



OFFICE OF FAIR TRADING

The Rules on the Polarisation of Investment Advice

**A report by the
Director General of Fair Trading**

August 1999



FIELD HOUSE
15-25 BREAM'S BUILDINGS
LONDON EC4A 1PR
0171-211 8000 (Switchboard)
0171-211 8920 (Direct Line)
FAX 0171-211 8966

From the Director General of Fair Trading
John S Bridgeman TD DL

The Rt Hon Gordon Brown MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

3 August 1999

Dear Chancellor of the Exchequer,

FINANCIAL SERVICES ACT 1986: REPORT ON THE RULES OF THE FINANCIAL SERVICES AUTHORITY, PERSONAL INVESTMENT AUTHORITY, SECURITIES AND FUTURES AUTHORITY AND INVESTMENT MANAGEMENT REGULATORY ORGANISATION ON THE POLARISATION OF INVESTMENT ADVICE

I enclose with this letter a report made to you under section 122 of the Financial Services Act 1986 on the rules of the FSA and the self-regulating organisations which polarise the provision of advice to investors on life assurance, personal pensions and units in collective investment schemes. I have found that these rules restrict or distort competition to a significant extent in that they prevent some forms of retail innovation in the market.

I have also used my powers under section 2 of the Fair Trading Act 1973 to review the activities of the market affected by these rules to assess its impact on the economic interests of consumers. I have found that vulnerable consumers have been excluded from the market by the complexity of products and the cost of advice. Other consumers benefit from the competition between providers generated by the number of independent financial advisers in the market, the clear lines of responsibility for the regulatory control of advice and the wide availability of independent advice. They also suffer detriment in that some retail innovations which could be of benefit, such as a wider range of sources of advice on competing products, are denied to them. In my opinion the benefits to consumers outweigh the significant adverse effect on competition of the rules in the case of investment products linked to life insurance but not in the case of units in collective investment schemes.

I have made a number of supplementary recommendations which I believe will help to relieve some consumer detriment in the market for investment products. I would draw your attention in particular to the recommendation that consideration be given to providing tax neutrality between commission and fee paid investment advice.

I am sending a copy of this letter and the report to Howard Davies, Chairman of the Financial Services Authority.

Yours sincerely
John Bridgeman
JOHN BRIDGEMAN
DIRECTOR GENERAL OF FAIR TRADING

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REPORT OF THE DIRECTOR GENERAL OF FAIR TRADING ON THE RULES ON THE POLARISATION OF INVESTMENT ADVICE

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LIST OF ABBREVIATIONS

Below is a list of abbreviations. For an explanation of some of the technical words and phrases in the report see the Glossary at Appendix I.

ABI	Association of British Insurers
AUTIF	Association of Unit Trusts and Investment Trusts
FIMBRA	Financial Intermediaries, Managers and Brokers Regulatory Association
FSA	Financial Services Authority
IFA	Independent Financial Adviser
IMRO	Investment Management Regulatory Organisation
ISA	Individual Savings Account
LAUTRO	Life Assurance and Unit Trust Regulatory Organisation
NOP	National Opinion Poll
OEIC	Open-Ended Investment Company
OFT	Office of Fair Trading
PEP	Personal Equity Plan
PIA	Personal Investment Authority
SFA	Securities and Futures Authority
SIB	Securities and Investments Board

1 INTRODUCTION

- 1.1 'Polarisation' is a requirement that those who advise on life assurance, personal pensions and regulated collective investment schemes are either independent of any product provider or represent one provider (or group) and advise only on its products. It is part of the regulatory regime for investment business introduced by the Financial Services Act 1986.
- 1.2 This report is of a review by the Director General of Fair Trading (the Director General) of the operation of the polarisation rules. His purpose was to establish whether the rules have achieved the objectives for which they were designed; whether they have enhanced consumer welfare; and whether they have had any significant effect on competition in the market. The review was launched on 3 August 1998.
- 1.3 In reviewing the polarisation rules account has been taken of other factors in the market which may influence the way in which the polarisation rules operate, for example, the payment of advisers by commission and the use of product panels.
- 1.4 The powers used to carry out the review are in section 122 of the Financial Services Act 1986, which provides for the Director General to review the effect of the rules on competition, and section 2 of the Fair Trading Act 1973 under which the Director General has a duty to keep under review commercial activities which might have an adverse effect on the economic interests of consumers.
- 1.5 A series of interviews based on the questionnaires attached at Appendices C-F were held with product providers, financial advisers, representative bodies and the Consumers' Association. Written representations were also received from a number of interested parties. A summary of the consultation exercise is attached at Appendix B. Reference was also made to previous research by the Personal Investment Authority (PIA), namely, the consumer research carried out for the Evolution Project, the series of reports on disclosure of information about life and non-life investment products¹, the series of surveys of the persistency of life and pensions policies² and the

¹ *PIA Life Assurance Disclosure One, Two and Three Years On (1996-8)*
PIA 1997 Disclosure Report: Unit Trusts, Investment Trust Savings Schemes and Personal Equity Plans (January 1998)
PIA 1998 Disclosure Report, Life Assurance, Unit Trusts, Investment Trust Savings Schemes & Personal Equity Plans (February 1999)

² *PIA First-Fourth Survey of the persistency of life and pension policies (1995-98)*

reports of the PIA Consumer Panel³. The consumer surveys carried out for reports by the OFT on pensions⁴ and *Vulnerable Consumers and Financial Services*⁵ provided valuable information about consumer needs for financial advice.

- 1.6 Polarisation is only one aspect of the regulatory regime which is intended to promote confidence in investment business, to guard against systemic market failure and to minimise investor detriment. The impact of the entire regime on vulnerable consumers was considered in the Director General's report: *Vulnerable Consumers and Financial Services* published in January 1999. The conclusion of this report was that the present regime was not adequately reflecting the interests of vulnerable consumers. It did not look specifically at the part played by polarisation, but it did conclude that the existing polarised distribution channels were incapable of serving low income consumers and many consumers were excluded by a regulatory framework in which polarisation plays a significant part.
- 1.7 A better deal for consumers could be brought about by changing the regulatory regime so that it encourages simple transparently-priced products and passively-managed equity-based products. Examples of simpler products are CAT standard Individual Savings Accounts (ISAs) and the Government's proposals for stakeholder pensions. The Director General has already observed in his report on pensions⁶ that the unpredictability of the securities market renders worthless much of the expert financial advice purporting to identify the best performing equity product. In carrying out this review the Director General considered what effect the polarisation rules might have on innovation and the wide availability of simpler products.

³ *PIA Consumer Panel Reports (1995-8)*

⁴ *Report of the Director General's Inquiry into Pensions (July 1997)*, OFT191

⁵ *Vulnerable Consumers and Financial Services (January 1999) Appendix 4*, OFT255d

⁶ See footnote 4 above

2 EXECUTIVE SUMMARY

- 2.1 The polarisation rules were introduced by the Securities and Investments Board (SIB), now called the Financial Services Authority (FSA), in 1987. The purpose of the rules was to protect investors from being misled into thinking they were receiving independent financial advice when in fact they were receiving advice from intermediaries with ties to one or more provider; and to make clear who was liable in the event that consumers sought redress after following advice. **(Paragraph 3.5)**
- 2.2 According to research by the PIA, 80% of clients of independent financial advisers (IFAs) correctly identified that they had received independent advice. A slightly lower proportion of the clients of advisers tied to life offices and bancassurers identified them as being tied. **(Paragraph 6.9)**
- 2.3 It is less clear that the clients receiving tied advice understood that they were only receiving advice on the product range of one financial provider. **(Paragraph 6.10)**

Market developments

- 2.4 Before 1988 most sales of life and pensions business were through ‘independent’ advisers, some of whom may have had ties with several providers. Most banks and building societies were offering their customers tied advice by 1991. Since then the market has stabilised with IFAs maintaining their overall share. There has not been the dramatic reduction in independent advice predicted by the then Director General in 1987. Sixty-eight per cent of new single premium life and pensions business and 45% of unit trust business was through IFAs in 1998. **(Paragraphs 4.7-4.11)**
- 2.5 Bancassurers appear to have the lowest distribution costs followed by distribution through IFAs. The highest costs appear to be through a provider’s own sales force or tied agents. The different costs of distributing the same product are not reflected in the charges paid by consumers. **(Paragraphs 4.13-4.15)**
- 2.6 The market has adapted to meet changing conditions and the constraints of the regulators’ rules in numerous ways. Developments in the market which have been influenced by the polarisation rules and affect their operation are:
- **IFA product panels:** Large national or regional IFAs search the market and compile panels of a limited number of products of each type. The panels change as new and improved products which meet the criteria set for the panel reach the market. **(Paragraphs 5.9-5.11)**

- **IFA networks:** A lead IFA authorised by the PIA is responsible for the advice and compliance of a network of IFAs who are the appointed representatives of the network. The network members may also receive help with product research, training, technical assistance and marketing. IFA members of the network benefit from economies of scale and from the confidence that the network will ensure their activities are in compliance with the Regulators' rules. **(Paragraphs 5.12-5.14)**
- **Information technology:** Developments mean that providers can inform all advisers instantly of changes in their products. New software enables IFAs to analyse the products in the market more easily to find those most appropriate for their clients. **(Paragraph 5.15)**
- **Product range in the tied sector:** Providers who wish to sell a full product range through tied advisers may develop their own new products. It is possible for them to specialise in the products that they produce most efficiently while providing a full range by contracting out the service elements of the products or by buying in the products of other providers to sell as their own. **(Paragraphs 5.16-5.17)**

Impact on consumers

- 2.7 There is an interaction between regulation, the range of products supplied and the distribution channels employed by providers. The commercial need for product providers to differentiate their products from one another and from their competitors' products has resulted in products that are complex and difficult for consumers to understand. **(Paragraph 6.4)**
- 2.8 Most consumers are not sufficiently well informed to buy the more complex investment products without specific advice or to shop around for specific advice. To overcome this the FSA is already considering how to implement the remit proposed for it in the Financial Services and Markets Bill to promote understanding of the financial system. The Director General concluded in his report *Vulnerable Consumers and Financial Services*, that large numbers of low income consumers are excluded from access to investment products by the need for specific advice. **(Paragraphs 6.2-6.8)**

- 2.9 Consumers choose a financial adviser they feel they can trust. Some put their trust in a brand name and approach a tied adviser. Others prefer independence and trust their IFA to recommend a particular provider. **(Paragraph 6.13)**
- 2.10 Four years of research by the PIA on persistency rates shows that consumers are more likely to persist with a policy bought through an IFA than one bought through a company representative. It is difficult to allow for differences in the types of consumer using IFAs and tied advisers, but this evidence does suggest that the advice from an IFA might be more appropriate to the customer than advice from a company representative. **(Paragraphs 6.15-6.17)**
- 2.11 Product providers compete to have their products included in IFA network recommended lists or IFA product panels. This competition can lead to improvements in products to the benefit of consumers. **(Paragraphs 6.18-6.19)**

Impact on competition

- 2.12 By preventing some innovations in the retail market the rules significantly restrict or distort competition. Some of the innovations which are stopped by the polarisation rules could be to the advantage of consumers if they were allowed.
(Paragraphs 7.8-7.12)
- 2.13 The rules which prevent tied advisers offering, what might appear to be better, products from other providers do not have such a significant effect on competition as might at first appear because it is possible to extend the tied range by contracting out services or buying in other producer's products for sale under the tied name.
(Paragraphs 7.13-7.16)
- 2.14 There is a barrier to entry to the market for new providers in that they cannot use existing advisers tied to other providers. There are other distribution channels available such as IFAs or direct sales, the number of product providers is already high and established tied outlets are unlikely to sell the products of a new provider whatever the rules on polarisation. The barrier to entry does not appear to restrict competition to a significant extent **(Paragraphs 7.17-7.20)**

Conclusions

- 2.15 The polarisation rules restrict or distort competition to a significant extent by preventing some innovation in retail markets. These effects are outweighed in the

case of life assurance and personal pensions by the competition between providers generated by the number of IFAs in the market and by the protection that the rules give to the consumers of these products. This protection arises both from the clear lines of responsibility for regulatory control of advice and the continuing need for consumers to receive independent advice on these products. The significant effects on competition are not outweighed to the same extent for advice on other packaged investment products where consumers do not enter into such long-term commitments and a larger proportion of products are sold direct to the public. It is sufficient that before giving advice on non-life products advisers should be required to make their clients aware of any ties with providers that they may have entered into.

