



# Navigating the post-RDR landscape in the UK

Assessing the potential impact of an  
RDR regime on the European fund industry





# Navigating the post-RDR landscape in the UK

---

Assessing the potential impact of an  
RDR regime on the European fund industry



FUNDSCAPE

© Fundscape 2014  
Maritime House  
Old Town  
London  
SW4 0JW  
United Kingdom

[www.fundscape.co.uk](http://www.fundscape.co.uk)

All rights reserved. No part of this publication may be reproduced, stored in any retrieval system, or transmitted in any form or by any means without prior permission of the publishers.

While all due care has been taken in the preparation of this publication, and comment and opinion contained in it is given in good faith, the publishers make no warranty and accept no liability in respect of any information given in it.

#### **IMPORTANT NOTICE**

This document was commissioned by ALFI. It was produced by, and the opinions expressed are those of Fundscape LLP as of the date of writing. It has been prepared solely for information purposes and the use of the recipient. The information and analysis contained in this publication have been compiled from sources believed to be reliable but Fundscape LLP cannot guarantee their accuracy or interpretation. This document does not constitute investment advice and should not be acted upon as such. Fundscape LLP does not accept liability for any loss arising from the use hereof. This report is not intended to be a substitute for detailed research or the exercise of professional judgement.

Cover and template design: Louis Mackay / [www.louismackaydesign.co.uk](http://www.louismackaydesign.co.uk)

## ACKNOWLEDGEMENTS

We would like to thank the following people who contributed invaluable thoughts and insights for this report. Their contributions not only formed an important part of the research process, but also shaped and guided our thinking on the lessons to be learned from the RDR.

Marcel Aaldering, Global Product Development, Robeco  
Brice Anger, Country Head France & Belgium, M&G  
Micaela Forelli, Director Global Banks, M&G  
Tiziano Giannotti, fund expert, Italy  
Peter Grimmert, Head of Fund Regulatory Development, M&G  
Marco Gruiters, Manager Sales Planner & Market Intelligence, Robeco  
Gavin Haynes, Managing Director, Whitechurch Securities  
Bob Hendriks, Head of Retail Netherlands, BlackRock  
Hans Janssen Daalen, CEO, Dufas (Dutch fund and asset management association)  
Diana Mackay, CEO, Mackay Williams  
Richard Mertz, fund expert, Germany  
Christian Pellis, Global Head of External Distribution, Amundi  
Laurent Ramsey, Group Managing Director, Pictet  
Keith Richards, CEO, Personal Finance Society (PFS)  
Patrick Smith, fund expert, Spain  
Tony Stenning, Managing Director, Head of UK Retail, BlackRock  
Chris Suiker, Head of Wholesale Distribution, Robeco  
Willem van der Scheer, Investment Manager, ING  
Philip Warland, Head of Public Policy, Fidelity  
Jonathan Willcocks, Managing Director, Global Head of Sales, M&G

### **Data**

European Central Bank (ECB)  
Eurostat  
Financial Conduct Authority (FCA)  
Investment Management Association (IMA)  
Lipper FundFile  
Matrix Solutions Financial-Clarity database

## ABOUT FUNDSCAPE

Fundscape is a research house specialising in the end-to-end research and analysis of the UK fund industry. It is the publisher of the quarterly Fundscape Platform Report, widely regarded as the industry benchmark for platform assets and flows in the UK. With many years' industry experience, its staff are well placed to provide unique insight into asset management and distribution trends, including product development, distribution and marketing.

### **Bella Caridade-Ferreira, CEO**

Bella has 17 years' experience in the research and analysis of the UK, European and Asian asset management industries. She set up Fundscape in 2010, a research house specialising in the end-to-end analysis of the UK fund industry. Before setting up Fundscape, she worked for Lipper FMI as Global Head of Research and Publications and was the author of numerous publications and reports including the popular European and Asian Data Digests.



Early in her career she worked in investment banking and then for a London-based consulting firm where she specialised in market entry strategies for retail and institutional asset managers. She has a master's degree in International Business and is fluent in four languages.

### **Phil Beattie, Consultant**

Phil is a consultant with over 15 years' experience working within distribution teams as a business and product strategist. He has covered UK and Continental European markets, mainly focusing on retail business ranging from execution-only to private banks and family offices. In his most recent role as Head of UK Business Management for JPMorgan Asset Management, key responsibilities included development of UK strategy and management communications, new business initiatives, oversight of CRM, compensation and management information programmes, and product strategy. Phil is a CFA charterholder.



# CONTENTS

11 Executive summary

## **PART ONE**

17 **Chapter 1: RDR: A review of key objectives**

17 RDR objectives and delivery

19 Platforms

21 TCF and other regulation

23 **Chapter 2: The run-up to RDR**

23 2011

25 2012

26 Mid-year point

27 **Chapter 3: A year in RDR country**

27 Taking in the orphans

28 Brave new world

30 Changes in the distribution model

32 DIY or corporate

32 Simplified advice

33 **Chapter 4: Impact of regulation on demand**

34 Supply-side reform

35 Demographic drivers

36 Reaching a broader audience

37 The UK Budget - using pensions for change?

38 The rise of execution-only business

39 Orphaned clients

40 Potential for new entrants

43 **Chapter 5: Impact on distribution**

44 Changing advice landscape

45 The demise of bancassurance advice

46	The changing face of the adviser market
51	Investment propositions
55	<b>Chapter 6: Impact on manufacturers</b>
55	The impact on fees - a red herring?
56	The operational impact
58	The effect on distribution and changes to product strategy
61	<b>Chapter 7: Impact on investment choices</b>
62	Passive move
63	Solutions
67	<b>Chapter 8: Concentration of influences</b>
68	The institutionalisation of the retail market
69	Platforms as influencers
70	What does this mean for fund managers?
73	<b>Chapter 9: Competition across the value chain</b>
74	Outsourced adviser business
75	Vertical Integration
77	Intercompetition
	<b>PART TWO</b>
81	<b>Chapter 10: The Dutch inducement Ban</b>
81	Size and scope of the Dutch industry
82	Historical development
84	Terms of the ban
85	Impact of regulation
91	<b>Chapter 11: Impact of RDR/MiFID on Europe</b>
92	Size and scope of the European fund industry
93	Retail banking channel
95	Private-banking and wealth management units
98	There may be trouble ahead
99	To be or not to be unbundled?

101	<b>Chapter 12: Potential impact on France</b>
102	French distribution model
104	Impact of MiFiD regime
104	Impact of harsher RDR-style regime
105	<b>Chapter 1: Potential impact on Germany</b>
105	German distribution model
106	Different types of advisers
107	Stricter regulations
108	Impact of MiFiD regime
109	Impact of harsher RDR-style regime
110	<b>Chapter 14: Potential impact on Italy</b>
110	Italian distribution model
113	Impact of MiFiD regime
114	Impact of harsher RDR-style regime
115	<b>Chapter 15: Potential impact on Spain</b>
115	Spanish distribution model
116	Independent financial advice
116	Impact of MiFiD regime
117	Impact of harsher RDR-style regime
119	<b>Chapter 16: Lessons to be learned from RDR</b>
119	Key differences between the UK and Europe
120	Positive engagement
121	Regulation will not kill the industry - demography is on our side
123	The advice gap and expanding beyond the 10%
125	What can the regulator do better?
128	Change needs to be embraced rather than feared

## **APPENDICES**

130	Glossary
135	Tables and charts



## Executive summary

### Opportunity or threat?

- The Retail Distribution Review (RDR) is a ground-breaking piece of legislation that came into effect on 1st January 2013 after eight years of discussion, debate and consultation. It fundamentally changed the way distributors are remunerated in the UK, breaking the formal link between product manufacturer and distributor.
- In the months (and years) leading up to RDR, many industry stakeholders had predicted that the UK financial services would implode under the weight of such radical regulation and that investors would simply disappear. However, these commentators failed to grasp the fact that this was a supply-side and not a demand-side reform.
- Latent demand or need for investment product per se has not been altered by RDR (although it may ebb and flow in line with the markets), but it is clear that access to advice and product has been disrupted, and in some cases, severely so.
- Investor demand will continue to grow in the long term. Demographic drivers such as ageing populations and the gradual reduction in state pension coverage will increase demand for long-term investments and savings.
- In the UK this has already begun with Auto Enrolment and the pension reform announced in the 2014 budget abolishing mandatory annuities, which will lead to increased demand for post-retirement advice and products.
- The impact of these changes on the shape of distribution is unclear, but the opportunity for the investment industry as a whole and manufacturers in particular is significant. It is therefore critical that all parts of the investment industry engage with employers, consumer groups, regulators and the government to address these issues in advance. This will lead to a better solution for consumers in the longer term, which will ultimately benefit the investment community as well.
- However, the expansion of the market through pension reform creates new avenues of opportunity for delivering investments and advice through the workplace including automated advice or access to simplified advice.
- The value of advice is still largely misunderstood by mainstream investors. There is an opportunity for the industry as a whole and financial advisers in particular to engage with consumers and demonstrate the value of the services they provide... but they may need to be innovative about how to do so. Charging a large upfront fee may put off investors. Other options include education, or employers paying

for an initial consultation in partnership with advisers, with the costs being repaid once clients are signed up.

### Impact on UK distribution landscape

- Unlike Europe, the UK distribution landscape is dominated by financial advisers and wealth managers, with the other channels accounting for smaller shares. A key concern was that the landscape would be severely disrupted by RDR. The advice channel was expected to contract significantly as a result of older financial advisers leaving the industry because of their unwillingness to qualify and/or move to a fee-based advice, as well as investors being unwilling or unable to pay for advice.
- Flows by distribution channel for the first year of the post-RDR era show that the advice channel has remained fairly stable. The most dramatic changes were in the retail banking channel which saw flows plummet as a result of an almost universal withdrawal from advice.
- The execution-only channel was also home to an upturn in flows. A recovering UK economy and a marked upturn in investor sentiment was a driver of increased flows, but RDR was also a driving factor.
- One reason for the growth of execution-only business was that advisers had evaluated the cost of advice, segmented their client base and found that it was too expensive for some clients, or it was too unprofitable to service some of their more modest clients. This led to customers being orphaned by their advisers.
- As a result of banks pulling out of advice, customers being orphaned by their advisers and/or being unwilling to pay for advice, an advice gap was born. The existence of this advice gap is the one area in which the regulator has singularly failed to meet its objectives of bringing better quality advice and better investment outcomes to retail investors.
- Taken together, these trends make it likely that unadvised business will grow in the medium term in the UK. As the investment industry is a normally functioning market with fairly low barriers to entry, it is likely to encourage new entrants into the market including non-traditional providers such as supermarkets.
- The biggest operational impact on the fund industry has been the move to clean or standard share-classes (commission-free), including an inevitable proliferation of share-classes to handle pre-and post-RDR business.
- One unwanted consequence has been the creation of exclusive share-classes, which may cause problems and additional expense for investors when transferring from one platform to another where those share-classes do not exist. These are issues that remain as yet unresolved.
- With advisers now in the driving seat, the focus on price has been inevitable but it has also played out in unexpected ways. For example, consistent alpha-generators

are able to charge a premium for their funds over and above the typical 75bps price, and at the other end of the scale, passive solutions have fallen to new lows with Fidelity charging just 0.07% for its UK tracker fund. Competition is toughest therefore for fund managers that sit somewhere in the middle of the price and performance spectrum.

- There has also been a substantial rise in packaged products such as funds of funds and risk-profiled solutions that allow advisers to provide a relatively low-cost and low-touch service. As a result of this trend, influencers and gate-keepers are increasing their overall control of the industry. Fund managers need to learn to dance to a new drumbeat.

### Potential impact on Europe

- In contrast to the UK, the advice channel in Europe is fairly small. The non-independent banking channel in Europe is the largest, controlling almost half of all European fund assets (46% or €3trn). As a result, MiFID would have less of an overall impact on Europe.
- One unwanted consequence would be to undo recent progress and reverse the ongoing move to a more open architecture model, which increases competitiveness.
- For fund managers, competition is far more intense. The move to packaged products or guided architecture solutions will tend to favour the larger generalist players that can work with large distributors across all their offerings and all asset classes. Model portfolio advisers and other influencers will also need to be courted.
- The fledging advice channel, which represents just 11% of total fund assets in Europe is the channel most at risk from the ban on inducements with potentially damaging consequences. However, protecting the industry alone is not sufficient justification for avoiding regulation. But killing off this immature industry with an early frost does not help either. To avoid this, regulators and stakeholders need to work together on a much longer-term roadmap for moving towards truly transparent pricing.

### Key lessons to be learned

- **Glass half-full approach.** Regulation can represent both an opportunity and a threat to industry participants. In the UK new solutions have begun to emerge in the wake of the advice gap. Legislation can create new opportunities for industry participants that are willing to adapt.
- **Positive engagement.** The main message for industry stakeholders has to be 'engage, engage, engage' as this will ensure that many of the pitfalls that have befallen the industry are anticipated and avoided.

- **Avoid uncertainty.** As for the regulators and the law-makers, it is important to remove uncertainty as much as possible with a clear timetable, an assessment of the regulatory cost over the period, and more importantly, a review of the downstream effects of regulation and how they should be addressed.
- **Advice gap.** The biggest failing of the RDR is the advice gap. Removing the cross-subsidy inherent in *ad valorem* management fees and advice charges may be fair, but the problem with the RDR is that it did not replace it with anything, or consider the downstream impact on lower-value customers.
- **Level playing field.** Another downstream effect is the potential for distortion of the market because of uneven playing fields or adjacent markets that are not in scope. The staggered introduction of overlapping legislation such as Prips, MiFID2 and IMD2 could lead to an unwanted and unfair distortion of the market and should be avoided at all costs.
- **One size does not fit all.** Europe is a patchwork of different markets at different stages of development and with widely differing distribution models. Regulators need to be careful of stifling advice in markets where independence and fees are less well-established, while recognising and working towards the long-term benefits.
- **The elephant in the room.** MiFID regulation does not address the vertically integrated value chains of most European banks which represent roughly half of all European assets. The way this is going to be addressed by EU regulators is still unclear. If not addressed, it has the potential to affect the main fund distribution channels in continental Europe and create an uneven playing field.
- **Improve consumer understanding.** Overall, measures that will improve consumer understanding and access to investment product should be encouraged, and the industry needs to do a far better job of educating consumers to achieve this.
- **Building blocks or solutions.** For mainstream investors, the shift to solutions is a Europe-wide trend. Fund managers can help themselves by deciding early on whether they simply want to provide the building blocks or deliver ready-made solutions. One good outcome of this legislation is closer working relationships between manufacturer and distributor.
- **Best for all.** Regulators and the industry need to work together to ensure clients of all sizes can access affordable advice and investment products, which will ultimately drive significant growth for the industry and lead to more satisfied customers.

# *Part one*

*Navigating the post-RDR  
landscape in the UK*



## Chapter 1: RDR: A review of key objectives

The Retail Distribution Review, or RDR, formally came into effect on 1 January 2013. However, this simple statement masks a hugely complex array of consultations, discussion papers and other regulation that have fundamentally reshaped the UK retail marketplace over the last few years. To provide some background, the RDR was first introduced by the then chief executive of the FSA, (Financial Services Authority) John Tiner, in a speech in June 2006, more than six years before it was introduced.

A review conducted by the FSA had concluded that there were severe failings in the market, which a major new review was designed to address. These included:

- low levels of financial capability among consumers
- poorly designed and unnecessarily complicated products
- lack of persistency for life and pension policies
- commission structures that created product bias, provider bias and churn risk
- poor professionalism in parts of the advice sector
- and unintended barriers to change created by regulation.

Between then and the final regulation coming into effect, the FSA issued 15 policy statements and almost 30 consultation papers of various kinds<sup>1</sup>. This complexity was the result of constant engagement between the FSA and other stakeholders in the market including industry associations, financial advisers, fund management groups, platforms, consultants and consumer bodies. No regulator considering similar regulation should underestimate the effort required to deliver a coherent and workable proposal, although lessons can be learned from the UK experience.

### RDR objectives and delivery

Despite the complexity of the process, the objectives of the RDR remained consistent throughout. These were to:

- maintain an industry that engages with consumers in a way that delivers more clarity for them on products and services
- create a market which allows more consumers to have their financial needs and wants addressed

---

1. FSA RDR Library <http://www.fsa.gov.uk/about/what/rdr/rdr-library>

- have remuneration arrangements that allow competitive forces to work in favour of consumers
- maintain standards of professionalism that inspire consumer confidence and build trust
- have an industry where firms are sufficiently viable to deliver on their longer-term commitments and treat their customers fairly
- build regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.

The initial paper focused a lot on the concept of a two-tier advice system, consisting of 'Professional financial planning and advisory services' and 'Primary Advice'. The aim of the Primary Advice segment was to fill a perceived gap for consumers who could afford to save, but could not necessarily meet (or require) the cost of a full advisory service. This later became known as *Simplified Advice*, but this distinction was eventually dismissed as unworkable, partly because the standards required for an adviser to give simplified advice were the same as for full advice, reducing the incentive to offer the service.

By the time the FSA Consultation paper was released in June 2009<sup>2</sup> the proposals sought to:

- improve the clarity with which advice firms describe their services to consumer
- address the potential for adviser remuneration to distort consumer outcomes
- increase the professional standards of investment advisers.

The first of these was the successor to the *Primary* and *Simplified advice* ideas. Put simply, it requires advisers to disclose whether they cover the whole of the market (unrestricted advice) or are restricted either by product type or by the manufacturer(s) whose product they are able to sell (restricted advice). Restricted advisers are forced to disclose upfront the nature of the restriction, and where appropriate, advise the client to seek advice elsewhere if alternative products could be more suitable.

The second aim is perhaps the most contentious part of the whole programme, and has already generated significant debate in Europe. Essentially, its aim was to ban bundled commissions and force advisers to disclose the full cost of their remuneration upfront. One element that is often overlooked is that the rules also banned factoring, meaning that financial advisers had to charge their fees in the year the service was provided. Ongoing payments not tied to a service were effectively banned, even if the customer was notified.

---

2. FSA CP 09/18

3. FSA PS10/6 and PS11/1

The third is self-explanatory, and the FSA was very open about the fact that it expected this to cause a reduction in the number of advisers in the UK market, and that they did not believe this would harm flows. The evidence so far bears out both of these points.

After a consultation exercise, the three proposals above were formalised in Policy Statements issues in June 2010 and January 2011<sup>3</sup>, with the former covering the first two proposals and the latter concentrating on adviser standards. This sent the industry into action as advisory firms rushed to get individual advisers qualified and providers sought to understand how the new rules would impact their business models.

## Platforms

However, in parallel, other regulation continued to overlap with the RDR. The role of platforms had been acknowledged right at the beginning by the FSA, as they had released a second discussion paper covering the role of wraps and fund supermarkets (see next page for definitions). However this thread had been somewhat lost in the intervening period, but industry feedback forced the FSA to return to the issue with a further discussion paper in March 2010.

This eventually led to a policy statement being issued in August 2011, to come into effect with the rest of the RDR at the end of 2012. The first issue this sought to address was to define a platform, which proved to be a harder task than it might appear. The FSA received a huge range of views from affected parties, but eventually settled on a definition whereby platforms were defined as an administration service, whereas as Sipp and other insurance wrappers were defined as products and were therefore excluded.

From a consumer perspective, the paper aimed to address three issues:

- the role of platforms in the facilitation of adviser charging
- rules regarding re-registration of assets from one administrator to another
- and the availability of relevant fund information to the end consumer.

Of these, the first had been a huge bone of contention in earlier drafts of the RDR when the FSA had sought to encourage fund managers to play a role in overseeing adviser charging. This had brought a concerted response from the fund management industry pointing out that the majority of retail business was now aggregated by platforms before being placed with fund managers, and as a result they had no way of knowing what individual arrangements were.

### DEFINITION OF A PLATFORM SERVICE

Platforms are online services, used by intermediaries (and sometimes consumers directly) to view and administer their investment portfolios.

According to the Financial Conduct Authority (FCA) a platform service is a service that involves arranging, safeguarding and administering investments, and distributes retail investment products that are offered to retail clients by more than one product provider. However, it is neither paid for by adviser charges nor ancillary to the activity of managing investment for the retail client.

### DEFINITION OF A FUND SUPERMARKET PLATFORM

Fund supermarkets were originally designed to allow advisers and direct investors a single point of access to a wide range of funds by different providers. Funds were included on condition that they rebated a proportion of their annual management charge (AMC) back to the supermarket. This meant there was no explicit charge for use of the supermarket. Indeed, the fund manager not only paid the platform provider but he also paid the adviser (trail commission). A typical breakdown of a fund AMC of 1.5% would be 0.25% (on average) to the platform 0.5% to the adviser and 0.75% was retained by the fund manager. The first fund supermarkets were really designed to buy and sell funds and there was only the ISA tax wrapper available. However, over time they began to include other tax wrappers such as pensions and unit-linked bonds, usually provided by third parties.

### DEFINITION OF A WRAP PLATFORM

Wraps were a natural extension of the services offered by fund supermarket, the key difference being that use of the platform was charged directly to the client. This allowed them to be agnostic about the investments and tax wrappers offered on platform and meant that funds and other investment vehicles were not excluded from selection on the basis of their charging structure and/or ability to offer rebates. To offset some of the platform charge to clients and to remain competitive with the fund supermarkets, favourable terms were negotiated with as many fund managers as possible. They agreed to rebate some of their charge back to the wrap client account. It is out of this account that platform charges and adviser fees (trail) were collected. The typical split of a fund manager's AMC of 1.5% on a wrap platform would be 0.75% rebated to the client account (which offsets platform charge and adviser charge) and 0.75% retained by the fund manager.

One issue not resolved by the paper was the payment of platform providers through rebates and subsequent cash rebates to the end consumer. The FSA stated its preference would be to stop both practices, but they accepted industry argument that the effect on operating models was not clear and deferred a decision until after the initial RDR implementation.

## TCF and other regulation

In addition to further policy statements and discussion papers on specific elements of the RDR, the FSA continued to emphasise its Treating Customers Fairly (TCF) initiative. This had first been introduced in 2006, and is in line with the FSA/FCA's desire to be seen as a principles-based rather than rules-based regulator. The distinction is important as it allows the FCA to retrospectively rule against practice, thereby reducing the need for the regulator to anticipate all forms of inappropriate behaviour towards customers. The key principles of the TCF initiative are:

.....

*Arguably TCF affected  
retail distribution more  
than RDR*

.....

