of that European agenda over the coming years. Both are statements of truth. We have given a lot of thought, therefore, to try to ensure alignment between the RDR and what we believe will come out of Europe. Also I think the timeline is somewhat longer than you have alluded to. I don't think we expect it to occur on that sort of timeframe. Again, Sheila can give you the detail.

Q69 Mr Mudie: Hector, I don't think you can say that you are quite sure about it or sure about it because they are still out for consultation, and who are you to anticipate what will arise out of consultation? It would be bad if you're speaking to the Commission and you are telling this Committee that the Commission have told you what they are going to do while they are still out consulting Member States.

Hector Sants: No, I am not saying that. I am saying that we are, as you would expect, in dialogue with the Commission, which I believe is our role to try to influence the European agenda, and I know it is very important to you that we do seek to influence the

European agenda. We are comfortable with the model we are introducing here in the UK and we are proposing that as a way forward in Europe, and that is what you would expect us to do. I am certainly not saying that I know what the Commission is going to do.

Q70 Mr Mudie: Yes, but the European one will be the one that wins, so if it is not as you suggest that they are agreeing with you—and you can't say that because it is still out to consultation—it means that you are charging the industry to spend £1.7 billion chasing ahead and Europe are doing the same job, instead of saying, "I think we'd better wait for Europe before you start doing those computer programmes and spending this and spending that" and even going out to the industry—

Hector Sants: The question then must be how many years do you want to weigh against the potential detriment? We have also laid out the statistics here before of the potential detriment, which includes some very big mis-selling events, which total up to some £15 billion. We have PPI as well currently ongoing as a major event. The question is what is the trade-off, and that is a judgment that we have to make.

We also note, in addition to the actual pounds million detriment numbers that we have laid out to the Committee before, we have in recent times done thematic visits and file sampling exercises. That sort of data strongly supports the type of detriment statistics of £0.4 to £0.6 billion per annum that we have previously reported to this Committee that the review processes—that is not the same as saying mis-selling has occurred, just for the record—in many of the samples suggests failure rates of 16% and 46%.

There is evidence—in our judgment, very good evidence—of significant current consumer detriment. So, yes, we have to make a judgment between seeking to address that problem now and the possibility—I take your point that we are not responsible for the final determination that Europe makes, that is absolutely correct—that at some point in the future, a number of years hence, the European regime might come out with an outcome that is somewhat different to our proposal. That is possible. The question is what if we make the judgment in the round, and we judge on the basis of the data we have, that that is a reasonable judgment to make?

Sheila, you might like to expand a bit on the timeline, which seems pretty important to us, of the European debate. If it was happening tomorrow, then your point, I think, is much more powerful.

Sheila Nicoll: I think, as you say, they are in consultation at the moment. We don't yet have legislation in the context of PRIPS and we are not expecting that until the end of this year. Most European legislation—

Mr Mudie: This doesn't come in until 2013, so you have plenty of time.

Sheila Nicoll: Yes, but most European legislation then has a lead-in period and a transitional period. We think that would take us well beyond the RDR deadline date.

Q71 Mr Mudie: That is okay, but you are asking an industry to spend £1.7 billion and you don't know that it is not going to be made redundant by the European legislation.

Hector Sants: Of course we are not asking them to spend £1.7 billion in one year. It is over five years and therefore in the event that, which we wouldn't expect, somehow or other the European legislation came in in a shorter timeframe they would not, of course, spend the money that would be due in any of the following years. I don't think it is quite the same as saying it is a one-off cost of £1.7 billion. I think that is slightly misleading.

Q72 Mark Garnier: Following up on that point, that £1.7 billion is going to be frontloaded, isn't it? It is going to be immediate cost, so a significant proportion will be in the first couple of years, so you do have some coming in.

Can I quickly turn to commissions, and in particular trail commissions? One of the submissions that we have had suggests that firms are moving to place business pre-transition to secure as much income as possible through trail commissions while the facility is still available. Have you done any work to monitor this or to try and assess whether that is right?

Sheila Nicoll: It is one of the risks that we have very specifically identified in the lead-up to the RDR and is one of the areas that we are very specifically looking to in our supervisory activity, yes.

Q73 Mark Garnier: What are you doing about it?

Sheila Nicoll: We will stop firms carrying on—if we do find that they are flouting the rules by taking trail commission inappropriately, we will take action against them.

Q74 Mark Garnier: How do you decide what is inappropriate? They could be genuinely selling a product that is absolutely right for the consumer but then you may turn around and say, "Well, we think you are doing the wrong thing". How does this work? You are not the financial adviser, are you? You are not the ones that can determine what is best for the consumer.

Sheila Nicoll: No, but we can consider whether advice, for example, is suitable. As Hector has already indicated, we do that now on the basis of file reviews and so on, whether advice is suitable and, for example, we can look at trends among particular advisers, compare particular advisers against other advisers. Particularly the way that we supervise smaller firms is by looking at trends and looking at returns data and we will continue to do that in the lead-up to the RDR.

Q75 Mark Garnier: Another suggestion is that if you do have a significant amount of selling of a product with trail commissions running up to it then it will prohibit or it will deter on-selling afterwards. So, you might get a lack of good advice afterwards because people want to leave their clients with the pre-sold package with the trail commission. So, therefore, you might get a reduction in advice afterwards.

Sheila Nicoll: Well, there may be an immediate effect, but I think if individuals are being given suitable advice then our approach would be exactly the same post-RDR as it is pre-RDR, in that we would take judgments about the suitability of advice. There are suggestions at the moment that there is too much churn in the market because of initial commission and so therefore a certain amount of less activity may be appropriate, depending on the circumstance of the particular individual.

Q76 Mark Garnier: One of the problems with this whole business of trail is that of course it gives a value to a firm, it gives ongoing recurrent earnings to a firm, and therefore the value will change. Clearly there is going to be an interest by firms in order to try and get some sort of replacement to a trail commission. I understand anecdotally that people are now looking at alternative ways of getting a trail commission, which can be a notional advisory fee given by a product provider. What are you doing to look into that?
Sheila Nicoll: Well, we are certainly saying, and our rules very clearly say, that if post the RDR, a firm is taking trail commission, then individuals will still be able to pay for the product through the product, but if trail commission is going to be paid going forward that has to be clearly against the provision of a continuing service and that the individual should be able to say, "I don't want that service any longer and therefore I want you to stop receiving trail commission".
Hector Sants: I think the general point that comes from a number of the questions raised, which we would completely agree with, is that strong policing is also required alongside effective rules. There is no question about that and we are much more active, as you know. In the last couple of years since we have changed elements of our supervisory strategy, we have been much more willing to firmly intervene with firms to stop them doing things. That is not something historically that the FSA was particularly inclined to do, as you know. We have had that debate. We do need to have a firm supervisory policy to sit alongside this rule framework; there is no question about that.

Q77 Mark Garnier: I am going to come to that in a minute. Can I just quickly look at commissions versus fees? What evidence do you have that the smaller investors—and I am particularly thinking of the bottom two deciles, the bottom 20% or so of investors—particularly want to go and pay a fee as opposed to commission? Anyone can answer it.
Hector Sants: I think we have the research, but generally speaking I think your point is well taken. There is reasonably good evidence of the willingness of potential investors to pay fees, but that does correlate with the available amount of money for the investment and clearly at the lower end—
Mark Garnier: What is "reasonably"?
Hector Sants:—there is a risk that they would not want to pay, which is why we are encouraging the development of the other advice channels and it takes us back to our simplified advice point earlier. So, we do absolutely acknowledge that moving to more of a fee-based environment in terms of the overall marketplace working requires simplified advice and other services to also be available.
Sheila Nicoll: That is also why we have said that the investor doesn't necessarily have to pay an upfront fee, and it was particularly thinking of that end of the market. If they don't wish to pay an upfront fee, they can continue to pay through the product but the difference between now and post RDR will be that that level will be agreed with the consumer and by the consumer rather than being decided by the product provider. So, the product provider can continue to facilitate the payment for the advice so there is not necessarily a need for the investor to pay an upfront fee.

Q78 Mark Garnier: So, it is essentially factoring?
Sheila Nicoll: No, it's not factoring. It is facilitation through the product so it is—

Q79 Mark Garnier: It just seems a very complicated system to go through. You talk about transparency, but the fact of the matter is that transparency is about disclosure. Surely it would just be a lot simpler and a lot cheaper to have a disclosure rule that says you have to show what the fees are, rather than going through this incredibly expensive and convoluted process?
Sheila Nicoll: We have a disclosure rule now and—

Q80 Mark Garnier: So why isn't it working?
Sheila Nicoll: The evidence from our consumer research is that consumers don't listen to that disclosure; they don't understand the effect.

Q81 Mark Garnier: What are you doing to educate the consumer?
Sheila Nicoll: Well, we have done quite a lot in terms of educating the consumers— **Mark Garnier:** But not enough.
Sheila Nicoll:—over many years, but it has become fairly clear across the board, not just in this area, that disclosure is necessary but not sufficient, particularly when dealing with consumers.
Hector Sants: But the point you are making is an important one, which is the general proposed shift in the consumer protection strategy of the FSA, which we would envisage being carried over into the FCA, as myself, Lord Turner and others have articulated here, does recognise a view that point-of-sale disclosure alone is not a sufficient mitigant for avoiding significant consumer detriment.
That was the model the FSA was working to, namely that the principal issue regulatory tool was not policing, it was point-of-sale disclosure: that was the prevailing philosophy historically. The evidence, however, suggests that overall, given what has happened with endowment mortgages, what has happened in PPI and a number of other areas, that society finds that level of consumer detriment unacceptable. Therefore, we are moving to a different model. So, that is correct and the educational remit, of course, of the FSA in any case now sits with CFEB, but that is a separate point.

Q82 Mark Garnier: You have referred on a number of occasions to your consumer research and there is one in particular that came up that 70% of people don't seek advice and of those people who do, 40% are unhappy with their advisers. What is the profile of those 40% who are unhappy with their advisers and in particular what is the profile of their advisers?
Hector Sants: Do you have the detail of that to hand?
Sheila Nicoll: I don't think I have the detail of that to hand.
Mark Garnier: If you don't have it with you if you can—
Sheila Nicoll: Certainly, yes.
Hector Sants: It is an important one, this, because—

Q83 Mark Garnier: If you could just give us a general view. You must know who they are.
Sheila Nicoll: I think any research that we have done, as I have indicated before, has been very deliberately across a cross-section. I can't tell you at this stage whether there was a particular profile, but certainly whenever we have done consumer research we have made sure it is across a cross-section of types of consumers.
Hector Sants: Our presumption is that we properly sample the marketplace as a whole. I am very reluctant to assert things with absolute certainty if I don't have the piece of text in front of me and we would rather confirm that, but I think that is our assumption.

Q84 Mark Garnier: What I worry about is that if you look at a *Which* survey done in 2007, that found that when they did it blind—sort of secret consumers—they found that 84% of bank advisers failed to pass all the benchmarks for good advice compared with just 66% for independent financial advisers. Unless you can be absolutely clear on who is creating that worry among that 40% then are you possibly not doing the right thing in terms of RDR?
Hector Sants: I think there is a presumption there that the RDR is targeted solely at the IFAs. It is a general reform of the savings environment. The debate does at times suggest this is an IFA-focused agenda. That is, of course, not the case.

Q85 Mark Garnier: But the reason why this has re-emerged and why we are getting a lot of submissions from people is that it is this type of independent financial adviser that George is talking about—the person that has been working for many, many years who has a trusted relationship with their consumer. The type of person like my constituent Mike Jacob who has a shop in Stourport High Street and he networks at the Stourport Working Men's Club. He is not treading the pavements around the family offices in Mayfair. This is somebody who is looking at the bottom end of the market and this is a key point. We have a savings gap and we have to address that and this RDR, from the huge amount of complaints we have had from people, is affecting exactly those people in the market who are going out trying to address this savings gap.
Hector Sants: First of all, I am perfectly conscious that we need to be very sensitive to and recognise the impact on individuals. To be fair, I don't think you are suggesting we are not as individuals sensitive to that point, and I perfectly understand why individuals may feel from their perspective this is an unreasonable initiative. I can see there will be individual circumstances when people might think that.
The problem is how we evaluate that in the round in terms of improving the overall savings market here. I come back to the point that I think we do agree that you need a complementary set of services, which include simplified advice targeting those who may want to have a more simple service and a potentially different charging structure. I recognise the point. There is plenty of evidence of IFAs currently operating to the model of charging that we are talking about, operating successfully and profitably. It is not that we are proposing a model that cannot operate effectively in the IFA environment. There are plenty of IFAs who already operate to that model successfully.
So I think it is not that we have not thought about the business model. We believe that an entrepreneurial, motivated IFA can adapt, thrive and prosper and that their clients can benefit from that in the new world. I am sympathetic to a point made earlier about individuals who at a certain point in their careers and so forth as individuals might feel it is an unreasonable burden; I understand that point. But I think we know that this is a workable model. We have people out there who work this model already.