(Paragraphs 6.20-6.22, 7.24-7.25, 9.2-9.3)

- 2.16 There should be no change in the ‘better than best’ rule for IFAs associated with product providers when giving polarised investment advice. **(Paragraphs 8.6-8.8)**
- 2.17 For products on which investment advice is polarised the rules should not be changed to allow multi-tied advice in any form, but the use of product panels and recommended lists should be encouraged as a cost-effective way of giving independent advice to low net worth consumers. **(Paragraphs 8.24-8.29)**

Recommendations

- The FSA should retain the polarisation rules but only for advice on investment products, including personal pensions, linked to life insurance.
(Paragraphs 6.20-6.22, 7.24-7.25, 8.9-8.15)

Recommendations which apply to polarised investment advice:

- The FSA should not relax the rules regulating the independence of IFAs. **(Paragraphs 6.13-6.18, 8.6-8.8)**
- The FSA should introduce rules to require that the selection of products for IFA product panels or recommended lists is formally separated from the negotiation of commission on the products. The FSA should consider whether other rules should also be introduced on the construction of product panels and lists. **(Paragraph 8.29)**
- The FSA should consider permitting lead product providers selling through tied advisers to add specialist products under the brand name of the specialist provider to their range as long as the lead provider takes full responsibility for the specialist products. **(Paragraphs 8.17-8.20)**

Recommendations which apply to non-polarised investment advice:

- The FSA should directly authorise financial advisers with multiple ties. **(Paragraphs 8.11-8.12)**
- The FSA should require all investment advisers to disclose to their clients any arrangements or ties, including ownership, they might have with product providers before giving advice. **(Paragraphs 8.13-8.15)**

Recommendations of general application:

- The FSA should consider whether more could be done to make clear to investors who receive advice from commission-funded advisers that payment for advice is included in the commission paid to the adviser and it is possible to negotiate a rebate to themselves of some of that commission. **(Paragraph 8.22)**
- HM Customs and Excise and Inland Revenue should consider the taxation of payment for investment advice with the aim, in particular, of ensuring neutrality between commission- and fee-based advice. **(Paragraph 8.23)**

3 REGULATORY BACKGROUND

- 3.1 The Financial Services Act 1986 made giving, offering, or agreeing to give advice on the merits of purchasing or selling an investment regulated by the Act a business activity which required authorisation. This authorised investment advice, which is tailored to meet the needs of an individual investor, is sometimes known as **specific advice** when being compared with **generic advice**, that is, general information about classes of product such as pensions. Authorisation is not required for the provision of generic advice.
- 3.2 Authorisation to carry on investment business may be obtained either directly from the FSA or through membership of a self-regulating organisation or recognised professional body. Members are required to comply with the investor protection rules made by the organisation to which they belong. Appointed representatives do not have to be directly authorised. The principal to whom they are tied is responsible for ensuring that they comply with the rules.
- 3.3 This report is about the rules of the FSA and the self-regulating organisations which require that specific advice to private investors about packaged investment products, excluding investment trust savings schemes, is polarised. At one pole are **company representatives**, that is, advisers who are employees of a product provider, and **appointed representatives**, that is, agents of a provider or marketing group, both of whom may advise on the products they believe to be the most suitable for their client only from the range of that provider or group. For convenience, in the rest of the report 'tied advisers' is used to mean both company representatives and appointed representatives. At the other pole are **independent financial advisers or IFAs** who are advisers with no ties to providers, and act solely on behalf of the investor. IFAs offer advice on those products which they believe to be the most suitable for their client from the full range on the market. Both types of adviser must disclose their status to their clients, that is, at which pole they work.
- 3.4 When investment advice leads to a sale the adviser, whether tied or independent, is usually paid by commission on the product. IFAs can only receive a fee from the investor or commission in cash from the provider whose product they recommend. An appointed representative firm receives commission on the products it

recommends. Some company representatives are paid a basic salary with various extra payments to reflect volume or quality of sales. If the adviser relies entirely on commission for remuneration the adviser receives no payment for his advice when no sale is made.

- 3.5 The objects of the polarisation rules are, first, to make clear to consumers whether they are receiving advice on the products of one provider or independent advice on the range of products in the market; and second, to make clear where liability falls if a consumer seeks redress after following advice. Before the introduction of polarisation there was a 'grey area' where some advisers, who had associations or ties with a range of providers, gave consumers the impression that they were giving them independent advice and the providers attempted to avoid liability for the advice given by their 'agents'.
- 3.6 The packaged investment products to which the polarisation rules apply are: life assurance, personal pensions and collective investment schemes (unit trusts and open ended investment companies). This includes the life insurance and/or collective investment scheme components of ISAs.
- 3.7 The rules which have been reviewed are those of the FSA and the following self-regulating organisations: the Personal Investment Authority (PIA), the Securities and Futures Authority (SFA) and the Investment Management Regulatory Organisation (IMRO). The PIA is the main regulator for firms conducting investment business with the private investor. It was created in 1994 from the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA) and the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO). FIMBRA had been principally responsible for the regulation of IFAs and LAUTRO for the regulation of the marketing of investments by life assurance companies and other product providers. The SFA regulates firms involved in the securities and futures sector of the financial services market. IMRO regulates fund managers.
- 3.8 The Government proposes that the functions of these self-regulating organisations will be taken over fully by the FSA if the Financial Services and Markets Bill⁷, currently before Parliament, is approved. Most of these functions have already been sub-contracted to the FSA.
- 3.9 The first polarisation rules under the provisions of the Financial Services Act were drafted by the FSA under its previous name, the Securities and Investments Board (SIB). Self-regulating organisations had to make sure that their rules offered investors

⁷ *Financial Services and Markets Bill: 17 June 1999*

protection that was at least equivalent to the protection given by the rules issued by SIB.

- 3.10 Linked to the rules on polarisation was an agreement between members of LAUTRO on the maximum commissions to be paid to IFAs. The object was to avoid commission bias in the advice given to potential investors. The agreement did not apply to tied advisers.
- 3.11 Under the terms of the Financial Services Act, the Director General was required to give the Secretary of State for Trade and Industry his views on whether the rules of SIB, including the polarisation rules, were likely to restrict, distort or prevent competition to any significant extent before SIB became fully operational.
- 3.12 The then Director General concluded in his report on the rules of SIB in March 1987⁸ that polarisation, combined with financial regulation, the cost of compliance and the costs of the compensation and complaints procedures for IFAs would significantly distort competition. He believed that the extra costs would reduce the number of IFAs. Because polarisation meant that there was no intermediate category of adviser, there would be an increase in the influence of the representatives of product providers. This would lead to a reduction in the information available to consumers on competing products.
- 3.13 The Secretary of State did not agree with the views of the Director General. He delegated authority to SIB and the rules, including the polarisation rules, were issued in 1987.
- 3.14 The following year the Director General reported that the LAUTRO rules which constituted the maximum commissions agreement were significantly anti-competitive⁹. LAUTRO had proposed that members of the agreement should not disclose the actual commissions paid to independent advisers, merely that the commission complied with the agreement, while providers outside the agreement were to reveal actual details. The Director General recommended that actual rates of commission should be disclosed to investors and that the LAUTRO scale of commission should be used as a commission yardstick, not to fix the maximum rates of commission.

⁸ *Securities and Investments Board: A report by the Director General of Fair Trading to the Secretary of State for Trade and Industry (March 1987)*

⁹ *The Life Assurance and Unit Trust Regulatory Organisation: A report by the Director General of Fair Trading to the Secretary of State for Trade and Industry (March 1988)*

- 3.15 The maximum commissions agreement was ended in stages: from the beginning of May 1989 members were permitted to give commission above the maximum in the agreement provided the amount was disclosed; from 1 January 1990 the agreement was no longer enforced.
- 3.16 Since the beginning of 1995 the PIA has required the firms it regulates to disclose to potential investors the actual commission to be paid to the adviser or, in the case of tied advisers, the equivalent cost of advice on life and pensions products. The requirements were extended to non-life packaged products on 1 May 1997.
- 3.17 The Commission of the European Union is considering proposals for a directive which would provide for mutual recognition of registration of insurance intermediaries by Member States. Among the minimum criteria for recognition is likely to be disclosure of status by the intermediary, that is, whether it is independent or tied to one or more providers.

4 MARKET DEVELOPMENTS

- 4.1 This chapter describes the markets to which the polarisation rules apply. The purpose is twofold. First, it is to describe the markets as they currently stand. Secondly, it is to examine market trends over the period in which the polarisation rules have applied. The focus is on factual information, rather than policy implications.
- 4.2 The products to which the polarisation rules apply, that is, life assurance, personal pensions and collective investment schemes, are packaged and sold by insurance companies, banks, building societies, friendly societies and other financial institutions. There are approximately 120 active providers of insurance products and just over 150 collective investment scheme providers.
- 4.3 The value of funds under management by life insurance and pension providers in the personal sector has grown from £875 billion in 1993 to £1,408 billion in 1998¹⁰. In 1993 the total values of new annual and single premiums for these policies were £3 billion and £15 billion respectively. In 1998 the equivalent values were £3 billion and £22 billion¹¹. The value of funds under management by unit trust providers in the personal sector has grown from £53 billion in 1993 to £113 billion in 1998¹². In 1993 annual net retail investment in funds was £5 billion. In 1998 the equivalent investment was £9 billion¹³. When making comparisons between the annual value of business in life insurance and pensions and the annual value of business in unit trust funds it should be noted that the figures quoted for life and pensions business are for new business only whereas the figures quoted for unit trust business are for annual net investment.
- 4.4 Products may be sold direct to the public, usually following some form of advertising, such as direct offer advertising or telesales operations. Products sold this way are not affected by the polarisation rules if no specific advice on investment is given. If firms give specific advice following a direct advertising campaign the polarisation rules will apply. Direct sales are still a very minor distribution channel for life insurance and pensions, although 20% of unit trusts and 23% of Personal Equity Plans (PEPs) with unit trust components were sold direct to the public in 1997.

¹⁰ Source: Office for National Statistics.

¹¹ Source: Association of British Insurers.

¹² Source: Office for National Statistics.

¹³ Source: Association of Unit Trusts and Investment Funds.

- 4.5 More usually product providers sell through an intermediary who provides investment advice to the customer. The intermediaries may be:
- **Tied advisers:** these are either employees of the provider, known as ‘company representatives’, or agents of the provider, known as ‘appointed representatives’ (see paragraph 3.3). Currently there are about 450 tied agency firms and around 51,000 tied advisers registered by the PIA; or
 - **Independent financial advisers (IFAs):** these are financial advisers who have no connection with a provider and act solely on behalf of the investor (see paragraph 3.3). Currently there are just over 3,500 IFA firms authorised by the PIA employing around 22,000 registered individuals. About a third of the individuals registered belong to one of 15 networks, that is, they are appointed representatives of an independent adviser authorised by the PIA who researches products and provides other services on their behalf. The two largest IFA networks - DBS and Countrywide - have doubled in size between 1992 and 1998.
- 4.6 The next few years may see new distribution channels becoming more important - for example, supermarkets or sales via the Internet. It will be a matter for the industry to decide whether to use these channels to give authorised investment advice. The rules of the FSA and the self-regulating organisations apply to advice and sales via these channels in the same way as they apply to more traditional channels.
- 4.7 Before 1988 there were no rules defining the meaning of ‘independent advice’ and many advisers purported to give independent advice when the reality was that they had a relationship with a limited number of product providers. At that time most sales of life assurance and personal pensions were through ‘independent advisers’. With the introduction of regulation, advisers had to decide on their status and there was an apparent reduction in the volume of sales through independent advisers. Since 1991 the division of the market between sales through tied and independent advisers has been fairly stable. IFAs have just under half the business in annual premium policies and over half the business in single premium policies. Direct sales have remained static at 3% and 1% respectively.
- 4.8 The big four banks, the largest newly-converted former building societies and the largest remaining building society, the Nationwide, all have their own life business. Such integrated banks are termed ‘bancassurers’. Other banks and building societies have entered into joint ventures with life offices or become appointed representatives.