**Outcome 1:** Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

**Outcome 2:** Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

**Outcome 3:** Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

**Outcome 4:** Where consumers receive advice, the advice is suitable and takes account of their circumstances.

**Outcome 5:** Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

**Outcome 6:** Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

This is the crux of the FCA's assessment of firm's behaviour, and the central tenet that each action must be in every individual client's interest rather than of benefit to the firm or to the client base has probably done more to affect the distribution propositions of adviser firms in the UK than even the RDR. The need to demonstrate

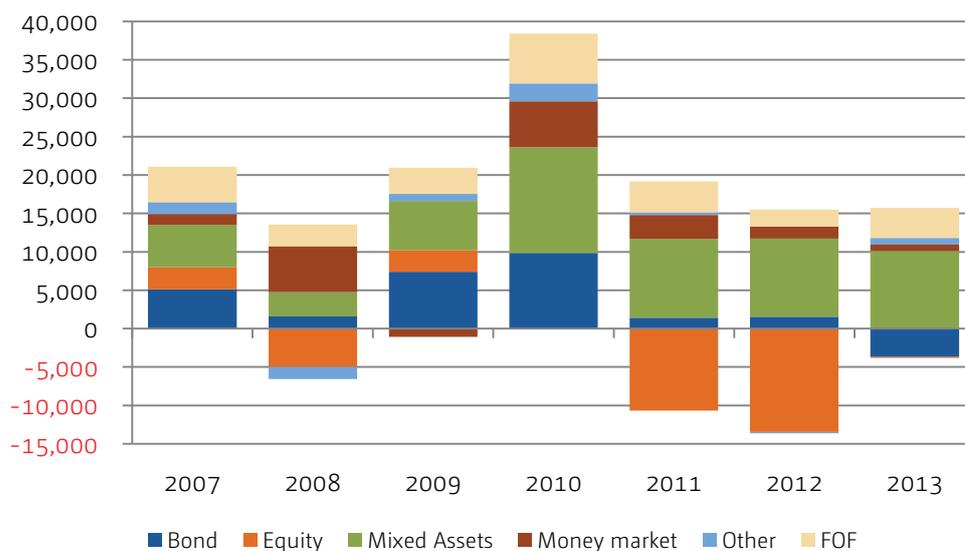
fairness to consumers has led firms to seek much greater consistency in their investment selections, which has greatly reduced the scope of individual advisers to make their own selections and build personalised portfolios.

This flurry of regulation was a lot to digest for the UK fund industry to digest and respond to, but the burden was greatest on advisers and adviser firms. Fundamentally, a large number of advisers had a significant volume of work to do to meet the new professional standards, meaning that without doing so they would be unable to carry on their jobs after December 2012. Only once they had cleared this essential hurdle could adviser firms turn their attention to their service and investment propositions, which would in turn affect product manufacturers and the platforms.

## Chapter 2: The run-up to RDR

The two years leading up to the implementation of RDR were characterised by the global sovereign debt/ Eurozone crisis, economies in deep recession, and painful austerity measures designed to get the UK economy back on its feet. The years 2011 and 2012 were particularly difficult for investors and it showed in the lack of flows to the fund industry. Having attracted robust flows in 2010 (£31.8bn exc funds of funds) the industry saw net sales fall almost tenfold to £4.4bn in 2011, a figure that was on a par with 2008 sales when the industry was in the throes of its second financial crisis. It was even worse in 2012 when the UK industry slipped into negative territory for the whole year (-£310m).

**Fig 2.1: UK net flows by asset class 2007-2013 (£m)**



Source: Lipper Fundfile. Estimated net sales.

### 2011

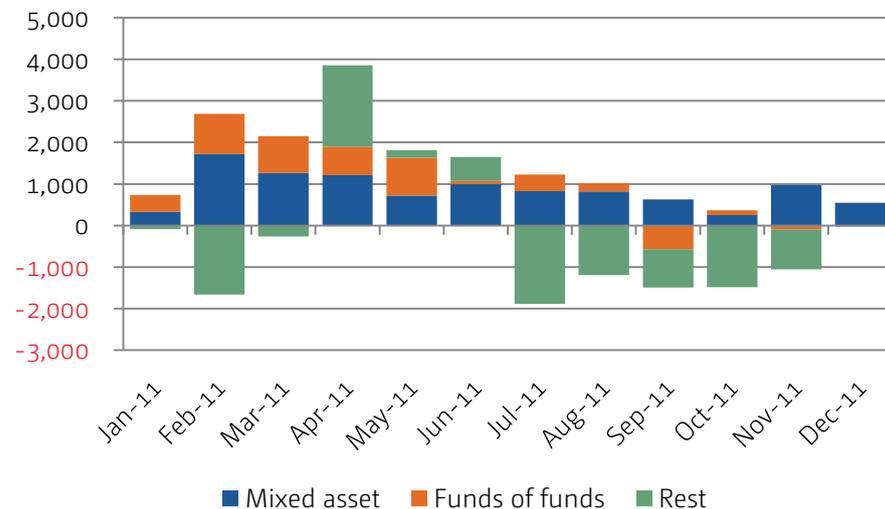
In 2010, stock markets had started to climb and sentiment was beginning to improve as a result. The feeling was shortlived however and by early 2011 austerity measures combined with the marked volatility of global stock markets, as a result of unrest in the Middle East and the Japanese earthquake, left investors not knowing quite where to turn. From then on, the situation got worse and risk aversion was heightened.

By the second quarter of 2011, for example, UK investor confidence had been badly shaken by the problems in the European government bond markets and the

increasingly gloomy outlook for the US and investors were increasingly reluctant to invest in risk assets.

However, it was in the third quarter of 2011 that the crisis really began to take a turn for the worse. Investors were spooked when US debt was downgraded at the beginning of August, leading to the sharp fall in global stock markets while the Eurozone continued to lurch from crisis to crisis. It was therefore no surprise that fund groups and distributors were glad to see the back of 2011, especially the last quarter when the Eurozone looked as though it was on the verge of imploding and investor nervousness had ramped up to new heights. Having registered net flows of £32bn in 2010, remarkably net flows stayed positive but dropped to just £4.4bn in 2011.

**Fig 2.2: UK net flows by month in 2011 (£m)**



Source: Lipper Fundfile. Estimated net sales.

Notes: Rest = bond, equity, money market, commodity and other.

For advisers, this was a particularly bleak time and their efforts were focused on helping clients navigate the choppy investment waters. Investments had fallen away, and investors had taken risk off the table completely and had moved into the safety of cash. Advisers had enough on their plates, but it was looking as though RDR was going to be implemented at a time when the markets and the global economy were in an unprecedented crisis.

A review of monthly net fund flows in 2011 is particularly striking. Either the bond or equity asset classes or both were in outflow for most of the year, while mixed asset and funds of funds attracted the lion's share of net flows. For advisers, navigating these choppy waters was fraught with danger, and so this is when funds of funds and multi-asset, absolute and total return funds began to come into their own and rise in popularity. Fig 2.2 plots funds of funds and mixed asset funds against the combined sales of the remaining asset classes and reveals that for much of the year the two asset classes were positive while the remaining asset classes were usually negative.

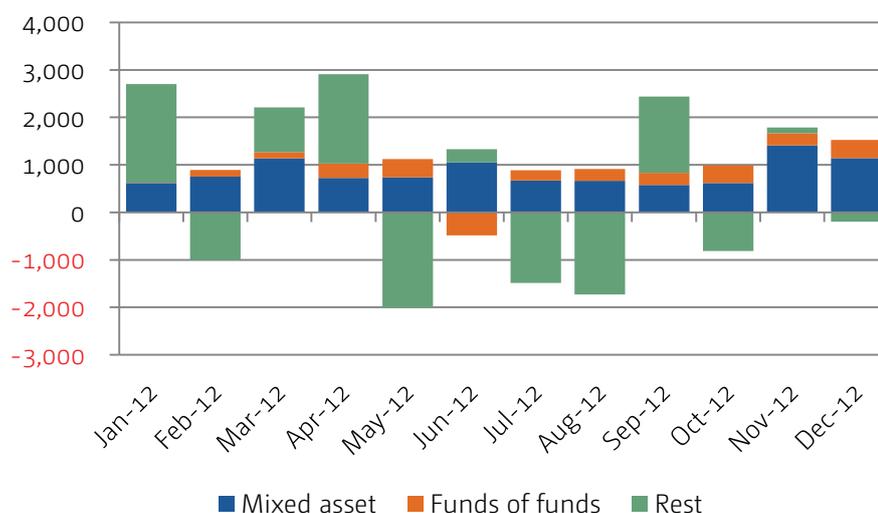
## 2012

Fund managers and distributors alike were pleased to see the back of 2011, but the market and regulatory environment made 2012 another challenging year for the UK industry. There was uncertainty about the global economy with concerns resurfacing about China, Europe and the US, although towards the end of the year the outlook had started to improve. In the UK, the economy was flat-lining and preparations for the impending implementation of RDR were a considerable distraction for many UK advisers. While new money was more difficult to come by, there was no shortage of switching going on as advisers repositioned investors in preparation for RDR, transferring them to mixed asset funds or funds of funds and other 'buy and hold' investments.

The new year had brought a change of sentiment in early 2012. It was risk-on again as the mood became more optimistic following the ECB's decision to step in and help European banks, and the economic news coming out of the US was better than expected. Investors started looking for the positive and putting money back into the market.

However, the good mood proved to be temporary and the optimism among investors at the start of this year had already turned to pessimism by the beginning of the second quarter. The uncertainty about the Eurozone continued to haunt stock markets leaving investors and advisers unsure about the future. Most decided to err on the side of caution and either leave their cash on deposit or choose lower-risk investments likely to provide a reasonably predictable outcome. As a result, the demand for fixed income products from retail investors was strong in the first half of the year.

**Fig 2.3: UK net flows by month in 2012 (£m)**



Source: Lipper Fundfile. Estimated net sales.

Notes: Rest = bond, equity, money market, commodity and other.

### Mid-year point

The third quarter proved a considerable challenge for fund managers. Investor sentiment weakened significantly over the summer helped by distraction of the London 2012 Olympics, and the RDR deadline was also beginning to loom large. However, in September there was some respite with sales bouncing back to their highest level since April, following a period of stock-market recovery after central bankers in the US and Europe pledged to continue increasing money supply.

Nevertheless, there was considerable doom and gloom about. The economic outlook was not encouraging. Investors were feeling hard-pressed and advisers who had not yet reached the required qualification standards had only a few months left to qualify. Mixed asset funds had been popular throughout the year as investors and advisers sought safe pairs of hands for their investments. Funds of funds had been weaker in the first half of the year, but with RDR fast approaching, there was a consistent increase in the allocation to funds of funds in the second half of the year.

New business in the second half of the year had started off slowly and flows were at their nadir in August partly due to the Olympic effect. But the fourth quarter saw advisers come to life again as the appetite for risk started to grow again. Combined outflows reduced to almost nothing as positive noises coming out of Europe and the US gave equity markets a boost, and it became increasingly clear that staying in cash was starting to look an unattractive option.

For funds of funds and mixed asset managers, it was also the last chance that advisers had to shelter investor assets in long-term products. As long as assets were undisturbed by advice events, these investments would continue to attract rebates for the foreseeable future and there was no sunset clause... a compelling reason to move client assets into funds of funds and mixed asset products. As a result, these products either maintained or increased their volumes of sales throughout the 2011-2012 period while the combined total of the remaining asset classes were in negative territory.

## Chapter 3: A year in RDR country

In the months and years leading up to RDR implementation in January 2013, many industry commentators predicted that the UK financial services industry would simply implode under the weight of such radical regulation. The dire warnings were similar to the apocalyptic vision for Y2K (the year 2000) when global technology was expected to go into meltdown once computer clocks went back to zero. In the event, with millions spent on getting ready for the change, Y2K passed off uneventfully and it was much the same with RDR.

Of course the predictions of a complete collapse of the financial services industry did not happen, but some of the more mainstream predictions have indeed come to pass. Pre-RDR consensus predictions include:

- A combination of fee-based advice and the higher qualification requirement would dramatically reduce the number of available advisers (✓)
- Advice would become the preserve of the wealthy, and advisers would prune their business of unprofitable clients (or those unwilling to pay) leaving some investors without an adviser (✓)
- As a result of the two above, direct-to-consumer business would explode (??)
- Banks would use this opportunity to step into the breach and fill the growing advice gap (✗)
- Charges would be driven down for fund managers and platforms (✓?)
- Investment solutions would expand and passive business (trackers, ETFs) would grow exponentially (✓?)
- There would be an increased use of packaged solutions (DFMs, model portfolios, FOFs). (✓)

### Taking in the orphans

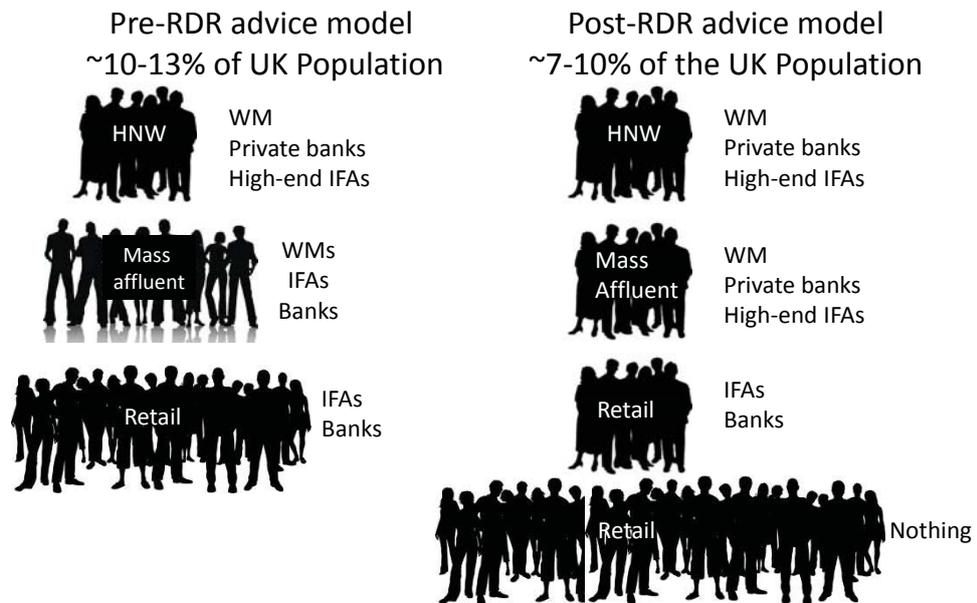
D2C platforms have been springing up to take advantage of the number of customers orphaned by their advisers. Only banks have failed to live up to their early promise. The reasons for this are multifarious, but a key factor is that banks have not been able to square the cost of providing advice and carrying out a full fact-find with a cost-effective solution that would be palatable to mainstream investors. Having had its wrists slapped over the financial crisis, the banking sector is also concerned about the risk of further mis-selling scandals in the future. As a result, most banks chose to

withdraw from mainstream advice and only offer it through their private banking units or wealth divisions.

### Just who gets advice in the UK???

The number of people who actually receive advice in the UK is estimated to be very small. Nonetheless, the changes in the distribution landscape have reduced the number even further. Fundscape estimates that roughly 10-13% of the UK population was advised prior to RDR and post-RDR that percentage is smaller at around 7-10%. In terms of flows, this small percentage would account for a considerable proportion of flows.

**Fig 3.1: Advice in the UK**



Source: Fundscape estimates.

Thus far, attention has focused on customers who previously took advice but now may lose access. Arguably of greater interest, however, is the untapped potential of people who have never accessed advice at all. Deloitte estimated that 5.5m people would fall into the advice gap post RDR as a result of IFAs moving up the wealth spectrum and the withdrawal of banks.

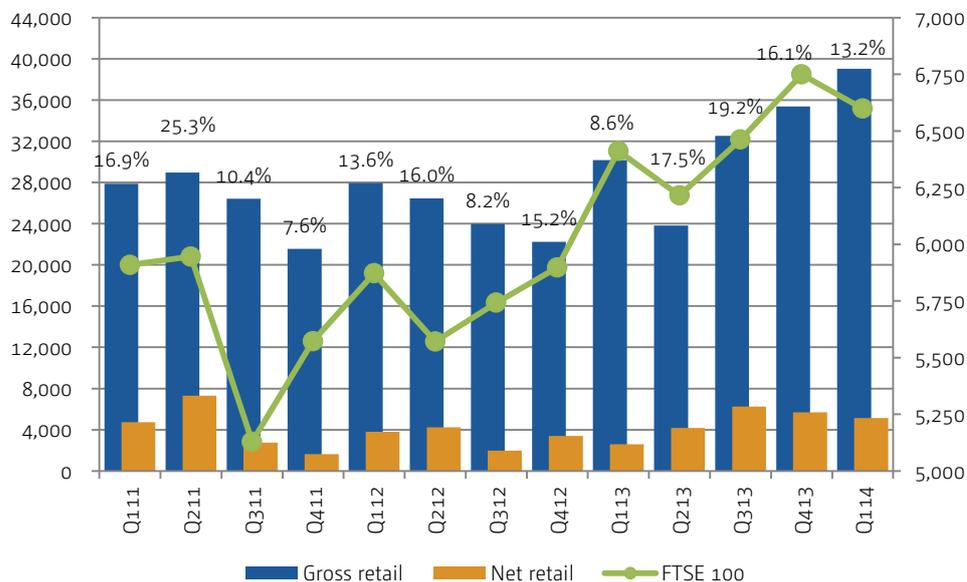
### Brave New World

When new legislation is introduced, there is always an inevitable dip in activity as everyone gets used to doing things in a different way. Much of the hard preparatory work has already been done and it's just a question of dealing with last-minute, niggly problems that might arise (and the odd adviser who doesn't know what RDR is). But

as any IT professional will tell you, if the project is 80% complete, it's as good as done and it was a question of waiting to see how advisers would behave in this Brave New World.

Figure 3.2 below suggests that after a temporary hiatus, the UK fund industry was able to shrug off the impact of RDR and storm ahead. RDR enthusiasts will point to such sales as evidence that RDR was successful, but we believe that adviser and investor reaction to the introduction of RDR has been masked by improving investor sentiment, the upward trajectory of the stock markets and the low interest rate environment.

**Fig 3.2: Evolution of gross and net retail sales**



Source: Fundscape, IMA, FTSE.

Notes: Percentages are for net retail sales as a proportion of gross retail sales.

### From a weak first quarter 2013...

For the first three months of the year, the uplift in the FTSE 100 was 8.7% and 9.3% on the All-Share index. Indeed, the first quarter of 2013 (the quarter in which RDR was introduced), was actually the third quarter of rising stock markets and although stock markets had been rising steadily, risk aversion had been strong, investors had been very slow to return and there was a substantial lag.

Advisers were preoccupied with bedding down RDR and getting used to working in the new regulatory environment. In the first quarter of 2013, gross sales jumped to more than £28bn for the first time in four quarters, but tellingly the volume of net sales dropped. Indeed, despite stock markets on the rise, the ratio of net to gross sales fell to just 8.6% in the first quarter, suggesting that new money was comparatively scarce and that gross sales had been driven up by assets being recycled between funds and sectors. This is interesting as switching activity remained high both before and

after the RDR deadline. This suggests that businesses actively changing their business to a fee-based model continued to review client portfolios after the deadline, whereas those more concerned with protecting legacy trail concluded their switching in 2012.

There was a marked correction in the month of June but against a backdrop of economic recovery in the UK, the threat of a Eurozone implosion receding somewhat, 12 consecutive months of rising stock markets, and the benign impact of the ISA season, investors shrugged off the correction and flows continued to rise. The trend continued for the rest of 2013 and the net to gross ratio rose to levels not seen since pre-financial crisis years.

### **... to volatile markets barely making a dent in first quarter 2014 sales**

In contrast, stock markets in the first quarter of 2014 were considerably more volatile than the previous quarters. The US Federal Reserve had announced a further reduction in monthly bond purchases at its January meeting. In Europe in early February the German Constitutional Court ruled that OMT appeared to be illegal under EU Treaties, triggering further debate and navel-gazing. The Ukrainian problem flared up later in the month. It was therefore no surprise that stock markets were yo-yoing. By the end of the quarter, UK stock markets were down 3%. Given these developments, industry flows could have been a lot worse, but investors and advisers continued to have faith in the UK's long-term economic recovery.

Demand for investments remains strong and RDR will not make that go away. But it may make investors think twice if the economic outlook deteriorates or stock markets contract significantly. It may also make it harder for investors to access investments.

To put it bluntly the UK has been fortunate. A combination of improved sentiment and a sustained upturn in stock markets made it difficult to assess the real impact of RDR on investor and adviser behaviour. Eighteen months after RDR was first introduced and the UK has not yet experienced a prolonged downturn in stock markets, or more relevantly, a rise in interest rates that would take the pressure off income-hungry investors and reduce demand for income-generating funds. Demand for investment product and advice will also be significantly boosted by recent budgetary changes such as the abolition of mandatory pension annuities, which should boost the market with an additional £15-20bn in flows per year, and the revamped ISA with its £15,000 allowance will also boost sales volumes.

### **Changes in the distribution model**

The table below charts how each channel behaved in terms of gross flows as 2013, the year of implementation, unfolded. In the first quarter of RDR, there were some robust changes with D2C business jumping by 41%, while adviser business was down by 5%. The starkest change was through the bank channel which saw sales flows dip by 19% relative to the same quarter in 2012.

**Fig 3.3: Gross flows by channel post RDR**

	Q113 v Q112	H113 v H112	2013 v 2012	Q114 v Q113
<b>Advisers</b>	<b>-5%</b>	<b>+20%</b>	<b>+28%</b>	<b>+23%</b>
Wealth managers	+15%	+37%	+50%	+22%
Insurance agents	+11%	+32%	+44%	-3%
<b>D2C platforms</b>	<b>+41%</b>	<b>+68%</b>	<b>+55%</b>	<b>+45%</b>
Banks	-19%	+5%	+6%	-14%
<b>Total industry</b>	<b>+10%</b>	<b>+28%</b>	<b>+34%</b>	<b>+21%</b>

Source: Fundscape, Financial-Clarity by Matrix Solutions

But if we move forward three months to the half-year point, things have started to look a lot rosier. Against the same period the year before, flows are now 28% higher. Analysis of the primary, customer-facing channels shows that progress has been positive across the board, but some have been more positive than others. IFA business is back on track with a 20% uplift on flows, even banks are managing to turn in some positive flows with a 5% increase that would be down to private banking units. D2C is still one of the strongest channels with a 68% uplift in flows.

