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Comment on Retail Distribution Review FS08/6 Nov08 and Provider Analysis Templates Health-check (PATH)

Lost in (retail) space?

Robbie the Robot was usually first to alert Swiss family Robinson to any undefined but emerging threat with his catch phrase "*Danger Will Robinson!*" We thought of this after digesting the contents of 'Feedback Statement 08/6 FSA Retail Distribution Review, November 2008'. Of course the 'review phase' is now over and the FSA are leading the way to action with the snappily titled 'Retail Distribution Implementation Plan' (hopefully it will not become known prophetically as the 'Retail DIP'). This marks the next stage in the biggest shake up and reshaping of UK retail financial services since 1988. But it does not seem to have galvanized the provider firms most impacted into a frenzy of proactive analysis and planning activity. This is worrying.

Past performance is not a guide to the future?

Historically, financial services providers in the UK have a poor track record of delivering major regulatory change (remember the fiasco of N3 mortgage regulation with mortgage product lines withdrawn temporarily by most of the major players as they frantically de-scoped projects to ensure delivery of a core range to stay in business by the deadline?). Major firms do get there by the deadline, but only at the last minute and after huge effort and high risk in their delivery programmes.

There is a tendency for providers to get 'lost in space' for a while by holding off from the serious practical analysis of product, services, process, technology and distribution channels for their own firm. They often wait until there is absolute clarity on all aspects of the regulatory change before serious mobilisation. Past experience shows the resulting compression of timescales massively pushes up the risk profile and resource requirements of their internal delivery programmes.

It all comes down to a sense of urgency

The RDIP for most firms is currently sitting in the *'important but not urgent box'*. On the other hand, coping with the impact of global financial crisis and recession is consuming most top management time and filling the *'important and urgent box'* (unless of course the firm is also in the middle of a merger in which case this particular box is probably about to burst at the seams). This is despite the huge strategic importance of the Retail Review and the opportunities it creates to generate innovative sources of short and long term competitive advantage. There tends to be lots of discussion, internal meetings and attending conferences by middle management but not enough effort mobilised on the practical analysis necessary for the top management team to drive out the best options and decision making for their firm. The FSA will consult in June 2009 on detailed Handbook changes. They also intend to consult on phasing in some of the proposals ahead of 2012 and say '*We encourage the industry to continue to take more immediate steps to transition ahead of regulatory requirements to do so, as many have already, for instance by upgrading qualifications and changing their remuneration practices and systems.*

We think that industry inertia is an emerging threat and say "*Danger Will Robinson!*"

Finding a PATH through it all

Most firms have a change management process which in generic terms has phases such as:

<u>Initiate -> Study -> Design -> Build & Test -> Implement -> Commercialise -> Review</u>

It is also worthwhile remembering some of the biggest drivers of success for major change programmes :

Sponsor at top level and high profile
Key players and resource engaged
Vision of the future clearly articulated
Urgency
Communication regularly at all levels
Strong project management
Quick wins

At present work should certainly be advancing rapidly in the *Initiate* and *Study* phases. There are some areas where the eventual regulatory outcome is certain in structure but lacking in detail, so prototype *Design* work could also be done.
A typical sub process to generate results at the *Study* stage is:
Data -> Information -> Analysis -> Insight -> Scenarios -> Decision
In a big and complex provider firm it is often surprisingly difficult obtain the necessary *Data* and *Information* fundamental to good quality *Analysis* and producing a clear 'snapshot' of the current situation. It may be necessary to make 'informed approximations'. The ability to model a range of future possible scenarios follows on from this solid base of understanding.

Everything has to start somewhere

The following set of **Provider Analysis Templates** suggest a selection of key actions in some major areas of focus for RDIP driven change such as **1) Strategy, 2) Products, 3) Distribution, 4) Finance + Actuarial, 5) IT** . The actions can start now and are generated from the FS 08/6 Retail Distribution Review document henceforth referred to as RDIP (Retail Distribution Implementation Plan).
The Health-check for any firm is to identify which Actions on these Templates are 'completed', are 'work in progress' or have 'not yet been considered'. This set of Templates is relevant for Life Companies, Banks, Fund Managers and Platforms and is a starting point for action rather than providing a Mutually Exclusive Collectively Exhaustive bespoke list which is suitable for the circumstances of any one particular firm.

