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## Competition scrutiny of the de-polarisation regulations

### Letter to Financial Services Authority

2 February 2005

OFT 774

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- 1 The Financial Services and Markets Act 2000 (FSMA 2000) requires the OFT to keep the regulating provisions and practices of the FSA under review. We have considered the FSA's de-polarisation regulations, set out in policy statement *04/27 Reforming Polarisation: Implementation*, and have found no significant adverse effect on competition arising from the regulations at this time. However, there remains some uncertainty over the way that consumers and firms may respond to some aspects of the de-polarisation regulations that may impact on competition in the future. We have set out a number of issues we consider relevant to reviewing the de-polarisation regulations in due course. The FSA may wish to bear these in mind when conducting its own post-implementation review of de-polarisation. The conclusions of our analysis are set out below.

#### **OFT's original concerns with the polarisation of investment advice**

- 2 The then Director General of Fair Trading<sup>1</sup> stated in 1999 that he considered that the polarisation regulations, which required financial advisers to be either independent (offering advice across the whole of the market) or tied (offering advice from a single product provider), significantly restricted or distorted competition by restricting innovation in retail models to those permitted by the regulations (tied or whole-of-market). The report also found that polarisation affected competition between product providers by increasing barriers to entry and dampening competition between products sold through tied advisers. These competition effects differed across investment products, and overall were considered to be significant for units in collective investment schemes but not for life policies.

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<sup>1</sup> *The rules on the polarisation of investment advice: a report by the Director General of Fair Trading* – August 1999.

- 3 In April 2002 we published our response to the FSA's consultation paper 121 *Reforming Polarisation: Making the market work for consumers*.<sup>2</sup> In the response we considered whether the restrictions arising from polarisation could be considered indispensable to achieving the consumer benefit arising from clear status disclosure. The evidence considered suggested that the majority of consumers buying packaged products tended to use tied advisers, where as a result of polarisation they could not choose between products at point of sale. Further, the status of advisers did not appear to be a significant driver for consumers when choosing an adviser, with choice mainly based on trust and convenience. Given these developments in the market we considered that the anti-competitive effect of polarisation could no longer be justified and de-regulation of investment advice was likely to better serve consumers.

### **Summary of the de-polarisation regulations**

- 4 The de-polarisation regulations apply to investment advice offered to private clients on packaged products. Packaged products and private customers are defined in the FSA's Handbook.<sup>3</sup> Packaged products include life policies (inc. pensions), units in a collective investment scheme, investment trust savings and stakeholder pensions.<sup>4</sup> Private customers are clients who are not market counterparties or intermediate customers.
- 5 There are two main changes arising from the de-polarisation regulations. First, the rules that polarised investment advice into those offering 'whole-of-market' or 'tied' advice have been removed and replaced with the concepts of scope of advice (either whole-of-market, a limited number of providers or a single provider) and range (the selection of products the adviser offers). Second, the new regulations impose a requirement on advisers to disclose to consumers the scope and range of products and provide indicative information on the cost of advice at the beginning of the advice process. In addition, a number of other changes have been made to the FSA Handbook to meet the Insurance Mediation Directive<sup>5</sup> (IMD) and to reflect changes to terms following removal of polarisation.
- 6 The original intention of the polarisation regulations was to ensure consumers clearly understood the status of their adviser, i.e. which product providers their adviser represented. This remains an important element of the regulation of

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<sup>2</sup> Liberalisation not polarisation – OFT's response to the FSA Consultation Paper 121 *Reforming Polarisation: Making the market work well for consumers*.

<sup>3</sup> See the Conduct of Business sourcebook and glossary of definitions at [www.fsa.gov.uk/handbook](http://www.fsa.gov.uk/handbook)

<sup>4</sup> The definition of packaged products does not include pure protection policies.

<sup>5</sup> the European Parliament and Council Directive of 9 December 2002 on insurance mediation (No 2002/92/EC).

investment advice and is necessary to address any potential conflict of interest arising from inducements or commission bias. The de-polarisation regulations address this through a number of measures. First, the Initial Disclosure Document (IDD) sets out the scope of advice (whole-of-market, a limited number of product providers or a single provider), range of products over which advice will be offered and any connection between an adviser and product provider. Second, the regulations restrict the use of the term 'independent' to situations where those holding themselves out to consumers as independent must offer whole-of-market advice and an option to pay for advice by fee. Third, the regulations on inducements establish the extent and basis on which product providers may invest in adviser firms, ensuring these reflect commercial terms and prohibit arrangements to channel business to particular providers.

### **Competition scrutiny of the de-polarisation regulations**

- 7 Our analysis of the de-polarisation regulations consists of two steps. Step 1 considers whether our original competition concerns with polarisation, as set out in the 1999 report and April 2002 response to the FSA, have been addressed. Step 2 considers whether the new regulations themselves raise any additional competition concerns. In the process of reviewing the regulations we have considered responses to the FSA's consultation documents, the analysis the FSA has set out to support its policy decisions and recent surveys of the financial advice industry. Our conclusions are set out below.

#### **Step 1 – OFT's original competition concerns**

- 8 We consider that the de-polarisation regulations address our original concerns, namely that innovation in the development of retail models was significantly restricted and competition between product providers was affected by increased barriers to entry and dampened competition between tied advisers. The polarisation requirements have been removed, allowing firms offering investment advice to adopt products based on, for example, commercial decisions and consumer preferences rather than regulatory requirements. In addition, responses to the FSA's consultation indicated that product providers, particularly those offering niche products, expected access to distribution channels to become easier. Evidence from recent market surveys suggests that a number of advisers would be looking at multi-tie or gap-filling strategies to select packaged products. However, it remains to be seen whether the de-polarisation regulations alone are sufficient to increase access to distribution channels.