This was also the case for full-year sales for 2013, but as we come full circle and compare the first quarter of 2014 with the first quarter of 2013, some of the trends are beginning to consolidate, and in particular banks and insurance customer-facing channels are lagging, while the direct-to-consumer channel continues to soar ahead. The traditional intermediated channels of advisers and wealth managers continue to hold their own.

So despite concerns about the advice gap, do strong flows mean that RDR has been a resounding success or were pre-RDR doom-mongers correct? The answer is probably neither. What it means is that market sentiment improved significantly, risk assets were back on the table, and investors were getting used to living with uncertainty and the long-discussed great rotation from bond to equity assets was starting to turn.

.....

*Improved market sentiment helped to cushion the impact of RDR*

.....

Market-driven sales volumes masked the impact of the RDR on the industry. The RDR has been good for the industry, but there are still a number of problems that need to be addressed and the proverbial can is being kicked down the road. These points are discussed elsewhere in this paper, but fundamentally the biggest concern is that RDR has not addressed advice for mainstream investors and savers.

## DIY or corporate?

There is latent demand for retail advice, but in the post-RDR world some of the options that were available to ordinary investors – advisers and banks – have effectively been closed off by regulation. Some would argue that bank advice was unfit for purpose anyway so it's no bad thing, while others would argue that what matters is easy access to financial savings and investment products. Some industry stakeholders also believe that modest investors do not need advice. We believe that no matter how small or large your assets, you should be entitled to good, independent advice.

The fundamental problem with the RDR legislation is that regardless of whether you offer independent or restricted advice, and regardless of whether the client has a £1m or £10,000 in assets, the fact-finds and regulatory requirements are the same and the cost of carrying them out are therefore high. This means that the advice market will be fundamentally biased towards wealthier clients who will be less fazed by the high fees.

In the current distribution landscape, the only two channels available to retail investors are the D2C channel and the corporate and workplace savings route. The latter is being boosted by Auto Enrolment. Under a law introduced in 2012, all employers must offer a workplace pension scheme and automatically enrol eligible workers in it. This requirement has applied to larger employers since October 2012 and by 2018 will apply to all employers.

The law means that every employer must automatically enrol workers into a workplace pension scheme if they are aged between 22 and State Pension age, earn more than £10,000 a year and work in the UK. The success of auto-enrolment makes the opportunity to cross-sell investment products such as ISAs through workplace savings platforms all the more compelling.

## Simplified advice

The retail opportunity is there but we need to find a more efficient way of delivering it. There are plenty of advisory firms that would like to look after the mass market but they need clearer guidance from the FCA, particularly on simplified advice and whether fact-finds for example can be simplified or reduced. The FCA has published a trio of papers on simplified advice. The results of its thematic review<sup>1</sup>, the research it commissioned from NMG Consulting<sup>2</sup> and its consultation paper<sup>3</sup> on simplified advice. It has asked for feedback by November 2014 with a view to publishing guidance in 2015.

---

1 FCA TR14/10. Developments in the distribution of retail investments: Purchasing investments without a personal recommendation or with simplified advice.

2 The motivations, needs and drivers of non-advised investors, NMG Consulting.

3 GC14/3: Retail investment advice: Clarifying the boundaries and exploring the barriers to market development.

## Chapter 4: Impact of regulation on demand

From the point at which RDR was announced, through its long gestation and even since its implementation, there has never been a shortage of naysayers predicting that it will have a terrible impact on the fund industry. These comments have generally focused on the impact of upfront pricing, both in terms of transparency and also the requirement to pay the full cost of the service when it is offered. Opponents claimed these changes would price consumers out of advice, leaving investors without the support they need to make suitable investment choices.

*“The first point is fewer consumers will be able to afford advice on the products they need, the second point is thousands of advisers will go out of business and the third is fewer consumers will be able to buy the products they want because there will be fewer advisers to provide them.”*

*“As a sole trader, I operate on both a fees and commission basis. I’m quite happy to go down the fee route, but customers prefer commission. I mainly deal with middle- and lower-income clients who often haven’t got the resources to pay an upfront fee. I am happy to take fee, but it’s not what the majority of my customers would choose.”*

*“What is the logic? The FSA is admittedly going to now restrict access to financial services for consumers. If it’s correct that in order to call yourself a professional adviser you can only charge fees, I resent that.”*

*“Commission, whether high or low, is not a determinant of buying behaviour. If it was, then the dreadful value plans of the 1980s would never have been sold by the bucketful. Do not try to protect them from mis-selling. Instead try to protect them from bad products.”  
(All comments made in June 2007 . Names have been protected).*

With a fact-find estimated by the FSA to cost around £700 on average, it is reasonable to suggest that forcing consumers to pay this upfront will lead to many consumers not taking advice. However, it is also fair to question whether this is a sensible fee for a client with, for example, £10,000 to invest. In reality, the old uncapped commission model effectively meant that larger clients subsidised the cost of servicing smaller clients, and it is difficult to argue this was in the interests of all clients.

Furthermore it is clear that before the RDR, many consumers had little or no idea of the fees they were paying and to whom. Most would know if they paid an upfront commission, but a large number of consumers did not realise what they were paying in annual fees, and

.....  
*To argue that it is  
damaging for clients  
to be put off advice  
because they realise its  
true cost is indefensible*  
.....

the majority were in the dark as to who benefited from them. To argue that it is damaging for clients to be put off seeking advice because they now realise its true cost is indefensible, and the onus has to be on the industry to communicate the benefits of both investments products and advice more clearly. However, complaints about consumers being priced out of advice do raise legitimate questions, but they miss a broader point about both demography and the relationship of the fund industry with consumers, and its ability to explain the benefits it is offering to a wider audience.

Even post RDR, advisers were still uncertain as to the benefits of the regulation. A survey by Lansons in March 2013 (three months after implementation) showed twice as many advisers thought it would have a negative impact on the industry as those who thought it would have a positive impact, although almost half thought it was too early to say. For new customers, the numbers were even bleaker, with only 10% seeing a positive impact against 44% who were pessimistic.

**Fig 4.1: Impact of RDR on advice industry**

In your opinion, do you think the RDR has had a positive or negative impact on...	The industry	Your business	Your clients	First-time/new investors
Positive impact	17%	24%	10%	10%
Negative impact	34%	34%	35%	44%
Too early to say	48%	40%	48%	38%
Unsure/don't know	1%	1%	6%	8%

Source: Opinium monthly advice tracker on behalf of Lansons. March 2013. 800 advisers surveyed.

The key issue for many advisers in the survey is that it had become unprofitable for them to service clients with lower levels of investments. But as illustrated by the second commentator, there is also scope for non-traditional advice methods that could reach a new audience put off by the high cost of a high-touch model.

*"We can't afford to service clients with less than £40k-£50k. The costs just don't make sense. It's not worth our while."*

*"Many clients will choose not to take advantage of independent advice due to the perceived high cost. However in the long term we feel that this market will respond to a different pricing such as an internet-based advice service that we are examining at the moment."*

## Supply-side reform

Those who predicted that the RDR would have a prolonged negative impact have missed the crucial point that it is a supply-side reform. None of the factors that make consumers decide to seek an investment solution have been affected. Indeed, the growth opportunity for the industry in the UK and Europe is significant, both from a

strategic and tactical point of view. Last year's ALFI paper by Mackay Williams<sup>1</sup> covered these issues in more detail, and as they are critical to understanding why the FSA introduced the RDR in the UK and why other regulators around Europe may follow suit, they are worth recapping here. Tactically, the opportunity for the fund industry in the short to medium term is simple – convert some of the mountain of cash investors are holding into longer-term product. Following the financial crisis this has already started to happen with €1.3bn<sup>2</sup> returning into long-term funds since the 2007/2008 crisis during which €522bn<sup>2</sup> was withdrawn.

It echoed, to a certain extent, the dotcom crisis of the turn of the century when investors poured into risky equity products (with significant encouragement from their banks), subsequently suffering huge losses in the dotcom crash and withdrawing from the market to lick their wounds for a long time. Indeed, it was as stock markets were finally reaching their pre-tech heights that the sub-prime crisis first hit. A total of €522bn was withdrawn in the 18-month period from August 2007 to December 2008, the industry having attracted flows of €1.2bn in the five years to June 2007. Recovery the second time round (after the financial crisis) would have been even slower if interest rates had not been low, forcing investors to take more risk.

## Demographic drivers

This boom and bust pattern is obviously harmful for the investor and the industry, and suggests that products are either unsuitable or consumers do not understand the risks they are taking. Or, as is more likely, a combination of the two.

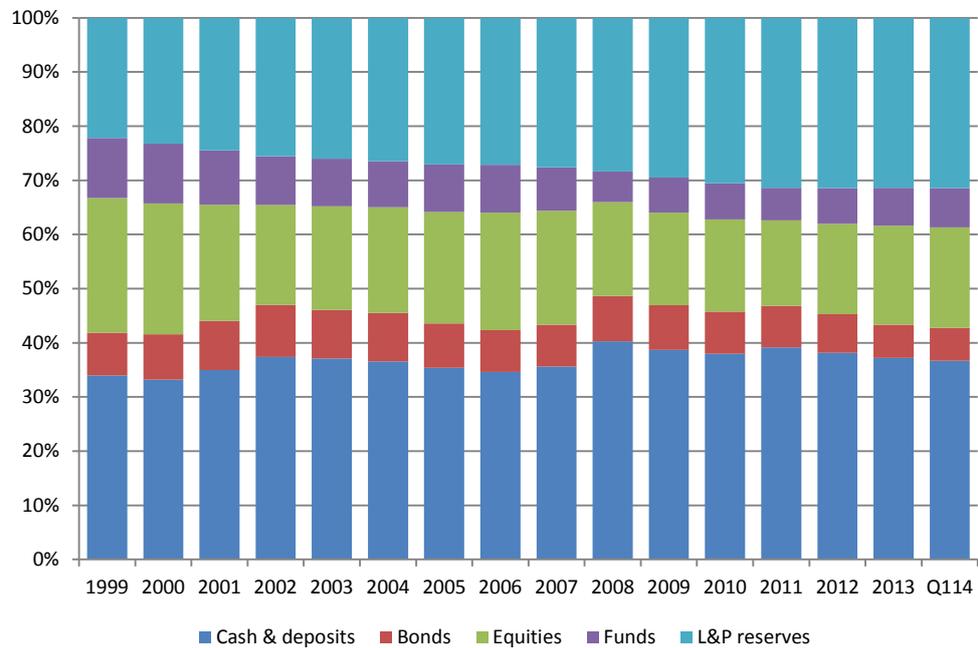
Strategically, however, the opportunity is even more compelling. Consumers will increasingly require returns greater than cash and deposit products can provide. The critical imperative for more saving to meet pension needs is well known, but so far there is little evidence of a shift in behaviour. In fact, figures from the ECB show the opposite, as although the percentage of household assets in retirement savings has risen slightly from 25% to 32%, it has been at the expense of investment funds and shares rather than cash.

In fact, allocations to cash have grown since 2000 from 33% to 37% at end 2013, while equity has dropped from 24% to 18% and funds from 11% to 7%. There is no evidence that this is a cyclical issue, as shares barely rose during the bull run of the early 2000s and investment funds have continued to lose out in relative terms throughout the period. In the year of the financial crisis, cash & deposits peaked at 40% while funds fell to their lowest share of overall financial assets (5.7%) before modestly improving to 7% by 2013.

---

1. 'Beyond 10%: the case for enlarging the pool of retail investors in Europe's investment funds'

2. Source: Lipper FundFile. Net flows into European long-term funds between Jan 2009 and June 2014. Funds of funds have been excluded to avoid double-counting.

**Fig 4.2: Evolution of European households' financial assets**

Notes: Source ECB and Eurostat

This demonstrates that there is a need to engage consumers and explain the benefits of longer-term investment, both as a solution to plugging the pension savings gap, but also to allow consumers to achieve other medium-term goals such as purchasing a home or paying for their children's education. This goes beyond converting cash into longer-term product, and means engaging with a huge bank of people who have never owned an investment product at all.

### Reaching a broader audience

As last year's ALFI paper showed, the growth of the industry over the last few years has been driven by two factors: recovering markets and a return to risk of the existing investor pool. What has not happened is a significant broadening of the investor base to allow more investors to benefit from investment returns to help with their savings needs. Across Europe, the overall penetration of mutual funds among households is just 11%, with a median saving of just €10k. This masks some regional variation, with Luxembourg being unsurprisingly among the leaders with 19% penetration and an average balance of almost €27k, compared to Greece and Cyprus with circa 1% penetration. However, several major markets have very low participation in the industry, with Spain and Italy having around 6%<sup>3</sup>.

As MackayWilliams showed, if European investors simply increased their allocation of long-term investment to levels seen in the US this would provide a €4,000bn uplift

<sup>3</sup> European Household Finance and Consumption Survey, ECB, April 2013.

in assets. In the longer term, it is probably necessary for this number to go higher, meaning an even bigger prize.

Even in those markets that have the most established fund industries, the vast majority of households do not hold a fund and probably never have. Given the demographics discussed above, it is vital for the long-term health not just of the fund industry but of European economies that a way is found to persuade households to save money and to do so more effectively. It is through this prism that we should consider the motivation of regulators and their attitude to RDR-style change.

### **The UK Budget – using pensions for change?**

As is the case with most developed countries, the UK has been experimenting with bringing more people into the investor pool to address the demographic time-bomb by compelling people to invest in pensions. Auto Enrolment, which came into law in 2012 is a case in point. It means that all employers must enrol their eligible employees in a workplace pension and workers must actively opt out. The process is being phased in and started with the largest employers in 2012 and will complete by 2018 with the smallest. As of April 2014, companies employing between 50 and 249 staff began the Auto Enrolment process.

The advent of Auto Enrolment and the continuing closure of Defined Benefit (DB) schemes (to new entrants in the public sector and in their entirety in the private sector) will make many more people direct holders of investment funds. However, there is little evidence as yet that those investors are taking the next step and topping up pensions significantly or broadening their buying behaviour into other investment products such as ISAs.

The latest policy change came in the 2014 Budget and will fundamentally change the pension arena in the UK. The Government announced in the 2014 budget that they were abolishing the requirement to buy an annuity at the point of retirement. The abolition came with a 'guidance guarantee' assuring voters that they will have help deciding how to manage their money after retirement. The language is instructive however, as although studies show that the words 'guidance' and 'advice' are synonymous for most people, they have entirely different meanings in the context of the UK regulated investment environment.

The impact of these changes on the shape of distribution is unclear, but the opportunity for the investment industry as a whole and manufacturers in particular is potentially significant, and comes from one obvious source and one less immediately so. The less obvious opportunity comes from the current investor pool. If an investor is planning to buy an annuity product, they will usually reduce the risk of their investment portfolio to at or near zero by the time of their retirement date. This greatly shortens the period their money will be invested and the glide path will be much steeper, de-risking at a time when wealth is at or near its peak.

This has often led to clients heavily reducing their equity exposure by the age of 50-55, reducing their future returns, and therefore their own portfolios and by extension



Glide paths could be extended to death and beyond

the fees of the investment industry. However, if they are no longer planning to buy an annuity, the glide path should now extend to, or beyond the time of their death (particularly if they wish to leave money to their children). Such a move would, on average, double the time they are invested and result in money remaining in higher-risk assets for longer, including when the portfolio value is at its peak.

However, the biggest opportunity is that it either retains or brings a significant volume of money into the advice and investment product arena which would have otherwise disappeared into annuity products.

Consumers who previously did not have enough money to justify the cost of advice (or in their own view, owning an investment portfolio) will now have large sums to invest, often with little previous experience of how to go about it. Even for the relatively lowly paid, their pension pots should be large enough to make not only access to advice, but also the importance of making the right decisions of critical importance.

There is a substantial opportunity for the industry as a whole and advisers in particular to engage with consumers and demonstrate the value of the services they provide... but they may need to be creative about how to do so. Charging a large upfront fee to assess a client's needs before the decision to take advice has been made may well be unpopular with many investors. Other options include education, or employers paying for an initial consultation in partnership with advisers, with the costs of these being repaid once clients are signed up and paying fees. The flaw with this model is that it is important that the advice is seen as impartial. A potential conflict of interest may be difficult to avoid when an adviser is laying out the need for his or her services.

It is therefore critical that all parts of the investment industry engage with employers, consumer groups, regulators and the government to address these issues in advance. As we have seen with other regulation, this is likely to lead to a better solution for consumers in the longer term, which ultimately will benefit the investment community as well.

### The rise of execution-only business

There have already been significant changes to the shape of distribution in the UK since the turn of the century, the most significant being the withdrawal of high street

banks from mass market advice. This was primarily caused by the concerns of those banks around their ability to guarantee the quality of advice at those portfolio sizes, or to make a higher quality model commercially viable.

At the same time, the size of the execution-only market in the UK has become clearer. In the 1990s, between 20-25% of retail investment business was execution-only, and the vast majority of this was placed directly with the manufacturers by end investors. As figure 4.3 shows, IMA data showed this figure to be in constant decline over the 2000s, reaching a low of 5.2% in 2008.

**Fig 4.3: Gross retail sales by distribution channel (%)**

	Direct	Intermediary	Tied/ Salesforce	Private client	Total
1995	16.6	50.3	23.4	9.6	100
1996	16.5	46.5	27.4	8.5	100
1997	19.8	44.2	27.4	8.5	100
1998	19.2	45.4	28.6	6.8	100
1999	17.8	48.5	27.2	6.5	100
2000	14.5	60.9	19.7	4.9	100
2001	14.3	64.0	16.1	5.6	100
2002	11.4	65.9	17.4	5.3	100
2003	9.3	65.4	20.2	5.1	100
2004	9.6	72.7	11.6	6.1	100
2005	8.5	77.3	10.4	3.8	100
2006	6.3	80.9	7.9	4.3	100
2007	6.3	85.2	6.1	2.4	100
2008	5.2	84.9	7.3	2.8	100

Source: Investment Management Association (IMA)

This was widely (and somewhat complacently) assumed to mean that the execution-only market was in terminal decline, when in fact there had been a paradigm shift in how investments were distributed in the UK. For example, the market share of tied agents and salesforces declined from 27% in 1996 to 7.3% due to their high cost and the decreasing sales of life and pension products. Many salesmen switched to working as advisers and selling a broader range of investments. This is why the share of intermediated business rose from 44% in 1997 to 84.9% in 2008, although direct business through platforms was also a factor.

Unadvised investments that were traditionally placed directly with fund managers did not disappear but were obscured by end-investors using platforms instead. The use of platforms allowed investors to consolidate and manage their investments in one place without the need for multiple accounts. In general, an end-investor using a platform such as Hargreaves Lansdown or Fundsnetwork would be reported by the fund groups

as intermediated business because the platforms do not provide sufficient information on the type of investor. So, although the IMA statistics say otherwise, in reality the market for unadvised business has never gone away and probably remained relatively stable in the period 2000-2013.

### **Orphaned clients**

One fear from the advice community was that the unbundling of fees would lead to clients opting not to pay for advice and going down an unadvised route instead. As we have seen, this fear was probably overblown, firstly because it ignored the fact that investment selection is only one part of the service being provided by advisers, but also because companies like Hargreaves were already offering a partial rebate of the advice fee for unadvised customers anyway. However, there is undoubtedly a market for investment hobbyists keen to make those decisions themselves and the RDR made it cheaper and easier for them to do so.

More importantly, the RDR has removed the cross subsidy within IFA books where ad valorem fees meant the larger clients were subsidising smaller ones. This forced some advisers to withdraw services from clients with smaller portfolios or of more modest means as the fee for their services became a far bigger proportion of the portfolio. It is widely known in the UK as 'orphaning'.

### **Potential for new entrants**

Taken together, these three trends from both the supply and demand sides of the market make it likely that unadvised business will grow in the medium term in the UK. As the investment industry is a normally functioning market with fairly low barriers to entry, it is likely to encourage new entrants into the market.

### **Industry**

Existing players such as Hargreaves Lansdown and Fidelity Fundsnetwork will continue to push their offering, and use their lower operating costs (once the customer has been found) to provide a service that is economically viable. Banks are likely to re-enter the mass market space with execution-only offerings using their branch distribution network to acquire clients. Existing distributors can also enter the fray, with IFA platforms (strictly B2B) such as Cofunds already providing a service for orphaned clients, (but encouraging them nonetheless to find new advisers).

In addition, life companies could look to enter the non-advised space, using their direct sales forces to create leads in the same way that banks use branch distribution. Although clearly these groups retain an advised offering, they could offer an execution-only service as a lower-risk proposition for lower-value clients,

converting them to advice as their portfolios grow and financial affairs become more complex. Interestingly, the idea of using execution-only services as a starting point for investment and as a feeder business for advice has also been considered by advisers, with a number looking into similar propositions. Several adviser platforms offer white-labelled execution-only propositions that can be used by advisers for their orphaned clients. This allows them to retain clients who may need advice later in life and also earn revenues from the service.

### **Supermarkets and retailers**

Finally, new entrants need not be from the investment industry. Big household brands such as Tesco, Sainsburys, John Lewis and Marks & Spencer have already branched into financial products, offering banking, insurance and (in the case of M&S) limited investment products including ISAs (Individual Savings Account). Other groups such as SAGA (who offer a range of products and services to the over 50s) have also looked into launching their own investment arm.

Two common factors unite these groups; they lack the expertise to deliver an investment solution themselves, but they have a high-quality relationship and level of trust with a large number of consumers, often in key target segments for manufacturers of investment product. A clear potential opportunity to partner with investment firms to deliver a capability through their existing relationships exists, and it will be interesting to see if any of these groups make such a move in the next couple of years.



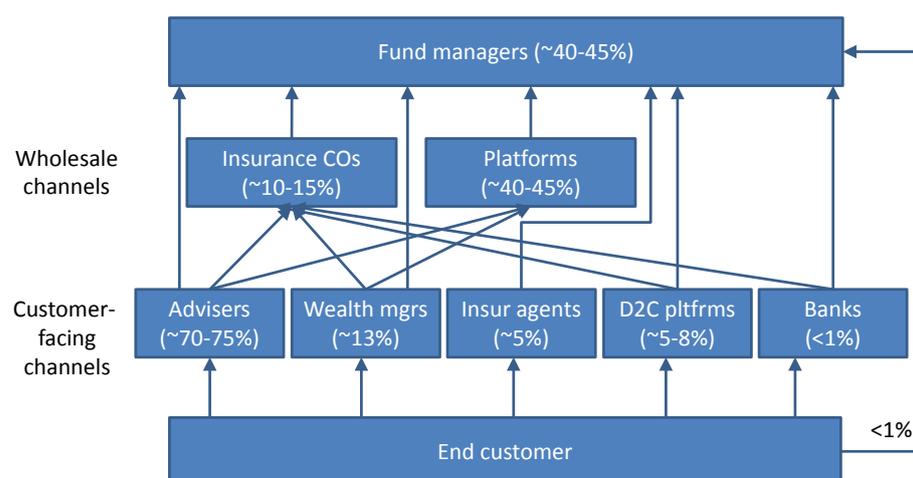
## Chapter 5: Impact on distribution

When assessing the impact of the RDR and other regulation on distribution, it is important to avoid generalisations and recognise the vastly different service and investment models that exist within the UK retail industry. The impact on a wealth manager might be very different from that on an IFA (independent financial adviser) or an execution-only provider. In addition, many businesses offer a variety of different propositions that cover different channels.