- 4.9 Some banks and building societies have an IFA subsidiary (outside the marketing group for their own products), to whom customers may be referred if they request it or if the bank or building society tied adviser cannot find a suitable product from the bank or building society range of products.
- 4.10 The following table, taken from Association of British Insurers (ABI) statistics, shows that the share of life and pensions business accounted for by banks and building societies has grown significantly between 1989 and 1998. It also shows a shift away by banks and building societies from IFA to tied sales. This shift is more notable for annual premium products than for single premium products. In the rest of the market

Table 4.1: Market share of life insurance and pensions business

	<i>Banks and Building Societies</i>			<i>Other</i>		<i>Direct</i>
	<i>IFA</i>	<i>Tied</i>	<i>Total</i>	<i>IFA</i>	<i>Tied</i>	
<i>Annual Premiums</i>						
1989	5%	5%	10%	30%	58%	3%
1998 ¹⁴	2%	11%	13%	39%	45%	3%
<i>Single Premiums</i>						
1989	4%	5%	9%	50%	40%	1%
1998	7%	11%	18%	61%	19%	1%

Source: ABI¹⁵

the IFA share of sales of single premium products has increased which suggests that consumers are more likely to receive, or seek out, independent advice if they have a lump sum investment than if they are arranging for a regular payment product.

¹⁴ See Appendix H for an explanation of the statistical changes that have taken place in the calculation of these figures.

¹⁵ ABI Statistical Bulletin (February 1999)

4.11 Data provided by the ABI, on new annual premiums and new single premiums for total individual life and pensions business, shows that only a small percentage of these products are bought directly. Ninety-seven per cent of yearly premium business and 99% of single premium business is bought through an intermediary. Data on the retail sales of unit trusts and unit trust based PEPs produced by the Association of Unit Trusts and Investment Funds (AUTIF) show that up to the end of 1998 over a quarter of retail unit trusts and unit trust based PEPs were bought direct or through a private stockbroker.

Table 4.2: Sales of individual life and pensions business and unit trust investments, by source of business

	<i>New Total Individual Life and Pensions Business (1998)</i>		<i>New Gross Unit Trust Investments (1998)</i>	
	<i>Yearly Premium</i>	<i>Single Premium</i>	<i>Total Unit Trust Sales</i>	<i>Unit Trust PEP Sales</i>
<i>IFAs</i>	40 %	68 %	45 %	31 %
<i>Tied</i>	56 %	31 %	28 %	42 %
<i>Stockbrokers</i>	-	-	7 %	2 %
<i>Direct</i>	3 %	1 %	19 %	25 %

Source: AUTIF / ABI¹⁶

4.12 Figures on the proportion of unit trust business undertaken by banks and building societies were not gathered as part of this review. However, it is clear that banks and building societies were important distribution channels for PEPs (now superseded by ISAs). Four out of the top ten suppliers of PEPs were bancassurers.

Commission and distribution costs

4.13 Since the introduction in 1995 of the requirement on advisers to disclose actual commission paid to them on life policies and pensions, the PIA has published annual surveys about the information disclosed. In 1998 it also published a survey about disclosure of commission on non-life products. In 1999 these reports were amalgamated to produce the *1998 Disclosure Report*. The following table (taken from the *PIA Disclosure Report 1998*) shows the average commission (or equivalent cost of advice for sales through tied advisers) paid for a lump sum investment of £10,000 invested in a number of life and non-life products.

¹⁶ *ABI Statistical Bulletin (February 1999)*
AUTIF Summary of unit trust statistics 1992-99

Table 4.3: Average commission paid (£) in 1998 based on a £10,000 lump sum investment

	<i>IFAs</i>		<i>Appointed Reps</i>		<i>Company Reps</i>	
	<i>Initial</i>	<i>Trail</i>	<i>Initial</i>	<i>Trail</i>	<i>Initial</i>	<i>Trail</i>
<i>Life Product</i>						
Unit Linked Bond	505	50	573	50	657	34
<i>Non-life Products</i>						
Unit Trust	310	50	470	40	490	30
Unit Trust PEP	310	50	470	50	520	30
OEIC	330	40	-	-	200	-
OEIC PEP	300	50	-	-	200	-
Investment Trust	300	50	-	-	230	-
Investment Trust PEP	300	50	-	-	230	-

Source: PIA 1998 Disclosure Report¹⁷

4.14 Table 4.3 shows that in this survey the IFA's commission was lower than the equivalent cost of advice through other distribution channels for the products most often bought by consumers, although if the consumer persisted with the product for more than ten years, the IFA would receive more total commission. [Please note that few company representatives or appointed representatives disclosed renewal or 'trail' commission figures and so these figures should be treated with caution.] A similar picture emerges from a study of the relative costs of different distribution channels carried out by Tillinghast-Towers Perrin. The following table shows the weighted average distribution costs of different methods of distribution as a percentage of the new Annual Premium Equivalent (APE).

Table 4.4 Weighted average distribution costs as a percentage of APE, 1995-1997

	<i>1995</i>	<i>1996</i>	<i>1997</i>
<i>IFA</i>	62	59	61
<i>Company Representative</i>	114	97	87
<i>Appointed Representative</i>	167	116	100

¹⁷ *PIA Disclosure Report: Life Assurance, Unit trusts, Investment Trust Savings Schemes & Personal Equity Plans, Figure 16, page 39 (February 1999)*

Source: Tillinghast-Towers Perrin

- 4.15 As with other surveys, the figures should be treated with caution, and not too much weight should be placed on individual numbers. In particular the figures for tied sales cover a smaller proportion of the market than those for IFAs and bancassurers, and they also conceal a wide range of costs. However, the general pattern is clear, with IFAs and bancassurers coming out as relatively 'low cost' distribution channels on average compared with company and appointed representatives. This does not necessarily prove the former is a more cost efficient form of distribution. For example, bancassurers tend to be larger operations than the other forms of distribution, and may benefit from economies of scale which are not evident in the other distribution channels, so distorting the figures.
- 4.16 Some IFAs charge their clients a fee for advice. This is often offset by rebating commission to customers. No evidence of the frequency of fee-based advice was gathered as part of the review.

Consumers

- 4.17 Surveys by NOP and IFA Promotions and general opinion in the industry suggest that IFA customers tend on average to be wealthier than those who purchase regulated products through tied advisers. They are also more likely to come from the AB social grouping. The evidence does not, however, suggest an absolute segmentation of potential customers along social or financial lines. The PIA report on *Life Assurance Disclosure: Three Years On*, January 1998, shows that the regular premium pension business written through IFAs and company representatives is in the following proportions:

Table 4.5: Percentage of new regular premium personal pension business written (weighted by volume of business)

<i>Monthly Premiums</i>	<i>IFAs (%)</i>	<i>Company representatives (%)</i>
Up to £50	20.86	26.57
£50-£400	66.07	66.91
£400 and above	13.07	6.52
Total	100	100

¹⁸ *PIA Life Assurance Disclosure Three Years On, Figure 3, Commission Rebating; Extent and Effect (January 1998)*

5 HOW POLARISATION IS WORKING

- 5.1 This chapter sets out the way in which the market for investment advice is operating within the polarisation rules.
- 5.2 Chapter 4 described the distribution channels available to product providers. The choice of which to use is a matter for their commercial judgement. Many use more than one channel. The costs of these distribution channels may vary as shown in paragraphs 4.13- 4.15. The reports¹⁹ on life assurance disclosure published by the PIA show that these differences in cost of distribution are not generally being reflected in what firms charge consumers.
- 5.3 All advisers must comply with the requirements to be fit and proper to carry on investment business as advisers. From 1 July 1997 they have all been required to hold an approved qualification and to have been assessed as competent by their firm.

Advice

- 5.4 All advisers, whether tied or independent, must ascertain the product types and the level of investment in each type most suitable for their client's needs. This is generally done during a face-to-face fact-finding meeting with the client at which a comprehensive financial questionnaire is completed. At this meeting the adviser becomes aware of the client's desired investment strategy, that is, the level of risk aversion, and preferences for a particular investment portfolio (for example, ethical investments).
- 5.5 In the case of a tied adviser the choice of product is restricted to the products of his employer or the marketing group to which he belongs. If there are no suitable products in the provider's range the adviser may refer the client to an IFA but is not obliged to do so. If a referral is made, the adviser must recommend at least two IFAs.
- 5.6 Having determined which types of products are suitable for the needs of the client, the adviser must make a conscientious search across the products that it is within his competence to recommend and recommend one that is at least as good as any other

¹⁹ *PIA Life Assurance Disclosure One, Two and Three Years On (1996-8);*
PIA 1997 Disclosure Report: Unit Trusts, Investment Trust Savings Schemes and Personal Equity Plans (January 1998)
PIA 1998 Disclosure Report, Life Assurance, Unit Trusts, Investment Trust Savings Schemes & Personal Equity Plans (February 1999)

available. This rule applies to tied advice as well as to independent advice. An IFA has a wider range of products to consider than a tied adviser but there is no obligation from the regulator for the adviser to examine every product in the market before giving advice.

‘Better than best’

5.7 Some company groups include IFAs and product providers selling through a marketing group of company representatives and/or appointed representatives. The IFAs are not permitted to recommend a group product unless it is demonstrably better than any other product of its type. The rule was introduced to avoid questions about the independence of IFAs who recommended the products of their own group. The effect has been that such IFAs rarely recommend group products. Consumers who seek investment advice from a bancassurer with an IFA member in the group are likely to be seen by a tied adviser in the first instance. Only high net worth customers or those seeking a product not produced by the bancassurer would be directed to the IFA.

Inducements

5.8 To ensure that it is transparently clear that IFAs maintain their independence, product providers are banned from giving independent advisers any indirect benefit that might be seen as an inducement to place business with any particular provider. It is permitted for providers to offer advisers training on their products.

Recommended product lists

5.9 IFAs are not expected to examine every suitable product in the market for each client. It is more practical and cost efficient for many IFA firms to compile a recommended list of products for use by its financial advisers. An IFA firm determines its own criteria for each product, such as financial strength, past performance, fund size and its clients’ interests and compiles a list of products which meet these pre-determined criteria. The analysis of products for inclusion in the list may be contracted out. The list is reviewed regularly and amended to take account of changes in the performance or characteristics of products.

IFA product panels

5.10 Many individual firms operate product panels. These are more selective than recommended lists. A conscientious search is made of the products in the market against characteristics chosen to suit the needs of the majority of the firm's clients. Those products that the IFA believes to be the best available that match, or better, the characteristics are selected for inclusion in the panel. Normally there is a limit on the number of any one type of product on the panel. The content of the panel is reviewed regularly. Product providers compete to be included on the panels of large, national or regional IFAs. After having selected products that meet the criteria for its panel an IFA may negotiate with the providers for a better rate of commission in return for an expected increase in business.

5.11 In 1997 the PIA Consumer Panel recommended²⁰ that the essential features of best advice panels, that is, recommended lists or product panels, should be:

- proper break procedures between research and commission negotiations;
- clear and objective criteria for inclusion so that the process is transparent; the selection criteria should focus on customer benefits;
- no set number of product providers - all those firms that meet the criteria to be included;
- adequate research resources and product reviews at least once a year;

²⁰ *PIA Consumer Panel Report 1997, The Last 12 Months (October 1997)*

- provision for individual advisers (who know the customer's circumstances) to go 'off panel' on reasonable grounds without unjustified obstacles;
- clients to be informed of the operation of the list and its purpose.

These features have been recognised by the PIA and the Large Network Association as forming the basis for good practice for those firms who use best advice panels.

IFA networks

- 5.12 Chapter 4 referred to the fact that about a third of IFAs regulated by the PIA belong to one of 15 networks. The PIA recognises an IFA network when an IFA firm either has five or more appointed representatives or has fewer than five appointed representatives but at least 26 financial advisers working for them. Networks must apply for authorisation as networks and are subject to additional PIA rules.
- 5.13 IFAs originally joined networks to share costs and to survive in the new regulatory environment. The lead IFA, which is the member of PIA, is responsible for the advice given by the members of the network and for ensuring that the members comply with the rules of the PIA. The benefits of membership include a guarantee that sufficient regulatory capital is available, access to the network recommended product list, assistance with compliance, training, education, technical assistance, IT development and marketing. Product providers compete with each other to be included in the recommended lists of IFA networks. The network negotiates commission with providers according to the quality of the business and the volume it is likely to provide.
- 5.14 According to the Large Network Association, networks conduct their reviews of companies and products without reference to commission and therefore recommended product lists contain some products on which commission is not paid. Fees are charged when advice is given on a non-commission product. Within each network there are a few members who charge only fees.