## Step 2 – additional competition concerns

- 9 We have also reviewed the de-polarisation regulations to determine whether they create any other significant adverse effect on competition. Our analysis has focused on the enhanced disclosure obligations, in the form of the IDD and fees and commission statement (known as the 'menu'). Together these disclosure documents provide consumers with important information about the type of services their adviser is offering and, at the beginning of the advice process, an indication of how much they may pay for these services. This is an important step to facilitating effective competition for investment advice. We do not consider that any significant adverse effect on competition arises from these regulations at this time. However, there are a number of points that should be kept in mind as these regulations become established, these are considered below.
- 10 The menu includes a requirement to set out a market average commission for those packaged products offered to customers. The market average is calculated by the FSA from information submitted by product providers, and then re-expressed by the adviser in a manner comparable to the adviser's maximum commission for specific product categories. The inclusion of the market average offers consumers a benchmark, enabling them to compare charges for advice and initiate a dialogue with advisers about the cost of advice.
- 11 However, as discussed in our response to the menu consultation<sup>6</sup> we have some issues with the approach to estimating market average commissions and the form in which they are presented. First, the method of calculation relies on a number of assumptions, such as the discount rate or standardisation of product terms. Any assumptions introduce a risk that the estimated market average will not reflect prevailing underlying market conditions or, most importantly, fail to reflect the changes to market structure and behaviour that arise following de-polarisation of investment advice. This may lead to a distortion in market outcomes in circumstances where consumers base their decisions on this information. Second, although fees (i.e. charges for advice paid directly to the adviser) may be generally easier to compare across advisers, it is not necessarily straightforward to compare the cost of fee-based advice with commission-based advice. The menu does not seem significantly to facilitate any such comparison. As a result, any distortion to competition between fee based and non-fee based advisers may remain due to a lack of transparency across different charging methods for advice. Third, at this early stage in the implementation of the menu, we cannot easily predict how the market average data may affect competition between investment advice firms. In general, better information about the cost

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<sup>6</sup> OFT's response of 17 May 2004 to CP04/03, *Reforming Polarisation: A menu for being open with consumers*.

of advice services should help, by putting consumers in a better-informed position, to bring a downward pressure on the charges made by advisers. This depends, in part, upon how consumers use this information (for example consumers may use the information in the menu to negotiate rebates on commission) and how advice firms respond. On the other hand, although the market for investment advice is relatively fragmented, the market average could in theory be used by investment firms to help co-ordinate advice charges, in particular for commission payments. There appears at present to be a low risk of co-ordination occurring in practice but this could have serious effects should it arise.

- 12 The form and requirements for the IDD and menu have been subject to extensive consultation, with the FSA revising their proposals to reflect the views of the advice industry. The documents contain a number of prescribed elements, for example the layout and wording of certain sections. Samples of the documents have been tested with consumers to ensure they are user-friendly and contain the information consumers need presented at the most appropriate level. Nevertheless, we note that the disclosure documents have been subject to criticism in respect of the volume of information that will be provided to consumers, their complexity (which may confuse consumers) and the cost of updating the documents. A number of respondents to the FSA's consultation stated that advice regulation across mortgages and general insurance should be aligned with the de-polarisation requirements. Where practicable, aligning disclosure regimes across financial advice services should have a number of benefits. These include: helping to establish the menu, and other up-front disclosure documents, as the common bench-mark for information that consumers should expect to receive when obtaining advice; reducing costs for advice firms which offer a range of advice services for investments, mortgages and general insurance; and, easing supply-side substitution by advice firms across financial services.

## **Conclusions**

13. Overall, the de-polarisation proposals offer a number of benefits for competition and consumers that we welcome, including the principle of transparent disclosure of advice charges. The regulations have only been in place for a short period and we cannot predict how consumers or advisers and product providers will respond to the disclosure obligations. We consider that the impact of these regulations should be kept under review and that any review should bear in mind the following issues.

*A The form in which the market average is presented and the statistical method and assumptions used to estimate it should be kept under review, together with an analysis of price movements across firms and product categories.*

14 As described in paragraph 10 above, calculation of the market average relies on a number of assumptions that can have a significant impact on the values calculated. At this early stage in the introduction of the menu the response of firms and consumers to market average information is not known. However, we consider the impact on market conduct should be kept under review.

*B The menu should be kept under review, so that prescribed elements or other aspects of the menu can be adjusted in light of the experience of consumers and firms, and to ensure the menu remains relevant to consumers of financial advice by conveying the key information that consumers demand.*

15 The menu should remain focused on the key information needed by consumers, and where possible become established as a principal source of comparative information. To do this the menu should be allowed to evolve in light of the experience of firms and consumers that use the menu. The prescribed form of the menu should be adapted if necessary to reflect innovations in service delivery or the retail models that firms adopt.

*C The regulations for financial advice, covering investments, mortgages and general insurance, should be aligned where possible, in particular with respect to the disclosure regime.*

16 Respondents to FSA's consultations considered that the regimes for mortgage and general insurance regulation should be aligned. This would seem to have a number of benefits. First, supply-side substitution into investment advice may be made more straightforward, by minimising the regulatory hurdle that firms must meet. Second, there are considerable benefits to consumers from de-polarisation, in particular the more open disclosure of advice charges from the menu. Where possible consumers of mortgages or general insurance products should benefit from these transparency requirements.

17 In Policy Statement 04/27 the FSA outline proposals for a post-implementation review of the de-polarisation regulations. We welcome this and ask that you consider the issues above when developing the scope of your review.