Q86 Mark Garnier: But by your own admission up to 20% of IFAs could drop out of this marketplace.
Hector Sants: "Could", first of all, and that will probably be for other reasons, such as the personal lifestyle reasons that have just been articulated.

Q87 Mark Garnier: As I say, not only have we had 700 pages of formal written evidence but collectively among us we have had huge amounts of informal, background material that has also been submitted, which I think totals another 1,000 or so pages of this stuff. There is a huge, huge weight of feeling out there.
Hector Sants: From the IFAs or from others?

Q88 Mark Garnier: From the IFAs, absolutely. I would completely agree that there are some people who think that RDR is a very good thing and that overall, I think, the profession does agree that a raise of this standard is not a bad thing—but not at the cost of 20% of IFAs, potentially, and importantly, up to 2 million to 3 million investors who have a trusted independent financial adviser who may, as a result of RDR, not have a financial adviser afterwards and then be having to go off and look for other advice. How is that a good thing? How is that meeting your stated objective of a market that allows more consumers to have their needs and wants addressed?
Hector Sants: First of all, as we have reflected on, I think, the 20% figure is the number of firms, not the number of advisers, and I recognise these are two slightly different points.
Mark Garnier: We are talking about thousands of individuals.

Hector Sants: Secondly, as I say, I don't wish to minimise the impact on some individuals who feel for personal lifestyle reasons that they do not want to embrace these changes. I do understand that, but we are making the point that it is a perfectly viable model that we are proposing they move to, which has been adopted by a number of fellow practitioners successfully and profitably. We are not in any way inhibiting them from moving to that new model and we have good evidence of that; for example, the training evidence which shows 90% of the people expecting to get qualified.

We have a position where as of April last year it would appear that 90% of the community are expecting to get qualified, or 89% to be absolutely precise. It would not be unreasonable, I assume, to presume that the people who are going to become qualified expect to continue to practise. We would presumably assume there will be a few more over and above that 89% figure, so at the end of the day our estimate on which we did our CBA—and, back to the earlier point, I recognise that we are obliged to do CBAs, you expect us to do CBAs—that figure, if anything, will not be as bad as that, if I can put it that way, in a positive way, if you look at it against the training number.

Then you come back to the basic substance of do we think it is going to significantly improve the trust in the industry and reduce the elements of mis-selling—nobody is disagreeing that there is good evidence for those mis-selling statistics? It is our job as a regulator to make that judgment in the round. I realise how uncomfortable it is for some individuals. I do understand that point.

Q89 Mark Garnier: Mis-selling: I will come on to that particular point. Of mis-selling, how much mis-selling is done as a result of ignorance and how much is done as a result of deliberate misleading?

Hector Sants: I think you know that is a very difficult question for us to answer.

Q90 Mark Garnier: It is a very important question, because just raising the level arbitrarily—and I agree that in the round it is not a bad thing to have better qualified people, but that doesn't get rid of malicious intent. If somebody wants to mis-sell and churn and this kind of stuff it doesn't matter how qualified they are, they will still do it. Your job is to police this, your job is to supervise this and to weed that out. I don't understand how a higher level of qualification will address that point. All you will have is better qualified crooks, if there are crooks there.

Hector Sants: I agree with that. I don't think it does address that point. I am not disagreeing that it would be wholly wrong for us to suggest that we are going to eliminate all mis-selling, and I don't think we suggest that. It is absolutely right, again I agree with you entirely, that the regulator both needs to be an effective policeman and an effective rule-setter. It is also true, by the way, which I am sure you also agree with, that the reality of the cost of regulation is such that even if we were the most efficient policeman, for the sort of money and resources we have we will still have mis-selling on top of that. There are certain types of wilful deception that, however good your regulatory policing process is, the cost to detect would not be acceptable. We are never going to completely solve this problem absolutely, and that was my earlier point. I am sure we all recognise that.

The question is, is this a significant improvement in the round on where we were? We believe it to be. We believe we have good, solid evidence to that effect and that is why we should go forward. A number of very useful, sensible points have been made, which I would like to consider on the margin, but on the central thrust of the argument, it still seems to me that the logic is compelling.

Q91 Mark Garnier: You challenged Mr Mudie to come up with new evidence, but surely the interpretation of the evidence you have is the important point, not necessarily finding new evidence to prove that you have done something wrong. The interpretation of the evidence, as I see it, is different from the conclusion that you are coming to.

Sheila Nicoll: I think it is worth saying that in our supervisory activity we are looking at and, as Hector mentioned, we are finding there is a lot of mis-selling. But what we are also finding is there is clear evidence that there is less mis-selling at the point where the adviser is more highly qualified, and that is being borne out in the work that we are doing in monitoring firms' activities.

Q92 Mark Garnier: This is ongoing monitoring?

Sheila Nicoll: Yes.

Q93 Mark Garnier: Let me ask a more general question. In terms of regulatory supervision, who are, of your members, the most hard-to-reach group in terms of policing?

Sheila Nicoll: Hard to reach? We have 16,000 small firms who we supervise and we take a risk-based approach to that supervision, so we are more intensive with those firms that we consider to be more risky.

Q94 Mark Garnier: 16,000, so there are quite a lot that you may never ever talk to.

Hector Sants: Yes. In the current model, broadly speaking, we changed the small firm advisory strategy in late 2007 where we moved from a model where there was little or no supervisory contact with the majority of the small firms to at least bringing in a model where roughly on a four-year cycle there is some form of direct contact with a firm on a thematic basis. But we do not work an inspection-based model where we go every year to every firm to look at the files and so forth, which is why, as we observed earlier, even with the more intensive policing model we introduced in late 2007 it would be wholly wrong for us to represent ourselves as being able to ensure that no mis-selling occurs.

Q95 Mark Garnier: But at the end of the day, it would be a lot easier if you didn't have all these small firms.

Hector Sants: I don't think that would be the case. We manage it in a very cost-efficient and effective way and we recognise the value of diversity in the

marketplace and the value that they bring to potential investors and current investors. I think you are trying to encourage me to make some comment that would suggest that we have an anti-small firms agenda. That is absolutely not the case.

Q96 Mark Garnier: I am not asking you to do that. This is what has been put forward by some people to me—that you do have an anti-small firms agenda and it would be a lot easier for you to regulate the banks than it is to regulate 16,000 small firms.
Hector Sants: Well, of course, I think you would probably agree with me that is not the case.

Q97 Mark Garnier: I would like you to give a very good reason why that is not the case, because a lot of people are watching this and they want to know why it is that you are putting so much pressure on them that quite a lot of people will go out of business. There is a huge strength of feeling out there about this.
Hector Sants: Absolutely, and I can assure you that when I took over as Chief Executive, one of my key objectives was to try to lay to rest this view, which I do recognise people have, that somehow or other there was an anti-small firms objective. Within the constraints of the considerable time pressures placed upon me within the last few years, I went out and spent some time with some individual firms; not as many as I would like, by the way. I have gone out of my way to encourage within the FSA an awareness of the small firms agenda. I absolutely see the value in the diversity in the marketplace.
We changed our small firms supervisory strategy under my leadership, which included not just the change in the visit programme, the supervisory programme, but also a dramatic increase in the outreach work. We talked earlier about our workshops and our regular visits around the country and we expanded our Edinburgh office. We have made a huge effort, I think, to reach out to the smaller firms and make them feel that they have good access to us so that working together we can improve the offering they make to their investors.
I absolutely reject the idea that we in some way or other have a hidden agenda here and I think all the efforts we have made over the last few years are testament to that point. I understand why some of the individuals feel uncomfortable but it is really not the case that we are trying to in any way damage the small firm sector. What we want is a better and more trusted small firm sector. If we come back to our opening comments, we do not have trust with small firms. The statistics can tell us also that we don't have trust with banks either. Clearly consumers don't trust banks either. The complaints data for the banks absolutely demonstrates that. We have a lack of trust in the whole financial system.

Q98 Chair: But you have evidence to suggest that small firms are more distrusted than big firms, do you?
Hector Sants: We do not have direct evidence that would enable us to say that and I would not expect that to be the case.

Q99 Chair: In which case, if you are trying to build trust, it doesn't strike me as—
Hector Sants: We have no evidence that would enable us to assert that small firms are less trusted than big firms, nor are we building the RDR case on that statement.

Q100 Mark Garnier: Of the people that are going out, including yourselves, to go and engage with smaller firms, how many of them have worked in firms with fewer than 10 members of staff?
Hector Sants: Certainly a number. As you know, our policy is to have a mix of people from industry as well as career regulators. That mix, I think, is a good approach. I know we have recruited a number into our small firms division. Our small firms division is 250-odd people. I couldn't tell you what percentage of that; I should imagine it's tens.
Sheila Nicoll: Also in my division I do have people who have worked in smaller firms.

Q101 Mark Garnier: So, you do have people who have hands-on experience?
Hector Sants: Absolutely.

Q102 Chair: Perhaps you would give us the number?
Hector Sants: Of course.

Q103 Chair: I would like to ask you about another issue, which is this longstop on complaints. We have received a lot of submissions that the absence of a longstop or time limit on complaints is a problem. Would you be prepared to look at that again?
Hector Sants: Yes, I think this is an interesting area. It is not specifically the RDR but the reality is that what we are looking at, I think you are rightly taking input on, is a whole series of issues that small firms feel concerned about—aggrieved about, in some cases.
This was looked at in 2007 and at that time there was not compelling evidence to change the situation—that is, to bring in a longstop. But I have to say that I have some sympathy with the argument that says if people are still concerned, 2007 now is a number of years away, and possibly if this Committee was to recommend to us that we should take another look at it, I think that is something we might usefully do.
It is a little bit of a question of what is the framework that you use to reach the determination, to be fair, in the sense that the way that it was looked at in 2007 was: what is the consumer benefit that would be brought by bringing in a longstop? There was no particularly compelling evidence presented; that was the backdrop. But you could be asking the question the other way round, which is there are other industries that do have a longstop, so why wouldn't this one have one? So, it depends on the framework, and I must admit when I looked at the question I thought there is an argument that says perhaps we should look at it again, so if you asked us to we—
Chair: On that anyway we seem to have something of an open door.

Q104 Jesse Norman: Very quickly, just to pick up the point you made earlier, Mr Sants. In your remark

that the result of this might be to lose 10% or 20% of capacity, you have clarified that you did not mean individuals, you meant firms. You separately said that in terms of small firms alone there are 16,000 or so regulated by the FSA. Does that mean that you, at least at that time, were contemplating the possible exit of between 1,600 and 3,200 firms from the market?
Sheila Nicoll: No, I think it is worth clarifying that the 16,000 firms, not all of those are doing investment business, so they would be mortgage brokers—

Q105 Jesse Norman: What would be the number?
Hector Sants: That is our small firms division. We have the number here.

Q106 Chair: How many firms are going to go?
Hector Sants: We have that number here. Make sure we get the right number.
Sheila Nicoll: If 8% were to go, the adviser numbers would fall by 3,802.
Hector Sants: Out of 48,000?
Sheila Nicoll: Out of 48,000.
Hector Sants: The 8% to 13%, which is the 10%, is the number of advisers. The adviser population is currently 48,000?
Sheila Nicoll: 48,000.
Hector Sants: So, the bottom of our 8% to 13% range is that figure of 3,800.
Sheila Nicoll: 3,800.

Q107 Jesse Norman: So, if it was double that, it was 16%—that is, in the middle of your range—it would be of the order of 7,500?
Hector Sants: Now we are in apples and pears, so our estimate of the number of advisers is 8% to 13%, which is 10%. The range of the 10% to 20% was a conflation of firms and advisers as a general point in the earlier submission, but now we are giving you the very precise—

Q108 Jesse Norman: I am sorry, I am completely confused. How many people are you expecting, or firms, to leave the market if it is at 10% or 20% loss?
Hector Sants: 10% is 4,800 people out of 48,000.

Q109 Jesse Norman: 20% would be 9,600 people if the worst effect that you contemplate happened?
Hector Sants: We were not forecasting that number of people leaving. The 20% was firms, 10% is mid-point of advisers. So the worst case number in our forecast number of people is 13%, so that is going to be—
Sheila Nicoll: 6,178.
Jesse Norman: Plus presumably support staff, because those would be registered people you are talking about, or authorised people?
Sheila Nicoll: That would be authorised people.
Hector Sants: That would be authorised people.
Chair: These are people's careers we are talking about here.