1) Strategy Template

Factor the impact of RDIP into 3 – 5 year strategic plans, particularly how it will change the financials for transition years 2010 – 2012

Apply a range of strategy analysis tools to improve understanding of the strategic impact. Consider Porters 5 forces looking at each of 'bargaining power of buyers', 'bargaining power of suppliers', 'threat of new entrants', threat of substitute products' on the 'rivalry among existing competitor firms'. Pay particular attention to low cost retail customer focussed 'New Entrants' such as Tesco in banking and Vanguard in fund management. Also the accelerating trend to commoditisation of product wrappers which leaves sources of innovation, differentiation and long term competitive advantage in the investment and risk control elements of the customer proposition.

Use scenario planning to drive understanding of the emerging market dynamics. Investigate combined scenarios on shape and impact of recession, RDIP (early/late adoption by key market players) and Personal Accounts from 2012. Pay particular attention to customer finances and attitudes to risk and savings. The FSA say in summary: *The market is developing and changing and we all need to be prepared for this. Our financial capability work, and a possible national Money Guidance service, should result in increasing numbers of consumers being better informed and more capable when using financial services. The introduction of auto-enrolment with Personal Accounts in 2012 will mean many consumers will be faced with new choices about their pension provision. The growth of platforms and wrap-based services means that the way investment services are delivered is changing with more emphasis on the underlying asset allocation, risk and performance than on product selection. Also the impact of the current level of personal indebtedness may yet cause a shift towards a savings culture where more people will seek expert help with their financial decisions*.

Map out the 2008 market total new business by product, channel, profit pool and your firm's market share. Project this forward year by year on various scenarios of volume and margin. Investigate what action is necessary to support high level corporate targets for profit, new business and retention of in-force.

Check current strategy and plan is coherent with FSA desired outcome for RDIP:
• *an industry that engages with consumers in a way that delivers more clarity for them on products and services;*
• *a market which allows more consumers to have their needs and wants addressed;*
• *standards of professionalism that inspire consumer confidence and build trust;*
• *remuneration arrangements that allow competitive forces to work in favour of consumers;*
• *an industry where firms are sufficiently viable to deliver on their longer term commitments and where they treat their customers fairly; and*
• *a regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.*

Do a reality check on sources of competitive advantage short, medium (through transition to end 2012) and long term such as diversity of channel access, low cost manufacture, strength of distributor relationship etc. Repeat this process on key competitors.

Analyse the pros and cons of switching to the new regime at 'earliest possible date' versus 'latest possible date'. Also analyse the pros and cons of any potential period of 'parallel running' during the transition period.

2) <u>Products (and Advice Tools) Template</u>

List all products in all business lines under broad categories: new product under development, current actively marketed, legacy part-open (eg increments as contractual right) and legacy-closed. For each product show: channels of distribution by volume , relative importance by profit and volume, summary of charging structure and mechanism (implicit or explicit by unit cancellation), commission options and levels, special deals, factory gate price/commission free terms available. This will indicate potential scope for product range rationalisation and simplification of charging structures when moving to factory gate pricing for independent advice channel distribution (no place for complex charges post RDIP). Principle of rationalising product range and simplification of charging structure applies even more strongly to non-independent channel even though factory gate pricing and exact matching of deductions to fund cost of advice may not be necessary. This particularly applies where a 'rebadged' complex IFA product has simply been plugged for expediency into a bancassurance channel at sometime in the past.

Identify any other areas of product or service to consider in scope for the firm as the RDIP applies new standards for all investments, not just packaged products eg Private Banking services..

Identify possible ways in which RDIP proposals for Adviser Charging and other high level changes might be applied to the corporate pensions market and corresponding products such as Group Personal Pensions.