The term IFA is itself a generic term that covers a wide variety of different advice models. These range from generalist IFAs, for whom investment business may be only a small part of their overall business, to specialist investment IFAs who make the majority of their income from selling investments.

In addition, the distribution chain itself can be complicated. The traditional model was a manufacturer to place a product with a distributor who then sold that product to an end consumer. Nowadays, the model can include far more stakeholders, for example a fund of funds provider buying product from a manufacturer, placing the fund of funds on a platform, the product being shortlisted by a head office selection unit and finally being selected by an adviser in consultation with an end client. The reality of the UK distribution model is even more complex as demonstrated in figure 5.1.

**Fig 5.1: The UK distribution model**



Source: Fundscape, Financial-Clarity by Matrix Solutions

## Changing advice landscape

In the two to three years leading up to RDR, financial advisers had two huge tasks in front of them —to get qualified and move to a fee-based advice model. Given that a significant number of advisers were in their autumn years, it was widely predicted that many would forego qualification and would retire early or take on other non-advisory roles in their organisations.

The longer-term demand for investment product was never likely to be affected by the RDR, meaning that the total size of the opportunity for the industry should not be affected. What is really under consideration is how the RDR and other factors have affected the market in the short term, and how they will influence the relative size and business models of different distribution channels in the long term.

Adviser reaction to the RDR varied widely depending on their business model. Undoubtedly, a proportion of advisers did not want to take on the burden of further qualifications and exited the industry. This was not a surprise to the FSA, and they had always claimed this would be inevitable consequence of their determination to drive up overall standards. The then FSA Chief Executive, Hector Sanz, had caused considerable controversy when he told the Treasury Select committee that a 20% drop in the number of advisers would be an acceptable consequence of the RDR, saying “We have some suggestion that a 10-20% reduction in capacity could flow from the RDR measures, we have obviously deemed that to be acceptable or we wouldn’t be going ahead.”

**Fig 5.2: Changes in adviser numbers**

	Est Summer 2012	Actual 31.12.12	Actual 31.07.13
Financial advisers	23,787	20,453	21,684
Banks & building society advisers	6,655	4,810	4,604
Stockbrokers	1,202	2,043	2,267
Discretionary investment mgrs	875	1,435	1,784
Other	2,554	2,269	2,221
TOTAL	35,073	31,010	32,560

Source: FSA, FCA and RS Consulting on behalf of FSA.

The FSA estimated that the number of individuals qualified to give investment advice dropped by around that number between December 2011 and December 2012, but this impact was not evenly spread. Independent or tied advisers did indeed fall by around the projected figure of 20%, whilst wealth managers were much less affected, with numbers staying fairly stable.

In reality, the biggest reduction in the adviser population has not come from the IFA sector at all, but rather from high-street banks. The number of bank advisers fell by 45% in the year before RDR, as banks conducted strategic reviews to see if they wanted to remain in the sector. More strikingly still, these numbers have continued to fall since the official implementation of RDR, as the latest FCA figures show. Figures released in January 2014 showed the number of bank advisers continued to fall to c.3,500<sup>1</sup> while other types of advisers stabilised. Both the banks and the FCA have attributed this fall to a difficulty in providing cost-effective advice on a fee-based model to the mass market, but this only tells part of the story.

**MARTIN WHEATLEY, CEO, FCA, JANUARY 2014**

“The biggest concern pre RDR was about adviser numbers, rather than the number of people getting advice. That has now changed.

“Overall adviser numbers are certainly down from six months prior to the RDR – there has been a fall of 11% since summer 2012, but that is almost entirely accounted for by the decline in banks and building society numbers. Numbers in the adviser space are relatively flat. Generally, IFAs would say the RDR has been a net benefit for them.”

## The demise of bancassurance advice

Traditionally these firms had offered a range of services, typically including private banking and wealth management services to their wealthier clients, with branch-based advisory services available for the mass market. The biggest change in UK distribution over the last few years has been the exit of the banks from the advice market, but it is debatable whether the RDR was the primary driver of this change.

Mis-selling scandals had hit the banking sector hard over the previous two decades, with banks facing large bills to cover compensation around the sale of (among other things) Payment Protection Insurance and Endowment mortgages. The generic processes used to target mass-market investors left them open to these large-scale compensation cases, because once the sales process for part of a book of business was found to be flawed, it was likely to mean that large swathes of that business would be similarly affected. Consequently, any problems with the quality of advice offered through mass-market branch propositions had the potential to spiral into large mis-selling cases with significant compensation demands, even if individual clients had not suffered through the advice.

---

<sup>1</sup> FCA, 13 January 2014.

Barclays was the first bank to act, announcing their intention to close their advisory business in January 2011, shortly after being fined for mis-selling by the FSA. They were found to have mis-sold investment products and were ordered to restore consumers to the position they would have been in, if they had not made the investment – ie restore any losses and pay interest that could have been earned on the cash if it had been on deposit. This was a classic example of the risk of bank sales models, and Barclays announced that although they would retain their wealth management and Barclays Stockbroking businesses, they intended to concentrate on the mass market sector through an execution-only (XO) proposition.

**Fig 5.3: Bank withdrawal from advice**

	Date announced	Jobs lost	Reasons	Mis-selling fines	Mass-mkt plans
Barclays	Jan 2011	c1000	Commercial viability	Yes	XO offering and Barclays Stockbroker
HSBC	June 2011 (reduction in advisers)	460	Drop in demand post RDR	Yes	
	April 2012 (closure of tied arm)	650			
RBS	June 2012 (closed IFA arm and halved financial planning headcount)	620	Planned new restricted proposition	No	New proposition launched Q114. XO offering in pipeline.
Lloyds	Sept 2012	Advisers absorbed elsewhere	Lower value clients won't pay fees	Yes	Basic protection advice only. XO for HNW.
Santander	March 2013	800	Concerns over quality of advice. Already referred to FCA for enforcement action	Yes	Continue to service existing clients.
Axa	April 2013	450	Closed partnerships with Yorkshire & Clydesdale and Cooperative banks	Yes	

Source: Fundscape

Over the next two years, the rest of the banking sector followed suit as figure 5.3 shows. The RDR was cited by all as a factor to a greater or lesser extent, but in fact the most common theme was a concern about the quality of advice provided by their advisers. The scale of the reduction has left a large number of consumers who had previously used branch-based advice to seek advice from elsewhere, make their own investment decisions through an execution-only service, or to exit the market. Only time will tell how this ultimately plays out.

## The changing face of the adviser market

Before RDR there was no shortage of doom and gloom over the future of the independent advice sector. As stated earlier, the FSA predicted a 20% fall in the number of advisers, but many feared the loss would be much higher. There were also widespread fears about the profitability of the businesses that would remain, with Ernst & Young predicting a continuing fall in adviser numbers post RDR as consumers refused to pay for advice.

The RDR is generally considered to have affected IFA businesses in five main ways:

- increased standards for professional qualifications
- the need to construct a fee-based business model
- the financial impact of pricing changes on revenue and the regulatory burden on their cost base
- the pros and cons of independent vs restricted business models
- changes to the way advisers select investments.

### Qualification requirements

The introduction of the RDR did lead to a contraction in the number of advisers in the marketplace. However before its introduction, there were widespread fears that the impact would be much greater. From around 2010, when it was clear that the final rules were not going to change much from what had been published, the first priority for both individual advisers and the management of the big nationals and networks was to work out who was qualified and what action was required for those who were not. The big firms did not have this data easily to hand, which helped to create the uncertainty over numbers and meant many were planning for far worse figures than was actually the case.

The big nationals and networks were typically planning for a 30% reduction in advisers as they were concerned not only about how many advisers would obtain the higher qualifications, but also that older, more capable and experienced advisers would bring retirement forward and exit the industry. In fact, numbers did not fall as much as the

worst predictions. And even where numbers did fall, the loss in revenues was smaller than expected; the Tenet network estimated that they de-authorized 15% of advisers at the end of 2012, with this only causing a 5% reduction in revenue.

**Fig 5.4: Differences between national and network advice firms**

	National adviser	Network adviser
Adviser status	Direct employee (appointed representative)	Individual firm renting services from networks (registered individuals)
Adviser revenue stream	Paid employee. Typically salary plus commission.	Adviser generates own revenues and pay network fees from this.
Freedom of movement	Would have to leave job and company.	Can re-register to another network or go independent. However, authorisation can take up to six months
Investment proposition	Must sell in line with head office requirements	Will have access to fund research and approved lists. Increasingly onerous requirements due diligence requirements for going off panel
Operations, compliance and insurance	All provided in-house	Adviser rents services from head office. Insurance provided centrally

Source: Fundscape

The only major casualty in this period was the collapse of Honister Capital, which went into administration in June 2012. This led to around 900 self-employed appointed representatives being temporarily unable to conduct business. But it is questionable whether this was caused by the RDR. Indeed, Grant Thornton, the administrator, confirmed this point, saying “Over the past few years Professional Indemnity (PI) insurance costs have increased to unsustainable levels, driven mainly by large claims relating to historical business and, to a lesser extent, wider industry issues. This has had a material impact on regulatory capital requirements and the company’s ability to trade.”

These 900 advisers did not exit the industry since other adviser networks moved quickly to sign them up. Tenet in fact saw a slight increase in their overall numbers, with advisers transferring to them from Honister more than offsetting the de-authorized advisers. Overall, Tenet eventually thought around 30% of its adviser population had work to do to meet the new standards, meaning around 50% of these did achieve the required standard.

Further evidence that the picture was not as bleak as many naysayers had predicted can be seen in the membership rolls of professional groups, which were often increasing both in total and particularly among the highest qualified. As an example, The Personal Finance Society (PFS) actually saw its membership increase steadily

between 2010 and 2014, rising by 28% from 27,076 to 34,682, with the jump in those with chartered status even larger, more than doubling from 1,916 to 4,053.

This was doubtless helped by the educational programmes that organisations like the PFS organised to help advisers reach the required professional qualifications, commonly known as ‘gap-filling’. These programmes offered credits for attending educational sessions that had been approved by the FSA across a range of topics, and involved a number of product manufacturers working with them as well to deepen their relationships. For example, JPMorgan saw over 6,000 advisers in 2010 and 2011, and did gap-filling sessions for over 900 advisers in just 3 sessions in 2011. Other groups provided similar programmes.

### **Segmenting the client base**

The second major task for advisers was constructing a new business model that was based on fee-based advice. Legacy business, ie any business that had been transacted before the deadline and was undisturbed (ie no fresh advice) could continue to benefit from rebates, but new business would have to be fee-based. For many advisers that meant defining (sometimes for the very first time), the services they offered to their end clients and the cost of offering those services.

Having worked out the baseline cost, they then segmented their client base, and more importantly, defined which client segments they would target in future. The old commission model meant that richer customers had always subsidised poorer ones, but fee-based advice swept this away. As a result, advisers were forced to consider a wide range of advice situations and decide whether their fees would still be appropriate and suitable. For example, a middle-income customer buying his annual ISA (£11,520) could be charged a fee of £500-£1000, which would be out of proportion with the size of his investment.

Interestingly, most financial advisers seemed to have settled on a minimum of £100,000 in investable assets. This effectively cut off a significant number of smaller investors and led some advisers to informing their modest customers that they could no longer advise them, effectively ‘orphaning’ them from advice. Savvier financial advisers have set up their own execution-only services and have directed their recently orphaned clients to this new channel in the hope of retaining their long-term business.

### **Impact on financials**

Once an adviser knew he was able to continue doing business post RDR, the next stage was to evaluate the impact on their profit and loss account (P&L). The RDR undoubtedly had a major impact on both sides of the P&L, as unbundling and

disclosure rules had an impact on revenues and the increasing regulatory burden had an impact on costs.

In the run up to RDR, there were fears that the new disclosure rules would lead to consumers suddenly becoming aware of the cost of advice and choosing to make their own investment decisions, leading to a further decline in adviser numbers and a shrinking of client books for those that remained. Although it is undeniable that not all consumers were fully aware of what they were paying and to whom, this always looked a little overstated as disclosure rules had been in place since the early 90s (through indicative examples of costs in Product Literature) and these had been strengthened further during the depolarisation reforms in 2005.

It is unlikely that before RDR the majority of consumers thought the advice they received was entirely free, however the majority did not understand who was receiving what. Unbundling gave customers the ability to decide not to pay for advice, however the assumption that large numbers of clients would choose to opt out misunderstands the client requirement and the nature of the service they are buying.

### Fig 5.5: The advice process



As figure 5.5 illustrates, for most customers the final investment decision is one part of the overall service when they seek advice, namely how to manage their wealth. It is therefore simplistic to say that because they could buy a single fund more cheaply without advice that it would be a viable or desirable option for them.

Arguably the greatest impact of unbundling is on lower-value clients and its effect is twofold. Firstly, in a bundled environment, lower-value clients were subsidised by larger-value clients, but this can no longer happen so the cost of advice has risen significantly. Secondly, the ban on factoring, meaning that clients paid for a service over several years through trail commission, has made fees unrealistic or unaffordable for smaller clients.

Taken together, this has created an advice gap, but it is really caused by advisers realising that smaller clients were not profitable in their own right or that the cost of their advice process had effectively priced clients out of advice. Many advisers have therefore shrunk their client book, but under the 80/20 principle they sustained a much smaller reduction in revenue. Indeed, many have reported an increase in revenue as they have reallocated time from low-revenue clients to larger high-revenue ones. Going into the RDR, 50% of advisers had predicted a 10-15% fall

in revenues, whereas in reality the average revenue has actually gone up as larger advisers are more likely to have remained in the industry.

For the Nationals & networks, their main fear going into the RDR was the impact on their adviser members, as these firms typically take a percentage of revenue or turnover. But as individual advisers have done better than expected, this has also flowed through to the groups.

There is more potential for impact on secondary revenue streams, particularly marketing payments as a result of the recent clarification of rules on inducements. After the dotcom crash, adviser firms started receiving marketing payments from fund groups, often indirectly linked to the position on a firm's investment panel or access to the underlying advisers. Spiralling markets had led to severe contractions in revenues, so fund groups stepped in with these payments to help prevent a large part of their distribution from exiting the market. However, groups became dependent on these payments, often as a result of price competition, meaning any regulatory clampdown could affect business viability.

The other cost that had been increasing significantly, as we have seen in the case of Honister, was the cost of Professional Indemnity cover. However, this was not directly linked to the RDR, but led nonetheless to a fundamental reassessment of advice models to reduce the future risk of mis-selling claims.

## Investment propositions

For advisers who were able to successfully navigate all these hurdles, the next decision was to assess their advice model and decide how to best to conduct an initial fact find and select investments for the customer. In many cases, large firms and advisers were keen to standardise both aspects to comply with TCF regulation and to increase the consistency and standard of advice being given.

A key decision for each business was how active they wanted to be in investment selection. The combination of the RDR's coverage requirements (whole-of-market or restricted) and TCF requirements on suitability of advice places a very heavy burden on anyone giving investment advice. For a one-man practitioner without access to broader resources, it is almost impossible to have an intelligent view on all of the products they are required to cover to be classified as an independent adviser. Advisers of all kinds therefore had two critical questions to answer: did they want to be independent or restricted, and would they continue to make their own investment selections?

.....

*How to make a research arm cost effective: become discretionary or sell it to other advisers*

.....

### Investment adviser

An adviser who wanted to retain an active role in defining the investment proposition still had a number of decisions to make. Firstly, they had to define their product universe – would they be whole of market or specialise in a smaller subset of products? Once an Investment IFA had decided to cover the whole market, and continue to actively manage their clients' portfolios, several, unsurprisingly, did not want to stop there.

To build a research arm capable of satisfying the regulator that it was whole-of-market is neither simple nor cheap, so a number of firms looked at how they could increase their revenue stream from this investment. This has taken a couple of forms. In terms of their client proposition, a number of IFAs have obtained discretionary licences and positioned themselves as Wealth Managers. Having discretionary authority over client assets makes portfolios easier to manage, but it also makes it much easier to justify taking a fee on an ongoing basis, rather than having an event-driven revenue stream.

The second route to maximise revenue from defining an investment proposition is to sell it to somebody else. This has obviously been a niche of the UK marketplace for many years, with research firms such as OBSR (now Morningstar) originally selling independent ratings to manufacturers, but later realising they could also sell model portfolios and recommended lists directly to distributors.

The RDR has encouraged a plethora of new entrants into this market with wholesale distributors making part of their research or product set available to the retail market. Stockbrokers have been especially active in this space, with groups such as Brewin Dolphin and Brooks MacDonald driving significant business growth through adviser distribution. However, other advice firms have also started to sell their investment propositions, in some cases significantly altering their business model to do so.

### Mass-market adviser

It is almost impossible to summarise how the many types of advisers choose investments, however, a number of broad trends are identifiable. The most significant being that the days of the individual adviser acting as a stock (or fund) picker and building client portfolios from scratch are gone. Advisers drifted into this model in rising markets when gains seemed to be easy to come by, but the financial crisis, the increasing risk of inconsistent or poor advice, and the reiteration of the coverage requirements spelled out by the RDR have forced advisers to re-evaluate. This has led to many businesses separating financial planning from investment decisions.

### *Financial planning*

As part of the financial planning process, an increasing number of advisers are using standard risk-evaluation tools as part of their Know Your Client exercises, and rather than pointing investors towards different asset classes or funds, they point them towards different risk categories. These are often better understood by the end investor as they focus on possible outcomes rather than complex (to a layman) concepts such as alpha and beta. (It was of scant consolation during the market downturn for investors to be told that the fund they had invested in had outperformed the market and ‘only’ lost 40% instead of 50%, even where fund picking had been successful).

### *Investment decisions*

For investment decisions, a number of different business models began to emerge. Before the RDR came into force, much of the focus was on whether advisers would be independent or restricted. For several of the big nationals and networks, they saw an opportunity for vertical integration where advisers would sell a highly restricted investment proposition dictated by Head Office, with the Head Office having considerable pricing power with manufacturers as a result. This model also had appeal to manufacturers, as it had the potential for partnerships to drive huge volumes of business from underlying advisers without the need for the same level of on-the-ground coverage that was needed in the world of fund-pickers.

In fact, many advisers valued their independence and the independent label very highly and pushed back against such policies, ultimately with the power to vote with their feet if they felt they were being forced into a model they didn't like. Furthermore, the focus on vertical integration led to some questionable business practices, eventually leading the FCA to issue a paper on inducements re-clarifying the rules and warning both manufacturers and advisers of the risks of tying marketing payments to investment decisions. Combined with the rush to get qualified, all this slowed down the introduction of Centralised Investment Propositions (CIPs), with many plans being repeatedly pushed back between 2011 and 2014.



Some firms underestimated how highly their advisers valued their independence.

The net effect is a market with considerable variation in how much independence an individual adviser has for investment decisions. At one end of the spectrum, some nationals and networks have fairly large panels of approved products, which an adviser can select from and build their own portfolios from these lists. They will also usually retain the ability to buy off-panel, albeit with the higher administrative burden of due diligence to perform to justify why that choice was made, leading to such behaviour being restricted to scenarios where there is high conviction and/or larger IFAs with enough resource to support the additional burden. Independent firms wishing to maintain input into the investment proposition may use another professional evaluation of funds as an initial screen, with a common example being firms using a universe of Morningstar rated funds.

At the other end of the spectrum, we are starting to see the emergence of restricted CIPs, as predicted before the RDR, but this is generally only happening where the underlying adviser is a willing participant in the change. Firms have learned from the experiences of some high-profile advice groups such as Sesame, who tried to force unwilling advisers down this route and saw many change their affiliation as a result. This should not be surprising, as it reflects the different nature and backgrounds of advisers in the UK market.

Appointed Representatives (ARs) of nationals or networks are likely to be far more willing to be pushed down this route, either because they are direct employees of the firm or because many had a background in the tied salesforces that dominated distribution in the 1980s and 1990s. Registered individuals (RIs) with an independent background are much more likely to prize their own independence, and are only likely to accept such changes only if they feel it has been their choice.

For information on how flows have changed through their various channels, see Chapter 3.

## Chapter 6: Impact on manufacturers

The RDR has also had a major effect on the fund managers who manufacture the product for distribution. It can be divided into two main categories, the operational impact and the commercial impact of changes to the distribution model and product preferences in the market place. Taken together, these changes have added costs, fundamentally reshaped the investment offering of many firms, but also offered huge opportunities for growth and vertical integration for those who get their strategy right... with the accompanying threats of increased competition and stagnation of product offerings for those who fail to grasp the importance of the changes and how they might fit into the new environment.

### The impact on fees – a red herring?

Before we look into the two big impacts identified above, it is worth taking some time to address the biggest fear of manufacturers going into the RDR – that it would lead to significant suppression of fees. There was a widespread fear that the unbundling of fees would lead to a value chain compression of up to 50bps, with consultants such as Deloitte's forecasting that manufacturers could potentially bear a large part of this reduction<sup>1</sup>.

At a headline level, this would appear to be inevitable – over the years a standard pricing model of 1.5% for equity funds, 1.25% for balanced and higher-risk bond funds and 1% for core bond funds had been attached to the A share-classes that dominated the retail market, whereas expectation for the industry were that clean, unbundled share prices might start at 75 basis points (bps), suggesting a 50% fall in gross revenues. This does not stand up to even the most superficial analysis, as the 1.5% model had always involved rebating 50bps in trail commission to the adviser, and since the growth of the platform model a further 25bps to the administrator as well.