Q110 Jesse Norman: 6,100 plus support staff, so it is going to be of the order of 10,000, because they will have people supporting them.
Hector Sants: It could be. It is very important in transparency that those figures are laid out for you.
Chair: Quite a lot of people's careers we are talking about here.
Hector Sants: But we are talking about structural change in a marketplace.

Q111 Mr Love: I want to pick up on a comment you made earlier on when you referred to the balance between judgment and, if I can call it that, tick box. This is an issue of quite a lot of interest to the Committee. We had the Governor of the Bank of England. I wondered if I could get your view, if I can call it that, as a seasoned regulator as to what the proper balance should be between judgment and regulation and whether you think we may be taking on risks if we depend too much on judgment.
Hector Sants: I think this is a question we should want to return to and I encourage at some point in the future the Committee to maybe have a wider debate on the overall supervisory approach to be taken by the two new authorities.
Mr Love: That may be something we will take on board.
Hector Sants: I digress briefly, but we are planning to publish some public material on the bank plus the FSA on the PRA and then the FSA on the FCA in the summer and that will be an opportunity to have such a debate with that material in front of you.
I think the balance between judgment, which is essentially saying a forward-looking concept to the regulator saying what might go wrong in the future and then intervening before it goes wrong, as opposed to having some rule-based system—that is possibly a better word than the rather emotive "tick-box" system—where you rely on the firms to comply with the rules and in the event they don't, you then take redress.
I think the balance between those two approaches should differ somewhat between a prudential authority and a consumer authority. Talking to the consumer agenda in the light of the topic we are talking about today, I think that it would be proper to have a slight shift, if anything, towards clear rules because I think individuals operating in the consumer environment like to have clear, understandable rules that they comply with, and I think that would be helpful. Also clear, understandable rules make it easier to achieve redress when mis-selling has occurred. I think the balance for the consumer is a bit more towards the rules-based approach.
I think the difficult area, which is where a very interesting debate could be had, is if you have moved away, as we are suggesting we might or we should, from solely point-of-sale risk disclosure to some form of product intervention, then that is more judgmental because that is the regulator saying, "We think in the future that product could cause an unacceptable level of harm—that is, it is likely to get mis-sold".
We have to assume that firms are not deliberately creating products that create harm; the question is is the possibility of mis-selling outweighing the obvious benefit that a single product can bring to a smaller group of customers. That is a judgment and I think that is a tricky judgment to be made and should only

be made in a very prescribed way, otherwise there is a severe risk that the pendulum will go too far and that innovation, competition, choice could be reduced. There is a very tricky debate here, which is in my view something that Parliament should opine on, which is if you are uncomfortable with the degree of consumer detriment that occurred in the previous regime around point of sale, how much risk do you want to run of reducing choice in exchange for possibly reducing that detriment? I think that is a very valid debate that the regulator shouldn't be having on their own. I think this is a debate we should be having together.

Q112 Mr Love: We have been somewhat surprised, certainly I have been somewhat surprised—I had better not speak on behalf of the Committee—that the Bank of England appears to take a view that decisions will be based more on judgment than perhaps we would have expected. Would I be right in saying that, and what do you think the risks are if we do depend significantly more on judgment than perhaps we have in the past?
Chair: A crisp answer will be appreciated.
Hector Sants: I think the Governor was trying to principally contrast the judgment component with a belief that there had been too much attention paid by supervisors to the minutiae that did not actually affect the safety and the soundness of the bank, which is what the prudential regulator needs to focus on. In the pre-2007 period of the FSA, I completely agree with that analysis.
There should be a switch of supervisory time and attention from the minutiae to the matters of substance: judgments about what will happen in the future. But you must still have in the prudential regime a very effective set of capital and liquidity rules because at the end of the day, analysis of the events that have passed show us that the first and foremost problem in the regulatory sense, as opposed to any management issues and so forth, was the wrong rules and we need to fix the rules. So we need the right rules and we need judgment; we don't need attention on the detail, and I think that was his message.

Q113 Chair: A few more very quick questions that relate to your responsibilities more broadly. First of all, and this has been touched on very briefly in comments today, we are re-regulating, we are rewriting FSMA to some degree—breaking it apart, creating two separate institutions. You saw Mervyn King's evidence to us. Do you agree with him that it would have been better had we had a new Act rather than trying to proceed by amendment of FSMA?
Hector Sants: Yes.
Chair: Why?
Hector Sants: I think I would make exactly the same points as I understand he made, which is we undoubtedly need to make sure that to get the best possible model going forward we design it on first principles, which is encouraging some of the discussion we were just alluding to a moment ago. So if we are going to look at first principles it would seem that then it would be right to have legislation drawn up from first principles, but I should perhaps say, as I believe the Governor did as well, that drawing up legislation, of course, is a matter for Parliament, it is not a matter for us. I have been asked the question, I have answered it, but I absolutely think it is for Parliament to decide how they frame their own legislation.

Q114 Chair: On another issue, I wrote to you about bonuses of the major banks at the end of January, asking for further information about remuneration levels. You wrote back an encouraging response quite quickly, which I was very grateful for, saying that you were going to go to the banks for this information. But we are now in mid-March. What have we had back?
Hector Sants: We, the FSA, are trying to be as helpful as possible on this point and we are in the process of collating the information we received in from the banks, because we had set them a deadline.

Q115 Chair: Are they being helpful?
Hector Sants: Unfortunately, no, is the short answer. I obviously have to be mindful of individual confidentialities, but I think I can say that four of the larger banks—in my definition, we have five large banks—have declined to give essentially the information. I am trying to be as helpful as possible. We do have some regulatory information that we have already that, as long as we give it to you in aggregated form, we can so do. I am in the process of writing to you to say what we can give you and then we will no doubt look to your response to that. But in terms of collecting the additional information that we don't hold, they have declined so to do.

Q116 Chair: I have been writing quite a bit to you recently. In mid-December, I wrote to you about RBS—or rather I wrote, strictly speaking, to Lord Turner, asking for a more detailed summary of the FSA's investigation into the failure of RBS. I did eventually get a reply, mid-February, suggesting a publication date for that work of mid-April. Are you going to meet that deadline?
Hector Sants: As you rightly point out, this report is being prepared by the Chairman and the board, not by the executive. That is right and proper since elements of the report are reviewing the supervisory activity of the FSA over the periods prior to the failure of RBS. It is properly for the Chairman to answer your question rather than myself.
I also just observe this, however, that of course ultimately that the timeline is not entirely within the FSA's control—I think you do understand that—in the sense that we need permission from various people from whom we have collected the data to release that data, since we collected it under our supervisory powers.
In summary, we are not entirely in control of the timeline, but broadly speaking, as I understand it, we are broadly on track to meet that sort of timeline,

roughly within a few weeks. But the issue is we are not entirely in control of the timeline because we are dependent on some of the responses from the firms.

Chair: Thank you for coming to give evidence before us this afternoon. This is a subject of considerable controversy and concern to a large number of people whose livelihoods are at stake and we have only managed today to express a relatively small proportion of the concerns that have been put to us in the large amount of evidence that we have received. We will now consider how to take this forward. Thank you very much for the evidence.

Letter from Hector Sants, Chairman of the FSA, to the Chairman of the Treasury Committee

Retail Distribution Review

We welcome the Treasury Committee's continuing interest in the FSA's Retail Distribution Review (RDR). The RDR is an important aspect of our programme to address fundamental flaws in the market for investment products and services in the UK and we will of course submit formal written evidence to your inquiry in January. In the meantime, I hope it will be helpful if I set out why we remain committed to modernising the industry through the RDR to address a market that was not working, and does not work, well for consumers, advisers or the firms which provide these products and services.

Problems in the Market

In recent years, mis-selling scandals and a lack of consumer trust have severely damaged the reputation of the retail investment market, with nearly £15 billion having been paid in compensation for mis-sold personal pensions and endowment policies. However, this is not just a historic issue. Our supervision has shown that problems continue to exist in the market and there is widespread agreement that fundamental changes are needed in the market to address these problems. Specific examples of unsuitable sales and an illustration of the associated annual cost of consumer detriment based on detailed reviews we have carried out are as follows:

Mis-selling review	*% of unsuitable sales*	*Illustration of annual consumer detriment*
Pension switching (2008)	16%	£43 million
Unit trust vs equity ISA (2005)	12–20%	£70 million
Investment bond vs equity ISA (2005)	12–20%	£92 million
Personal pensions (2005)	Analysis indicated a link between commission payments and market share	Up to £18 million

These figures, which amount to an annual consumer detriment of £223 million, under-estimate the scale of the problem as they are based on just four incidences of mis-selling. Ongoing supervisory and enforcement action means we are unable to cite more recent examples; however, we estimate that the average annual detriment arising from the sale of unsuitable products to be nearer the range of £0.4 billion to £0.6 billion.

At present, around 70% of consumers do not seek advice from an investment adviser.[1] Trust in advisers is higher for those that use an adviser than those that do not but it is worth noting that 40% of those who have recently used an adviser say that they do not trust financial advice. Our consumer research has found trust to be a more important factor than price for selecting an adviser[2] and that confidence can be established in advisers through the demonstration of knowledge and qualifications.[3] Achieving greater trust in the investment advice sector could lead to greater engagement in investment advice, and so to more consumers seeking advice.

RDR Proposals

The high incidence of mis-selling in this sector arises from fundamental flaws in the market. We launched the RDR in June 2006 to work with the market to identify and address these flaws and have developed our proposals in conjunction with industry, consumer groups, trade associations and professional bodies following the FSA's most extensive and far-reaching consultation process to date.

The RDR is designed to provide a clean and sustainable market for the future. It will ensure customers get good quality advice, products and services suited to their needs from advisers displaying higher standards of professionalism and expertise. The regime needs to change and this change will be supported by our intensive supervisory approach including a greater focus on individuals. Our policy proposals aim to do this by:

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[1] *Baseline Survey of Financial Capability*, FSA (2006): "In the last five years, have you received any professional advice about planning your personal finances? By that I mean things like planning for retirement, tax planning, or investing money, but please do not include advice related to running a business"

[2] February 2008, BMRB Social Research, *Services and Costs Disclosure*, FSA Consumer Research Paper 65a (www.fsa.gov.uk/pubs/consumer-research/crpr65a.pdf)

[3] November 2008, Strictly Financial, *Assessing investment products*, FSA Consumer Research Paper 73 www.fsa.gov.uk/pubs/consumer-research/crpr73.pdf

- increasing the professional standards of advisers;
- improving the clarity with which firms describe their services to customers so that they know whether they are getting advice which is truly independent (covering the full range of possible investments) or is restricted in some way (for example advising on a particular range of products, or on products from one or a limited range of product providers);
- addressing the potential for commission bias to distort consumer outcomes; and
- ensuring personal investment firms have adequate capital resources for complaint redress.

Our rules on adviser charging, service description and capital have already been made by our Board. We believe all these reforms are necessary in order to equip retail investment advisers to deal with the challenges they now face and to remove distortions in the way the market has operated in the past. This will provide better protection for consumers and better outcomes for consumers.

Professionalism

We are, of course, aware of the concern that has been voiced in recent weeks by individual advisers and some of your parliamentary colleagues about the impact the RDR, and in particular our professionalism proposals, may have on this sector. We do not agree that the RDR will threaten the availability of good quality advice.

To achieve our aim of a more professional advice market, under our proposals all advisers will be required to adhere to common professional standards, including reformed qualifications and effective continuing professional development. If consumers are being advised on how to invest their life savings or choosing the right pension to support them when they retire, they expect an adviser to be professional and for that professionalism to be closer to the standards of, for example, a lawyer or accountant. At present this is not the case.

The new measures come into effect at the end of 2012, by which time existing individual advisers will have had four years to prepare, including meeting the qualification requirements. We were clear in November 2008 about our intention to raise professional standards, including modernisation of qualifications and we said that those who are on course to complete, or already hold an appropriate qualification[4] could continue to give retail investment advice.

The new requirements will apply to all those giving investment advice to retail customers, regardless of the type of firm they work for (eg banks, insurers, independent financial advisers, stockbrokers or wealth managers). They will not apply to those who advise solely on mortgages or general insurance. I should point out here that due to the enhanced consumer protections provided by stakeholder products, the RDR will not apply to those giving advice under the Basic Advice regime.