Investigate possible RDIP response of external portals and product analysis services to support best advice panels. The FSA say *'we want consumers to see independent advice firms as being equipped to give comprehensive and fair analysis of their relevant markets …. we propose to modernise the requirements that independent advisers have to meet in making suitable recommendations'* Any change in criteria for rating products and services by third parties or internal 'panel selection' teams of major intermediaries needs close monitoring to maintain competitive positioning.

Note that factory gate pricing may not be required for non-independent advice channel. Also RDIP acknowledges that the 'factory gate price' may vary according to channel due to different business mix and persistency. As the FSA wants to allow both independent and non-independent advisory services to be offered by the same firm, then providers must examine how to keep the two parallel product lines separate but coherent in terms of design and systems. This increases complexity of business model therefore cost and risk for providers. RDIP comments on the impact on firms offering non-independent services as follows:

5.21 While it is perhaps unsurprising that the same remuneration standards could usefully be applied to what are currently described as multi-tied advisers as to independent advisers, it is less obvious that advisers employed by banks and other product providers – to advise solely on their own products – would be able to adopt exactly the same standards. So we may need to apply requirements in different ways for different types of non-independent firm, but in doing so we will want to remain focused on delivering equivalent outcomes for consumers.We aim to hold discussions with both the independent and non-independent sector to determine the best way forward as we work up our detailed proposals ahead of consultation in June 2009.

5.22 We are particularly keen to apply equivalent disclosure of charges to all types of firm. However, providing the right information to consumers to help them to make informed choices is not a straightforward task. Although firms have had to disclose their own costs in the past they have not previously had to consider what a customer actually pays through implicit or explicit charges for different elements of the full service. Putting a figure on this may be an arbitrary process for some as the cost of the product and advice is tied up in aggregated charges, and there are lots of cross subsidies within and between the product portfolios of a firm. But a low stated charge for advice could be mirrored by a higher implied charge for the product – it may not be easy for a firm to offer competitive cost elements for both simultaneously.

5.23 We will also consider the banking reform work we are doing on internal remuneration and how this may assist achievement of the standards we require. The recent 'Dear CEO' letter contains a number of points that could be read across to remuneration practices for advisers. For example, the traditional model of a base salary with significant extra bonus payments made on the basis of revenue generated (i.e. products sold) may lead to advisers being primarily motivated to sell products to consumers rather then offer appropriate advice. Any adverse consequences can be partly mitigated by scaling bonus payments according to certain 'quality' factors, which may include persistency. How effectively these arrangements address the risks of poor consumer outcomes often depends, however, on how well management exercises broader controls over sales activity.

Review collective investment scheme and structured product charging structures. Note that fund managers offering trail commission through share of annual management charge (amc) on an OEIC may find this practice is no longer allowed for business from independent advice firms. There is a need to study the impact of requiring a 'factory gate' price with lower amc and trail 'adviser charging' by cashing in shares. This may have tax and other implications for customers and will impact OEIC administration systems..

Platforms (particularly WRAPs) offered by a product provider which restrict choice of products or' transfers off' are not likely to allowed as product recommendation from independent advice. Review all platforms for availability of truly open architecture functionality and if the firm owns a platform then assess the effort to allow it to comply.

Review pricing strategy across the product portfolio for all distribution channels. Note relevant FSA comments in RDIP:

5.55 We also need to consider pricing issues for non-advised transactions. Often the cost to the consumer of buying certain products, particularly life assurance products, is the same whether they take advice or not. However, if we are to require for independent and non-independent advice, that there is separation of the cost of advisory services and the cost of the product, then a consumer might expect a lower price when buying products directly without taking any advice.We would not necessarily expect a provider's product costs to be the same for all channels of distribution, and prices may reflect many factors including different target customer characteristics (e.g. propensity to lapse, and where relevant, mortality experience) and different marketing costs.

5.56 With Execution-Only transactions there can still be an intermediary (e.g. 'Discount Brokers'), and we intend to apply similar disclosure standards so that the costs of their services are separated out.We will also consider how professional standards should apply to individuals providing intermediation services but who are not providing advice. However, as with non-advised guided sales, standard setting would fall to the Professional Standards Board in the same way as we anticipate for those supplying forms of advice.