In addition, many large distributors across the spectrum, from large execution-only providers such as Hargreaves Lansdown to the big global financial institutions and large private banks, had long received rebates over and above the 75bps in return for their distribution power, receiving rebates of 55% and even 60%. This meant that in reality average revenues in the industry had never been as high as the A share-class suggested. That is not to say that the RDR posed no threat to manufacturers as a result of fee unbundling, but that pressure was indirect, with many advisers considering allocating more of their clients' portfolios to lower-fee products such as ETFs or

---

1. Deloitte: Responding to the Retail Distribution Review: Shaking up investment management?

trackers in order to keep the overall cost down whilst maintaining as much margin as possible for the provision of advice (see chapter 7 for impact on investment choices).

## The operational impact

From the start, it was clear that the biggest single operational impact on fund managers was the management of share-classes. As consultants such as Deloitte identified, there was likely to be a requirement for at least three different share-classes. The existing A class would be maintained for existing business, which the FSA/FCA had made clear could still receive commission on a legacy basis after RDR until an advice event occurred. Secondly, a clean or factory-gate share-class with all adviser and platform charges stripped out, and lastly a hybrid class stripping out trail but including platform fees, needed as the FSA/FCA had indicated this would be allowed, at least for a transitional period.

However, this would not restore fund groups' pricing flexibility, as the percentage rebate system in theory allowed for infinite pricing points and many large distributors were already receiving below factory-gate prices. Since it is unlikely these groups would accept an increase in fees to the level of much smaller distributors without

their pricing power, discussions began around the creation of a further class or classes, often referred to as 'superclean'.



Fund managers are reluctant to move to clean and superclean pricing as it brings all negotiations into the open.

This debate has yet to reach a conclusion, with many groups looking to rebate the clean share-class to maintain pricing flexibility. By moving to a clean/superclean share-class system, what had previously been private arrangements between a distributor and fund manager were suddenly open for all to see, discuss and of course, demand. This has the potential to put fund managers on a collision course with their large global and regional distributors, particularly if the super-clean prices

are more advantageous than they have previously negotiated. For that reason, fund managers are increasingly likely to offer a standard share-class and/or, an institutional share-class, both of which can be rebated as necessary.

Another option is to move money into sub-advised accounts, meaning pricing arrangements can stay private. The distributor then launches a mirror fund under its own fund umbrella.

## Clean v superclean

At one end of the spectrum, Investec were the first movers in the market to superclean, announcing a share-class priced at 65bps on a number of their leading funds as long ago as September 2013. At the other end, large distributors such as Standard Life announced they had secured an average rebate of 9bps from the clean prices with 15 leading fund groups. More recently, Hargreaves Lansdown announced it had received average prices of 54bps on its core 27 fund offering compared with 66bps on its overall Wealth 150 panel and 71bps as the industry average for clean share-classes.

Although the longer-term solution to the share-class debate is not clear, two key impacts can be identified. The number of share-classes has grown, and this has occurred across Europe not just in the UK, with Ignites Europe reporting a doubling of share-classes across Europe from 50,000 before 2010 to 98,000 earlier this year. This has obviously had an impact on fund managers, not only because each share-class carries its own cost, but also because it has distracted from other product development activity. The second impact of share-class proliferation is the potential for confusion it creates for consumers, and more importantly the impact of increased disclosure on relationships between distributors and manufacturers.



Comparing funds with different share-classes is difficult and potentially misleading and inaccurate

For the consumer, proliferation causes two main problems. Firstly, the number of share-classes available makes comparison of different funds difficult and increases the possibility of clients misunderstanding the impact of fees on their investments. In fund documentation, fund managers need to decide which share-class or classes to use when disclosing the potential impact of fees, which clearly could cause confusion.

Similarly, comparing performance numbers between funds with different fee structures could also mislead, but perhaps the biggest difficulty comes from re-registration of portfolios from one adviser or platform to another. In the past, the almost universal use of the A share-class made moving share-classes easy to do and with minimal or no impact on administration or tax issues. Now, the risk is that if a client wishes to transfer, the same share-class is not carried and they could be forced to sell and rebuy their investments, potentially triggering capital gains tax obligations.

Lastly, because there is no sunset clause on when clients can continue to hold A share-classes, this situation has no end in sight meaning confusion could continue for many years. This is clearly one area where, although the principle behind unbundling

is laudable, the execution was not fully thought out in advance and has created unnecessary complexity for fund managers, platforms, advisers and most importantly consumers.

### **TCF requirements**

In parallel to operational costs introduced as a result of the RDR, fund managers have also had to deal with an increasing burden to comply with TCF rules. Although fund managers successfully pushed back on the requirement to individually monitor adviser recommendations and pricing as part of the RDR (see Chapter 1) the FCA has continued to focus on suitability, and the fund manager's role in ensuring that not only are its products targeted at appropriate segments of the market, but also to appropriate individual clients. This is obviously difficult when the overwhelming majority of business is conducted through aggregated accounts, meaning firms will need the cooperation of platforms and other intermediaries to comply.

The requirements cover all parts of the process, with research required before products are launched to assess the target markets, and post sale assessments of whether a product has achieved the client's outcomes. The latter is potentially problematic as customer satisfaction with investments is usually heavily influenced by performance, meaning managers will need to be creative in finding suitable methods for documenting whether a fund is reaching the right clients and is being managed in line with client expectations.

Fund managers are required to implement management information processes and documentation to ensure compliance with these requirements, which will impose a significant administrative burden in time and cost. This may squeeze smaller players with broad distribution capabilities and give an advantage to larger houses that are better able to absorb such costs.

### **The effect on distribution and changes to product strategy**

We have covered many of the major changes to distribution in Chapter 5, but obviously those changes also have a critical impact on fund managers, as they each have relative strengths and weaknesses in the different distribution channels that have historically driven flows. As discretionary fund managers and execution-only channels are commonly forecast to grow significantly as a result of both demographic change and the RDR, groups with existing strong relationships in these areas are well-positioned to benefit, although they need to consider the likelihood of increased competition in the near future. Conversely, groups that have historically relied upon pay-to-play arrangements with platforms and/or nationals and networks to position their product advantageously will have to re-consider their business models.

All fund groups should consider whether their existing channel coverage is right for the future, with a number of groups already announcing major changes to the structure of their sales teams to better serve the market. Groups such as JPMorgan, Fidelity and Standard Life have already announced major changes, with the emphasis being on the shape of coverage rather than an attempt to downsize their teams.

The focus on inducements will also affect many groups, with the enforced separation of marketing arrangements and fund selection placing more scrutiny on the cost-benefit analysis of those marketing arrangements. That is not to suggest that such deals have no value to fund managers in the future, but they will need to be more focused on which advisers they are gaining access to, and whether they have the right product to sell to them.

Perhaps the most fundamental impact on fund managers is the impact on investment choices. The rise of solutions and risk-based client-profiling has given fund managers a choice between whether to focus on selling solutions directly to advisers, concentrate on selling single-strategy products to others who are building those solutions, or both. Groups wishing to do the former will need to consider whether they have the required product in the form of multi-asset funds, fund of funds, or discretionary solutions, while those in the second camp need to consider their pricing and alpha strategies carefully to maximise their appeal to other fund buyers.



## Chapter 7: Impact on investment choices

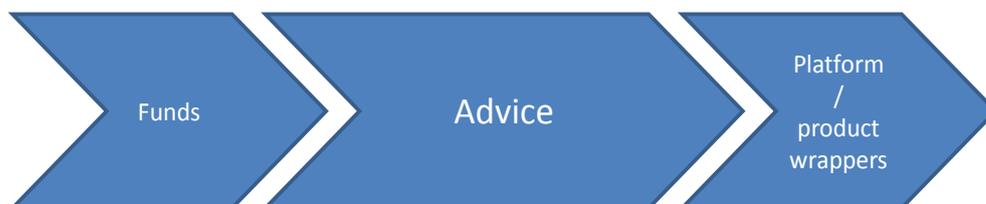
**T**hroughout this paper on the changes to the UK marketplace, a number of major themes influencing investment choices in the market have been touched on. This chapter reviews these themes and their overall impact on investor choices.

It is important to note that for large segments of the market the shape of product distribution has not fundamentally changed. Wholesale fund buyers not only continue to pay for alpha across a very broad range of asset classes and strategies, but also retain the ability to build their own portfolios and make their own asset allocation calls, limiting the market for solutions-based products through these channels.

While buying patterns have changed over the last few years, this is mainly down to natural changes in the investment cycle and changing investment trends rather than fundamental change driven by regulation. What has changed is the volume of business written by these channels, as they seek to capitalise on both the expansion of the mass-affluent sector and the increasing trend among advisers to outsource their investment decisions. For this reason, it remains an entirely viable business model for a small- to medium- sized fund manager to concentrate on these markets, keeping budgets under control through smaller sales teams and lower marketing costs than groups targeting the mass retail market.

However, in the retail market much greater change is occurring and the balance of power in the value chain has shifted to advisers. Before, adviser investment behaviour was often dictated by the relationship with the fund manager, its brand and reputation and its generosity in terms of retrocessions. But now that advisers are no longer influenced in this way and are effectively in charge of the value chain, they can decide which provider(s) to use.

**Fig 7.1: Adviser squeeze on product and service providers**



One factor driving the growth of low-cost products such as ETFs and trackers has been advisers' desire to keep the overall cost down for end-customers, while at the same time maintaining their margins on advice. This has manifested itself in advisers placing far greater emphasis on the relationship between fees and performance to

make sure that the overall cost for the investor does not rise and certainly that it remains on a par with pre-RDR costs.



Advisers rule the value chain and are creating a cost barbell.

As a result, advisers are increasingly using passives and ETFs for cheap core beta exposure, while happily paying more for fund managers that are consistent alpha generators. This has created a cost barbell with cheap passives at one end (and prices have been falling rapidly in the passive arena), and expensive alpha generators at the other. Managers of expensive and mediocre funds that sit in the middle of that cost range will lose out.

At face value, this sounds alarming for the active fund industry, and for consumers if the change is driven by arbitrary pricing points rather than the ultimate consumer outcome. But the reality is that there has not been a mass move away from actively managed funds post RDR. One reason for this

is that there is still a huge volume of legacy, pre-RDR assets, which advisers will be loath to disturb. However, in tidying things up from an RDR perspective for the platform world, the FCA has banned platform service providers from retaining rebates on new business from 5th April 2014 and on legacy business from April 2016<sup>1</sup>.

In theory, platforms will still be able to receive rebates on behalf of end-customers and pass them on in full beyond April 2016. In practice, however, most platforms have decided to move to a clean share-class basis by April 2016 with at least half of the adviser platforms in the UK, deciding to bulk convert from current commission-loaded share-classes to clean ones by April 2016. Many adviser platforms have decided to bulk-convert advisers before then. Standard Life Wrap, for example, is already 100% clean. Most platforms will be operating on a clean basis by April 2016 and as a result, changes in the types of underlying investments will become more pronounced from that point onwards.

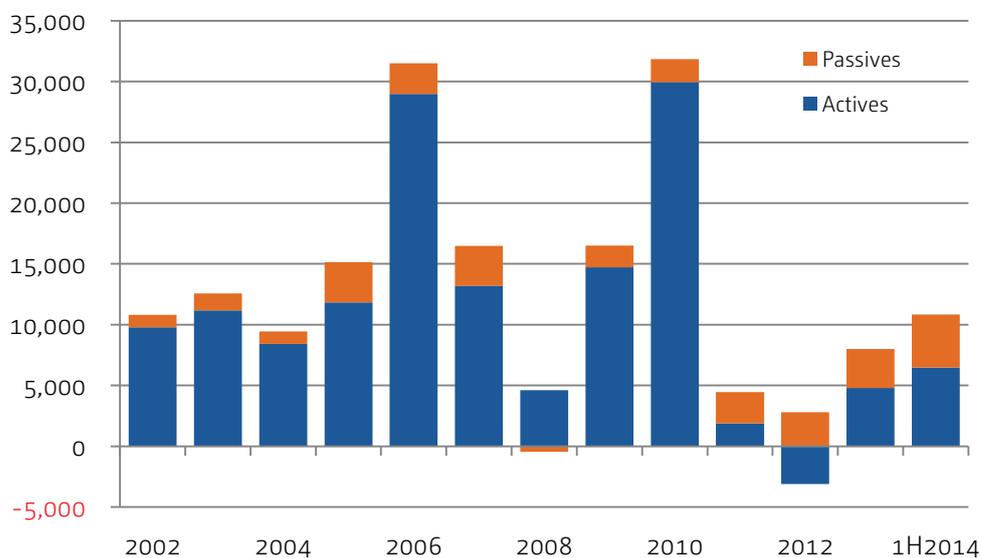
## Passive move

Where the impact of ETFs and trackers has been felt most strongly has been in core equity markets. This has arguably been an overcrowded marketplace for many years, with over 330 UK-domiciled funds in the UK All Companies sector alone. While this sector has been in net outflow for several years, it is arguably a result of two trends that should not be viewed as a threat by fund managers. Firstly, there has been a decline in the home equity bias in the UK market. This is a healthy development as

1. FCA PS13/1 policy paper

UK investors had been structurally hugely overweight in UK assets for many years, reducing the risk-weighted returns of their portfolios. A good example of the risks of this approach came with the BP oil spill in 2010, when risks to BP’s future cash flow highlighted the fact that their dividends were responsible for a seventh of the entire UK market, which meant that investors that were over-exposed to the UK Equity Income sector were potentially vulnerable. Since then, investors have diversified into other equity income markets both global and regional, bond-based solutions such as high yield and strategic bonds, and multi-asset income solutions that give broad exposure across a range of asset classes. Despite the diversification, there is still a significant weight of assets in the UK sector.

**Fig 7.2: Passive v active net sales in the UK**



Source: Fundscape, Lipper Fundfile

Secondly, the move to passive has squeezed the lower alpha end of the fund market. Sales into actively managed funds have increasingly gone to funds with a higher alpha target, with old style index plus 2% products in terminal decline. The trend of paying for significant alpha or taking the beta from a cheaper product is to the consumer’s benefit, as the merit of a fund with a TER of around 1.8% targeting alpha of 2% is not easy to defend. The market for actively managed funds that can actually deliver superior returns has certainly not dried up, even in the UK equity sector.

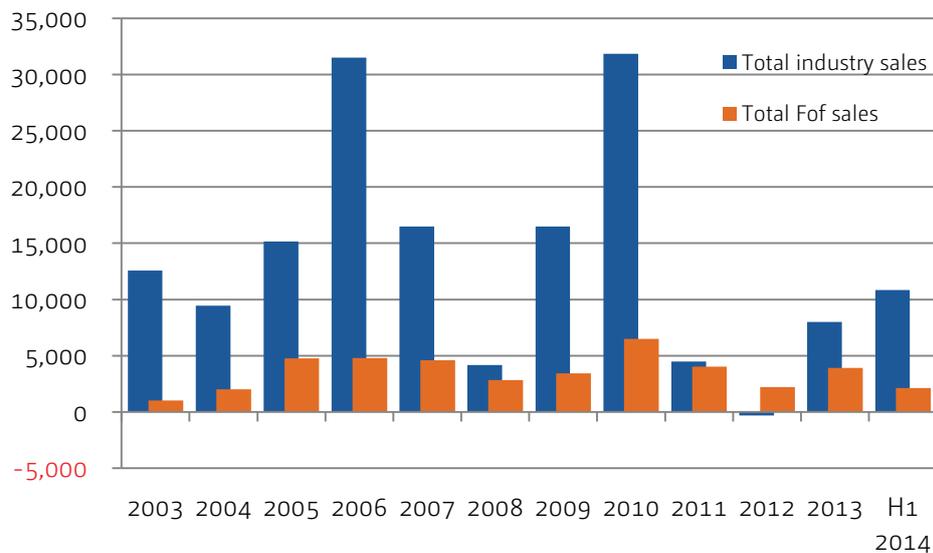
### Solutions

The other major trend in the retail market has been the increasing role of solutions products, often tied to a risk model and a level of volatility. These are more in line with desired consumer outcomes than buying individual products, but they can also be big positives for both the adviser and fund manager communities. For advisers, outsourcing and/or buying solutions can reduce the risk of mis-selling by standardising the investment selection process, focusing on consumer outcomes and

allowing them to concentrate on their core skills of financial planning rather than picking fund winners.

Many nationals and networks are interested in building a centralised investment proposition (CIP) using this model, since it allows the head office to use its scale to centralise and shortlist suitable investment product for all underlying advisers.

**Fig 7.3: Total v funds of funds net sales in the UK**



Source: Fundscape, Lipper Fundfile

These solutions have taken two primary forms, fund of funds and discretionary models. Both of these existed before the RDR and TCF regulation, but the way they have reached their target audience has changed as a result of the changes in the UK market. As figure 7.3 shows, fund of funds started to grow significantly in the early 2000s and held up well relative to other funds in the market downturn. These were originally sold as a straight alternative to a single-manager fund, with a message of superior alpha generation through the best-of-breed approach. Although this message may still appeal to some advisers and their clients, the risk-based solution model has created a new market for these funds.

At the same time, discretionary models have started to compete for these flows. These were traditionally the preserve of the mass-affluent sector, sold by DFMs to clients with £200k and upwards to invest. They can be positioned as a more exclusive product than fund of funds to investors, and when paired with sophisticated reporting can give them a higher-touch service proposition.

In reality the investment proposition is commoditised in the same way as it is for a fund of funds. This means that if costs can be controlled then it can be offered to retail clients. Combined with the growing desire of investment advisers to get a discretionary licence, this has eaten into funds of funds' market share.

### Fund manager solutions

There are also potential advantages for fund groups in selling solutions as well. They are a defence against the threat of passive, since they cannot be indexed easily and rely on asset allocation skills for much of their returns. Although the managers of these solutions can use passive instruments within their funds, they are likely to use active management where they think alpha can be added, enhancing returns for the investor and fees for the industry.

The second commercial advantage of creating solutions is that the manager controls the whole portfolio, increasing revenues and decreasing the threat to revenues of a single strategy struggling for performance. There are two drivers of increased revenue: a further layer of fees and, more importantly, the opportunity to increase market share. A fund manager selling to a fund picker or selling building blocks to a fund of funds manager would consider itself to have done well to gain a 10% market share, whereas a solution means a 100% share is achievable at the client level and an overall level well in excess of 10% can be achieved where panels are restricted to a shortlist of fund managers.

**Fig 7.4: Single strategy v solutions**

	Single investment		Total end client portfolio		Total adviser business	
	Single	Solution	Single	Solution	Single	Solution
	£10k	£10K	£1m	£1m	£20m	£20m
Market share	100%	100%	10%	10%	10%	20%
Allocation to own product	100%	15%	100%	15%	100%	15%
Fees on own product	0.75%	0.50%	0.75%	0.50%	0.75%	0.50%
Revenues on own product	£75	£7.50	£750	£750	£15,000	£15,000
Fees at FOF level	0.0%	0.75%	0.0%	0.75%	0.0%	0.75%
Revenues from FOF	£0	£75	£0	£7,500	£0	£30,000
<b>Total Revenues</b>	<b>£75</b>	<b>£82.50</b>	<b>£750</b>	<b>£8,250</b>	<b>£15,000</b>	<b>£33,000</b>

The table above shows how this can boost revenues. On a single deal, the difference in revenue is not large as solutions are often priced at the same level for the client as individual funds. However, managers may boost their fees by allocating to their own underlying funds and taking a fee on them. Although this is sometimes referred to as double dipping, and some managers choose to waive this revenue stream to avoid negative feedback and/or to boost performance, this is not really accurate as two separate services are being provided. The fee charged at the fund of funds level

is charged directly to the client as a payment to the manager for the asset allocation and fund selections he or she takes on the client's behalf. The fees on the underlying products are borne by the fund and are to pay the manager of that product to provide a return in that strategy.

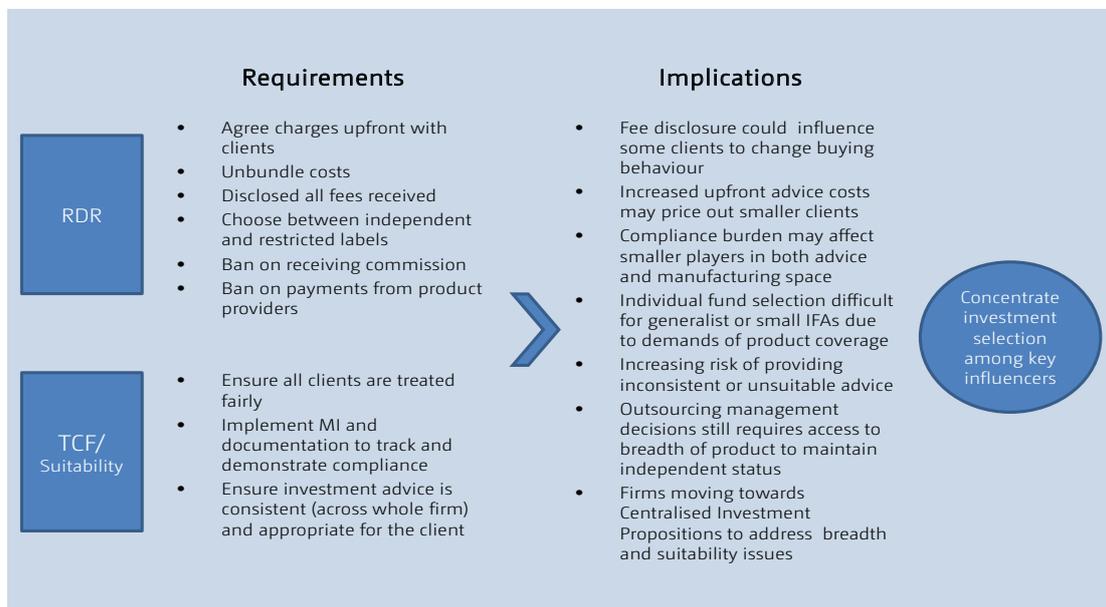
Where the difference starts to become more noticeable though is when you consider the overall market share achievable at the client or adviser level. At a client level, advisers may allocate the whole portfolio to a single solution, giving a greatly enhanced revenue stream. At the aggregate adviser level, a fund manager would have to have at least 3 funds achieving very high market shares to reach the same position a shortlisted solutions provider can get to by being one of 5 fund managers selected. This increases the chances of there being clear winners and losers in the retail market, it will be interesting to see if this drives further consolidation in the industry.

## Chapter 8: Concentration of influences

The days of an individual adviser building portfolios have largely disappeared. As the graphic below shows, the combination of RDR and TCF/Suitability rules has simply made it too difficult and too risky for advisers and adviser companies. The breadth of product coverage required has pushed many advisers down the outsourcing route, while those who continue to see the investment proposition as a critical part of their offering have increased the professionalism of their research capabilities and standardised the advice process to ensure more consistent outcomes.