Our experience is that advisers are now, on the whole, getting on with attaining qualifications, where they need to. According to research[5] carried out in March 2010, 49% of all individual investment advisers were already appropriately qualified. A further 40% expected to have completed the qualifications by the end of 2012 and only 4% were steadfast in their view that they will not seek to attain a new qualification. Of the remainder, 1% expected to complete after end-2012 and 6% fell into the "not known" category. Connected to this, one of the main awarding bodies, the Chartered Insurance Institute (CII) indicate they have seen a 65% increase in candidates sitting their qualifications in 2010 compared to 2009.

The qualification standards have been developed by the industry itself[6] following extensive consultation by the FSA and the Financial Services Skills Council (FSSC). The response to our June 2007 interim report and the FSSC's own 2009 consultation on the qualification standards (which cover content and level) showed strong support for qualifications to include practical application of knowledge: QCF level 4,[7] which is the vocational equivalent to the first year of an academic degree, is the lowest level that achieves this. The reformed qualifications now include investment risk and ethics as well as practical application of knowledge, as part of the syllabus—we believe these changes are fundamental to equip the modern adviser to give good quality advice.

A minority of individual advisers have expressed concern about the time it may take them to attain the qualification they need. The FSSC's consultation and working groups established that the new syllabus would map to a diploma sized qualification under the QCF. The Office of Qualifications and Exams Regulations (OfQual) guidelines suggest the average learner takes 370 hours to complete a diploma: this includes directed

[4] Our current proposals are that advisers holding certain existing appropriate qualifications may need to carry out activity to fill knowledge gaps through structured continuing professional development (a form of grandfathering).
[5] Research published in March 2010 by NMG, a financial services consulting and research firm.
[6] The FSSC established industry working groups to draft the qualification standards.
[7] The Qualifications and Credit Framework: the UK implementation of the European Qualification Framework.

study, homework, assessment and preparation time. This is the expected time that a new entrant would take: we would expect those advisers with considerable experience to find that the time they need to study will be significantly lower than that. The main qualification providers for this sector have indicated to us that it is taking between 6–24 months for most advisers to complete their qualifications.

The majority of respondents to our consultation were opposed to the use of grandfathering, meaning existing practitioners should not be exempt from meeting the new qualification standards,[8] Those respondents (who included consumer and IFA representatives) told us that they felt that this would not achieve a level playing field for investment advisers and would not provide a consistent message for consumers about professionalism of the sector. Our experience in allowing grandfathering rights for mortgage brokers has been that it has seen a continuation of mis-selling, resulting in nearly 100 brokers being disqualified to date for incompetent and unethical practices. Whilst complaints can indicate potential issues, due to the long-term nature of investments the absence of complaints does not necessarily mean consumers have received suitable advice. This puts advisers in a difficult position because their customers very often do not understand the position they are in until many years later. Therefore, without applying the new qualifications to the whole industry, problems of mis-selling may continue under the new regime, further undermining confidence in the industry and at a cost to consumers.

We understand that many advisers find the prospect of taking further exams daunting and are sympathetic to this. In June 2009 we responded to consultation feedback and feedback from some individual advisers that we spoke to, and agreed to allow for a move away from written examinations to allowing other types of assessment to be used in awarding qualifications. We have, and continue to, work with the qualification providers, IFA firms, and their representatives to make these types of assessments available. Since then, we have seen the launch of three qualifications that do not rely on written examinations to determine an award, spanning qualifications for the various types of adviser that are within the scope of the RDR. Additional qualifications using assessment methods other than written exams continue to be developed. There are also qualifications that do involve written examinations but are very much based on case studies and are highly relevant to the role of an adviser. For example, one qualification involves a candidate making recommendations based on a specimen fact find that is provided to the candidate two weeks prior to the examination itself.

The link between higher professional standards and better consumer outcomes is also borne out by several pieces of research in this area. Recent thematic reviews of industry performance that we have carried out show a clear link between advisers' professional qualifications and the quality of their service. We will expand on the research in this area further in our written submission; however, two examples of this research are as follows:

- Our data from early 2010[9] on platforms shows the advice of advisers meeting current qualification standards was deemed to be "suitable" in 11% of cases and 89% of advice was either "unclear" or "unsuitable". The advice of advisers with a similar qualification to the new standard was suitable in 43% of cases, "unclear" in 32% and unsuitable in the remaining 25% of cases. Cases from the few advisers who had attained qualification in excess of the new standards indicated that 71% were classed as "suitable" advice and were "unclear" in 29% of cases.
- A review of the quality of financial planning advice by an expert panel from Australia (ASIC 2003 study)[10] also showed that plans completed by advisers with a "certified"/qualified status (around QCF Level 6) scored better than unqualified advisers.

Adviser Charging

Adviser charging is another key element of the RDR. At present, many consumers using the services of a financial adviser believe they are getting free advice. In reality, they do pay, as charges for advice have simply been added to the cost of the product and then the product provider pays the adviser commission. This creates a potential conflict of interest. For example, research referenced in our March 2010 Policy Statement found evidence of product bias in the equity ISA market, where in 20% of mystery shops with commission-based IFAs and in 12% of mystery shops with a tied-adviser an ISA was not recommended when suitable—instead clients were recommended unit trusts or unit linked bonds that could potentially pay the adviser a higher commission.[11] Furthermore, our consumer research found that only around half of respondents understood how the value of their product would be affected by commission. This can be damaging to consumers and undermines trust in the investment industry.

Our new RDR rules will prohibit the receipt of commission in relation to advised sales of retail investment products. After that date adviser firms will have to set their own charges for advised sales. These charges should reflect the services being provided to the client, not the particular product provider or the product being

[8] Our definition differs to that used in other member states where the regulator sets the regulatory examinations and grandfathering is simply recognition of certain other qualifications as opposed to allowing unqualified individuals to operate.

[9] This information is based on 12 firms and 46 advisers and 113 cases.

[10] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Advice_Report.pdf/$file/Advice_Report.pdf

[11] CRA (2005) *Study of Intermediary Remuneration,* a study for the ABI.

recommended. We believe that this will remove the risk that provider influence could lead to product bias (or the perception of it) thereby contributing to improvements in consumer confidence, the fair treatment of customers and the sustainability of the UK retail investment market.

The new rules require advisers to discuss and agree with their customers how they will pay for advice, and there are a number of different charging structures that might be adopted. Payment could be a fixed charge, it could be based on an hourly rate, reflecting the time taken by the adviser to perform the service, it could be based on a % of the amount invested or through some combination of these methods. Some customers with a lump sum to invest may wish to pay for advice upfront. Others may wish to invest a regular amount each month and so be unable or unwilling to pay for advice at the outset. In such cases there are a number of different charging structures that can be adopted, for example, spreading the payment over a period of time. This might be by means of a regular payment to the adviser, or if the product provider agrees, customers would also be able to ask for their adviser's charges to be paid out of their investments. The difference between this and the present system of payment by commission is that it would be for the customer and adviser to agree how much should be paid. The product provider's role is simply to collect and pay the agreed amount.

Capital Resources

Holding capital resources against all Professional Indemnity Insurance (PII) exclusions, regardless of whether they relate to regulated business activities or other FSA-instigated events, ensures firms are in a position to redress complaints against which they are not insured. We are simplifying how firms will calculate this requirement and making it consistent for all firms. We are extending the expenditure-based requirement to all firms based on three months of relevant annual expenditure and increasing the minimum capital resources floor to £20,000. We have also set out more specific requirements as to the level of additional capital resources needed where firms have any type of exclusion in their PII policy.

RDR Costs

The detailed cost benefit analysis we have undertaken on all of the RDR changes has estimated the implementation costs, based on industry feedback, to be in the region of £1.4 billion to £1.7 billion over a five-year period. This covers professionalism, clarity of services, commission bias and capital requirements for the whole of the retail financial sector, including intermediaries (a broader population which includes IFAs), banks and providers. The total initial costs to both intermediaries and providers are estimated at £600 to £750 million. The proportion of these costs applicable to intermediaries is 18%, banks 30%, and insurance companies a further 37% with the remaining 15% due to other types of advisory firm such as stockbrokers.

Clearly any additional compliance cost for firms, and ultimately consumers, is a matter of concern to the FSA. However, the cost benefit analysis we have carried out shows the annual consumer benefit of RDR to outweigh the annual implementation costs. While we anticipate the ongoing annual costs of the RDR to be between £178 million to £221 million, this needs to seen in the context of the annual consumer detriment from the sale of unsuitable products, which we estimate to be in the range of £0.4 billion to £0.6 billion. We have been transparent about the implementation costs, but industry also has to be transparent about the cost to consumers of mis-selling.

In terms of market exits, Oxera[12] estimated that, if new firms do not enter or existing firms do not expand, overall turnover would be reduced by 9%, the number of advisers by 11%, and the number of advised clients by 11% as a result of market exit.

This is supported by research examining the implication for individual advisers[13] In terms of individuals, research indicates that 5% of advisers say that they were already due to retire by 2013, 3% of advisers will retire earlier than planned, a further 3% will leave the industry completely and 2% will take another role within the industry (the remainder gave no response). We conclude that, in economic welfare terms, advisers leaving the market would not create a net cost because the supply of advice in the longer term will not be affected.

Any dilution of the proposals will result in an increase in the cost to consumers through continued mis-selling.

Despite the vocal concerns of some in the IFA community, we believe the RDR is absolutely fundamental to address the root causes of numerous problems we have observed in this sector and to improve consumer outcomes. We will expand further on the points made in this letter in our written submission.

Hector Sants

13 December 2011

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[12] http://www.fsa.gov.uk/pubs/policy/oxera_rdr10.pdf
[13] Research published in March 2010 by NMG, a financial services consulting and research firm.

Written evidence submitted by the Financial Services Authority

Executive Summary

1. We welcome this opportunity to submit this memorandum to the Committee's inquiry into the Retail Distribution Review (RDR).

2. We launched the RDR in June 2006, to address the root causes of significant problems identified in the distribution of retail investment products and services. There was broad support from the market at that time for the need for reform which meant that our review was able to focus on solutions rather than analysing the past.

3. The RDR is a key part of our consumer protection strategy, and an example of intervention where we have decided that there is a need to address problems across a whole market because previous, more piecemeal approaches had not addressed the issues effectively. We aim to modernise the industry and establish a resilient, effective and attractive retail investment market in which consumers can have confidence and trust at a time when they need more help and advice than ever with their retirement and investment planning. The rule-making which has already taken place, and continues, will be supported by our intensive supervision of firms and complements the work of the Consumer Financial Education Body (CFEB) to improve consumers' financial capability. We continue to work closely with CFEB as we move towards implementation of the new RDR regime.

4. A broad range of firms operate in this market, with diverging views on the best way to implement reform. We have taken these opinions into account in forming our proposals and making new rules. We recognise that the RDR involves significant change in the market so we would expect some of our proposals to be controversial. This is why we have consulted so extensively and over such a long period. We spent two and a half years (June 2006 to November 2008) encouraging ideas and views from industry practitioners, consumer representatives, investors and potential investors, trade associations, professional bodies and other stakeholders on the issues that needed to be addressed and to identify potential solutions that we could research before finalising our policy and rules.

5. We are grateful to all those who have contributed considerable energy to this review. They have helped us to identify and develop ideas, giving us feedback along the way to help us understand the likely impact of our proposals. This gave us a very clear view of where our regulatory interventions are most needed and the likely market impact. We believe that we have settled on the right combination of measures to reduce the cost to consumers of continued unsuitable advice and to deliver a clean and sustainable market for the future. We also fully recognise the need to monitor the impact of these policies on a continuing basis, both before and after, implementation of the new regime.

6. Our analysis shows that the longstanding problems in the market have been created by an asymmetry of power and information between product providers, advisers and consumers, as well as other factors such us remuneration structures, levels of professionalism and a lack of clarity on the part of consumers about the service they are getting.

7. Our proposals aim to ensure that:

— consumers are offered a transparent and fair charging system for the advice they receive;

— consumers are clear about the service they receive;

— consumers receive advice from highly respected professionals; and

— advisory firms are more stable, than now, and better able to meet their liabilities.

8. Within the definition of retail investments we include, products and services such as pensions, investment funds (unit and investment trusts), life products (endowments, with-profits and unit-linked policies) and exchange-traded funds. Our new rules will apply to all advice given in relation to such products and services, regardless of the type of firm for whom any individual adviser works—so advisers within banks, asset managers, life insurers, sole traders, partnerships, stockbrokers, networks, IFAs or financial advice firms will be subject to the same regulatory environment. We have also considered the development of new distribution channels such as platforms.