List and Review the full current portfolio of advice related tools owned by the firm (or operated by third parties which incorporate products from the firm). This will include portfolio risk analysis, asset allocation, fund selection, income drawdown etc. and may be available by internet, software on distributors platform or 'on request analysis' direct to the firm. Check each for product charges or commission specific elements which need to be changed for RDIP.

Check any tool offered by the firm and used by the independent advice channel for fund selection to ensure the underlying criteria are transparent, unbiased and consistent with the tighter independent adviser requirements from RDIP.

3) Distribution Template

Identify for the market overall and particularly for the firm's current new business producers (and in-force business servicers) which IFA businesses are sustainable in the long term under RDIP. This requires data and analysis of their ownership, size, personnel, qualifications, capitalisation, access to capital, cost base, cash flow and current business model. Focus initially on biggest IFAs by volume and profitability + persistency of new business

Form a view on current supporting IFAs as to whether they will make transition to post RDIP marketplace (or simply exit in 2012 because they cannot meet the qualification, capital or new customer advice process requirements). If continuing then identify whether this will this be as an independent or non-independent or hybrid

(offering both) advisory firm. Decide appropriate way of managing down the firm's commercial relationship with IFAs planning to leave the sector due to age and lack of qualifications. In this case indemnity/factored commission, in-force book size, persistency and orphan clients are all a consideration.

Identify 'fee based' and any other IFAs most likely to make their business model fit a post RDIP marketplace. Strengthen relationships with those already producers and develop new relationships with those who are not.

Consider the impact with and without a read-across of RDIP to Mortgage and General Insurance markets where your firm is active in more than one area.

Develop business modelling and financial analysis tools collaboratively with current key IFAs to assist them in managing their transition to a sustainable business model post implementation of RDIP. This will also help identify the attractive business distribution partners who will thrive post RDIP.

Check any in-house wealth management advice processes and ensure they will meet RDIP criteria.

Examine feasibility of creating (or expanding an existing non-independent channel of the firm) from IFAs exiting the independent sector but sufficiently well qualified to stay in the industry in a customer advisory role

Review all simplified or focussed sales processes used by the firm to see how these relate to RDIP proposed new 'non-independent advice' , ' guided sales' and 'other non-advised sales' categories.

Create options as to how the proposals for independent firms could be applied to the current business model and remuneration structure for non-independent advisory firms (the biggest of these being bancassurance). RDIP proposals are:

a. *we expect adviser firms to decide on their standard charges for different services in advance of meeting clients*
b. *adviser firms would also need to make clear to each of their clients individually what services they are to receive, and how current or future charges will cover them*
c. *any new pricing structures that adviser firms adopt would need to be compatible with the firm giving impartial advice*
d. *advisers will need to be aware of how the new approach to their remuneration may affect the advice they provide.*

Document and review any non-advised sales processes in the firm. RDIP highlights FSA concerns about non-advised processes and firms understanding of the boundary. Any such processes in operation or planned by the firm should be examined in light of the current FSA view which is:

5.38 Non-advised guided sales services can be delivered within the current regulatory regime. However, it appears that firms may be unclear about what does and does not constitute advice regulated by us. For example, we have seen business models for new services that the designers intended to be non-advised processes, but that would constitute investment advice under our rules because the process added up to an implicit 'personal recommendation'.We recognise the attraction for the industry of reduced liability associated with a non-advised service, but in light of the risk of crossing the boundary into advising on investments, or providing what might be interpreted as 'advice' under the general law, firms may derive greater certainty if they design their models as advised processes that satisfy the suitability standard.

5.39 This lack of clarity about what does and does not constitute advice could potentially deter firms from offering non-advised guided sales services.With this in mind, we are publishing a set of Questions and Answers which were originally developed for the roundtable group we refer to above, to help them better understand the boundary between advised and non-advised processes. This material, which can be found in Annex 7, should be of assistance to firms developing new processes in helping them assess whether their process is advised or non-advised and the reasons why.