Information technology

5.15 Developments in IT over the last ten years have had a significant impact on the advice process. Providers are able to send information about product changes to advisers, whether tied or independent, by electronic means almost immediately. The increased capacity of computers to store and manipulate large volumes of information has made it easier for advisers to analyse the properties of competing products. In particular, the development of software search engines for IFAs has enabled them to carry out sophisticated analyses of large numbers of products to find the characteristics which satisfy the needs of their clients. Networks and larger IFAs now use computers extensively to provide a standardised analysis of the products in the market.

Product range in the tied sector

5.16 Advisers in the tied sector may give advice only on the products of the marketing group to which they belong. This has led some providers to develop new products to ensure that they are able to offer their customers the full range of products normally required. There are, however, other methods of widening a product range permitted by the polarisation rules.

5.17 Providers may contract out some of the service elements of the product such as customer servicing, marketing etc., or some of the production elements such as fund management for unit trusts. Care must be taken to ensure that the customer is not aware that services have been contracted out except in the case of fund management. The polarisation rules allow a provider to contract out all the service elements of a product to another provider and effectively to buy in that provider's product. However, the polarisation rules do not permit a product provider to sell the regulated product of a second provider under the second provider's brand name.

Commission

5.18 The level of commission paid to advisers, both tied and independent, is based on the old LAUTRO maximum commissions agreement and is expressed in such terms as 130% or 140% LAUTRO. It appears providers believe that there is a benchmark rate

for each range of products, and that they must set their commission at about this rate to obtain IFA business. IFAs with a large customer base try to negotiate higher levels of commission in anticipation that they will provide a greater volume of business for the providers.

- 5.19 IFAs as agents of the consumer are paid by the consumer. However, the payment is indirect when it is paid through commission. It is sometimes argued that IFAs cannot be genuinely independent as long as they depend for their remuneration on the commission they receive from the providers of the products they sell and that consumers can only be sure of receiving disinterested advice if they pay a fee for it. It is widely believed in the industry that consumers do not understand the true value of advice and would not be prepared to pay a fee for it.
- 5.20 The tax system works in favour of commission. A fee for investment advice is subject to VAT whereas payment for advice included in the premium paid by the investor is not subject to VAT. There is also income tax relief at the highest rate for premiums, which would include commission, on some products, for example, personal pensions.
- 5.21 Some high worth consumers do pay fees for financial planning and if, as a result of advice, they buy a product that includes commission, the adviser may then rebate the commission to his client or take the commission as his fee. No direct evidence on the frequency of fee-based advice was gathered as part of this review. However, information in the *PIA 1998 Disclosure Report*²¹ suggests that the commission on 32% of regular premium personal pension business written through IFAs was rebated in 1998 either in part or totally (24% in 1997)²². Commission was rebated on 2% of the business written through company representatives (less than 1% in 1997).
- 5.22 It must be concluded that the payment of advisers, whether independent or tied, by commission will exert some influence or create a bias in just the same way that retailing margins influence the proportion of shelf space devoted to a particular

²¹ *PIA 1998 Disclosure Report, Life Assurance, Unit Trusts, Investment Trust Savings Schemes & Personal Equity Plans, Figure 3, Commission Rebating: Extent and Effect (February 1999)*

²² *PIA Life Disclosure Report Three Years On, Figure 3, Commission Rebating: Extent and Effect (January 1998)*

product line in a store. In particular, there appears to be a bias in favour of insurance-linked products and away from simple investment products. However, such biases in terms of broad product types could occur in any type of outlet in response to differences in margins. It is not a factor related specifically to polarisation.

PIA compliance monitoring

- 5.23 The PIA uses the same methods to monitor the compliance of tied and independent advisers. In addition to studying persistency records, that is, the proportion of life policies which remain in force after a set time period, and responding to complaints, PIA visits business premises to inspect client records and documentation. In general, PIA has found that where poor advice has been given, technical breaches are also likely to have occurred.
- 5.24 PIA also considers whether an IFA is being unduly biased towards particular products, indeed, if a firm records 20% of its business as being with one provider it is required to notify the PIA.

6 IMPACT ON CONSUMERS

- 6.1 Under consideration in this chapter is the category of consumer likely to buy medium- to long-term investment products, the type of advice they need, whether they recognise the status of their adviser and whether they understand the significance of their adviser's status. Also examined is the quality of the advice they are likely to receive from different sources and how far they benefit from polarisation.

Category of consumers excluded from investment advice

- 6.2 The consumer survey undertaken for the OFT report on *Vulnerable Consumers and Financial Services*²³ provided evidence that many vulnerable consumers are excluded from access to the equity risk premium contained in medium- and long-term savings products. Of those who took part in the survey, 40% had a long-term savings product, but this fell to 15% for those on low incomes and 8% for those on very low incomes.
- 6.3 There are likely to be various reasons for this exclusion. First, those on a low income need immediate access to low risk savings rather than medium- to long-term savings products. Secondly, the fixed charges for administering small policies are high in proportion to the size of the policy. Thirdly, it is widely accepted within the industry that it is uneconomic for IFAs, or tied advisers with similar cost structures, to offer advice to consumers who cannot afford to pay at least £50 per month on savings products.
- 6.4 While polarisation cannot be held responsible for this outcome, it nevertheless represents an important element in the regulatory regime. If the wider regulatory system, including fiscal measures, encouraged simpler reliable products which could be bought without the need for specific advice, such as CAT standard ISAs, fewer low income consumers would be excluded because of the cost of specific advice.

²³ *Vulnerable Consumers and Financial Services (January 1999) Appendix 4, OFT255d*

Types of financial advice

- 6.5 Consumers who are not excluded from the equity risk premium by cost face difficult decisions about which products to buy and for the most part rely on advice before making a purchase. The reasons for their difficulties are:
- the benefit or otherwise of the purchase is not immediately obvious;
 - the products themselves are often complicated or difficult to understand;
 - many products require a long-term commitment; and
 - purchases are typically made infrequently.
- 6.6 These consumers appear to need more generic advice about financial products than they are currently receiving before they seek specific advice. For example, the consumer survey accompanying the OFT report on pensions revealed some major misconceptions about pension entitlements (Volume Two, Appendix A)²⁴. Several other authorities have also identified this need. Accordingly, the Financial Services and Markets Bill²⁵ currently before Parliament gives the FSA a remit to promote public understanding of the financial system. The FSA have already issued a policy statement²⁶ on how to implement this remit provided the legislation comes into force.
- 6.7 The benefits of increased consumer education will not be seen in the short-term. Until simpler products are more widely available, and the tax system has been altered to accommodate them, it is important that consumers receive specific advice of a high quality before committing themselves to the purchase of a savings product. Such products can tie up a large proportion of consumers' spare money for long periods of time. On the whole consumers do not appear to shop around for specific advice. In the sample of non-pensioners surveyed for its report on pensions²⁷ the OFT found that only 15% of those surveyed had consulted more than one source of advice. It is also of interest that about one third of the sample had taken advice from an IFA and over half had consulted a tied adviser.
- 6.8 In a fully competitive market, the forces of competition would result in similar prices for similar products and little price dispersion. The gains from shopping around or consulting an independent adviser would be correspondingly small. However, this is not necessarily the case in the market for financial products. There is a wide variation

²⁴ *Report of the Director General's Inquiry into Pensions (July 1997)*, OFT191b

²⁵ *Financial Services and Markets Bill: 17 June 1999*

²⁶ *FSA Policy Statement on Consumer Education: A Strategy for Promoting Public Understanding of the Financial System (May 1999)*

²⁷ See footnote 24 above

in charges for similar products. Figure 7 in the *PIA 1998 Disclosure Report*²⁸ shows the reduction in yield from a projected 7.5% investment return on a ten year endowment/savings plan with a monthly premium of £60 can vary between 6.4% (indicating a high level of charges) to 1.5%. Consumers would benefit if they shopped around more for specific advice.

Has polarisation achieved its objectives?

6.9 In a survey of the effect of the disclosure of status 80% of the clients of IFAs correctly identified them as independent. A slightly lower proportion of clients of advisers tied to life offices and bancassurers correctly identified them as being tied.

6.10 Taken at face value these results might seem to indicate that at least three-quarters of investors correctly understood the status of the adviser through whom they had purchased a financial product. Less clear is what they understood by ‘independent’. The PIA Consumer Panel commented on the table below: ‘The majority of consumers do seem to recognise the status of their adviser correctly although it is far from clear whether they understand the significance of the fact.’²⁹

Table 6.1: Recent purchasers’ understanding of polarisation status

<i>Purchase from</i>	<i>Proportion saying that their adviser was</i>		
	<i>Tied</i>	<i>Independent</i>	<i>In between/ don’t know</i>
<i>IFA</i>	15	80	5
<i>Life office</i>	76	17	8
<i>Bancassurer</i>	79	14	7

*Source: PIA Consumer Panel Report*³⁰

6.11 It is suggested that consumers might confuse the word ‘independent’ with ‘giving advice which is in the interests of the consumer rather than the supplier’, something which is required of all firms regulated by the PIA. Faced with the statement ‘a bank is the best place to get independent financial advice’, about one third of those surveyed by the PIA³¹ thought that it was, even though most advice offered by banks is tied. Just over half of those surveyed disagreed with this statement. Social groups

²⁸ *PIA 1998 Disclosure Report (February 1999)*

²⁹ *PIA Consumer Panel Report 1998, Annex 5, Conclusions, page 68 (December 1998)*

³⁰ *PIA Consumer Panel Report 1998, Annex 5, Table , page 65 (December 1998)*

³¹ *PIA Consumer Panel Report 1998, Annex 1, Table 8, page 40 (December 1998)*

A, B and C1 were less likely to be confused about the meaning of independence than social groups C2, D and E. It appears that a significant proportion of consumers consider they are receiving independent advice, giving them a choice of supplier, when they are not.

- 6.12 Even though consumers may not be aware of the significance of the status of their adviser, the very clear distinctions between independent and tied advisers have enabled the regulators to see easily where responsibility lies for ensuring compliance with rules put in place for the protection of consumers as investors. It is clear who is responsible when consumers seek redress after following inappropriate advice.

Quality of financial advice

- 6.13 The consumer's first step is to seek advice. Confidence in the advice-giver is a determining factor in the consumer's choice. Some consumers trust a brand name while others trust an independent opinion. A substantial amount of inter-brand competition is dependent on the consumer's initial choice of outlet.
- 6.14 The consumer who seeks advice from an IFA may be making a conscious decision to receive advice not only on the suitability of a particular product but also on the choice of provider. If a consumer opts to approach a tied adviser the choice of provider has already been made whether or not the consumer is aware of this. Providers who sell products through tied advisers tend to compete on brand image rather than on price or quality. Strong retail brands have been able to enter the market and although some of their products have been innovative, few offer a clear advantage in terms of value for money on such clearly defined issues as charges. The main high street banks all have

a strong brand image. The entry to the market of Virgin and Marks & Spencer has demonstrated that a brand strong in any retail market can diversify into financial services.

- 6.15 One way of measuring whether consumers are receiving suitable advice is to look at rates of persistency - a measure of the length of time a financial services contract runs. Life and pensions contracts are long-term investments, the benefits of which are greatest if they run to their full term. Losses from early surrender (transfers in the case of personal pensions) are well-documented. Low persistency in general can suggest overselling of particular product types, notably of protection products - life and pensions - in preference to more straightforward savings or investment products such as ISAs or unit trusts.
- 6.16 Persistency rates vary according to the product. The *PIA Fourth Survey of the Persistency of Life and Pensions Policies*³² shows that in over 82% of endowment policies bought through IFAs or from direct offer advertisements consumers have persisted for four years. This figure drops to 77% and 62% for policies bought through company representatives and home service advisers respectively. The four year persistency rates for whole of life policies are: direct offer advertisements, 81.7%; IFAs, 76.8%; home service, 74.2%; company representatives, 60.2%.
- 6.17 It is unclear how far the variation between outlets can be accounted for by differences in the mix of consumers using the various types of outlet. It could be argued that any differences in personal circumstances should have been taken into account when advice was given and that persistency ought to be similar across all types of sales. However, the OFT's report on *Vulnerable Consumers and Financial Services*,³³ highlighted evidence of a link between low persistency and low income. Industry-financed research from the Life Insurance Market Research Association (LIMRA) found that persistency rates were worse for consumers on lower incomes. In addition, these consumers suffer a proportionately larger loss on early termination than those on higher incomes.