9. In the following sections we cover:

A. Problems in the market;

B. Our extensive consultation programme;

C. Myths and misconceptions about the RDR;

D. Changes being introduced under the RDR;

E. Contentious issues; and

F. Costs and benefits.

A. Problems in the Market

10. The RDR was launched in response to both our, and market participants' observation of significant problems in the UK market for retail investments. In deciding whether to invest, consumers are being asked to make decisions about markets which are, by their very nature, uncertain and which can be complex. When they decide to invest they are also being asked to take risks which can often be quite difficult to assess and they may not crystallise until a long time after the decision to invest was taken. This is one of the main reasons why consumers seek advice; it is also why consumers need advisers they can trust, why advisers need demonstrably to behave in a professional way and why the interests of advisers need to be clearly aligned with those of their clients. These are not characteristics of the retail investment market.

11. While risks of unfair treatment of retail customers have, in several respects, been accentuated by the financial crisis, the issues reflect longstanding problems created by asymmetry of power and information between providers, advisers and consumers, together with unsustainable business models. While we are putting measures in place to address issues that led to the banking crisis, we believe that addressing the root causes of problems in the retail investment market—which pre-date the crisis—is also required if consumers are to be better protected.

Market complexity and lack of consumer understanding

12. We note above the risks and complexities involved in investments and the information asymmetries. There are sophisticated investors who are confident in making investment decisions, but, in many cases consumers purchase retail investment products relatively infrequently (such as arranging a pension), so have little experience to draw on. Retail consumers also tend to find the effect of total charges on their investments hard to determine. They simply do not have the same information as the sellers of these products and receive poor quality advice.[14] As a consequence of this market failure, compounded by the low level of financial capability among many consumers and their overall lack of interest and engagement, consumers do not act as a strong pro-competitive force in this industry.

Incentives from adviser remuneration

13. The role of the intermediary is to provide advice to the consumer. However, advisers' remuneration structures are such that the cost of advice (commission) is often built into the product charges. Our consumer research shows[15] that only around half of respondents understood how the long-term value of their product would be affected by commission. Consumers are left with the impression that advice is free.[16] The adviser's interests are often aligned with the provider, not the customer. Competition between product providers tends to focus on encouraging the adviser to recommend a particular product. As a result, product features, including charges and commission, provide incentives to attract the adviser rather than focusing on product features which are attractive to the consumer (such as delivery of good performance and long term growth or income).[17]

14. This leads to an inherent misalignment of interests between the intermediary and the consumer, which can lead to various forms of bias:

- *Provider bias*—advisers recommending a provider's products on the basis of commission payments;
- *Product bias*—some products carrying higher commission payments than others, biasing advisers' recommendations to those products paying higher commission; and
- *Sales bias*—generation of income is contingent on a sale being made due to the advisory firm's business model being dependent on payments of commission. This can lead to an incentive to "churn" the client's investment in order to generate income.

15. Once products have been purchased, there is limited evidence of consumers switching if performance is not satisfactory. However, the potential conflict of interest created by commission, due to the risk of bias, or a perception of it, leads to low persistency, and undermines trust. This does not help the long term sustainability of the sector. For example, our thematic work on pensions revealed evidence[18] of consumers switching for other reasons, such as inappropriate advice from advisers motivated by income generation. The table below summarises three further examples of where we have found evidence of bias:

[14] The Money Maze: Are consumers getting the advice they need? Which? (2009).
[15] Depolarisation Disclosure, FSA Consumer Research Paper 64, GfK NOP (2008).
[16] Services and Costs Disclosure, FSA Consumer Research Paper 65A, BRMB Research (2008).
[17] Retail Distribution Review proposals: Impact on market structure and competition, Oxera (2009) and Retail Distribution Review proposals: Impact on market structure and competition, Oxera (2010).
[18] Pensions switching thematic work, FSA (2008).

Examples	% of unsuitable sales	Illustration of annual consumer detriment
Pensions being transferred inappropriately[19]	16%	£43 million
Unit Trusts sold outside an ISA where a tax benefited equity ISA was more suitable[20]	12–20%	£70 million
Investment bonds sold outside an ISA where a tax benefited equity ISA was more suitable[20]	12–20%	£92 million
Personal pensions[20]	A 1% increase in commission leads to an increase in personal pension market share of 1.4%	Up to £18 million

Detriment to consumers

16. The table above reveals approximately £223 million of detriment arising only from those sales that were unsuitable. The data in this table is drawn from cases of unsuitable sales of a number of different types of retail investment products, where detailed research has been conducted on mis-selling. Research on mis-selling is not available for all products in the market, and therefore this figure of £223 million is likely to underestimate total consumer detriment.

17. To provide an indicative estimate of total detriment, we have extrapolated the estimates of consumer detriment to all sales in the market, taking the following approach:

(a) ABI and IMA data suggests that the total annual market for retail investment product new business is £109 billion;

(b) Assuming 12–20% of all products sales are unsuitable (as set out in Table 4 of PS10/6); and

(c) Using an estimate of the detriment to consumers published in CP 09/18—3% of the value of the amount invested.

18. This suggests that the annual detriment arising from the sale of an unsuitable product could be in the range of £0.4 billion–£0.6 billion:

Total annual market (£ bn)	Average unsuitable sales	Level of consumer detriment	Total annual detriment (£ bn)
109	12%	3%	0.4
109	20%	3%	0.6

Cost of poor quality advice

19. Poor quality advice or unsuitable advice often results in consumer detriment. However, as noted above, this may not be identified until years after the sale, if at all. There are limitations in the way that capital resources requirements and Professional Indemnity Insurance (PII) requirements for firms currently remedy this. Product providers also have responsibilities for treating customers fairly. Again, it may be many years before problems become apparent, for instance with the performance of a product relative to what the consumer was led to believe. The result of this can be uncertainty for consumers and can mean potential claims against those who supplied the product or gave advice many years after the original purchase. By the time these claims come to light, those that gave the advice may no longer be in business, leaving others in the industry to meet the costs of compensation.

Credibility of advisers

20. Currently 70% of consumers do not seek investment advice from an adviser. While levels of trust in advisers are higher among those who use one than among those who do not, 40% of those who have recently used an adviser say they do not trust financial advice[21]. Our consumer research has found trust to be a more important factor than price[22] when selecting an adviser and that confidence can be established in advisers through the demonstration of knowledge and qualifications.[23] The consumer's current perception of financial advice presents a disincentive to consumers seeking advice in the first place. We therefore believe that trust is key—the RDR will instil more trust and confidence in the retail investment market from consumers, leading to more engagement which should attract new people to seek advice and possibly invest.

[19] Pensions switching thematic work, FSA (2008).
[20] Charles River Associates (2005) and FSA calculations.
[21] Wells and Gostelow (2009) analysis of the Baseline Survey of Financial Capability, FSA (2006).
[22] Services and Costs Disclosure: FSA Consumer Research Paper 65a, BRMB Social Research (2008).
[23] Assessing investment products: FSA Consumer Research Paper 73, Strictly Financial (2008).

21. Taking the problems we discuss above together, we believe that the market for retail investments has not worked and still does not work efficiently. It serves neither the interests of consumers or firms, whether providers or distributors of retail financial services.

B. Extensive Consultation

22. From the start of the review there was encouraging consensus from market participants, as well as consumer groups, about the problems in the market and the need for change. There has also been consensus that the time was right for substantial change.

23. We have held an open debate about industry-led solutions, wherever possible, in what has been the FSA's most extensive and far-reaching consultation process to date. This involved some two and a half years of discussion and a further two years of formal consultation, during which we have received nearly 2,000 formal responses and proactively contacted around 2,500 firms, in addition to considerable additional correspondence and discussion.

24. We used industry working groups, as well as considering the views of individuals, consumer representatives, a wide range of firms, and their representatives, to develop our proposals. Often debate has arisen around detailed points of the proposals. We have listened to the arguments and evidence presented, amending several proposals in response to this debate, where appropriate. For instance, we have amended our professionalism proposals to allow alternative assessment methodologies to be used in light of concerns about written exam-only qualifications, and we have also allowed for an additional transitional year for our capital requirements proposals, to take account of difficult trading conditions. However, there are detailed areas where some decisions were more controversial; we explain the reasoning behind these decisions in more detail in section E.

25. This extensive consultation has enabled us to listen and respond to market participants concerns and so develop, with industry, a package of reforms that we believe is necessary to address the problems in the market, improve consumer outcomes and confidence, as well as support the long-term viability of the retail investment market.

C. Myths And Misconceptions

26. A number of misconceptions about our RDR proposals have arisen over the years. We take this opportunity to clarify our position on these

Consumers will have to pay for advice upfront; many will be unwilling to do that and will not take financial advice at all

27. We recognise that consumers may not wish, or may not be able to afford, to pay an upfront fee for advice. Our approach offers consumers some flexibility on methods of payment. They can make the payment for advice by an upfront deduction or by the charge being deducted from regular payments over time, through the product. The critical change is that payment for advice can continue to be facilitated by the provider through the product, but the amount cannot be decided by the provider; that is decided directly between the adviser and the client.

The absence of complaints is an indication of quality advice

28. Some IFAs argue that, because only 2% of complaints that go to the Financial Ombudsman Service are levelled against IFAs, it follows that the independent sector provides a better service than the banks. We do not accept this. The total figure for complaints referred to the Ombudsman Service, on which this 2% figure is based, includes complaints about services and products such as banking and credit which are not provided by IFAs, so the comparison is not a fair one. The more relevant data to use relates to products and services provided by both IFAs and banks, such as investments and pensions. 14%[24] of new cases referred to the Financial Ombudsman Service in 2009–10 relate to this area—22,278 cases out of a total of 163,012 of which 50% were upheld. Of these 22,278 cases, IFAs accounted for 12% of investment-related complaints, compared with 29% for the banks. On pensions, IFAs accounted for 28% of complaints and the banks 10%. This demonstrates that there are problems which need addressing, irrespective of the advice service (independent or restricted) or firm type (small or large). These figures are broadly representative of the source of advice because the Baseline Survey of Financial Capability found that 30% of the adult population sought advice; of which 57% used an IFA and 36% a Bank.[25]

29. While complaint volumes are one important indication of the quality of advice or services received, a complaint—by definition—relies on the consumer becoming aware that there is a problem with the product or service and raising that with the firm. The asymmetries of information mean that a consumer may never realise they have been advised to purchase an inappropriate product, the time lag between the advice being given and a problem crystallising, and often the firm no longer being in business when a problem is discovered (this leaves others in the industry to meet any costs of compensation) mean that while complaints received can

[24] FOS annual review 2009/2010, FOS (2010).
[25] Wells and Gostelow (2009) analysis of the Baseline Survey of Financial Capability, FSA (2006).

provide one indication of poor quality advice, an absence of complaints is not a reliable indicator of good quality advice.

Access to advice

30. Some in the industry believe that the RDR will reduce access to advice for the less well off. We do not agree. We have said that changes from the RDR are significant and there will indeed be changes within the market; however, the impact on market capacity and structure is likely to be limited. For example, Oxera reported[26] that around 14% of firms that currently provide independent advice indicated that they are likely to provide restricted advice post-RDR. This market impact will, in some cases, simply be a shift in the service description of the firm from independent to restricted advice because of the new definition of independence.

31. Another element of market impact comes from the number of advisory firms and individual advisers who will completely leave the sector. A number of studies have been carried out which produce estimates and these indicate a range of 10—20% of advisory firms may leave the sector. Our own research tells us that around 23% of advisory firms may exit the market because of the RDR proposals. Whereas the number of individual advisers who may leave could be in the region of 8—13%, excluding those who plan to retire anyway and based on surveys of firms' expectations of their advisers, and advisers own intentions[26, 27]. This range is consistent with NMG's own estimates of the impact of the RDR on IFA numbers based on their IFA Census survey. We consistently used a forecast of 10%—15% when considering the reduction in adviser numbers by December 2012, once planned retirement is excluded. Previous research by the FSA estimated the level of exit to be 11%. If 8% do exit the advice market, adviser numbers will fall by 3,802; at 13% this increases to 6,178. IFAs represent a disproportionate number of those most likely to leave with 11% of IFAs expressing an intention to leave the market completely compared to 8% for all advisers. A 10% fall in the number of IFAs would result in a decline of 2,635, ie they would account for 69% of all those exiting. Age is an important part in advisers' decisions with the proportion intending to remain an adviser reducing from 84% (under 35 years) to 65% (35–54 years) and still further to 40% (55 years+). Firms with fewer advisers, and that earn lower revenues, indicate they are more likely to leave the industry; this is why the impact on the number of advisers is proportionately less than on the number of firms.

32. As a result of market exit, and if new firms do not enter or existing firms do not expand, around 11% of people currently receiving advice will not have access to the adviser they are using at the moment because their adviser will leave the market. They can, of course, consult another adviser, and other firms may seek them out as clients. We believe that the final figure is likely to be less than the 11% identified.