List and review all contractual 'terms of business' with internal and external firms to identify what needs to change and by when to reflect RDIP proposals.

4) Finance + Actuarial Template

Form a high level view on RDIP impact on the firm's cash flow, cost base, risks in business model, return on capital, capital requirements and routes to raising capital.

Complete an initial assessment of the accounting implications and Solvency II reporting impact from 2012 for the RDIP changes given significant changes to product portfolio design, cash flow and capital requirements.

Investigate impact of change to factory gate pricing for all IFA new business products on volumes, mix , profitability signature (IRR, payback period, cash flow, sensitivities), lapses, capital required, regulatory and management reporting.

Review all cost modelling and Activity Based Costing expense analysis. Separate customer disclosure will be required of cost of 'advisory services' and 'product costs' for both independent and non-independent advisory firms (eg bancassurance and direct channel). Increased transparency and focus on these costs suggests a critical review of the quality of current cost modelling and allocation in the firms product provider business unit and similarly for any in- house distribution channels. Independent advisory firms will correspondingly need to understand their cost base and drivers to build a realistic 'Adviser Charging' structure. Note the RDIP statement '*we are particularly intent on consulting on separate disclosure of the costs of advisory services from product costs for both independent and non-independent advisory firms'.*

Analyse and develop an appropriate risk based discounting basis for factoring of Adviser Charging. This may be necessary to smooth the transition for current IFA firms from current to new marketplace rules post 2012. Understand associated risks and selection criteria for IFAs to benefit from factoring based on analysis of their business model with quality, persistency and volume of past new business (include maintenance of previously introduced in-force book).

Benchmark current costs for independent and non-independent channels against key competitors as increased transparency and disclosure will reveal low cost operators and profit margins in a competitive marketplace.

5) IT Template

Prepare an updated consolidated and comprehensive systems architecture map for the enterprise.

Prepare an updated consolidated and comprehensive process map for the enterprise.

Include in systems architecture and process maps the elements of any end to end process performed by external third parties such as Platforms or distribution firms (independent or non-independent advice)

Identify and list all elements of systems architecture and process supporting commission calculation & payments, product disclosure, FSA reporting, deduction and accounting for product charges. Validate by mapping this to the product portfolio comprehensive list.

#. Consider how to replace current calculated commission amounts with an 'Adviser Charging' rules base unique to each adviser firm and which may vary according to type of advice given (therefore separate for independent advice and non-independent advice but specific to the customer and product). Also, consider scope for customisation per new business case to take adviser input for special terms. Use this to drive directly product charging on an exact matching basis by deduction from sterling premiums or unit cancellation from customer product. Identify how validation and limits might operate as part of automated prudential controls.

Identify all systems for Product Sales Data reporting to FSA. Study the feasibility of replacing current persistency reporting requirements with additional information in Product Sales Data regarding number policies terminated during a reporting period split by product type and advisory firm.

Map the RDIP High Level Provisional timetable (6.12 Table 1) against the firms ‘business transformation’ or ‘enterprise wide’ plan for IT, processes and people. Highlight ‘hot-spots’ on resource and risk recommending what mitigation could be put in place.

Investigate impact of early or late ‘big-bang’ implementation of change and alternatively the phased introduction of change components (with and without periods of parallel running). This phasing could be by distribution channel or by product line. Particularly look at complexity of implementation and associated risk.

For more information or to discuss this White Paper please contact Harry Taylor.

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About HARRY TAYLOR BSc (Hons) FFA FSAI

Harry Taylor is an independent actuary and business consultant with extensive commercial experience of insurance, pensions, investment and banking. He has been director at several of the UK’s major financial services companies leading proposition development, marketing and operations (including outsource). He specialises in creating and delivering innovative solutions for financial services firms to solve complex problems and develop new opportunities. Consulting specialist areas are Innovation, Strategy, Proposition Development & Marketing, DC Pensions, Workplace Savings, Platforms, Auto Enrolment, Default Funds, Segmentation and RDR.