³² *PIA Fourth Survey of the persistency of life and pensions policies 1998, Table 1, page 5 (October 1998)*

³³ *Vulnerable Consumers and Financial Services (January 1999), OFT255*

- 6.18 A further factor might indicate that IFAs are more likely than tied advisers to give consumers advice on products more appropriate to their needs. This is the competitive pressure on providers to ensure their products are included on IFA product panels or recommended lists. It has been suggested that this pressure may have led to improvements in life products which are in the interests of some consumers. For instance, the early surrender values of some life insurance policies (or transfer values in the case of pensions) have been increased. This has been done largely by moving away from loading most of the charges on to the start of the policy or pension. The effect is to increase the risk to providers of losses on policies surrendered early but it also gives providers and IFAs greater incentive to sell good quality products with which the consumer is likely to persist.
- 6.19 Some of the competitive pressure to improve life products sold through IFAs will eventually affect the products sold through tied advisers. But inter-brand competition in the tied market does not appear to be working to pass on to consumers the cost advantages bancassurers enjoy over other tied outlets. The evidence on distribution costs in Table 4.4 (at paragraph 4.14) indicates that bancassurers' costs are substantially lower than the cost of selling through tied advisers or IFAs. No evidence was found of moves by bancassurers to use this apparent cost advantage to compete on price and, hence, for consumers to receive any benefit from these lower costs.

Conclusion on consumer effects

- 6.20 The most complex investment products that consumers are likely to consider purchasing are those linked to life insurance. These are long-term products where the life cover provided is likely to be just as important to consumers, particularly those with young families, as the investment element. Early surrender can leave policy holders with very little to show for their investment by way of surrender value, or transfer value in the case of a personal pension. In spite of these consequences the *PIA 1998 Disclosure Report*³⁴ reveals that in 1998 only 69.8% of regular premium policies started in 1993 were still in force. It is obviously important that consumers are fully aware of the implications of committing themselves to such policies before purchase.
- 6.21 On the whole IFAs appear to offer consumers better quality advice on life products than tied advisers. It would be detrimental to consumers if there were to be a reduction in the amount of independent advice currently available. The complexity of life products also means that there is a higher degree of probability than there is on non-life products that on some occasions consumers might feel they have been given

³⁴ *PIA 1998 Disclosure Report February 1999*

bad advice and wish to seek redress. If advisers were to be allowed to become tied to more than one provider of life insurance-linked investment products, liability would be less clear should consumers need to seek redress. It is in the interests of consumers that the FSA continues to require that investment advice on these products is polarised.

- 6.22 Non-life products are different. They tend to be simpler and more transparent. Consumers can regularly check the value of their holdings by looking at the buying and selling prices of units or shares published in the press and can make their own decisions about when to realise the value of their savings. However, the performance of funds varies and consumers should be aware before making a purchase of any bias their adviser has towards particular funds through ties or other arrangements. Many consumers are confident enough to buy these products without specific advice. It would not be detrimental to consumers if the rules on polarisation were removed from advice on these products. Removal of the rules should benefit consumers, provided advisers are required to disclose their status, since removal should result in an increase in the number of sources of advice on these products and a greater selection of products from some advisers.
- 6.23 Vulnerable consumers, notably those on low incomes, may find themselves excluded from some financial services because of the high cost of the advice relative to the value of the sale. This applies equally to tied or independent advice. It is unlikely that the existence of polarisation has any particular effect on the willingness or otherwise of suppliers or intermediaries to provide a service for vulnerable consumers.

7 IMPACT ON COMPETITION

- 7.1 This chapter is about the impact that the polarisation rules have on competition in the markets described in Chapter 4. In particular, the aim is to assess whether the polarisation rules restrict, distort or prevent competition to a significant extent.
- 7.2 The main concern of the then Director General in his 1987 report on the rules of the SIB was that the introduction of polarisation, combined with other regulatory costs, would lead to a sharp reduction in the availability of independent advice. A particular concern was that the main high street banks and building societies would choose to become tied agents of a single insurance company, or vertically-integrated bancassurers.
- 7.3 It was believed that there would be a reduction in competitive pressure on product providers for two reasons. First, because company representatives would no longer be able to advise on the products of other companies. Secondly, because it was thought few advisers would opt for independent status due to the high cost of compliance. There were two related consequences. First, the client of an adviser tied to a single supplier would receive information only on that supplier's products. Secondly, fewer independent advisers acting as the agents of their customers would be performing the role of a 'well-informed customer' so stimulating competition between product providers. The complex nature of many regulated products combined with the relatively low level of financial sophistication of many consumers, would mean that competition would be weaker than it could be.
- 7.4 The data provided by AUTIF and ABI on market share by distribution channels in Chapter 4 shows that banks and building societies have predominantly chosen to offer tied advice rather than to become IFAs. As Table 4.1 at paragraph 4.10 shows, almost three-quarters of all life insurance and pensions business transacted through banks and building societies in 1998 was tied.
- 7.5 The proportion of life and pensions business accounted for by IFAs has stabilised and the IFA sector has, if anything, strengthened its position in recent years. The pattern has been slightly different with non-life products, but independent intermediaries still account for a substantial share of business. This suggests that non-tied advice is available to consumers who know where to look. The development of product panels, recommended product lists and market research software means that non-tied advice can be supplied 'cost-effectively'. This is supported by the evidence in Chapter 4 on distribution costs, which suggests that the costs to providers of distributing through IFAs are lower than through tied advisers.

- 7.6 The continuing viability and relative success of the IFA channel indicates that the then Director General's gravest concerns about polarisation - that is, that it would lead to a severe shortage of independent advice and comparative information on products - have not come to pass.

Retail Distribution

- 7.7 Two ways have been identified in which the polarisation rules may adversely affect competition between different types of financial adviser.

Polarisation rules prevent innovation in retail distribution

- 7.8 In most retail markets - for example, clothing or food - it is possible and common for a retailer to sell both own-brand and branded products or to sell products from a limited range of suppliers. In a well-functioning market, the balance between the two will be determined by consumer preference, rather than by regulatory design.
- 7.9 Assessing the effect of any rules on innovation is hampered by the difficulty in foreseeing what types of innovation would take place in the absence of the rules. Innovation is - almost by definition - hard to predict. Also, in the case of polarisation, firms have already adapted themselves to carry on business while complying with the rules.
- 7.10 Examples of the way in which the polarisation rules restrict the advice that might be given on maxi-ISAs are as follows:

- advisers tied to a life office might want to offer a maxi-ISA with the life insurance component provided by that company and the unit trust from a range of other companies; and
- similarly an adviser tied to a unit trust provider might want to offer a maxi-ISA with a choice of life insurance policies.

Currently, the only way in which an adviser tied to a life office could offer a maxi-ISA with even a limited choice of unit trust suppliers would be if his principal had bought in unit trust products from several different providers and packaged them in his own name. The same would apply to an adviser tied to a unit trust provider who wished to offer a choice of life insurance policies.

- 7.11 It has also been argued that if polarisation rules were relaxed product providers might provide more IT support and equipment to IFAs, for example, by installing direct on-line access to IFAs, which would reduce costs and increase efficiency to the benefit of consumers.
- 7.12 The form of retail distribution appears to be constrained by the polarisation rules to a significant extent. Not all forms precluded are obviously against consumers' interests and some might benefit them. If the polarisation rules were to be abolished supplementary rules might have to be introduced to ensure that consumers were fully informed about any ties their advisers might have with providers. For instance, if the rules were relaxed to allow product providers to supply IT equipment to IFAs the source of the indirect funding of the IFA would have to be made clear to the adviser's clients so that they understood that any advice they received would be likely to be biased. Consideration would also need to be given to the danger that investment in an IFA's computer hardware could be used to circumvent the rules requiring the disclosure of commission.

Tied advisers are prevented by the rules from offering advice on a better range of products

- 7.13 It has been argued that tied advisers are at a disadvantage compared with IFAs, as the product provider to whom they are tied is unlikely to be able to offer competitive products across the full range. Where tied advisers are required by the rules to offer advice on weaker products than they would wish there may be some detriment to those customers who buy the products. Among others, Sir Mark Weinberg, Chairman of J Rothschild Assurance, has argued that the polarisation rules restrict one of the main benefits of the market economy, namely specialisation in production (see paragraphs 8.17-8.20).
- 7.14 There are a number of ways in which the tied adviser or the provider selling through tied advisers can at least partly overcome these disadvantages: first, the tied agent can refer the customer to an IFA if there is no suitable product in-house. This is not an attractive option if the IFA is a competitor. Secondly, product providers who sell through tied advisers can improve their product range by contracting out various aspects of the provision of their own product or by buying in the product of a second company and selling it as their own.
- 7.15 This suggests that the disadvantageous effects on product ranges are smaller than might at first appear. Polarisation constrains the contractual arrangements that the principals selling through tied advisers can reach with other suppliers and this may

create some extra costs. These costs are likely to be passed on to consumers. The effect on competition does not appear to be significant.

- 7.16 It has been suggested that it would be more cost-effective if some of the niche products currently bought in by a number of providers were allowed to be sold under the niche provider's own brand name rather than that of the tied advisers' provider. This would enable the fixed costs of marketing and product development to be shared by the niche provider and other providers who wished to offer the same niche product to consumers. While there may be advantages in this both to the adviser and to the supplier of the niche product, there is no evidence that the restriction on the use of the supplier's brand name puts the tied adviser or the niche product provider at a significant disadvantage.

Product providers

- 7.17 There are three ways in which the polarisation rules may affect competition between product providers.

Polarisation as a barrier to entry

- 7.18 Those providers entering the market for the first time cannot add their products under their own brand name to the range of an existing adviser tied to a different provider. It has been argued that this acts as a barrier to entry for new product providers. The point has been made particularly strongly by some unit trust providers. These companies have stressed that they are unable to sell through banks - which are a major distribution channel in other countries - because banks offer their own unit trust

products. A rule which raises a barrier to entry could distort competition by reducing the number of players in the market, making it easier to coordinate and sustain price rises.

- 7.19 However, there are a number of reasons why the effect of the polarisation rules on barriers to entry might not be significant in competition terms. First, new product providers have alternative distribution channels for their products - notably IFAs and direct sales. The direct sales channel has been an important source of new entry for unit trusts and PEPs. Secondly, the number of product providers is high, so that effective competition should be feasible even with entry barriers. Thirdly, tied advisers are most likely to sell the products of their associated product provider whatever the rules on polarisation. Some of the current entry barriers would therefore still face a new entrant under other types of regime.
- 7.20 The above suggests that the rules on polarisation do create some barriers to entry for new providers selling products under their own brand name but that the effect on competition in the market is not significant.

Competition-dampening effects

- 7.21 Although independent financial advice is readily available, a large proportion of business continues to go through tied channels. Much of the competitive pressure on providers comes from competition between the products sold through an individual adviser. In the case of a tied adviser this will only be between the competing products of one provider or marketing group.

Competition-enhancing effects

- 7.22 It is also argued that IFAs, acting as customers' agents, sharpen competition between product providers because the providers have to convince the IFAs of the quality of their products. Polarisation makes it impossible for other advisers to pass themselves off as independent when in practice they are tied to two or more providers. In the absence of polarisation between independent and tied advisers, it is argued, there would be fewer incentives for advisers to incur the research and other costs necessary to offer independent advice; so there would be fewer IFAs, more customers would take advice from tied or multi-tied advisers, who would predominate, and competition between providers would be less intense.
- 7.23 Life offices argued strongly in support of the competition-enhancing effect of sales through IFAs (see Appendix B, paragraph 9). The complexity of their products has

meant that to date a very small proportion are sold direct to the public without specific advice. A far larger proportion of unit trust sales are made direct to the public. In addition to the competitive pressure between collective investment scheme providers to increase their sales to IFAs, there is competitive pressure to increase sales direct to the public through improvements to the products on offer. So, the importance of IFAs to product development in the interests of consumers is not as great for non-life products as it is for life products.

Conclusions on competition effects

- 7.24 Competition between retailers is restricted or distorted to a significant extent by the rules on polarisation in that they restrict innovation to those retail models which comply with the rules. In other words some forms of innovation in retail markets are prohibited by the rules. The rules have a number of conflicting effects on competition between product providers. Polarisation increases entry barriers. It also dampens competition between products sold through tied advisers. However, it might help to maintain a strong IFA sector for whose custom product providers compete.
- 7.25 The balance of these effects on competition may differ according to the product. Overall, the extent of the restriction or distortion on competition caused by the polarisation rules is likely to be significant in the case of units in collective investment schemes but not in the case of life assurance and pensions. It is, however, important that the status of advisers should be effectively disclosed and that there should be no return to a situation in which multi-tied agents were able to describe themselves as independent.