33. As we have said, we will be monitoring the changes in the market, including exits during and after the transition. Even if demand for advice outstrips supply, entry barriers are low. In the longer term, new entry or expansion by existing players is likely to fill the gap. Some customers may question whether they need advice when they understand how much it costs them (a cost which is currently opaque because of commission) but that is a personal decision based on how much individuals actually value the service they receive.

34. The majority of the UK's population has little or no liquid savings (the median financial wealth for families in Britain was just over £1,000 in 2005).[28] Until savings have been established, investment products and services are unlikely to be suitable. For many people in this position, the proposals by CFEB for an annual Financial Health Check seem likely to be particularly valuable. There could also be potential benefits to this group from the Treasury's proposals for simple products. Those consumers who have established savings, and for whom investment advice is the right way forward, have access to simple, low cost stakeholder products. The charge caps and simple terms of stakeholder products provide strong consumer protection and as a result we are not extending the RDR to the Basic Advice regime. This means, for example, that advisers on such products can continue to receive commission and give advice without holding a qualification.

35. However, we acknowledge the concern of mainly product providers that the market for stakeholder products is small and we believe this is primarily due to the lack of profit margin. At the same time, we are aware that there is a widespread belief that the RDR will result in a reduction in the take-up of advice and that some lower-cost option (along the lines of Basic Advice) should be available to those consumers whose needs are relatively simple and likely to be met by straightforward products. We have had extensive discussions with the industry on the concept of simplified advice to support the development of such a process and we know that a number of firms have developed pilot processes to test out the attractiveness and viability of such a service. Furthermore, to assist the firms who are developing such processes, we will produce some material on the concept of simplified advice this year.

D. Changes being Introduced under the Rdr

Consumers are offered a transparent and fair charging system

36. A key objective of the RDR is to address the potential for remuneration of advisory firms to distort consumer outcomes. Under our new rules, an adviser will be required to say how much their services cost and

[26] Retail Distribution Review proposals: Impact on market structure and competition, Oxera (2010).
[27] The cost of implementing the Retail Distribution Review professionalism policy changes, NMG (2010).
[28] The wealth and saving of UK families on the eve of the crisis, Institute of Fiscal Studies (2010).

will agree with their customer how much they will pay. This means that advisers will have to talk to their customers about the cost and value of their service which could stimulate competition among advisory firms. This change realigns the adviser's interests with those of their clients.

37. We acknowledge concerns from some IFAs that despite these changes there is still potential for certain reward structures for in-house sales staff in banks and other advisory firms to cause the types of bias we have described. We are scrutinising those reward structures for in-house sales staff across the advisory sector.

38. The new rules will also prevent advisers from receiving ongoing commission ("trail" commission) where they are not providing the customer with an ongoing service.

Consumers are clear about the service they receive

39. A further objective of the RDR is to improve the clarity with which firms describe their services to consumers. It is important for consumers to know if their adviser is able to recommend from all of the market or only from a limited range of products. At present, to describe themselves as independent, advisory firms must consider the whole of the market for packaged products (these are products such as pensions, endowments and collective investment schemes) and offer the option of paying by fee.

40. The new advice landscape will be made up of independent advice, restricted advice (including simplified advice services) and basic advice (about stakeholder products). Before any advice is provided, firms will need to make clear to the consumer which of these services they are offering. The new rules for independent advice means that consumers will receive recommendations that consider all relevant options, free from any restrictions or bias. Those advisory firms who do not meet those rules for independence will have to explain the nature and extent of the restriction, for example, whether they advise on a particular range of products or on products from a limited range of product providers.

41. These new rules have received significant support in our consultation and require firms that provide an independent advice service to have the knowledge to consider a wider range of products than now. For example, the new definition includes investment trusts and exchange traded funds.

Consumers receive advice from respected professionals

42. From the start of the RDR, concerns about the credibility of advisers were often at the heart of the debate, which concluded with an early consensus among stakeholders on the need for professional standards to be raised. We believe that to raise trust and instil confidence it is important that consumers receive advice from professional, respected advisers.

43. The RDR will establish standards of professionalism that, when delivered by advisers will inspire consumer confidence and build trust in the market so that financial advice is seen as more of a profession. We are doing this by instituting an overarching code of ethics, modernising qualifications and enhancing standards for continuing professional development (CPD). We will require advisers to hold a Statement of Professional Standing (SPS) confirming that they meet these standards. We developed and agreed these proposals with our Professional Standards Advisory Group (PSAG)[29] which comprised trade associations, professional bodies and consumer representatives. We then measured the proposals against other professions.[30]

44. In developing our policy and rules, we consulted on a proposal from our industry groups that advisers wanting to provide a wholly independent service should have to achieve qualifications at graduate level.[31] While many advisers tell us that they want to become more professional, feedback was that this level was too high for the market at the moment. We therefore settled on the vocational equivalent to the first year of an academic degree[32] as this level requires more relevant skills than is required by the current standards.[33] In the light of feedback about the relevance of the content, we added more on investment risk and ethics as well as practical application of knowledge to the syllabus. We believe these changes are fundamental to equip the modern adviser to give good quality advice, and many advisers recognise that these skills have great relevance to their role.

45. The enhanced professionalism requirements will also mean that advisers, on the whole, will be more competent than at any time in the past. As the professionalism and reputation of the adviser community increases, new entrants will be attracted to the sector. We are seeing more learning opportunities for new entrants and some firms are creating graduate recruitment schemes to accommodate some of the demand.

[29] This group comprised the Association of British Insurers, Association of Investment Companies, Association of Independent Financial Advisers, Association of Private Client Investment Managers and Stockbrokers, British Bankers' Association, Building Societies Association, CFA Society (UK), Chartered Institute of Bankers in Scotland, Chartered Insurance Institute, Chartered Institute for Securities and Investment, Financial Services Consumer Panel, Financial Services Practitioner Panel, Financial Services Skills Council, FSA Smaller Businesses Practitioner Panel, the Treasury, Institute of Financial Planning, *ifs* School of Finance, and the Investment Management Association.

[30] Professional Standards Bodies: Standards, Levels of Compliance and Measuring Success, PARN (2009).

[31] Level 6 of the Qualifications and Credit Framework.

[32] Level 4 of the Qualifications and Credit Framework.

[33] Level 3 of the National Qualifications Framework.

Advisory firms are more stable and better able to meet their liabilities

46. We have put in place new rules requiring personal investment firms (which broadly derive the majority of their business from advising on and managing investments for retail customers) to have adequate capital resources in order to minimise the financial impact of unsuitable advice. We believe that it is important for firms to have a strong capital base so that they are able to deal with complaints arising from their advice. This would reduce the situations where the Financial Services Compensation Scheme (which is funded by firms who remain in business) has to pick up the cost. In developing our proposals we reviewed the extent to which such rules could mitigate the incidence, and the impact, of unsuitable advice by personal investment firms. We concluded that such rules could not mitigate the incidence of poor advice but could affect the impact on the sector as a whole. We are implementing an expenditure-based requirement (EBR) and will require firms to hold (at least) a level of capital resources equivalent to a specified number of months of their fixed expenditure. The new rules will come into effect on 31 December 2011 with two years for the transition. In response to feedback we agreed an additional transitional year because firms were experiencing difficult trading conditions.

47. We have confirmed that, in the light of the feedback we received, we will review how the new capital resources rules apply to firms with different business models to ensure that they deliver consistent regulatory outcomes. We will consult on this in July 2011.

E. Contentious Issues

Absence of a Long-Stop

48. Some advisers express frustration at the absence of a long-stop time limit on the period within which complaints must be brought or the application of the statute of limitations because they want to limit their liabilities. This strength of feeling, particularly amongst IFAs, was made clear to us when we first consulted on long-stop in 2007. To justify the introduction of a long-stop we need to identify benefits to firms or consumers beyond the savings for firms in compensation payments. These benefits would need to exceed the consumer detriment from time-barred complaints.[34]

49. Responses to our consultation focused on "fairness" arguments around the statute of limitations and concerns about handling "stale" claims—particularly into retirement. We were unable to convert these arguments into a persuasive analysis that it would be reasonable to impose responsibility on consumers to identify any and all issues with advice within a given period.

50. Other respondents highlighted the consumer detriment and reputational damage that a long-stop could cause. Due to the strength of feeling on the issue we made a further call for evidence in 2008 but only three firms responded with further evidence. This prompted us to seek further evidence to see if we could build a persuasive argument. We could not and we had to conclude that we should not introduce a long-stop because we were unable to demonstrate that it would bring additional benefits to consumers and firms (for example from greater investment in the sector).

Experienced Advisers and Grandfathering

51. We considered grandfathering but the majority of respondents to our consultation[35] were not in favour (including AIFA, the main representative body for independent financial advisers). Any grandfathering provision would have to be made available to all advisers operating in the market, irrespective of who they work for. There was a broad consensus that grandfathering would not support the necessary efforts to restore confidence in the industry and would thwart efforts to implement demonstrably consistent minimum standards across the profession. This was the view of the majority of advisers and their representatives.

52. Our own recent experience in allowing grandfathering rights for mortgage brokers has been that it has seen a continuation of mis-selling, resulting in nearly 100 brokers being disqualified to-date for incompetent and unethical practices.

53. The majority of those in favour of grandfathering said that to be eligible, advisers would have to meet certain conditions, such as the absence of complaints against them. As noted earlier, we do not agree that this is an objective measure of competence. Other suggestions have been that advisers tell their customers they are not qualified. However, this approach requires the consumer to exercise a judgement that they are generally ill-equipped to make.

54. We also considered a working group recommendation in 2008 to permit existing advisers a grace period of two further years (to end-2014) under supervision to allow them longer to get qualified. However, we had serious concerns about the supervision of these advisers being effective. At its most unacceptable supervision carried out within firms is a form of remote file checking with no coaching, mentoring or training of the individual. Instead, we found an acceptable compromise and said that those who are on course to complete, or already hold, an appropriate qualification can continue with this. This meant that from November 2008, existing advisers could continue or begin their studies using existing higher level qualifications, without having to wait

[34] Retail Distribution Review—Interim Report, FSA (2008).
[35] DP07/1, FSA (2007).

for the new qualifications to be made available. Overall, our view is that, by the end of 2012, established advisers will have had enough time to meet the new standards.

55. While we are sympathetic to the issues raised by some advisers with significant years of experience, experience alone does not necessarily equate to competence—and it is competence that the new minimum qualification standards aim to address. We are not satisfied that the existing standards are adequate to meet the demands of today's challenging investment market or that advisers have been maintaining their knowledge in line with changes in the market. This is borne out in our platforms thematic review[36], published in March 2010, where advisers were recommending a service they did not understand themselves. So the professional standards have been modernised to reflect the role actually performed by advisers.

56. In light of concerns from advisers about sitting traditional written exams, and having taken advice from PSAG[37] and the Office of Qualification and Examinations Regulation (OfQual), we agreed to allow alternative forms of assessment. These assessments provide those advisers who do not wish to sit a written examination with a viable alternative to demonstrate that they meet the standards. These test the relevance of advisers' knowledge as well as practical application. PSAG, however, rejected a form of FSA kite marking, where the proposal was that we assess individual advisers against the examination standards based on the content of client files—these are unlikely to cover all of the areas within the examination standards. In summary there are a number of different ways in which advisers may become qualified without taking a traditional written exam, notably:

(a) There are two qualifications that do not involve any written examination instead they use what is called a "competency day". This involves reading a series of case studies and discussing these with an assessor.

(b) We are currently consulting on including a work based assessment in our qualifications list.

(c) There are also case study based written exams which involve the candidate being given a fact file prior to entering the examination hall and then being asked to write their recommendations on the file in exam conditions.

57. However it should be noted that the take up of these types of options is very low.

Market Impact of Professionalism

58. We do not believe that the RDR will result in the loss of the most experienced advisers, despite recent concerns, as we expect that those advisers who have actively sought to maintain competence by keeping up to date with market developments not to have to commit a significant amount of time to study. OfQual guidelines suggest the average new learner takes 370 hours to complete a diploma: this includes directed study, homework, assessment, and preparation time. This is the expected time that a new entrant would take: we would expect those advisers with considerable experience to find that the time they need to study will be significantly lower than that. The main qualification providers for this sector have indicated to us that it is taking between 6–24 months for most experienced and new advisers to complete their qualifications.

59. We have worked closely with qualification providers to ensure we recognise as many relevant qualifications as possible. In some cases qualification providers have altered their qualifications to meet the new standards eg including practical application of knowledge in university degrees and adding UK taxation into overseas qualifications. This approach differs radically from regulators in other countries, who provide no choice at all as they set their own qualifications. The list now includes over 60 appropriate qualifications. There is a wide range of support available to individual advisers to help them complete the qualifications, some of it free of charge.