One result of these trends has been the increasing separation of financial planning and investment management decisions, which is a positive development allowing professionals from both sides to concentrate on their core skills. That is not to say that many businesses do not or will not continue to offer both advice and investment management capability, but these are increasingly seen as distinct skills and managed as separate units.

**Fig 8.1: Regulatory requirements v implications**



If we accept that access to the market place will increasingly be controlled by a smaller number of key influencers or gatekeepers, who are these people and what are the implications for fund managers? Gatekeepers fall into a number of categories, but one common characteristic is that they do not directly manage money on behalf of clients. The majority are fund researchers and selectors, whose only task is to evaluate funds against each other before placing them onto a panel or into a model portfolio.

Obvious exceptions to this include funds of funds managers or managers of discretionary portfolios, but even then a fund of funds manager is investing pools of money from clients predetermined by others to have similar investment goals, while DFMs often have research units that influence a high percentage of their portfolios.

### The institutionalisation of the retail market

The rise of these kinds of gatekeepers is changing the shape of the UK retail market, where achieving a fund rating or placement with highly qualified investment professionals is a pre-requisite for winning business from the underlying advisers. This is making the market more similar to the institutional space, where investment consultants have played a similar role for many years. As is the case in the institutional arena, firms are starting to differentiate between the sales skills required to service these gatekeepers and those required to win business from end advisers,

**Fig 8.2: Key influencers of fund selection**

Retail (IFA and execution-only)	Wholesale
<ul style="list-style-type: none"> <li>• Head office panels eg Hargreaves Wealth 150, national &amp; network adviser company panels</li> <li>• Qualitative ratings agencies</li> <li>• Risk/volatility-based ratings agencies</li> <li>• Outsourced model portfolios</li> </ul>	<ul style="list-style-type: none"> <li>• Fund selection units (private banking)</li> <li>• Fund of funds managers</li> <li>• Multi-manager managers</li> <li>• Discretionary fund manager research units</li> <li>• Life company panels</li> </ul>

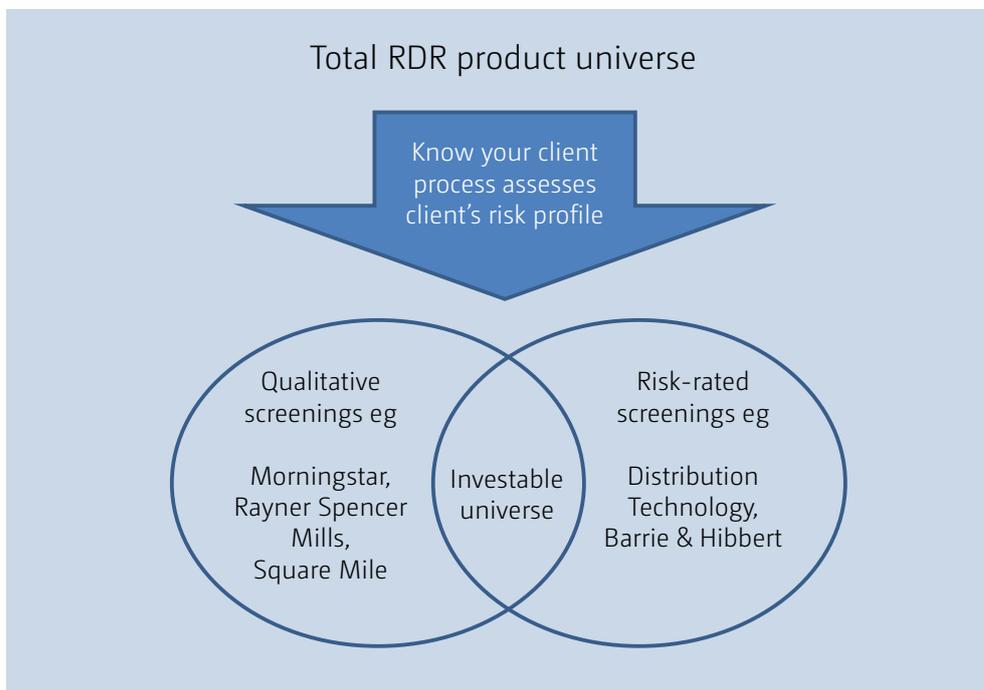
and creating separate teams to do so, with groups such as Fidelity and JPMorgan announcing similar moves in 2013.

At the wholesale end of the market, these relationships have not changed much over the last few years, although within the discretionary fund manager (DFM) channel the pressure on individual investment desks to buy from a panel is definitely increasing. The change is predominantly at the retail end, where several different gatekeepers might be involved in an advice firm's buying process, and these gatekeepers will vary from client to client. Many firms will have a qualitative and a risk-based input in their advice model, leaving the end adviser with a pool of available investment choices, as the figure 8.3 shows.

The qualitative rating screen could be a head office panel for a national or network, or for an independent adviser it might be Morningstar-rated funds, but in either case it

reduces the total universe an adviser must consider in a way that does not threaten their independent status with the regulator. The risk-rating screen is a relatively new concept, where a risk tool (off the shelf or proprietary) is used to assess a client's attitude and ability to take risk, giving them a score representing a band (usually based on volatility) of risk that the client portfolio should fall into. The risk-rating firms then assess funds, and assign them into one of these risk buckets. These ratings are based purely on the asset allocation and management style of the fund and make no attempt to rate the quality of the fund or the manager, but a relationship with them can still be critical.

**Fig 8.3: Sample retail buying model**



### Platforms as influencers

One other group that has played an increasing role in influencing fund choices are platforms. Platforms were originally conceived as an administrative solution to aid management of a multi-provider portfolio and to save cost. However, platforms swiftly realised that as the owner of the relationship with the adviser and/or the end client, they had influence that could be monetised even if they did not actually give advice. They have influenced product sales in two primary ways, which often go hand in hand: how they position product on their platform and through pricing power.

A good example of this is Hargreaves Lansdown. Although the majority of business written through its platform is execution only, Hargreaves Lansdown has done its own qualitative fund research for many years and has used this to recommend preferred product to their customers. Before the RDR, Hargreaves maintained a Wealth 150

list of recommended funds, and used its scale to get rebates from fund managers, with typically 25bps of this rebate passed back to the customer. The exact size of the rebates received was not public, meaning any additional discounts Hargreaves could negotiate went straight to the bottom line.

With the introduction of the RDR and clean share-classes, the group changed tack. It now recommends a core list within the 150 called the wealth 150+, where it has negotiated fees below the clean share-class price. This is passed onto the customer but obviously helps to make Hargreaves more attractive to the end-consumer, and in turn increases their pricing power with fund managers. The 27 or so funds on the Weath 150+ list are expected to attract around 80-90% of the platform's flows so it is no surprise that it asked fund managers for their best possible price in return for inclusion in the list.

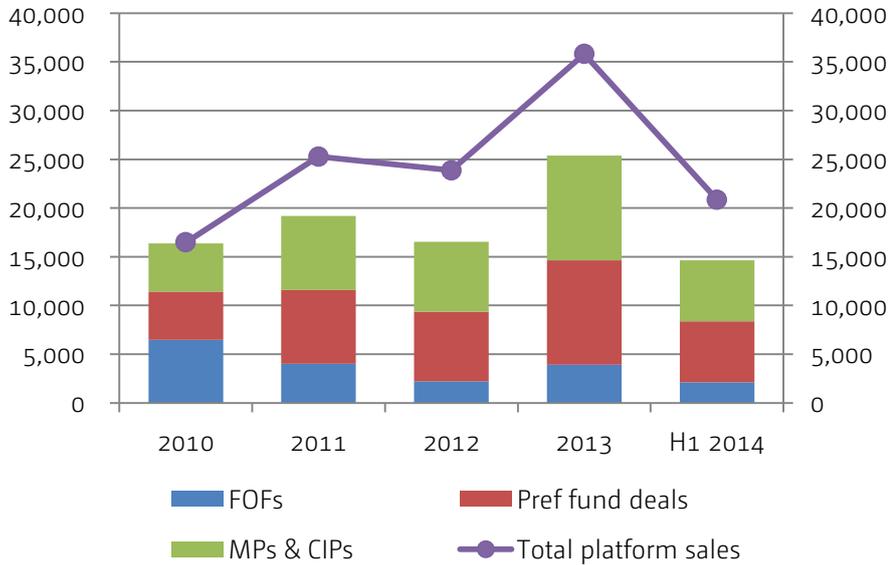
Another example of platforms influencing distribution is Old Mutual/Skandia. We look in more detail at their business model in Chapter 9, but of relevance here is that Skandia has continued to use its influence to command discounts from the fund manager. Like Hargreaves, its pre-RDR model was to use their scale to negotiate larger discounts on standard retail fees. Unlike Hargreaves, it has maintained a higher margin post-RDR by converting fund holdings with other managers into sub-advised accounts, allowing them to negotiate their own price for access to the product, then sell a mirror fund under their own brand at a standard retail price.

### **What does this mean for fund managers?**

For fund managers, the changes in the retail marketplace have a number of effects. Relationships with the gatekeepers are critical, as even if you have a good relationship with end advisers you may not be able to win business without meeting their screening requirements, whether these are qualitative, quantitative or a mixture of both. For many firms, it may be worthwhile considering the structure of the sales team to ensure that the coverage of gatekeepers is of the required quality. However it is important not to lose focus on the end-adviser. While strong relationships with gatekeepers can give access to large pockets of underlying distribution, the final investment decision still lies in most cases with an individual adviser who owns the relationship with the end client.

Using total platform net sales data as a starting point, figure 8.4 below charts the volume of flows that are estimated to be under some kind of influence. Funds of funds are the traditional gatekeepers with fund groups such as Jupiter attracting considerable flows.

In the platform world there are several large platforms that have preferential deals with their in-house group manager(s). Key examples include Fidelity, Standard Life, Axa and Old Mutual/Skandia. Buyers of house funds get cheaper, exclusive rates

**Fig 8.4: Platform sales by influence**

Source: Fundscape Platform Report and Lipper Fundfile for funds of funds.

Notes: Actual total net flows for platforms, estimated net sales for preferential fund deals and MPs & CIPs.

than equivalent funds. Indeed, the same funds on other platforms will be more expensive. Some of these preferential deals are also in the form of funds of funds, so some double-counting is inevitable, nonetheless we estimate preferred fund sales to account for 30% of net flows.

The influence of model portfolios and centralised investment propositions is more difficult to assess. Discussions with platforms point to a wide range depending on the type of platform. At some platforms model portfolios account for more than 50-60% of flows whereas elsewhere they can account for as little as 5%. As a result, we have estimated the industry average at around 30%.

### Symbiotic relationships

Acquiring a panel listing does not guarantee business will be written, and the ability to influence the underlying adviser will still be critical to maximising market share. Indeed, the support and information available to advisers may well be one of the criteria used when deciding whether a product can be panelled.

The end of the fund-picking era and the increasing influence of gatekeepers does mean that huge regional coverage teams alone are not enough to win business. It allows small- to medium-sized fund managers that previously specialised in the wholesale market and have the skills and product to appeal to gatekeepers to consider whether the retail market is now a viable prospect for them.

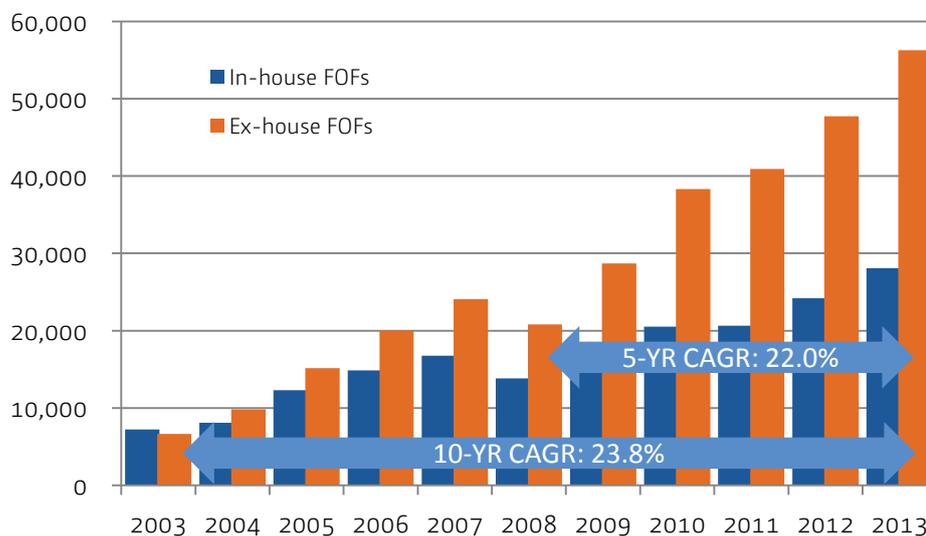
However, end advisers will continue to prize their own role in the process, so a sales model that engages individual advisers and provides them with a quality relationship are still likely to be the biggest winners – providing they have the product and strategic relationships. This symbiotic relationship will define the retail marketplace in the future, and groups that succeed in both areas will see their market share grow.

## Chapter 9: Competition across the value chain

Twenty years ago, the value chain in the retail asset management industry in the UK was remarkably simple. Fund managers managed and administered their funds, distributing them either through IFAs, directly to the consumer or through the tied sales forces of banks and life companies.

Many banks and insurers had proprietary fund managers and in-house capabilities, but the basic model remained intact. So how did that model change into what we see today, with a web of companies competing with and servicing each other, often at the same time? The answer lies in the power of the profit motive. The desire to control costs led to the birth of platforms, a boon for advisers which also allowed fund managers to concentrate on their core competency of managing money. On the revenue side, however, there is a limit to how far you can grow in a highly competitive market by pushing out product or trying to reach more consumers, so naturally fund groups looked to diversify their revenue base.

**Fig 9.1: Growth of UK funds of funds assets**



Source: Fundscape, Lipper FundFile

The trend started well before RDR with the arrival of platforms in the late nineties/ early 2000s. These were generally launched by fund managers or life companies as a way of widening distribution (for example the Fidelity Fundsnetwork platform for direct customers) or to own more of the value chain — tightening relationships with clients, gaining pricing power, and being able to position product more advantageously.

The trend was further accelerated with the rapid growth of third-party funds of funds in the early 2000s. Funds of funds have been sold in the UK for many decades and initially these were invested in in-house funds. However, their performance often failed to impress and this came to a head in the technology boom and bust years. Faced with losing unhappy clients, many funds of funds began to use third-party funds and saw that there was an opportunity to use reputable fund managers in their portfolios, while maintaining both the client relationships and the level of revenues from the share of the annual management charge (AMC).

The big retail distributor firms had seen an erosion in their margins from their core revenue stream (the fees they received from their underlying advisers) through fierce competition and were keen to find new sources of revenue. They secured these through marketing arrangements from fund managers in return for access to their adviser base (see Chapter 5 on Distribution), but they also began to look for revenue from the investment management side.

## **Outsourced adviser business**

### **DIFs and the move towards outsourcing**

Adviser firms started to offer their own multi-manager products, known as distributor-influenced funds (DIFs), using their access to distribution to receive favourable terms from the underlying managers as well as receive fees from the end client. The fall out from the RDR, and in particular the increasing trend towards outsourcing in the IFA sector, has greatly increased the pace and scope of this competition. Because distributors are able to influence the content of the underlying fund and may try to shoehorn all clients into them, the FCA has frowned heavily on DIFs. Arguably, the creation of Centralised Investment Propositions (CIPs) will recreate many of the same dynamics, albeit without the explicit fee for the distributor.

Where the lines have become most blurred has been in competing for outsourced business from advisers. Anybody with robust asset-allocation and fund-selection capabilities can enter this arena as there are very low barriers to entry (depending on how sophisticated they want the reporting and client experience to be), and all types of groups have done so. Fund managers had already begun to push these offerings several years earlier, and the marketplace has become more crowded since.

The biggest challenge for fund groups in this arena is how they differentiate themselves from the competition. Without stand-out performance most fund of funds look fairly similar, making it hard to persuade advisers to move on from their existing providers especially if the new offering lacks a demonstrable track record. This has led groups to consider offering their own multi-manager expertise through their proprietary platforms or through tie-ups with existing platforms where they can use client reporting and adviser information as a differentiator. Groups or platforms

with experience of servicing the private client sector could have an advantage here, as they have capabilities of taking relatively commoditised investment propositions and providing rich, personalised reporting and servicing to the client. The key challenge will be finding a way to do so in greater bulk and doing so more cost efficiently.

### **Wealth managers move into retail**

At the same time, discretionary fund managers (DFMs) themselves moved into the IFA market. There has always been competition at the top end of the client spectrum for individual clients, but now DFMs were looking to compete with fund managers for outsourced business. This is expected to be a key driver of growth for DFMs, with groups such as Brooks McDonald already acknowledging in their results the role IFA business is playing in their growth.

Brooks Macdonald has branched out from its core business of managing bespoke portfolios for high-net-worth individuals, charities and trusts and now sell their managed portfolio and fund of fund services, partnering with IFAs to make this a core part of their investment proposition. In this way the traditional relationship of client and provider between DFMs and fund managers has been complemented (and arguably complicated) by a simultaneously competitive relationship.

Although there are a good number of providers that specialise in providing multi-manager products, and many traditional managers who have not branched out into the sector, many of the biggest houses are continuing to run both models. These groups sell building blocks to wholesalers and Investment IFAs and solutions to outsourcers. In fact, it is not only fund of fund providers who are competing for both single strategy and solutions business, as many groups are now positioning their own multi-asset capabilities as cheaper alternatives to outsourcers because they do not have the second layer of fees.

### **Vertical integration**

The other way of generating new revenues is to capture more of the value chain through vertical integration. There has been a myriad of examples of this in the UK market over the last few years, with examples including:

- Insurance companies creating product, buying or developing platforms and buying IFAs
- Fund companies buying or developing platforms and L&G buying advice capability
- Nationals and networks creating investment capability
- Wealth managers creating commoditised investment product

### Insurance groups

Insurance companies have often been labelled as the big losers in the RDR and other changes to the UK market over the last decade. It is certainly true that the combined effect of these developments have made much of their old product set obsolete. Historically, large chunks of their flows came from unit-linked pensions, with-profit products and annuities, but the market for these products has been hit by the commoditisation of individual pensions such as Self Invested Personal Pensions (SIPPs), mis-selling scandals and changes in government policy.



Vertical integration is a growing post-RDR trend

Insurance companies have therefore been active in creating or strengthening their own investment product, developing wrap platforms and buying up other forms of distribution. Standard Life developed retail investment product, including the Global Absolute Return Strategies fund, (one of the UK's best selling funds), and a strong multi-management proposition available exclusively to advisers who use its Standard Life Wrap. It also has a stake in the Tenet network of advisers.

Other examples of insurance companies moving into distribution include L&G, which had been one of the six founding stakeholders in Cofunds, the UK's largest adviser and institutional platform with assets under administration of c£70bn as at end June 2014. It acquired 100% of the platform in March 2013 to develop closer links with advisers and have the technology to develop a D2C proposition.

Aegon strengthened its investment capability and spun off its investment arm into a separate brand (Kames) to appeal to advisers. It also bought considerable adviser distribution, with a stake in the Tenet network and full ownership of Origen (a national advice company). Origen launched a restricted advice pension and benefits solution for small businesses linked to its parent company Aegon and its Aegon Retirement Choices platform. In August 2013, it was announced that Origen would become fully tied. The insurance company has also launched Retiready, a D2C retirement platform.

### Fund groups

The best example of vertical integration in the UK market comes from a fund manager. Old Mutual Wealth bought the Skandia platform in 2006 and this year acquired Intrinsic, a large advice network with over 3,000 advisers. This effectively means that it now owns a complete value chain, with each entity capable of operating independently but with clear benefits from combined operations.

Old Mutual and its Skandia platform developed a range of funds, the Wealth Select range, which is sub-advised and jointly branded by well-known third-party fund managers. By offering a smaller range of funds, the platform was able to guarantee distribution in exchange for cheaper access to leading funds. Due to the size of its legacy business, the Skandia platform was expected to see large revenue losses once the platform rules were introduced, but this arrangement allows it to earn revenues from funds and to replace some of the revenue it would lose from moving from a commission-based model to a fee-based model.

It was a win-win situation for all concerned. Fund managers were willing to offer a lower price for larger sales volumes. It's also good for advisers on the Skandia platform since not only do they get access to lower-cost funds, but they are also able to access model portfolios for free, which obviously appeals to IFAs looking to keep down non-advice costs. For Old Mutual, owning advisers makes it easier to capture distribution on platform, and ultimately into their own products. Members of the Intrinsic network are apparently under no obligation to use the Skandia platform, but have access to very beneficial pricing if the whole range of in-house services are used (from platform to product).

Perhaps the biggest issue with all these examples of vertical integration comes from the independent label cherished for so long by many IFAs. Any fund manager, insurer or platform that owns IFA distribution cannot coerce any of the underlying advisers to use their services, but the ability to influence their selections of product and administration tools is clear. At the very least, owning distribution gives them a far closer relationship with those advisers that will put them top of mind when the IFA is making a decision.

## Intercompetition

It is to the credit of the maturity of the UK market that this increase in intercompetition between distribution, manufacturing and administration has not caused more friction than it has. DFMs and fund managers compete with each other for IFA business whilst continuing to have productive relationships with each other as fund buyers and sellers. Nationals and networks, have for the most part accepted the FCA rules on inducements and are again concentrating on the quality of service they can provide to their advisers,



Back to the future: the industry is returning full circle to where it was in the 1990s.

including a superior investment proposition and quality materials from and access to the fund manager community.

The trend towards combining investment capability with administration (returning full circle to where we were in the 1990s) is unlikely to go away, as these two factors will be key in determining the winners in the industry's next big opportunity – the personal pensions market.

# *Part two*

*Assessing the potential impact of an RDR regime on the European fund industry*



## Chapter 10: The Dutch inducement ban

The only other retail investment market to have introduced a broadly similar and all-encompassing regime to the RDR is the Netherlands. However while the UK's RDR regime also covered higher professional standards and qualifications for advisers, the Dutch law focused purely on banning commissions and inducements from the retail market.