8 ALTERNATIVES TO POLARISATION

- 8.1 A number of alternatives to polarisation are considered in this chapter. A broad assessment is made of the costs and benefits of each approach compared with polarisation. There is no attempt to quantify these costs and benefits.

Success criteria for systems of regulation for product distribution

- 8.2 There are a number of factors which will determine the effectiveness of any regime that regulates the nature and disclosure of links between suppliers and advisers. These factors have been separated loosely into regulatory and competition issues, although there is some overlap between the two.

Regulatory

- 8.3 First, a good regulatory system would have effective **status disclosure**. Customers would have a clear understanding of the nature of the service they receive from an adviser, in particular, who the adviser represents and any potential sources of bias in the advice. Secondly, it should be clear to all involved in the transaction where **responsibility** lies for the quality of the advice given and for the product sold. This is important to ensure customers can obtain redress easily and so that regulation can be targeted on the appropriate business. Thirdly, **regulatory costs** should be kept low: clear rules which can be easily monitored are preferable to more complex rules that are difficult and expensive to monitor for compliance.

Competition

- 8.4 First, as a general principle, rules should impose as **few constraints on firms as is necessary** to minimise consumer detriment. The organisation of firms and the structure of markets should be determined as far as possible by competition rather than through rules. Secondly, **rules should not stand in the way of innovation** either at the retail level or in terms of new products. Although they should not encourage complexity which does not benefit consumers. Thirdly, rules in this area should enable firms and customers to achieve any efficiency benefits that arise from

specialisation in production. Fourthly, going back to the original concerns of the then Director General in 1987³⁵, an ideal regime would **facilitate comparison between competing products**.

Discussion of options for change

8.5 Nine possible changes to the polarisation rules are discussed below.

a Keep all rules except ‘better than best’ (paragraph 5.7)

8.6 Keeping all the current polarisation rules except ‘better than best’ would, on the face of it, involve a relatively minor change to FSA rules on polarisation. Advisers would still either be tied to one provider, or obliged to search the market. However, IFAs owned by, or associated with, a product provider would be permitted to recommend that provider’s product if it were at least as suitable for the investor’s needs as other products in the market. Commercially this appears to be a good solution.

8.7 This regime would have the following points to commend it. First, it might encourage more product providers, including banks, to offer independent advice across a range of products. This should increase the availability of independent information on competing products at the point of sale. It might also encourage IFAs, including IFA networks, to develop new products based on their experience of customer demand. There could be slightly more variation in retail distribution methods than at present which could stimulate some product innovation. However, it is likely that the effect on distribution would be seen in only a very small part of the market.

8.8 However, the benefits are likely to be outweighed by the overall advantage the present rule has of making absolutely clear to all participants in the market that the advice of an IFA associated with a product provider is not biased towards that provider. The removal of the ‘better than best’ rule would take away the main benefit of polarisation - namely, clarity of status - for relatively few tangible improvements. The ‘better than best’ rule should, therefore, be retained for advice about any products on which investment advice is required to be polarised.

b Reduce the scope of polarised advice

³⁵ *Securities and Investments Board: A report by the Director General of Fair Trading to the Secretary of State for Trade and Industry (March 1987)*

- 8.9 The conclusion of Chapter 6 was that it is in the interests of consumers that the FSA should continue to require that investment advice on life assurance and personal pensions be polarised. Life assurance and personal pensions were the most widely available packaged investment products sold to private investors when polarisation was introduced. Unit trusts were considerably less widespread as a retail investment then than now. Unit trust products are simpler than products linked to life insurance, the price is more transparent and there is not the same need for long-term commitment. The conclusion of Chapter 6 was that there is not the same need for advice on these products to be polarised in the interests of consumers as in the case of life products.
- 8.10 A narrower application of the polarisation rules would have several potentially desirable effects. First, it would allow more room for specialisation by suppliers in products not covered by the regime. Secondly, it would permit some retail innovation. Thirdly, product innovation would be facilitated by allowing the widest possible means for new products outside the rules to reach the market. Fourthly, there should be opportunities for the clients of tied advisers to receive advice about a wider range of products to which the rules on polarisation of advice would not apply. This advantage might of course be offset by the detriment suffered by clients of IFAs who might not receive independent advice on such a wide range of products.
- 8.11 There are two potentially significant problems to be resolved. The first of these is to establish who would be responsible to the regulators for non-polarised advice. It is likely that some advisers would have associations with more than one provider of products on which investment advice is not required to be polarised. In these circumstances it would be difficult to apportion the responsibility of ensuring the compliance of the adviser with the regulators' rules between the various principals.
- 8.12 It is therefore recommended that responsibility for ensuring that financial advisers with multiple ties to providers comply with the regulators' rules should rest with the FSA and that such advisers should be authorised directly. It has already been proposed in the provisions of the Financial Services and Markets Bill that the FSA

should be required to authorise directly the regulated activities of banks and building societies. Some of these banks and building societies are tied to life offices and these are the outlets which are most likely to take on additional ties to unit trust providers.

- 8.13 The second problem is to ensure that consumers understand on which products they are receiving polarised advice and on which they are not. A particular issue here is that advice on ‘non-polarised’ products would benefit from a halo effect if sold by an IFA. Consumers might assume that they were receiving independent advice on all products offered by the IFA whereas in fact the IFA might have ties with providers of products on which advice is not required to be polarised.
- 8.14 This problem is not new and applies at present to products that are not regulated under the Financial Services Act 1986. So, for example, tied representatives of life insurance companies are permitted to (and do) act as mortgage brokers. Conversely, IFAs are not obliged to offer a full brokerage service if they sell general (non-life) insurance.
- 8.15 A good regulatory system should have effective status disclosure so that customers have a clear understanding of the nature of the service that they are receiving. It is recommended that all those offering advice on products for which the polarisation rules do not apply should be required to disclose to their customers any arrangements, including ownership, that they might have with the providers of products they could recommend. It would be for the consumer to make a judgement about any bias in the advice received. If more products are brought within the regulatory ambit under the proposals in the Financial Services and Markets Bill these simpler disclosure rules should apply so reducing the ‘halo’ effect which already exists. The Council of Mortgage Lenders Code already requires all intermediaries to disclose their status.

*c **Extend the scope of polarised advice***

- 8.16 The polarisation rules could be extended to products which might be brought within the scope of regulation under the terms of the proposed new legislation. This would be the cleanest solution in terms of status disclosure, but would risk distorting the existing markets and restricting innovation in products and methods of distribution to which the rules on polarisation of advice do not currently apply. There is no apparent need for the polarisation of investment advice to be applied more widely. This is not recommended.

d Retain polarisation, but allow providers to come to arrangements with other providers to ‘fill in the gaps’

8.17 This alternative was proposed by Sir Mark Weinberg. As today, advisers would either be tied to one provider (the principal), who would be responsible for their advice, or not tied at all. However, the principal would be permitted to come to arrangements with one or more other providers, in areas where the principal did not itself offer a product, to allow the tied advisers to advise on the products of the third party providers. The principal would be responsible for the regulatory compliance of its advisers when advising on the third party products.

8.18 The advantages of this approach are as follows. First, it would enable providers selling through tied advisers to derive some benefits from specialising in their most efficient and cost-effective products. Secondly, the customers of tied advisers might be able to obtain a better product in those areas where the product provider was weak. Thirdly, there would be slightly more variety in retail forms. Responsibility for ensuring regulatory compliance would be clearly with the ‘lead provider’.

8.19 Some of these benefits can be over-stated. Providers selling through tied advisers can already benefit from specialisation through contracting out services or by buying in products. Sir Mark Weinberg’s suggestion would allow greater freedom, for example, in branding, but it is not as big a change from the current arrangements as has been claimed. It allows for only limited variation in retail structures and does nothing to supply comparative information on competing products at the point of sale.

8.20 However, this slight increase in freedom for tied advisers to extend their product range would also allow small specialist providers to benefit from the marketing of their brand name by the principal provider. It seems unlikely that such a move would achieve a great deal for more than a small minority of consumers but it is worth consideration.

e Only allow fee-based advisers to be called ‘independent’

8.21 This is a question of names rather than polarisation on the assumption that some advisers with no ties would continue to be paid by commission. Any bias that commission-paid advisers might show in favour of certain products is not a factor

related specifically to polarisation. Nor do the polarisation rules prevent IFAs who offer a fee-based financial consultancy service advertising their services to potential clients.

- 8.22 It would be in the interest of consumers to be more aware of the cost of the advice they receive. It could be made more explicit that, in the case of commission-funded advisers, payment for advice is included in the commission which the provider pays to the adviser and deducts from the investor's premiums. Customers might be encouraged to bargain directly with advisers about how much they pay for advice. Fees are the most transparent way of paying for advice and it is recommended that any regulatory impediment to an increase in fee-based advice should be removed. One possible impediment is a lack of neutrality in the tax system between payment by fee and payment by commission (see paragraph 5.20).
- 8.23 It is recommended that HM Customs & Excise, Inland Revenue and the FSA look further at these issues. It is not, however, advocated that there should be a change in the remuneration of independent advisers which could lead to less independent advice being available to low income consumers. The point has been made that such consumers would be highly unlikely to pay fees.

f Multi-tied agents

- 8.24 There are several variants of the multi-tie model. For example, in one, advisers might be able to be tied to a number of providers offering a mixture of competing and complementary products. The tie would mean only that they would not sell or advise on the products of providers not on this list. In another, more restrictive variant, advisers might be tied to several providers but to each provider for one product type only, and they would not sell or advise on competing products from any other adviser.
- 8.25 Potentially the first of these could provide consumers approaching tied agents with more comparative information on products. The second could allow more room for specialisation in the tied sector and could lead to some customers obtaining better products. It also allows some room for innovation in retail models.
- 8.26 One problem is that these models do not make it clear where responsibility to the regulator for advice should lie - whether it should be with one of the product providers to whom the agent is tied (if so which) or with the agent himself. The lead provider might be unwilling to take responsibility for the other providers' products. Take-up of these options would be limited unless a multi-tied adviser were directly authorised by the FSA.

8.27 The incentives for IFAs to search the market for best value would be weakened if customers found it hard to distinguish an IFA from a multi-tied agent. Some current IFAs might choose to become multi-tied leading to a possible increase in exclusive or semi-exclusive agreements between product providers and IFAs and less rather than more competition between providers. The main advantage in the multi-tie approach is that it enables advice over a range of suppliers' products to be offered more cost-effectively than by a market-wide search. It would also reduce barriers to entry for new product providers without an existing tied network of advisers.

8.28 It is recommended that multi-ties should not be permitted for advice on products linked to life insurance because the strong IFA presence in this market appears to have had a pro-competition effect on product providers. However, this effect does not appear to exist in the market for units in collective investment schemes. It is therefore recommended that advisers on collective investment schemes should be permitted to hold multi-ties.

g IFA product panels

8.29 Product panels are used by IFAs to reduce the cost of making product searches. This has generally been a benign development in the interest of consumers because of the reduction in the cost of advice. The PIA's 'light touch' approach to regulation here, has allowed a variety of approaches to product selection to develop. Some aspects of 'good practice' for product panels - for example, separation of commission negotiation from panel selection - could and should be codified into rules.

h Allow any arrangements between product providers and advisers provided they are fully and clearly disclosed to consumers

8.30 This is probably the most radical change from the current system if it is to be applied to all investment advice that is currently polarised. The proposal would require some adjustment to be made to other rules, for example on product advice, responsibility and redress.

8.31 The key advantage of this type of approach is that it allows the maximum freedom to develop new methods of retailing financial products. From a pure competition perspective, an approach which relies on disclosure of status alone might be considered ideal. Such an approach is taken in most consumer markets where consumers do not face the severe information problems they do when purchasing some long-term investment products.

8.32 An approach relying on disclosure of status alone may be seen as a goal once customers' information problems have been resolved sufficiently effectively to be able to do without much regulation of the selling process. This point has not yet been reached for at least some packaged financial products. It is not currently recommended for life insurance-linked products. But it is the approach recommended for collective investment scheme products, investment trust savings schemes and other packaged products which may be regulated by the FSA in the future.

i All financial advisers must be independent

8.33 On the face of it, this proposal appears attractive from the point of view of increasing the information on competing products available to customers. Complete vertical separation would remove at a stroke the competition dampening effects of vertical integration in retail financial services markets.