60. Our experience is that advisers are now, on the whole, getting on with attaining qualifications. In March 2010, 49% of all advisers were already appropriately qualified.[38] A further 40% expected to have attained an appropriate qualification by end-2012. Of the remaining 11%: 6% did not know or did not answer the question, 4% will not qualify at all, and 1% will not qualify by end-2012. In fact, far from being put off by studying, many advisers are going further and taking more advanced level qualifications. We will continue to monitor market developments and the progress being made towards the deadline.

Removal of Factoring

61. In developing our proposals, and in response to feedback from our industry working groups and our consultations, we explored with the OFT whether a maximum commission agreement or a standard commission rate could be created for all investment products. However, the OFT expressed the same concerns about the competitive impact as they did when they banned the maximum commission agreement in 1989.

[36] Investment advice and platforms thematic review, FSA (2010).

[37] This group comprised the Association of British Insurers, Association of Investment Companies, Association of Independent Financial Advisers, Association of Private Client Investment Managers and Stockbrokers, British Bankers' Association, Building Societies Association, CFA Society (UK), Chartered Institute of Bankers in Scotland, Chartered Insurance Institute, Chartered Institute for Securities and Investment, Financial Services Consumer Panel, Financial Services Practitioner Panel, Financial Services Skills Council, FSA Smaller Businesses Practitioner Panel, the Treasury, Institute of Financial Planning, *ifs* School of Finance, and the Investment Management Association.

[38] The cost of implementing the RDR professionalism regime, NMG (2010).

62. Under our new rules product providers will be allowed to offer consumers the choice to have adviser charges paid out of their investments. In particular, consumers who contribute to their investments on a regular basis will be able to spread the cost of initial advice fees, thus helping to maintain access to the market. However, unlike the current indemnity commission, providers will not be allowed to advance this money to advisers before it has been collected (a practice sometimes referred to as factoring).

63. Effectively this means that providers cannot use their own funds to advance this money to advisers before it has been collected from regular premium insurance products (such as endowments), as they currently can by using indemnity commission—where a future stream of commission payments is rolled up and paid in a (discounted) lump sum when the product is sold. It should be noted this is only a feature of the insurance market and does not feature in other product markets such as mutual funds. In a market without commission, but with adviser charges, it has been suggested that product providers should be allowed to achieve the same result by "factoring" the stream of adviser charges that would accrue over time in a regular premium product, discounted at a rate of interest chosen by the product provider, in order to encourage new saving and provide stability in the adviser sector of the market.

64. However, we see a number of reasons why this would be undesirable. First, there is no evidence that the current indemnity commission, which proposals for factoring by product providers would replace, has led to any substantial increase in new saving. In fact, there is some evidence that it has encouraged churn in the market, adding to its lack of sustainability. Second, the discount rate in factoring offered by product providers would have the potential to bias the recommendations of adviser firms, as different discount rates would generate different "factored" amounts for the adviser. Product providers could compete not on the price of the product to the consumer, but on the discount rate that generates income for the adviser. We have discussed a single factoring rate with OFT and their view is that this would be anti-competitive.[39] During pre-consultation and consultation, we asked the industry for reasons to allow product provider factoring but no compelling arguments were provided.

65. We recognise that some advisers have been dependent on upfront remuneration and that there may be transitional liquidity problems for some advisers. However, we believe that a limited proportion of income is earned via sales of regular contribution products and it is important to note that advisers may still be able to arrange third party factoring if this is something they would find valuable in running their business and improving stability.

F. Costs and Benefits

66. We published our cost-benefit analysis (CBA) for the RDR in June 2009 which we updated in March 2010 in light of responses to our consultation. We have published additional CBA as and when we consulted on other rule changes that also relate to the RDR, such as in June 2010 for the supervision and enforcement of professional standards. Some of the market impact costs of our CBA have drawn specific comment which we respond to below, but the RDR is a package of measures and to realise the benefits those changes must be delivered as a package.

67. We used data provided to us by firms to estimate that costs for the first five years of the RDR would range from £1.4 billion to £1.7 billion; an increase from our earlier estimate of £0.6 billion (also based on estimates provided by firms). The difference arises because the draft rules we published gave firms a better understanding of the changes they will need to make and the costs they are likely to incur. Consequently, firms' responses to our second CBA survey are materially different in some areas from the responses to our first survey on estimating compliance costs. The main changes in the cost estimates are increases in the costs of introducing the move away from commission to "fees".

68. Clearly any additional compliance cost for firms, and ultimately consumers, is a matter of concern to the FSA. We believe these changes are necessary to increase consumer protection. The main benefits of the RDR changes would be an improvement in the quality of advice and a reduction in the incidence of mis-selling caused by product, provider and sales bias. In our March 2010 Policy Statement[40] we presented evidence of annual benefits in the region of £225 million which was from a sample for mis-selling cases. To give an indication of scale of potential detriment to consumers caused by mis-selling annually, we have extrapolated the levels of mis-selling in these studies to the whole market and used an estimate of detriment presented in our June 2009 Consultation Paper[41] to obtain an estimate of £0.4 billion to £0.6 billion.

69. An increase in the quality of advice should lead to increased persistency and a reduction in unnecessary transaction costs. In addition, Oxera concluded that providers are likely to compete on the cost of advice and by offering better services to advisers post RDR, and that this is likely to benefit consumers indirectly.

70. We based our decision to raise professional standards on recommendations from our initial industry working groups, which were refined and developed by PSAG, throughout which we carried out substantial consultation. This was supported by some focussed research on how higher professional standards might lead to better outcomes. The research we obtained indicated that both in the UK and non-UK markets advisers

[39] Published correspondence regarding factoring arrangements between product providers and adviser firms, Office of Fair Trading (2010).
[40] PS10/6, FSA (2010).
[41] CP09/18, FSA (2010)

meeting higher professional standards give more suitable advice. We have summarised this research, and the main findings, in the following paragraphs:

(a) *Professional Standards and Consumer Trust*.[42] This research found that in the longer term, measures to improve compliance with professional standards may result in improved consumer trust and engagement in markets.

(b) *Professional Standards Bodies: Standards, Levels of Compliance and Measuring Success*.[43] This research demonstrated that professional bodies operating in markets with potentially similar consumer problems are taking a broadly similar approach to us in standard setting and establishing processes for monitoring and enforcement.

(c) *Linking Professional Standards to "Consumer" and Other Outcomes in the Financial Sector*.[44] The research presents two case studies showing positive links between standards and outcomes. The first was a review of financial planning advice by the Australian regulator and consumer agency. The evidence suggests that qualification at the level of higher education and engaging in Continuing Professional Development (CPD) contribute to increasing professionalism and improving the quality of financial advice. The second study aimed to identify whether qualifications of fund managers could be used to explain differences in the performance of their funds. The research concludes that clients with advisers holding professional membership and/or higher qualifications ought to improve outcomes.

(d) *Platforms thematic review*.[45] Our data from early 2010 on platforms shows the advice of advisers meeting current qualification standards was deemed to be "suitable" less often than that of advisers with a similar qualification to the new standard.

(e) *Major banking group—internal review:* The review analysed quality of advice provided by level 4 and level 3 advisers. Analysis of fail rates (a measure of "poor" quality) and risk scores (a blend of Key Performance Indicators including complaints) showed that indicators were better for higher qualified advisers.

71. In the longer term the RDR should remove some of the negative perceptions of the advisory process, which undermine confidence and often deter people from seeking advice. This could provide further opportunities for the advice sector.

Conclusion

72. The number of people currently seeking advice, as a proportion of the population, is small. If more people are to seek advice in the future, then they must both trust the advice and view the service as good value for money. Our proposals address both these issues by improving the likelihood of there being trust and confidence in the market and by making clear to consumers the cost of advice and the nature of the service they are going to receive.

73. The RDR is absolutely vital if we are to build consumer trust and confidence in the advice sector. We expect the package of changes we are making will result in a sustainable market that is a better place in which to do business in the long-term and advisers will be better equipped to give good quality advice. Any dilution of the proposals will result in an increase in the cost to consumers through continued unsuitable advice.

74. We will continue to support advisers towards the end-2012 deadline to ensure they fully understand the new requirements. We will be running further industry events this year, producing more material—particularly for smaller firms—and continuing our supervisory programme to assess firms' readiness for the RDR.

January 2011

Supplementary written evidence submitted by the Financial Services Authority

1. We are submitting this note as a follow-up to the oral evidence given by Hector Sants and Sheila Nicoll on 9 March.

2. In this note we provide answers to the specific questions the Committee asked on:

A. the age profile of independent financial advisers (IFAs), specifically numbers for those aged over 55 and 60, and statistics on length of service;

B. the breakdown of statistics on consumer trust in financial advisers;

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[42] Professional Standards and Consumer Trust, Wells and Gostelow (2009).

[43] Professional Standards Bodies: Standards, Levels of Compliance and Measuring Success, Professional Associations Research Network (2009).

[44] Linking Professional Standards to "Consumer" and Other Outcomes in the Financial Sector, Professional Associations Research Network (2010).

[45] CP10/14, FSA (2010). This information is based on 12 firms and 46 advisers and 113 cases.

C. RDR compliance requirements for firms that passport into the UK from elsewhere in the EU, with or without a UK base;

D. FSA staff with experience working in small firms; and

E. FSA accountability/liability.

A. Age Profile of Financial Advisers

3. As part of the RDR, we have conducted detailed research to ensure we understand the impact our proposals could have on financial advisers and the market. Age profiles and length of service of financial advisers have, of course, been taken into consideration when developing our proposals and set out below are the statistics we have in this area.

4. Research carried out by NMG in March 2010 estimated that there are 48,000 advisers impacted by the RDR. Of these, the age profiles based on responses to the research were as follows:

Age-band	*All advisers*
18–29	4%
30–39	21%
40–49	35%
50–54	16%
55–59	11%
60+	12%
No answer	1%

5. Therefore, in answer to the Committee's specific question, we can say that 11% of advisers are aged 55–59 and 12% are aged 60 or more. This profile is for all financial advisers, including those working in IFAs, banks and stockbrokers. Using the same research, but looking only at those working for IFA firms, this shows that IFAs have a slightly older profile with 14% aged 55–59 and 18% aged 60 or more.

6. The same research asked about length of service—nearly three quarters of all advisers (73%) have 10 or more years of experience. This research did not break down length of service into categories longer than 10 years.

Consideration of these statistics and our decision not to allow grandfathering

7. We are concerned about the lack of consumer trust and believe there is a need for a step change for the whole financial advice sector. This explains why the increased professional standards will apply to all advisers, even though we do recognise that there are many advisers who have considerable experience.

8. This position is supported by our extensive consultation on the RDR, which found broad industry and consumer consensus that higher professional standards are necessary, with the majority of respondents opposed to grandfathering. We also do not see how advisers can evidence their improved professional standing if they do not demonstrate this through an objective measure—a qualification—that tests this. This goes to the heart of restoring consumer confidence and trust.

9. We consider our changes to be a fair and proportionate step in meeting the consumer protection objective, consistent with our legal obligations. Allowing grandfathering for a proportion of advisers, perhaps based on age, experience, a good track record (as evidenced by no or few complaints), or some combination of these, would create its own problems and would lead to different issues of "fairness". Creating conditions under which grandfathering is acceptable would inevitably lead to challenge from those advisers that didn't meet the precise conditions set out. Allowing grandfathering would also be unfair to that majority of advisers who are either already appropriately qualified or who are well on the way to being qualified.

10. Moreover, if some advisers were to continue to advise without meeting the same standards, there are risks that consumers will not be made aware of this or may fail to appreciate that their adviser is not qualified to the same level as other advisers. We believe this could further undermine trust and confidence in the sector.

11. That said, we do recognise the concerns of some older and more experienced advisers about the pressure to gain new qualifications and specifically to sit exams. So we do not require the qualification to take the form of a written examination and we do recognise qualifications that use other assessment methods. We have worked closely with qualification providers to ensure we recognise as many relevant qualifications as possible—the list now includes over 60 appropriate qualifications. Those advisers with a lot of experience, and who have maintained their knowledge, will find that qualifications involve less study and preparation precisely because they have the benefit of that experience.

12. A further consideration when developing our professionalism policy was our legal obligation to take account of implications of our proposals from the point of view of equality and diversity, including age considerations.

13. The Equality Act 2010 requires us to have due regard to the need to eliminate unlawful discrimination in the exercise of our functions. This includes discrimination on the basis of age. Given our consumer protection statutory objective, any grandfathering rights would need to be granted on the basis of a certain number of years' experience rather than upon age alone. This is because an adviser who is, for example, 60 years old will not necessarily have worked in the financial services industry for a significant number of years.