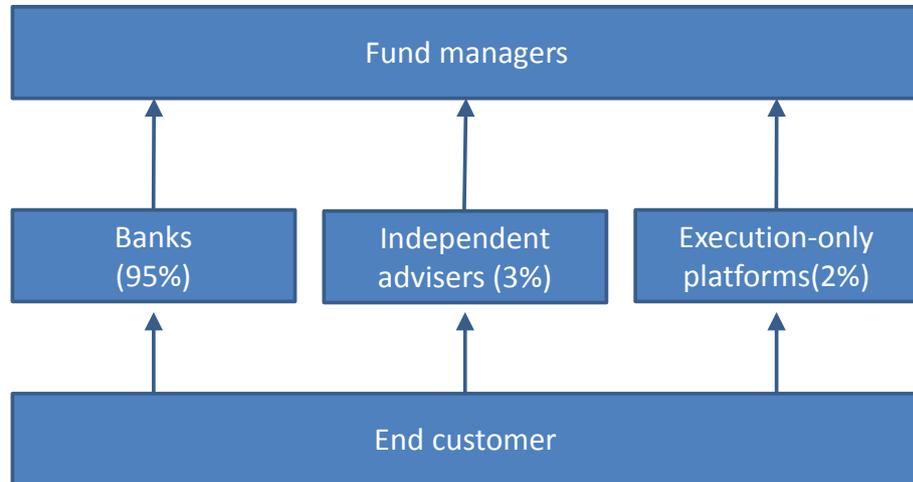
The background to the inducement ban is that the Dutch regulator wanted to definitively break the link between providers and distributors of retail investment products. The Netherlands Authority for the Financial Markets (AFM) had developed the view that it was impossible to give unbiased advice if intermediaries/ distributors were receiving commissions from fund managers and product providers and as a result, the regulator wanted to rid the retail market of this bias. A Dutch ban on insurance product commission had been already in force from 1st January 2013 and the ban on commission in retail investment funds was to come into force a year later on 1st January 2014.

### Size and scope of the Dutch industry

The Dutch fund industry is principally an institutional market with approximately €1.7trn of assets under management as at June 2014. Around €1trn of this amount is invested through Dutch DB pension funds and schemes, a further €600bn is invested in the life insurance products, with only €150bn is invested in retail investment funds.

In terms of distribution, the retail investment fund market is heavily bank-dominated with banks accounting for more than 95% of fund distribution. It is also highly consolidated with the top three banks representing 80-85% of the market. The remainder of the market is subsumed in the last 4-5%. This is principally independent advice, online discount brokers and execution-only services. None of the large Dutch banks have in-house fund managers so banks have preferred suppliers and closer working relationships with fund partners.

Independent advisers and intermediaries number no more than 250-300 and represent around 2-3% of the market. Fund platforms in the form of adviser platforms that are common in the UK for settlement and custody reasons are not present in the Netherlands. Even execution-only services are provided in the main by the banks, however there are independent discount brokers such as Binck Bank and Alex that account for around 1-2% of the market. Many of these execution-only providers have their origins in stock-broking.

**Fig 10.1: Dutch distribution landscape by AUM (%)**

Source: DNB, AFM, Dufas, Fundscape estimates.

## Historical development

In its review of the market, the AFM decided that the only possible roadmap was towards a full ban on commissions. It looked at developments in Europe such as MiFID, the direction of travel for RDR in the UK as well as developments in Australia and India. The government had also lobbied for the introduction of this kind of ban during the negotiations on the review of MiFID and MiFIR, but other Member States and the European Parliament did not support its proposal and so the Netherlands pressed ahead with its own ban.

Dutch ruminations on this second ban really began to take shape in 2010 and 2011. They were an almost inevitable consequence of the financial crisis of 2007-2009, which had placed banks and insurance companies under far greater scrutiny and significant pressure to improve their reputations, solvency and business models. But the origins of their thought processes went back much further.

In the 1980s and 1990s, the Dutch and UK financial services industries were similar in that a light-touch regulatory approach had existed and had resulted in a number of mis-selling scandals. This light-touch approach changed when the Dutch government established a conduct authority in 2002, the Netherlands Authority for the Financial Markets (AFM), bringing with it a much more customer-oriented ethos. In the insurance arena it introduced, among other things, minimum disclosure requirements and standard policy documentation.

## woekerpolisaffaire

Dissatisfied with the way the insurance sector was conducting itself, in 2006 the AFM launched an investigation into the costs and charges in insurance products. This ultimately led to the widespread mis-selling scandal known in the Netherlands as the *woekerpolisaffaire*, which translates as the ‘profiteering affair’.

The ‘profiteering’ occurred in unit-linked savings and endowment policies, which were used not only as savings vehicles to build nest eggs for retirement, but were also used to pay off the capital in endowment mortgages. The AFM found that as well as excessively high charges, there were myriad hidden costs and punitive early redemption fees. The result was that there was usually a significant shortfall at maturity. It is estimated that as much as 80-90% of premiums were swallowed up in insurance costs and intermediation fees.

The fallout from the scandal has been substantial and Dutch insurers are still licking their wounds. Investors distrust of insurance companies reached new heights and remains heightened. New insurance business has taken a considerable hit. The *woekerpolisaffaire* has been estimated to have cost Dutch insurers more than €5bn to date and there are still many legal cases on the go.

In the aftermath of the scandal, the Dutch regulator began to reduce the upfront commissions on insurance products first so that the commission was split 80/20 meaning that 80% was paid upfront and 20% was paid as trail over ten years, gradually descending to a 50/50 split. In 2009, the process of banning inducements began and eventually they were banned outright in unit-linked and insurance-wrapped products by January 2013.

## Gentleman's agreement

While implementing the ban in the insurance arena, the regulator was already looking to broaden the scope of its ban to investment funds and other non-insurance-based investment products. These discussions started in 2010-2011 when the regulator began to make increasingly frequent references to its view of how banks should behave, and their need to change policies and attitude to customers. It became increasingly clear to all concerned that banks should not expect to continue to receive rebates or commission in the long run.

Eventually, in the summer of 2013, the regulator concluded a gentleman's agreement with six banks, ABN Amro, ING and Rabobank, Van Lanschot, SNS and Binck, which between them cover the lion's share of the distribution market. The gentleman's agreement took shape before the actual law had even been drafted. The proposed law to ban commissions went through parliament without a hitch and became law in the

last quarter of 2013. It came into force on 1st Jan 2014, but by which time the majority of Dutch banks had already ‘voluntarily’ banned commissions, although just how voluntary it was is open to debate.

### Terms of the ban

The ban applies to ‘both the receipt and payment, either directly or indirectly, of any kind of inducements to and from third parties in relation to the provision of investment services or ancillary services’. Thus it applies to all investment services and products for retail investors. Professional investors are excluded.

The ban affects portfolio management, investment advice and execution-only services, and it covers all types of advice from independent, tied and multi-tied advice, through to discretionary and private-banking services. It covers all types of retail investment products such as funds, life policies (banned a year earlier) and structured products. This is meant to ensure that investment firms (banks, investment advisers, discretionary managers) will only be paid directly by investors and may no longer receive indirect payments from third parties.

The Dutch ban is much more extensive than the British one since there are no grandfathering arrangements for investment funds that were bought before the introduction of the ban, although the AFM allowed a one-year transition for trail commission. Some grandfathering arrangements are in place for insurance products and structured products because contracts cannot be changed retrospectively or because of the life-cycle of the product. In many of these cases, much of the costs for such products has been charged upfront.

In contrast to the UK, which had unlimited grandfathering of existing business that could continue to pay trail fees, the AFM only allowed for one year of transitional arrangements. This means that businesses would no longer receive expected revenues for business already written before the rule change, directly affecting their P&L. This is likely to hit smaller firms such as the nascent adviser channel particularly hard, with the big bank distributors better able to absorb the loss of revenues.

Some marketing fees will continue to be allowed as long as there is no quid pro quo arrangement such as leads in exchange for fees.

A fund group can continue to make payments for general marketing purposes, such as advertisements. For example, if a fund group places a banner or advertisement on a website and pays the website provider for clicks, it would not be covered by the ban on inducements as the payments would not be related to the actual investment service.



## Impact of regulation

At the time of writing, the ban on inducements had been in place for six months, which is insufficient to judge the success or otherwise of the law. There are, however, a number of clear trends and tendencies that have begun to emerge and consolidate. Arguably, the greatest impact is on the distributors as there are no transitional arrangements.

### Banks

Banks are the largest retail distributors in the Netherlands with approximately 95% of the total market. In the last 12-18 months they have had numerous uphill battles to contend with including re-designing their products and services, negotiating new deals with fund managers and more importantly, explaining the change to end-customers.

Prior to the the ban, some banks had a variety of distribution channels ranging from discretionary to advisory and execution-only services. But the potential loss of revenues has pushed some of the larger banks to closing their mass-market channels or scaling them back quite substantially. There is undue focus on cost and banks are reorganising their businesses to more low-cost models. As a result, some have developed internet portals for their lower-end clients. These might involve automated decision-tree advice systems or execution-only services. As a result of these tendencies, bank services are bifurcating into two extremes: the high-net-worth route, or the low-cost automated model for retail investors.



Banks are opting to offer discretionary for HNW or execution-only for LNW

### *Packages and solutions*

The lack of inducements and the low-cost approach has also pushed banks into greater use of packaged solutions such as distributor-influenced funds (DIFs), risk-profiled model portfolios and funds of funds. This has led to smaller panels of funds and fund managers and therefore a shift from open architecture to guided architecture. To some extent the open to guided architecture shift was already a trend in the market, but the move to model portfolios and packaged solutions is a new development directly related to the ban on inducements.

### *Customers and fees*

For high-net-worth investors, there would be little change because they are likely to have been on a fee-based footing anyway (although banks are likely to have taken retrocessions and charged fees). The change has been more radical for retail investors and so the banks have been looking for ways to play up the positives as much as possible, while playing down any negative aspects such as paying fees.

One way to do this is to focus on the quality of the overall service and solutions offered, but they are also aware of the implications of charging newly created advice fees. As a result, they also take pains to emphasise that the shift is cost neutral for customers and, rather than paying the full 1.5% fee to the fund manager, they are now better off as they are paying only half of the fee. With this significant saving, consumers can cover all the other costs of advice, administration, distribution and maintenance etc.

Where possible, banks are rolling advice and maintenance fees into one quarterly bank account administration charge that is automatically deducted from the account, making it quick and painless for customers and more importantly, less obvious that they're paying additional fees.

### **Independent advisers**

Independent advice represents a very small part of the Dutch distribution landscape. Private banking and discretionary fund managers have come through the ban relatively unscathed as their clients have always paid fees and are therefore used to paying them.

The pain is more evident among smaller advice companies who are less able to cope with the drastic change. These companies, which service mainly modest and low-net worth customers are less able to cope with the change, as they do not have the resources to develop a robust fee-based business model or sufficient time to transition to one. More importantly, they have struggled to prove their worth and articulate the value of their services to clients.

Some fund managers, Robeco is a case in point, also had their own distribution channels. However, the lack of a branch network and the cost of compliance are likely to have been behind the fund manager's decision to reduce these services and go straight to execution-only services. More are likely to follow suit.

### **Fund managers**

The inducement ban created pros and cons for fund managers. When Dutch banks first started talking to their fund manager partners about non-rebate share-classes,

some were reluctant to cooperate preferring to use existing institutional share-classes rather than create new Dutch non-rebate versions, particularly cross-border players, but eventually most moved to the standard non-rebate share-class. From a Luxembourg perspective, institutional classes have a tax advantage over retail non-rebate classes (taxe d'abonnement of 0.01% versus 0.05%), but this lower tax is only applicable if the share class only allows institutional investors, which would technically be the case if the bank was seen as the investor.

Fund managers that have only a small retail base, may opt to offer institutional classes instead of non-rebate classes in order to limit operational impact. Moving to a non-rebate fee model creates operational efficiencies for fund managers and reduces their workloads, but conversely a proliferation of share-classes for different markets and types of distributors creates additional costs and complexities.

Cost and fees appear to have become less of an issue, but the move from open to guided architecture has meant that fund groups now have to work much harder for shelf space or inclusion in the packaged solutions. Some banks are likely to prefer to work with a panel of large, generalist fund managers that cover all the asset classes while others will pride themselves on including boutique and niche fund managers in their selection. In any case, competition has increased not only from other active fund managers but also some light competition from passive players as packagers add some passives to their solutions.

### *Regulator's next steps*

Fund managers will also need to contend with the regulator's direction of travel on fund selection. It wants to make sure that the managers and funds selected have been selected appropriately and without bias. The regulator finds it somewhat difficult to believe that the same fund manager could remain in a bank's portfolios for many years. As a result, it would like to introduce a formal auditing system whereby banks will need to review their fund managers and fund selections every year.

The underlying selection process and how banks assess and select will be open to scrutiny, with the ultimate aim of ensuring that bank customers get access to good independent advice and products. That does not mean that banks will be forced to change their selections on an annual basis, but it does mean that they will need to audit and justify their selections. These discussions are still in the early stages, but are indicative of the regulator's thinking.

*“These developments make life harder for smaller fund managers to get a suitable place, to get a proper share of the market, and it's even more difficult for the big fund houses. But when you look at it from the the perspective of integrity you can't deny that this is a good move.”*

Hans Janssen Daalen, Director General, Dufas.

### Retail investors

When customers start to pay explicit fees, they also develop explicit demands and outcomes, so any perceived failure in delivery will result in customers voting with

.....

*“The next big focus will be on added value as customers will question what they’re getting for the service and will want to see clear outcomes to their needs.”*

.....

their feet. Since the ban was implemented, retail investors have received two quarterly statements and the issue of fees has passed by with fairly little noise and controversy. However, these quarterly statements have been issued against a backdrop of slightly volatile, but nonetheless healthy stock markets and an overall improving economic outlook. Investors are unlikely to question fees while markets are broadly in the ascendancy, but a marked correction in the markets could lead to investors questioning what they are actually paying for.

Industry stakeholders believe that this issue is still to be fully addressed or understood by the retail market. As a result, the next big focus is likely to be ‘added value’ as customers will question what they’re getting for the service and will want to see a degree of correlation between the fees they pay, their needs and the expected outcomes.

### Advice or product or platforms

Overall, the regulator’s intentions are laudable, but in driving through this regulation and making fees mandatory, it has, like the regulator in the UK, created a potentially damaging advice gap. If retail investors are driven from the market because they cannot afford fees, then the regulators have failed to meet their key objective of bringing good quality advice and product to the retail investment markets. The Dutch regulator may argue that it’s better to get no advice than poor advice. A counter argument would be that bad advice is impossible if there are only good, well-designed and well-priced products available. Equally, no advice is likely to lead to poor investment choices or consumers not making the decision to invest at all, making it harder to achieve their goals.

Understanding the difference between product and advice and the benefit of advice as a stand-alone service may take years to achieve. As is the case in the UK, most Dutch retail investors are unaware of the cost of advice and assume that advice is free. For that reason, some retail investors will be reluctant to pay for advice and will opt for execution-only platforms.

“The issue is slowly, slowly dawning on investors. DB pensions are now being superseded by DC pensions so whereas before investors thought their financial futures were taken care of, now, slowly but surely, they’re beginning to understand that they need to take charge themselves.”

Bob Hendriks, Head of Retail Netherlands, BlackRock.

However, gaps in the market of this kind generally create opportunities for new players and more importantly, new ways of resolving the issue. One such area will be in the execution-only and low-advice platforms arena. Some banks have launched their own services, and existing independent execution-only platforms like Binck and Alex are likely to benefit significantly.

Helping to partly offset this trend will be demographic drivers and the growing realisation among the public that they will be living longer and will need to make their money work harder to fund their retirements and therefore will need some kind of advice.

However, there are also opportunities for other new entrants, particularly from stock-brokers or online traders. In addition, these services could be supplemented with low-cost advice. The technology is such that offering a fully automated advice proposition is now theoretically possible, particularly for the relatively mainstream needs of the low- and middle-income brackets.



## Chapter 11: Impact of RDR / MIFID on Europe

Part one of this report reviewed the impact of RDR legislation on the UK, the known and unknown consequences of the legislation, and how those consequences have re-shaped and continue to re-shape the distribution landscape. Part two focuses on the lessons to be learned from the UK legislation and the potential impact of RDR and MiFID on the European market, where the complexity is far greater due to the many different jurisdictions involved.

For the UK, the RDR legislation was eight years in the making and went through many iterations, consultations, guidance papers and policy statements before finally being implemented. And it has not yet finished. RDR2 — as the platform part of the legislation is known — comes into force in April 2016. Moreover, the FCA recently published its thematic review on execution-only services and simplified advice<sup>1</sup> and has issued a guidance paper for consultation<sup>2</sup>.

This latest guidance paper is an example of how regulation can sometimes hinder and hamper a market. Despite the acknowledged advice gap in the market, there had been a distinct lack of development of simplified advice solutions since the introduction of RDR, mainly because of regulatory confusion. Distributors were worried that they would accidentally stray into regulated advice territory and so simply steered clear of this arena. Secondly, qualification requirements that were just as stringent as those for full advice left many wondering what the benefit of the simplified designation would be. As a result, the FCA was forced to review the different legislations at the national and European level, clarifying the boundaries, and setting out more clearly what it considered to be information, guidance and regulated advice <sup>1, 2</sup>.

.....

*The FCA's latest thematic review illustrates how regulation can hinder developments*

.....

These complications have arisen from one set of rules in the UK and so implementing similar legislation across multiple jurisdictions, with different cultural values and

---

1. FCA TR14/10: Developments in the distribution of retail investments. Purchasing investments without a personal recommendation or with simplified advice.

2. FCA GC143: REtail investment advice: Clarifying the boundaries and exploring the barriers to market development.

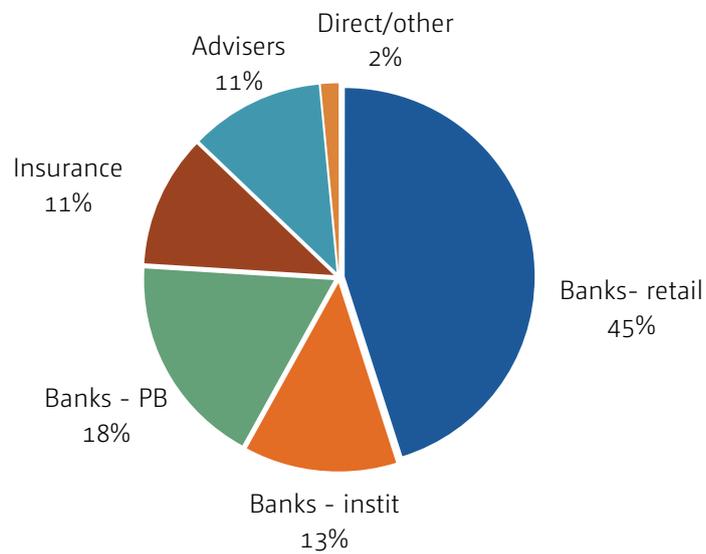
3. Lipper FundFile, June 2014.

distribution landscapes is fraught with danger, and has the prospect of many more unknown consequences on Europe's markets. This chapter aims to review the potential impact of legislation such as RDR and MiFID on Europe and its multi-coloured patchwork of markets.

### Size and scope of the European fund industry

The European fund market currently stands at just under €7trn<sup>3</sup>, of which long-term assets account for almost €6trn<sup>3</sup>. Twenty five years ago, the European industry was

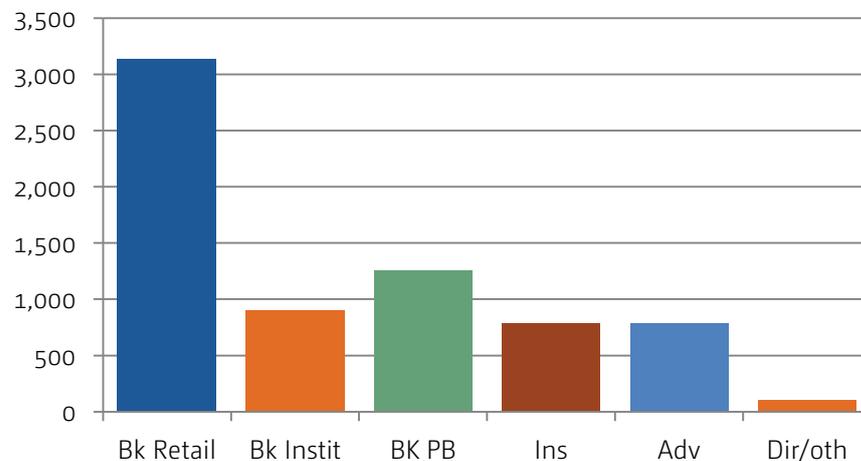
**Fig 11.1: European assets by distribution channel (%)**



Source: MackayWilliams estimates.

Notes: Some channels have been grouped. PB = private banking and wealth management units.

**Fig 11.2: European assets by distribution channel (€bn)**



Source: MackayWilliams estimates.

just a disparate group of domestic industries, but the advent of Ucits and the impact of other European regulation is visible in the current structure of the European fund industry. Today, the previously non-existent cross-border or international market, and mainly hosted in Luxembourg and Dublin, represents almost half of Europe’s funds under management (46% or €3.2trn).

Figures 11.1 and 11.2 chart how fund assets are distributed among the main distribution channels in Europe. These estimates suggest that across the whole of Europe, the largely captive client base of retail banking accounts for 45% of assets or around €3.1trn, while the next biggest channel is the private banking channel with 18% or €1.3trn in assets. These are big numbers so any changes to legislation could have a profound impact and need to be considered carefully.

### Retail banking channel

The retail bank distribution channel was underdeveloped in the UK and since RDR, has shrunk even further. Despite the lack of similarities between the UK and Europe, it is worth noting

**RETAIL BANKING DISTRIBUTION**

Est. 45% of total European assets or €3.1trn.

that this channel contracted in the UK because banks have been unable to work out how to provide cost-effective advice. This may well be an issue that affects the retail banking channel in Europe, depending of course on the final technical guidelines for MiFID2.

The retail banking channel in Europe provides a limited range of fund products and solutions for its captive client base. The underlying investments are predominantly proprietary or exposed in a very small way to guided architecture. Packaged products and solutions dominate across most European markets, ranging from life policies (both traditional and unit-linked) to funds of funds and guaranteed funds.

• • • • • • • • • •

*Allowing proprietary models to grow unchecked fails to meet regulatory objectives for investor outcomes*

In theory, the introduction of MiFID legislation should have a relatively light impact on this distribution channel. Under current MiFID rules (although Esma’s technical guidelines may put a spanner in the works) retail banks can define themselves as non-independent and would continue to receive rebates from fund managers.

However, it is important to note that the objective of RDR and MiFID regulation is to provide better quality advice and improved outcomes for the end investor. Creating a system that entrenches the



closed-architecture, vertically integrated bank distribution model does not meet those objectives and would leave almost 50% of the investor assets untouched. Equally, third-party penetration and guided architecture, however, small, have been growing and the regulator should avoid doing anything that might jeopardise that growth and increased competitiveness.