8.34 But this is the option which would most constrain retail innovation. It would also remove the ability of product providers to exploit any efficiencies that arise from both producing and retailing a product. It could be expected to increase significantly the costs of providing advice to at least some customers, which could lead to fewer rather than more customers seeking advice. It is not therefore an attractive option on closer inspection.

9 CONCLUSIONS AND RECOMMENDATIONS

- 9.1 This review has dwelt on the effect of the polarisation rules both on competition and on preventing harm to consumers arising from information problems. The dual approach reflects the dual nature of the work of the OFT, and a belief that an assessment from a single perspective would not provide a well-balanced understanding of the issues.
- 9.2 Chapter 7 discussed the impact that the polarisation rules have had on competition in the markets where they apply. It found that the initial concerns raised by the then Director General in 1987 have not been entirely borne out by experience. A flexible interpretation of the rules by the regulators - for example, with respect to product panels and contracting out - has avoided some of the more severe distortions of competition. Nonetheless several appreciable effects on competition have been identified, both between advisers and between product providers. The report concludes that the rules restrict or distort competition to a significant extent by limiting innovation in the retail sale of packaged financial products. The overall effect on competition is less significant for advice given on life insurance-linked products, including personal pensions, than it is for advice on units in collective investment schemes because of the strong competition between life offices to distribute their products through IFAs.
- 9.3 The polarisation rules have provided consumers with the benefit of clear lines of responsibility for the regulatory control of the advice that they receive. This is less important for advice on non-life products than on life insurance-linked products which, because of their complexity, are more likely to give consumers cause to seek redress. Because of differences in the products and their distribution the continuation of the polarisation rules appears to be justified for life insurance-linked products, including personal pensions, but not for units in collective investment schemes. There are a number of other ways in which consumer detriment might be removed from the market. Several different models were discussed in Chapter 8. The following recommendations arise from that discussion.

Recommendations

- The FSA should retain the polarisation rules but only for advice on investment products, including personal pensions, linked to life insurance.
(Paragraphs 6.20-6.22, 7.24-7.25, 8.9-8.15)

Recommendations which apply to polarised investment advice:

- The FSA should not relax the rules regulating the independence of IFAs.
(Paragraphs 6.13-6.18, 8.6-8.8)
- The FSA should introduce rules to require that the selection of products for IFA product panels or recommended lists is formally separated from the negotiation of commission on the products. The FSA should consider whether other rules should also be introduced on the construction of product panels and lists. (Paragraph 8.29)
- The FSA should consider permitting lead product providers selling through tied advisers to add specialist products under the brand name of the specialist provider to their range as long as the lead provider takes full responsibility for the specialist products. (Paragraphs 8.17-8.20)

Recommendations which apply to non-polarised investment advice:

- The FSA should directly authorise financial advisers with multiple ties.
(Paragraphs 8.11-8.12)
- The FSA should require all investment advisers to disclose to their clients any arrangements or ties, including ownership, they might have with product providers before giving advice. (Paragraphs 8.13-8.15)

Recommendations of general application:

- The FSA should consider whether more could be done to make clear to investors who receive advice from commission-funded advisers that payment for advice is included in the commission paid to the adviser and it is possible to negotiate a rebate to themselves of some of that commission.

(Paragraph 8.22)

- HM Customs and Excise and Inland Revenue should consider the taxation of payment for investment advice with the aim, in particular, of ensuring neutrality between commission and fee-based advice. **(Paragraph 8.23)**

APPENDICES

A REGULATORY RULES

A.1. The rules of the four regulators: the FSA, PIA, SFA and IMRO, concerning polarisation are all very similar. For ease of reference we have quoted one of the Regulators' rules about a particular subject and noted where the corresponding rules of the other regulators are located. We have also noted where there is a significant difference between the other rules and the text quoted. Some rules have not been formally adopted or repeated in each rulebook but their application is clearly implied by the drafting of other rules.

A.2. Polarisation FSA Core Conduct of Business Rules. 4.

1. A firm which advises a private customer on packaged products must either:
 - a. be a product company or its marketing group associate; or
 - b. do so as an independent intermediary.
2. A firm which is a product company or its marketing group associate must not advise private customers to buy packaged products which are not those of the marketing group.
3. A firm which acts as an independent intermediary in advising a private customer on packaged products must act as an independent intermediary whenever it advises private customers on packaged products in the course of regulated business.
4. But where a firm acts as an investment manager for a customer, the core rule on polarisation does not prevent the firm from advising the customer on any packaged product.

A.2.1. Rule location:

FSA: Core Conduct of Business Rules 4; **SFA:** 5-19; **IMRO:** CII, S6.1(1)(a) - only rule 1.

A.3. Disclosure of polarisation status PIA Rule 4.2.1

In carrying on business relating to packaged products, a Member must make clear to its customers, and must require its investment staff, and its appointed representatives and their investment staff, to make clear whether any advice given in the course of that business will be

- (1) independent advice, or

- (2) advice only on the packaged products of one product provider or marketing group,
and the Member must secure compliance with that requirement.

A.3.1. Rule location:

PIA: 4.2 - PIA also include specific rules covering Disclosure in premises (4.2.2.), disclosure in advertisements (4.2.3.), Oral Disclosure (4.2.4.). **FSA:** Core Conduct of Business Rules 11; **SFA:** 5.21 - Unless firm is acting as an investment manager; **IMRO:** CII, S6.1(1)(b) - unless the firm is acting as an investment manager. Firms should also give clients a copy of the appropriate buyers guide detailed in Appendix 6.1(1)(b).

A.4. Suitability

SFA Rule 5-20

- (1) A firm which advises private customers to buy packaged products must take reasonable steps to inform itself and relevant agents—
- (a) where the firm is a product company or its marketing group associate, about packaged products available from the marketing group; or
 - (b) where the firm is an independent intermediary, about packaged products which are generally available on the market and on which it can advise.
- (2) Where a firm is a product company or its marketing group associate, it must not advise a private customer to buy a packaged product, or buy a packaged product for him in the exercise of discretion, if it is aware of a packaged product of the marketing group which would better meet his needs.
- (3) Where a firm is acting as an independent intermediary, it must not advise a private customer to buy a packaged product, or buy a packaged product for him in the exercise of discretion, if it is aware of a generally available packaged product which would better meet his needs.
- (4) Where a firm is a product company or its marketing group associate and is acting as an investment manager, it must not advise a private customer to buy a packaged product of a product company outside the marketing group, or buy such a product for him in the exercise of discretion, if it is, or reasonably should be, aware of a generally available packaged product which would better meet his needs.
- (6) In assessing the merits of a packaged product to be held as the plan investment of a PEP or to be held within an ISA, a firm must take into account the characteristics (including charging arrangements) of the plan or of the ISA, as well as those of the product.

A.4.1. Rules location

PIA: PIA Adopted Rules FIMBRA F28(1), F29(7), but also note additional requirements in F29(5) and F29(6), PIA Adopted Rules LAUTRO Schedule 2, L8(1), PIA Adopted Rules IMRO I:6(1)(a); **FSA:** Core Conduct of Business rules 17(1) - (4) and (6); **SFA:** 5-20(1) - (4) and (6); **IMRO:** CII, S6.3(1) Duty of a Tied Firm, CII, S6.3(2)(a),(b) and (d) Duty of an Independent Intermediary

A.5. 'Better than best'

SFA Rules 5-20(5)

- (5) Where a firm is acting for a private customer as an independent intermediary but not as an investment manager, it must not advise him to buy a packaged product from its extended group if it is aware of a generally available packaged product which is not a product of the extended group and which would meet his needs as well as the extended group product

A.5.1. Rules location

PIA: PIA Adopted Rules FIMBRA F29(7)(2), Uses 'issued or operated by a connected person of yours or its marketing group associate' in place of 'of the extended group'; **FSA:** Core Conduct of Business rules 17(5); **SFA:** 5-20(5); **IMRO:** CII, S6.3(2)(c) Duty of an Independent Intermediary.

A.6. Independence

PIA Adopted rules of FSA. S2.03

- (1) A Member which holds itself out as offering to provide for its customers independent advice or the independent exercise of discretion on their behalf in relation to investments generally or to any class of investments shall not, unless constrained to do so by law, have any association or arrangement with any other person under which it will be constrained to recommend to its customers or to effect with or for them (or to refrain from doing so) (otherwise than in their capacity as market counter parties) transactions:
- a. in some investments but not in others,
 - b. with some persons but not with others, or
 - c. through the agency of some persons but not of others.
- (2) A Member shall not advise a customer (otherwise than in his capacity as a market counterpart) to use the services of another person who is known by the Member to be an associate of the Member unless the Member has disclosed to the customer that fact and the nature of the association.

A.6.1. Rules location

PIA: PIA Adopted Rules of SIB S2.03(1) and (2); **FSA:** Conduct of Business Rules 1990, Part 2, 2.03(1) and (2)

A.7. Inducements

FSA Core Conduct of Business Rules. 1

A firm must take reasonable steps to ensure that neither it nor any of its agents:

- a. offers or gives, or
- b. solicits or accepts,

either in the course of regulated business or otherwise any inducement which is likely significantly to conflict with any duties of the recipient (or the recipient's employer) owed to customers in connection with regulated business.

A.7.1. Rules location

PIA: PIA Adopted rules of IMRO I:1.6(1), note also PIA adopted rules of FIMBRA F28.9, Bribes and acceptable incentives; **FSA:** Core Conduct of Business Rules 1; **SFA:** 5-7; **IMRO:** 1.6(1), IMRO provide guidance about this rule.

B RESULTS OF THE CONSULTATION EXERCISE

- B.1 At the launch of the review a questionnaire was sent to a representative sample of 17 organisations chosen to cover the range of interests in the market for packaged investment products. Copies of the questionnaires are attached at Appendices C-F. Many of the organisations contacted fell within two or three categories (for example, the NatWest Group contains a product provider and supplies tied advice primarily, but the group also has an IFA arm). In addition to those organisations contacted directly, a large number of representations were received from others in the field wishing to make their views known. All of these were followed up. A list of respondents is attached at Appendix G.
- B.2 The general views expressed are summarised below.

Tied advisers and providers selling through tied advisers (including bancassurers):

- B.3 Life offices believed that the polarisation of advice did not greatly affect their core business, nor their core business operations. They believed that without polarisation they would essentially continue to trade through their own tied agent network.
- B.4 Bancassurers felt forced to offer as wide a range of products as was economically feasible to ensure they could satisfy the majority of consumer needs to prevent their tied advisers losing business. It was impossible to provide excellent products across the whole range. As a consequence, because of the rules on polarisation, their advisers sometimes had to offer customers products that they knew were weak.
- B.5 Apart from the impossibility of providing efficient cost-effective products across the whole range, there were no direct competitive pressures on the products sold through tied advisers to encourage improvements in design. The polarisation rules prevented the clients of tied advisers being able to choose some of the more specialist products that a provider might have decided not to add to its range because there was not sufficient demand to make them profitable.
- B.6 Bancassurers felt that the polarisation rules should be revised to allow them freedom to offer the products of other providers.

Providers selling through IFAs:

- B.7 Life offices whose main distribution channel is through IFAs were in general happy with the market structure which had resulted from the polarisation rules. These providers attempted to produce products that would appeal to the perceived client base of IFAs and tended not to produce products which had appeal to those with low disposable incomes.
- B.8 They opposed the abolition of polarisation because they believed that the larger IFAs and networks would want to become multi-ties if polarisation were abolished. This would raise costs for the providers and ultimately for consumers as there would be a commission war to become tied to the best performing IFAs. The providers might also be responsible for the compliance of multi-ties.
- B.9 These life offices therefore argued at length in support of the advantages to consumers of receiving advice from IFAs. They believed that their products were distributed in a very transparent market through agents who were professional. There was active competition between these providers to ensure that their products were included on IFA product panels which were normally reviewed at least every six months. This competition resulted in improved products for consumers. Indirectly this led to product improvement in the tied sector which had to keep up with developments in the independent sector. There would be less competitive pressure on multi-ties because the relationships with providers would be for longer periods of time for contractual and practical reasons. Also, panels had to be selected using objective criteria while there would be no such obligation in selecting multi-tie partners.
- B.10 The market was not unduly influenced by the level of commission payments but providers had to pay the 'going rate' for particular products to be considered. Networks and product panels were produced to rigorous standards and were useful tools in providing products economically to consumers. The level of commission was greater for greater volumes of business (that is, 15% to small IFAs, 20% to large or regional IFAs and 25% to networks or national IFAs) but these rates of commission made no difference to the charges to consumers.