14. Allowing grandfathering on the basis of a certain number of years' experience would indirectly discriminate against younger advisers. Therefore, in order to comply with our obligations under the Equality Act, we would have to be able to justify this indirect discrimination on the grounds that it is a proportionate means of achieving a legitimate aim. We do not consider granting grandfathering rights for more experienced advisers to be proportionate on the basis that more experienced advisers will need to invest significantly less time acquiring the necessary knowledge to pass the qualifications and granting such rights would not be consistent with our statutory duty to achieve an appropriate degree of protection for consumers.

Progress of advisers in gaining the new qualifications

15. We continue to monitor market developments and we are encouraged by the progress made by advisers, across all age groups, towards the new qualification requirements.

16. In March 2010, 49% of all advisers were already appropriately qualified.[46] This varied by age group as follows:

Age band	*Qualified*
18–29	48%
30–39	58%
40–49	54%
50–54	48%
55–59	52%
60+	42%

17. We also asked advisers what their future intentions were. Overall, 82% expected to remain as a retail investment adviser. As might be expected—because of proximity to retirement—this percentage was lower for those aged over 55.

	Age over 55	*All advisers*
Likely / definitely remain as a retail investment adviser	59%	82%
Retire as planned	17%	5%
Retire earlier than planned	8%	3%
Stop advising on retail investments	5%	2%
Leave the industry	3%	3%
Other / don't know	7%	5%

B. Adviser Trust Statistics

18. During our evidence session, we referred to statistics about the number of people seeking financial advice and levels of trust in advice. The table[47] below provides a more detailed breakdown of these statistics:

	% of adults	*% trusting financial advice*	*% not trusting financial advice*
All		45.0	48.0
Using any adviser	30.6	60.0	39.0
Not using a financial adviser	69.4		

19. This table shows that 69.4% of consumers do not currently seek advice from an investment adviser. Of the 30.6% who have sought advice, 39% have indicated that they do not trust financial advice.

20. As requested by the Committee, the table below provides a further a breakdown of the 30.6% who have used a professional adviser. This includes statistics on the type of adviser used and whether the consumer trusts

[46] Whilst 49% of all advisers were already qualified with an appropriate qualification in March 2010, please note that this table includes 3% of advisers who held a MLIA designation that was incorrectly classed as RDR compliant in the research.

[47] Wells and Gostelow (2009) analysis of the Baseline Survey of Financial Capability, FSA (2006): "In the last five years, have you received any professional advice about planning your personal finances? By that I mean things like planning for retirement, tax planning, or investing money, but please do not include advice related to running a business". In these tables, the "% of consumers trusting" (or not trusting) are a combination of those that answered "agree strongly" or "tend to agree" that they trust / do not trust financial advice. Please note that consumers were not asked if they trust their own adviser but if they trust "financial advice"

financial advice. Some consumers have used a mix of IFA, bank, building society, accountant or solicitors for advice, therefore the total "% of all adults" is more than 30.6%:

Received professional advice from:	*% of all adults*	*% trusting financial advice*
IFA	18%	63%
Bank or building society adviser	11%	55%
Accountant or solicitor	3%	53%

21. While these statistics show that levels of trust are greater amongst users of IFAs, a significant minority of consumers using each type of adviser do not trust financial advice. Overall, there are issues of trust across the whole sector. This issue of trust and confidence is a key factor that we are seeking to address through the RDR.

22. This research also looked at whether other factors played a role in determining trust. As shown in the table below, investment advice is more likely to be sought by older consumers because it takes more time to accumulate disposable income and capital for investment. At the same time, the profile of consumers who do not trust financial advice is older than consumers who trust financial advice.

Age band	*Trust financial advice (45% of all adults)*	*Don't trust financial advice (48% of all adults)*
Under 30 years old	25%	14%
30–49 years old	39%	36%
50–64 years old	20%	27%
65 years plus	16%	23%
	100%	100%

C. Compliance Requirements for Firms from Other EU Countries

Passporting

23. The Committee asked for further information about the compliance requirements for firms from other EU Member States in relation to the RDR. The activity of providing services on a cross-border basis is usually described as "passporting". Firms can passport into the UK either by:

— setting up an establishment here, usually described as a branch; or

— by providing services with no physical presence in the UK, such as by telephone or internet.

24. There are currently 2,030 firms authorised to passport into the UK. Between them, these firms have 195 establishments around the UK. The precise requirements vary between different EU directives, but in general for the investment advice sector the following additional points are relevant:

— the UK's conduct of business requirements (including the RDR rules on describing services and adviser charging) would apply to branches set up in the UK for business conducted with UK clients. The FSA would have responsibility for supervising the conduct of business, including, for example, assessing whether advice given was suitable;

— if a firm passports into the UK without having a branch here (ie, provides cross-border services), then it will have to comply with its home member state conduct of business rules;

— a firm may not conduct its business on a cross-border basis if it is doing so to evade the host state standards. An indicator of this might be where a disproportionate volume of business is being conducted in the host state compared to the home state, particularly if the firm had previously been authorised in the host state; and

— the competence of individuals is the home state regulator's responsibility. Firms passporting into the UK are not subject to the FSA's training and competence requirements, which includes requirements for individuals to hold a relevant qualification or carry out continuing professional development. Individuals operating in branches established in the UK will need to be approved by the FSA, if, for example, they are advising retail customers.

25. It is important to note that EU directives do not currently include all investment products. For example, UK personal pensions are outside the scope of these directives. This means that if a firm passports into the UK and wants to advise on pensions the firm will typically require an additional permission from the FSA (a "top-up"). Under the top-up permission, the firm will be subject to the host state requirements, so in this example the firm would be subject to the RDR requirements for their advice on pensions.

26. In addition to complying with applicable RDR requirements, any passporting firm providing investment advice would also need to comply with the relevant rules of their home state, which may include further requirements that are not part of the UK's framework.

Proposed EU Legislation

27. The Committee also asked whether our new rules should take account of the timing of proposed draft EU legislation. We support the European Commission's Packaged Retail Investment Products (PRIPs) initiative, which has the potential to be an important step forward in delivering consistent consumer protection. We believe our rules will be compatible with the outcome of the Commission's recent consultation, and we keep closely in touch with the Commission on both our developments and theirs.

28. We are confident that, rather than waiting for any new EU rules to come into force, we should move to strengthen protection for UK consumers now. It is worth noting that rules about specific professional standards, including qualification levels, are not covered by the PRIPs initiative and our rules on professional standards would not be affected by the current Commission consultations.

D. Regulation of Small Firms and FSA Staff with Experience of Working in Small Firms

29. During our evidence session, the Committee also raised the issue of the FSA's regulatory approach to small firms and specifically asked for further information about the number of FSA staff with past experience of working in firms with 10 employees or fewer.

30. Unfortunately, we do not hold data on the number of staff with experience of working in small firms with 10 employees or fewer. However, a key element of our HR strategy is to ensure we recruit staff from a diverse range of backgrounds, including small firms.

31. In order to fulfil our objectives, FSA staff need to have a range of skills and experience, such as market knowledge, policy formulation, economic analysis, and legal expertise. This applies across many areas of our work, including the RDR, investments, life assurance and the pensions sector. Our recruitment process ensures that we get this balance of skills and experience, including reviewing relevant qualifications where applicable. This is supported by a very good internal training programme, which ensures policymakers and those implementing that policy gain a wide variety of industry and regulatory experience and qualifications.

32. The FSA recognises the value of diversity in the market and we take supervision of small firms very seriously. Our small firms division employs over 250 people and we have significantly changed our approach to small firms' supervision over the last three years. We have also considerably increased our outreach work to ensure small firms have good access to us and that we have a strong understanding of the specific requirements of this sector.

33. We now have much more regular direct contact with smaller firms and since 2008 we have seen around 8,500 small firms at our roadshows. We have also carried out a series of regional education programme workshops which aim to provide further help and assistance to smaller firms and to demonstrate our support for the ones willing to comply with our requirements. Those firms who caused us concern were subject to further, more intensive supervision.

34. We provide regular feedback and assistance via our website specifically for smaller firms and we also have a dedicated call centre for small firms to ring and ask us for assistance on any regulatory issue.

35. We believe that this direct contact is the best way to supervise and communicate with our smaller firms and our future work will be conducted on this basis. Smaller firms unanimously tell us this is also their preferred approach and last year we engaged an external consultancy to conduct an independent survey of this approach, the results of which were very favourable. This month we start a series of RDR roadshows and around 2,000 firms have already signed up to these.

E. FSA Accountability/Liability

36. This section discusses the issue of the level of liability to which the FSA, and in time its successor authorities, should be subject. The current standard is set out in FSMA, which exempts the FSA and its staff from liability in damages for anything done or omitted in the discharge of its general functions except if done in bad faith or in violation of the Human Rights Act. This standard is in line with that for other UK and international authorities. We believe this strikes an appropriate balance between, on the one hand, the accountability of the FSA and its staff to those affected by its decisions and, on the other, the desirability of regulators making difficult judgements and taking difficult decisions so as to promote the authority's regulatory objectives rather than to mitigate the risk, institutional and personal, of litigation.

37. Under FSMA, FSA staff cannot be held liable for negligence in carrying out their functions but can for acts or omissions in bad faith. In this regard, FSMA simply crystallises the state of the common law. The formulation used has become standard across the UK statute book. For example, the acts governing the Bank of England, the Pensions Regulator and the Accounting Standards Board use the same language. Overseas regulators, such as the Australian Prudential Regulation Authority and the Irish Central Bank, also have similar standards of immunity.

38. The kind of egregious behaviour to which the Committee referred—"doing something really stupid knowing it's really stupid"—may well already be covered. The BCCI case against the Bank of England suggests that the difference between recklessness and bad faith will often be a question of degree, and that reckless

indifference by a public officer to the illegality and consequences of his actions can be enough to establish bad faith and hold the officer liable.

39. We are not in any way suggesting that the FSA or its staff should be completely immune from liability in damages. The question is rather one of balancing conflicting goals and providing the right incentives to make the right decisions.

40. Regulators need a certain amount of protected space to be able to take the difficult decisions that supervision entails. This principle is recognised on the international level. For example, the Basel Committee recognises this point in its Core Principles for Supervision: "an effective system of banking supervision requires a suitable legal framework, including legal protection for supervisors against lawsuits for actions taken or omissions made while discharging their duties in good faith".

41. Judgement-based supervision requires a supervisor to make judgements, some of which may be wrong. A supervisor that faces potential liability of millions of pounds for a wrong decision taken in good faith will tend to act more cautiously and defensively, particularly towards the large institutions that have deep pockets to finance litigation. This applies even more if the liability was personal to the supervisor and we have serious doubts whether you could find someone willing to do the job in those circumstances. Such a defensive posture would not promote the kind of intrusive, judgement-based supervision that Government policy is calling for. A supervisor that always errs on the side of caution will not be doing his/her job properly. Nor is it likely that a standard derived from the hindsight judgement of the court will give you a more optimal result.

42. These are high-stakes issues. Claims by the creditors and shareholders of a failed institution for regulator misconduct could easily run into the billions if the firm were large enough. Firms, who provide our sole source of revenue, are unlikely to be willing to finance such an amount to cover the regulator's mistake and it would be unfair to force them to do so. In the end it is the government who would be required to step in and take responsibility for the costs. If the bar to liability were low enough, creditors and shareholders of a failed firm would come to see the regulator, and through it the state, as another means of recovering their lost investment. The state would effectively become a second-tier guarantor of institutions that fail.

43. Even lower-stakes claims would have a negative effect. If recovery becomes easier, one can reasonably assume an increase in the number of claims. The inevitable result will be a diversion of financial and human resources away from the task of regulating effectively to defending legal claims.

44. Tort liability is not the only means of holding the FSA and its staff accountable for their decisions. Our decisions are subject to judicial review. Many supervisory decisions can be referred to the Upper Tribunal. There is also the independent Complaints Commissioner, who investigates complaints against the FSA for maladministration and can recommend the payment of ex gratia compensation. Finally, there are the wider accountability measures to which we are subject: our annual report and annual public meeting; our accountability to the Treasury and its rights under FSMA to arrange a public inquiry; and our accountability to Parliament such as via our evidence to your Committee. All of these have the effect of discouraging the kind of reckless behaviour you are concerned about.

45. We take our accountability obligations extremely seriously and, as mentioned before the Committee, we support the proposals made in the Treasury's consultation document to improve our accountability framework. The question of regulator immunity is, however, one that deserves debate and careful consideration, and we welcome the opportunity to engage further on this issue.

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