B.11 Some providers of units in collective investment schemes such as unit trusts or OIECs which distribute through IFAs and by direct sales would welcome a relaxation in the polarisation rules to allow them to sell through bank and building society branches in competition with the tied products.

Small or specialist providers:

B.12 Small providers such as friendly societies believed the polarisation rules had a significant effect on their ability to do business. They did not, in general, have access to the tied distribution network of the banks and building societies and did not have the resources or product range to set up their own tied adviser network. Many had seen links with traditional partners such as building societies disappear as these businesses had either been forced to tie with a larger organisation offering a wider range of products or to operate as IFAs with limited product panels.

B.13 Friendly societies were particularly critical as their enabling legislation permitted them to produce only a restricted range of products and the commission they paid was not high enough to be attractive to IFAs. If friendly societies had difficulty selling their products there would be an adverse effect on vulnerable consumers as the societies had been set up to help them.

B.14 They would like the polarisation rules to be relaxed to allow them to offer their specialised products through tied advisers but using their own brand name. The principal of the tied adviser would retain responsibility for advice and obligations to the investors for the product but the specialist producer would be able to develop sales by marketing under its own brand image.

Independent Financial Advisers (IFAs):

B.15 IFAs believed that the polarisation rules were essential to ensure their survival. If the polarisation of advice was abandoned they did not expect to be able to compete successfully with multi-ties. Many of their views were similar to those put forward by the life offices which sold through IFAs.

- B.16 To enable independent advice to be provided economically to consumers they had developed networks, product panels and software to analyse and keep up-to-date with products. Consumers were becoming more educated and were increasingly aware of the value of seeking advice from an IFA rather than a tied adviser.
- B.17 They wanted no steps to be taken which would blur the polar distinctiveness between the tied and independent sectors, believing that any confusion in the mind of the consumer would lead to a distinct threat to the continuing existence of the IFA as a major force in the marketplace.

Consumers' Association (CA):

- B.18 A clear demarcation in the status of advisers was of huge benefit to consumers. Consumer choice and understanding was enhanced by the polarisation regime. Even after ten years of the polarisation rules, consumers had yet to appreciate the full value of the polarisation regime. Many consumers were still confused about the differences between tied and independent advice or had unrealistic expectations of independent advisers.
- B.19 Research by the Association had shown consistently that advice given by IFAs had produced better results for consumers in terms of suitability of products than advice from tied advisers. Consumer education was necessary to make consumers feel more comfortable with financial products and more confident about their choices. Informed consumers would be more likely to appreciate the value of independent advice and to be able to spot poor advice when they met it.

C QUESTIONNAIRE TO INDEPENDENT FINANCIAL ADVISERS

- 1 What factors influenced your decision to become an IFA and have they changed?
- 2 What products do you sell?
- 3 What products do you sell on which there is no commission payable?
- 4 Who are your main competitors - other IFAs, company representatives, tied agents or direct sales?
- 5 What commercial advantages do you have over them and they over you?
- 6 What are the attractions of networks to IFAs?
- 7 How do you select products from the full range available?
- 8 What has been the effect of the introduction of product panels?
- 9 What has been the effect of the introduction of IT?
- 10 How does the level of commission vary between providers, products and sales outlets?
- 11 What effect has the disclosure of commission levels had on your business?
- 12 What inducements, other than commission, do you receive from product providers and how do these influence your choice of product?
- 13 What do you expect consumer reaction to be to any suggestion that they might pay a fee for advice?
- 14 What advice do consumers expect/need from you?
- 15 What influences consumers in their choice of financial product?
- 16 What effect has the requirement on training had on your business?
- 17 What would be the effect on your business if multi-ties were permitted or tied agents or company representatives were permitted to give independent advice on some products?
- 18 What improvement would you like to see in the current system?

D QUESTIONNAIRE TO TIED ADVISERS

- 1 What factors influenced your decision to become a tied agent and have they changed?
- 2 What products do you sell?
- 3 What products are you precluded from selling because of the polarisation rules?
- 4 Who are your main competitors - other tied agents, company representatives, IFAs or direct sales?
- 5 What commercial advantages do you have over them and they over you?
- 6 What effect has the development of IT had on your business?
- 7 How do commission levels vary between products and sales outlets?
- 8 What effect has disclosure of commission had on your business?
- 9 What inducements do you receive from your product provider?
- 10 What is the effect of sales targets?
- 11 What has been the effect of training requirements?
- 12 What would be the effect on your business if you were permitted to be tied to more than one adviser or to offer independent advice?
- 13 What improvement would you like to see in the present system?

E QUESTIONNAIRE TO PRODUCT PROVIDERS

- 1 What products do you sell to which the polarisation rules apply?
- 2 In what proportion is distribution of your products divided between independent financial advisers, company representatives, direct sales and tied agents?
- 3 What advantages/disadvantages are there in dealing with IFAs, company representatives, direct sales and tied agents?
- 4 What difference does it make in the price of your products to consumers if they are sold by independent financial advisers, tied agents, company representatives or direct?
- 5 What is the difference between dealing with IFAs who are members of a network and IFAs who are not?
- 6 What information about your products do you provide to salesmen whether IFAs, company representatives or tied agents?
- 7 What has been the effect of the introduction of product panels?
- 8 What has been the effect of the introduction of IT?
- 9 How does the level of commission vary between products and sales outlets - how is this affected by fee paid advice?
- 10 What evidence is there that the level of commission might influence the sale of products?
- 11 What inducements, apart from commission, do you give to IFAs, company representatives, or tied agents and what evidence is there that these might influence sales?
- 12 What effect has the disclosure of commission had on sales and distribution?
- 13 What effect do sales targets have on sales?
- 14 What has been the effect of the training requirements?
- 15 What effect have the rules on polarisation had on your business?
- 16 What improvement would you like to see in the present system?

F QUESTIONNAIRE TO CONSUMER ORGANISATIONS

- 1 What do consumers look for when choosing a financial adviser?
- 2 How do consumers choose a financial adviser?
- 3 What do consumers understand by tied agent, company representative and independent financial adviser?
- 4 What do consumers know about product panels?
- 5 What advice do consumers expect/need from their financial adviser?
- 6 What complaints do you receive from consumers about the advice they have received?
- 7 What effect would the removal of the rules on polarisation have on consumers?
- 8 What improvements would you like to see to the present system to the benefit of consumers?

G LIST OF RESPONDENTS

Allied Dunbar Assurance plc
Association of British Insurers
Association of Friendly Societies
Association of Unit Trusts and Investment Funds
Berkeley Independent Advisers Ltd
Bradford & Bingley Building Society
British Bankers Association
Building Societies Association
Chetwood Financial Management
Consumers' Association
Countrywide Independent Advisers Ltd
DBS Financial Management plc
Fidelity Investment Services Ltd
Financial Options Ltd
Financial Services Authority/PIA
Halifax plc
Independent Financial Advisers Association
International Consumer Policy Bureau
Institute of Chartered Accountants of England and Wales
IFA Promotion Ltd
Investment and Life Assurance Group
Large Network Association
Life Insurance Association
Lowe's Financial Management Ltd
M & G Group plc
Marks & Spencer Financial Services Ltd
Merrill Lynch International Bank Ltd
NatWest Group plc
Norwich Union plc
N P I
PIA Consumer Panel
PIA Small Business Panel
Scottish Provident
Society of Financial Advisers
Society of Pension Consultants
Standard Life Assurance Company
The Research Department
Towry Law Financial Services Ltd

H MARKET SHARE OF LIFE INSURANCE AND PENSIONS BUSINESS (TABLE 4.1) - EXPLANATION OF STATISTICAL CHANGES

H.1 The source of the information for Table 4.1 is the *Association of British Insurers Statistical Bulletin* (February 1999). The way of reporting the figures was changed from Quarter 1 1998. This needs to be taken into account when considering the figures. The February 1999 Bulletin contains the following explanation of the changes which relate to the market share of life insurance and pensions business:

Changes from Quarter 1 1998

H.2 The reporting of **increments to yearly premium pension policies** has changed. Prior to Quarter 1 1998, only amounts for voluntary increments were included within the new yearly premiums. However, from Quarter 1 1998, amounts for all increments (whether voluntary or contractual) are to be reported under new yearly premiums. This change will give a more accurate representation of the total new yearly premiums that are written by insurance companies. As expected, the main category that is affected by this change is pensions.

H.3 **One major player previously submitted all increments to pension policies under 'single premiums'. As these are now reported under yearly premium policies, the overall effect in the Quarter 1 1998 results has been an unusually large increase in the total yearly premium pensions matched by a drop in the figures for single premium pensions. This change affects data for both personal and occupational pensions. Retrospective changes (for previous quarters) have NOT been made.**

H.4 The 'Best Estimate of DSS Rebates' is no longer collected and is therefore not included within the results for Personal Pensions. The actual amounts of DSS Rebates are now collected and shown separately from personal pensions.

- H.5 Telesales has been introduced as a new distribution channel from Quarter 1 1998. For extraordinary business not covered elsewhere, e.g. over the counter sales, staff sales and flotation proceeds, a new distribution channel entitled 'other' has also been introduced (for the purposes of this report, these new channels have been amalgamated with the 'direct' channel data for 1998).
- H.6 In Quarter 1 1998 one large non-ABI member began submitting data and this has significantly altered the percentage of business sold through certain categories [this mainly affects the single premiums figures for 1998 where company agents share of the market fell by 6% mainly due to the inclusion of this firm's figures].
- H.7 For the reasons mentioned above, it is not possible to accurately compare the results in Quarter 1 1998 against those of previous quarters.

I GLOSSARY

appointed representative	agent - either an individual or a firm employed to carry on investment business on behalf of an authorised business and for whose activities the authorised business has accepted responsibility in writing;
bancassurer	large banks and building societies who have their own life offices;
‘better than best’	independent financial advisers who are part of a company group cannot recommend a product of the marketing group with which they are associated unless the product is demonstrably better than any other available product of its type;
CAT standard	CAT stands for Charges, Access and Terms; Individual Savings Accounts (ISAs) which meet voluntary minimum standards of charges, access and terms defined by HM Treasury may be sold as CAT standard;
company representative	employee (sometimes self-employed) of a product provider who may advise only on the products of that adviser;
independent financial advisers (IFA)	financial advisers who act on behalf of investors and have no ties with any provider;
marketing group	a group of people/firms who are associated through the common purpose of selling, and procuring the sale of, the group’s packaged products;
maxi-ISA	an Individual Savings Account which must contain a stocks and shares component and may include an insurance and/or a cash component;
network	an authorised independent financial adviser which has five or more appointed representatives, or whose appointed representatives (being fewer than five) have, between them 26 or more financial advisers;

packaged product/ packaged investment product	either a life assurance policy, a unit or share in a regulated collective investment scheme, or an investment trust savings scheme;
persistency	a measurement of the length of time a consumer maintains a policy;
polarisation	the requirement that an adviser who advises a private investor on packaged products must either act as a tied agent, or as an independent financial adviser;
private investors	an investor who is an individual, and who is not acting in the course of carrying on investment business;
product panel	a limited selection of products, drawn up after a conscientious search of the market to find products that meet certain criteria, which an IFA would use to make recommendations to private investors;
product provider	a firm which is a life office, an operator of a collective investment scheme, a friendly society, or the manager of an investment trust savings scheme, or an authorised investment business which the regulator has deemed it appropriate to designate product provider;
recommended list	a list of products which satisfy the minima criteria set out by an IFA;
regular premium	a payment under a long-term insurance contract which is part of a regular payment schedule for a period exceeding one year;
single premium	a payment which is not a regular premium;
tied advisers	advisers who may only recommend products of one provider;
trail commission	renewal commission which takes the form of a percentage of the value of the policy each year;

vulnerable consumer

a member of the public who might have a low income, be unemployed, suffer from a long-term illness or disability, belong to an ethnic minority, be old or young, and has particular difficulty in accessing useful information about financial products, which can lead to exclusion from financial services or the purchase of unsuitable products.