Under current legislation, expected developments include the following:

- A shift towards products that are not in scope
- A shift towards closed architecture and/or proprietary product and greater vertical integration
- A shift towards sub-advised arrangements
- An advice gap

### **Not in scope**

One of the dangers of a silo approach to regulation in Europe is that it creates an uneven playing field. Currently, insurance products are covered under the Insurance Mediation Directive and are therefore out of scope of MiFID2. Unless the different European legislations such as MiFID2, Prips and IMD are harmonised across the board and any potential inconsistencies removed, it could lead to a bias in products that are not in scope and will allow retrocessions. MiFID2 introduces specific rules on conflict of interest on Insurance-based products and gives countries the possibility to introduce inducement restrictions on those products (however unlikely this may be).

The initial aims of the Insurance Mediation Directive 2 (IMD2) were to extend MiFID2-style rules to insurance intermediaries, however the most recent text calls for greater transparency on the intermediary's remuneration, although this could still change. The final text has not yet been agreed, and the date of implementation, although not yet defined is supposed to be aligned with MiFID2.

### **Sub-advised arrangements**

In order to retain some guided architecture within their structures, banks are likely to increasingly look at sub-advised arrangements with third-party fund managers. This would allow distributors to create their own funds, and give segregated mandates to fund managers to manage the investment, retaining the difference between the segregated mandate fee and the total AMC.

### **Advice gap**

As has occurred in the UK, there could be a closure of retail bank services and potentially only offering high-net-worth or mass-affluent services. This would create

an advice gap and leave investors with no guidance or push them towards execution-only internet platforms. This may be suitable for some types of investors, particularly more experienced and sophisticated investors, but cultural factors may also play a part. Northern Europeans may react well to this kind of change, but most Southern Europeans tend to prefer face-to-face relationships, although there has been a fairly strong uptake of platforms in Italy (see Chapter 14). In our view, however, this is unlikely to happen. Instead banks are likely to offer proprietary products and argue that there is no loss of advice to their clients, merely that their choices are limited to proprietary or packaged products.

The other important aspect of a move to execution-only platforms is that under MiFID2, commissions can still be paid to execution-only platforms. In assessing and evaluating the different options available to them, investors are likely to find it difficult to make comparisons on a like-for-like basis since the fees and services will not be priced in a comparable manner.

Treating distribution channels differently can lead to confusion and differences in outcomes and experiences for the end customer. This happened in the UK because of the regulator's staggered RDR legislation, but it is now closing the gaps as a result of feedback from the industry.

In a harsher environment where fees are banned in retail bank distribution too, we would expect the retail bank channel to evolve along the lines of what is currently happening in the Netherlands. This would likely see the advice fee being bundled into other banking fees and charged automatically, or alternatively wrapped into the product or solution. However, this is essentially bundled pricing and raises questions about the so-called transparency that the regulators are trying to improve through legislation. Greater vertical integration and the almost exclusive use of closed-architecture models would also be the norm. These factors are discussed later in this chapter.

## Private-banking and wealth management units

Overall, the private-banking channel accounts for just under a fifth of the total market or assets under management of €1.3trn. In large swathes of this channel, fee-based advice is already a key feature. But in some parts of Europe, a mixture of commission and fees has been the dominant business model. As a result, the impact of a ban on inducements could vary greatly from market to market, and even within a market there could be substantial differences.

### PRIVATE BANKING DISTRIBUTION

Est. 18% of total European assets or €1.3trn.

Rebates were banned from Italy's two core GPM and GPF wealth management services following the implementation of MiFID1, which decimated what had once been a very popular and highly profitable services for the banks. This was not because investors were not happy to pay for the service, but because banks were no longer making sufficient revenues to warrant the continued investment in the business model and services. In Switzerland, where fees and rebates were common, a private-banking customer successfully sued his bank for the return of his rebates, forcing Swiss banks to refund clients and move to a strictly either/or basis. Most have chosen to go down the fee route and reimbursements continue.

### **Impact of inducement ban**

The inducement ban will have a considerable impact on this channel, but we expect it to have the least negative impact of all the channels. That is because fee-based advice is already an established feature across most European markets in this channel, and the mass-affluent and high-net-worth investors are likely to be more open minded about paying for advice and discretionary portfolio services.

Nonetheless, among this more sophisticated and knowledgeable cohort of investors, there will be a considerable number who will choose to take the Do-It-Yourself (DIY) route and will turn to the plethora of online platforms that are sprouting up around Europe. Many are also offering risk-profiled or automated advice and discretionary solutions for small fees per month or per year. Examples include Nutmeg in the UK while Moneyfarm in Italy offers a similar ETF-based investment proposition. Following the FCA's recent guidance consultation clarifying the boundaries between information, guidance and advice, the largest D2C platform in the UK, Hargreaves Lansdown, has announced that it will be offering a <£10,000 discretionary service for its D2C customers.

Despite the more open-minded nature of investors through this channel, there is the danger that an uneven playing field would lead to investors being shunted into out-of-scope products such as life policies. Other expected developments would include:

- A move towards guided architecture
- A shift towards sub-advised arrangements
- A broadening of the scope of investments

### **Guided architecture and sub-advised arrangements**

Attempting to maintain and replace the level of revenues currently provided by retrocessions will lead distributors to develop closer working relationships with key fund manager partners that can offer a compelling price proposition across a broad range of asset classes. This will undoubtedly favour the larger, generalist fund

managers not only because of the breadth of their offering, but also because they will have the financial clout to offer more competitive pricing.

Distributors may also be seduced by the siren call of creating their own product and tendering segregated mandates to third-party fund managers, retaining the difference between the segregated mandate fee and the total fee on the fund. While in theory, this gives them economic freedom and allows them to replace revenues effectively, it does not give them investment freedom since they will be tied to a sub-advised arrangement for a set period of time and will not be able to bow out so quickly, if performance does not go as planned.

.....

*Mandates provide economic freedom, but restrict distributors' investment freedom*

.....

For third-party fund managers, these arrangements are interesting because it allows them to manage assets without any of the peripheral requirements of doing so through a fund (these are left to the distributor) and to do so for a lower price in exchange for a minimum volume of assets. Fund managers have a minimum expectation in terms of volume, and so this too will encourage the use of fewer fund managers and mandates.

**Other investments**

Moving to a non-commission model also gives distributors, particularly portfolio managers and discretionary managers, the use of a broader palette of investments to achieve client outcomes. Exchange-traded funds (ETFs), passive investments, closed-ended funds, direct securities will be able to compete on a level playing field with mutual funds.

The emphasis on keeping down the overall cost for the investor may encourage some distributors to move into lower-cost investments which will also put pressure on active fund managers. Passive index-tracking funds are likely to benefit in particular from an inducement ban, but it could open the market up to huge systemic risk.

**Advice channel**

The independent advice channel is one of the smallest channels in the Europea industry, but arguably the most at risk from the inducement ban. Throughout most of Europe, this channel is still in the early stages of development, legislation having only been brought in the

**INDEPENDENT ADVICE DISTRIBUTION**

Est. 11% of total European assets or €786bn

last decade or so. Examples include the CIF legislation in France, which came into force in 2003, and the Spanish EAFI (Empresas de Asesoramiento Financiero) legislation in 2009.

Much like the advisers in the UK, the business models in this channel can vary greatly. Due to their relatively recent entry into the market, EAFIs tend to operate on a fee-based basis with only 20% of their revenues being commission-based. At the other end of the spectrum, it is estimated that 80% or more of revenues for French independent advisers (Conseiller en Investissements Financiers, CIFs) are commission-based.

Unless managed carefully, and with an exceptionally long lead time to allow advisers time to adapt their business models, a ban on inducements would have many negative repercussions on the advice market. In the short term, it would likely result in many advisers choosing not to be independent and opting for easier option of the tied or multi-tied route. The majority are likely to take this route, leaving the independent channel a rather barren and arid territory.

### **Getting rid of dead wood**

There is no doubt, however, that in some markets, a ban on inducements could 'clean up' the advice channel, leaving only the truly committed, advisers in place. Germany is a case in point where following the increase in qualification requirements from 1st January 2013, the number of advisers fell from c80,000 to c40,000. Many of these advisers were selling investments in their spare time and were also insurance agents, lawyers or estate agents, for example. Cleaning up the industry in this way a good thing since it raises the profile and professionalises the industry, and which is important if advisers are to move to a fee-based model.

### **There may be trouble ahead**

For advisers that do decide to continue in the market as independent advisers, there are difficulties in terms of adapting business models, educating and informing investors. A loss of clients would be inevitable, not only because some investors would not want to pay, but also because having worked out the cost of their advice, some clients would be priced out of the market.

Indeed, in markets where commission disclosure requirements already existed, this will, in part, contribute to some of the concerns around fees today. An investor will not always understand that the percentage of the actual investment eg 0.5% of €10,000 is €50 in absolute cash terms. It will also have the impact of downplaying the actual cost of advice since the investor has been subsidised by larger investors, and which of course, is far higher than €50.

For the end-investor this would lead to more limited investment choice, and the proliferation of proprietary product. Generally open architecture fosters competition, which in turn leads to better performance, cheaper funds and significantly more choice for investors.

### **To be or not to be unbundled?**

In the UK section of this report, we said that the regulator's desire to unbundle pricing was laudable and should not be argued with. It is important for a client to understand what he is paying for and the value of the advice he receives — without this, the market is not a properly functioning market. However, there are also some caveats that need to be considered. Unlike the UK advice channel, the independent advice model in Europe is a fairly young and fragile channel. If regulators in Europe move too quickly to an RDR-style regime, the short-term effects could be devastating, creating an advice gap for lower-value consumers and restricting investment choice and product innovation for the investors that remain.

To avoid this, regulators and industry participants need to work together on a longer-term roadmap of how they can move towards truly transparent pricing, with appropriate costs for different levels of advice. This will require honesty from manufacturers and distributors about the true cost of their services, but also huge consumer education to outline the value of advice and how it can help them achieve their goals.

Similarly, regulators need to be very clear about what does and does not constitute advice, and ideally create a basic advice model that will help draw lower-value customers into the industry — a track the FCA are only belatedly starting out on now in the UK, eight years after the RDR was conceived.

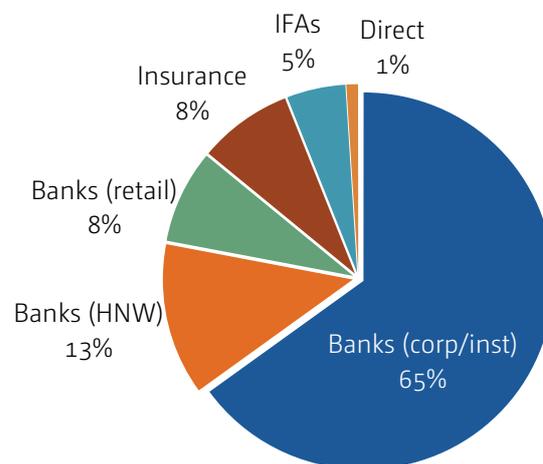


## Chapter 12: Potential impact on France

The French fund market is the second largest domestic fund market in Europe with assets of €596bn in investment funds at the end of June 2014<sup>1</sup>. However, it is a shadow of its former self, with assets having effectively fallen by a third since the industry peak of €891bn in May 2007. The financial crisis that began in 2007 caused collateral damage, particularly when it came to light that US sub-prime debt was one of the main underlying investments of enhanced money market funds — funds that were perceived, until then, as unimpeachable. These funds were not classified as money market funds, but were nevertheless perceived as such.

There are a number of other reasons for the decline in overall assets. The French fund market is essentially an institutional market with significant exposure to money market funds. At the time of writing there was €283bn in traditional and enhanced money market funds, with €331bn<sup>1</sup> in the remaining asset classes combined. Corporate treasurers and institutional investors use money market funds for both short- and long-term needs, often creating significant swings in flows.

**Fig 12.1: French assets by distribution channel (%)**



Source: Fundscape estimates.

The ultra-low interest rate environment has also had an impact, resulting in the loss of some money market activity to direct investments and bank-based cash and deposit accounts. Only a relatively small proportion of assets has shifted into other asset classes. The loss of this type of business has had a profound impact on the large

<sup>1</sup> Lipper FundFile.

French domestic managers, mainly bank-owned, which generally specialise in money market and short-term bond funds and other institutional-type funds.

The downturn in institutional business has been accompanied by a loss of retail business. The retail market was a comparatively small part of the industry, but since banks dominate distribution, it has been affected by their cash-building efforts and intense focus on balance-sheet products. This was partly due to strong inflows into the State-guaranteed and tax-free Livret A savings accounts (owing to artificially high interest rates and increased savings limits) and the rise of risk aversion among French savers.

### **French distribution model**

As in most continental European countries, the distribution of investment funds in France is primarily part of the universal bank model or, more specifically, the bancassurance model. Figure 12.1 above illustrates the French distribution landscape. Banks dominate with around 86% of overall distribution, the bulk of which is corporate and institutional activity.

Wealth management and private-banking units account for around 8% and retail banking another 8%. All three channels represent very different types of products and architecture. The institutional/corporate channel tends to be proprietary business, high-net-worth is guided and in the retail channel the architecture is guided or almost closed.

The insurance channel itself captures a fairly small share of distribution. Life products are highly popular in France because of their generous tax benefits, but these are sold through every distribution channel and account for the bulk of high-net-worth and retail sales in banks.

### **Independent advice**

The French legal status of investment adviser (Conseiller en Investissements Financiers, or CIF) was formally introduced in August 2003 under the Financial Security Law. The term CGPI (Conseiller en Gestion de Patrimoine Indépendent) is no longer an official status, but is a term that is still widely used by investors and advisers themselves. The law was designed to increase and harmonise investor protection. It brought together the different types of advisers that already existed in the market under one umbrella term, CIF, and set out minimum criteria and requirements for practising as a CIF.

There are some qualification requirements, but professional experience of at least two years counts as an exemption. There are minimum standards including transparency, behavioural standards, and supervisory ones such as the CIF belong to an association

that has been authorised by the French regulator (Autorité des Marchés Financiers) and registration on the intermediary register, ORIAS. Currently there are five CIF associations, the largest being the Chambre des Independents du Patrimoine with 2,000 members. According to ORIAS, there were a total of 4,866 CIFs registered at the end of 2013.

## Products

Life assurance products are by far the most popular products in France, dominating the retail bank, independent advice and high-net-worth channels. There are two main types of life product France, the traditional endowment policy with capital protection and annual guaranteed returns and unit-linked life policies. Since the financial crisis, the former has been the most popular, but guaranteed returns have been falling year on year.

## Impact of MiFID regime

### Winners

A major strength of the current distribution landscape is that insurance products, which are a big feature of the French market are out of scope since they are covered by the Insurance Mediation Directive (IMD). Setting aside the type of product, since retail bank distribution is mainly proprietary there is likely to be very little impact.

Apart from life policies, packaged solutions such as funds of funds and guaranteed funds of funds are the main products of choice for this channel. However, French funds of funds by law are unable to receive retrocessions from fund managers so these have typically operated with institutional pricing and would therefore be unaffected by a switch to clean pricing.

MiFID also creates opportunities for fund managers to work more closely with distribution partners, particularly generalists with large fund ranges. Fee-based advice could create opportunities for smaller, boutique players to play alongside their larger peers based purely on the power of their performance since they will no longer be inhibited by the lack of rebating capacity. There are also sub-advisory opportunities.

In the growing advice gap that would be an inevitable consequence of a restriction on rebates (see losers below), workplace savings is an area where opportunities for providing solutions for mainstream mass-market investors could grow. The French workplace savings market has been growing at a fairly rapid pace. According to the AFG, at the end of 2013 there was just under €9bn in PERCOs (third-pillar DC schemes), but workplace savings schemes were much more popular with more than €104bn invested.

## Losers

The French market is already largely vertically integrated with third-party distribution limited in scope. Guided architecture with preferred partners is the dominant pathway for banks and insurance providers in France. The implementation of MiFID would reinforce this pattern.

The biggest threat would be for the relatively small CIF (independent adviser) segment of the market. Under MiFID2, CIFs will no longer be able to receive retrocessions. Retrocessions currently make up more than 80% of adviser revenues, so a ban on inducements would effectively kill off this fledgling industry since it would take a long time to convert investors to a fee-baying model. French investors are unwilling to explicitly pay for advice, although they understand that they are paying commission through the products. It is a cultural characteristic that it would take time to change and which would require extensive education and information.

While some higher-income investors may make the transition to fees, more modest customers, who would have been previously cross-subsidised by larger investors, would no longer be able to access advice. The only options available to them in the market would be the closed architecture options offered by their banks or local insurance agents. Online platforms are available, but because of their trading heritage, they tend to account for a very small share of mutual fund transactions.

## Impact of harsher RDR-style regime

If an RDR-style full commission ban were to be implemented, it would have a significant impact on the French market. Banks are likely to go back to closed architecture offering their own product or sub-advised funds for mainstream investors. This would also include funds of funds with limited access to some underlying third-party funds, although it is unlikely to be extensive since French legislation prevents underlying funds from paying retrocessions to funds of funds managers. Overall, banks would sell even more balance-sheet products. In banks' mass-affluent and private banking divisions, a likely strategy would be to offer a very limited guided proposition.

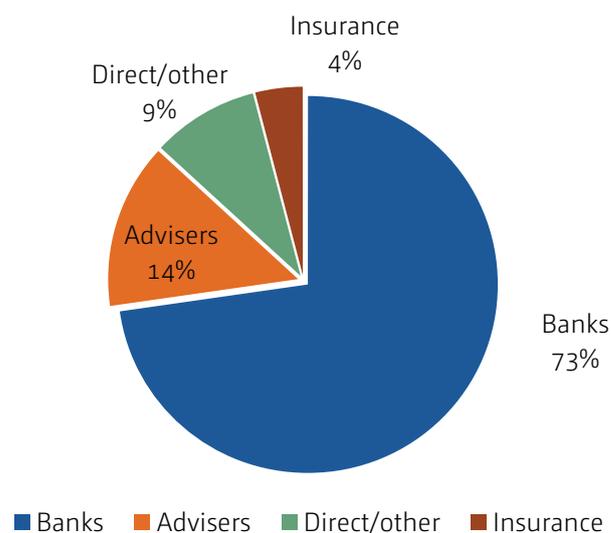
## Chapter 13: Potential impact on Germany

The German fund market is the second largest domestic market in Europe with €530bn in funds at end June 2014<sup>1</sup>. At least two thirds of domestic assets are hosted in Luxembourg by German fund managers. In addition, around 8-10% of assets is estimated to be invested in international, cross-border funds (again mainly domiciled in Luxembourg). Assets are fairly evenly spread across the three main asset classes. However, since the start of the financial crisis, investors have been averse to risk, staying out of equity despite stock markets having risen for nearly two years.

### German distribution model

Funds can be distributed through a variety of customer-facing channels and wrappers in Germany. This formerly mono-distribution system, whereby sales were channelled almost exclusively via branch networks, has evolved into a multiple channel system over the last couple of decades. Nonetheless, bank involvement in the distribution chain is all embracing and encompasses sales via direct banking and fund platforms, private banking and wealth management and their multi-manager products. As a result, the bank channel dominates with around 73% of assets under management.

**Fig 13.1: German assets by distribution channel (%)**



Source: Fundscape estimates based on BVI data and anecdotal evidence.

<sup>1</sup> Lipper FundFile.

A key factor in bank dominance is that the leading fund management groups in Germany are owned by the major bank players: Deutsche Wealth is the fund/distribution arm of Deutsche bank, Union Investment is part of the Volksbanken (corporate banks), Deka is the fund manager for Sparkassen (savings banks), while Allianz Global Investors is part of Allianz insurance. Demand for advice is another factor that can explain the strength of banks as distributions channels. According to the BVI, three quarters of retail investors buy funds after advice, which in most cases is provided by banks.

Insurance represents a fairly small share of the overall German distribution landscape, but in reality its share of the market is covered by the adviser segment where advisers can have many different types of registrations and sell different types of product, often as a second or part-time job in addition to their main roles. In addition, some financial advisers are closely tied to one or more broker pools, which play a dominant role in the German market as they can dictate terms and conditions. As a result, only large advisers can really act independently. Most of the large banks in Germany also have a discount broker subsidiary.

## **Different types of advisers**

### **Fund shop**

Fund shops are usually small operations, catering for lower-net-worth clients. They are independent advisers, specialising in offering a wide range of funds. Their focus is on giving in-depth advice, and they usually expect to receive the whole of the front-end fee for their services. The more important fund shops have founded an association, the Bundesverband Deutscher Investmentberater e. V. (BVDI), and market consolidation in recent years has mopped up some of the smaller operations. With the implementation of MiFID, and the increasing role of banks in giving advice and a generally fuller service to their customers, all but the best equipped fund shops are in danger of losing their special niche as 'value adders'.

### **Independent financial advisers**

Though operators in this sector are generally referred to as financial advisers, here the term is taken to include both those that are truly independent and those with multi-tied distribution agreements. Until 1st January 2013, no formal qualifications or proof of knowledge were required to obtain the status of independent adviser. For advisers selling only funds, it was simply a matter of applying for the basic certification. This has now changed (see below).

Discretionary managers are also considered independent financial advisers, but banking authority registration and fall under the control of the Bundesaufsicht für Finanzdienstleistungen (BaFin).

## Strukturvertriebe

Strukturvertriebe are pyramid-type structured sales organisations and, as 'Allfinanz' advisers, cover a full range of products including insurance, pension provisions, savings vehicles, real estate financing and investments, as well as private finance management. Some *Strukturvertriebe* target selected professional groups such as MLP and ZSH, which have a particularly strong customer base in the medical and academic spheres respectively. Generally *Strukturvertriebe* are tied to a number of management groups where the trend in recent years has been towards establishing close relationships with a relatively small selection of fund managers.

Owing to their multi-layered structure, in which each layer has to profit from each sale, *Strukturvertriebe* have tended to focus on life assurance products, which offer higher commission income. However, following the 2005 tax changes for life assurance products, the focus shifted to pension products and larger companies like AWD and MLP developed individual pension savings vehicles and schemes for mid-sized and small corporates. With the increasing demand for quality services, the bigger organisations have evolved towards being wealth managers in their own right.

## Broker pools

Broker pools are master organisations offering network brokers access to their infrastructure to research and select the best range of funds and products. In addition they offer a wide range of services that includes the handling of all background administration, product and sales training, marketing and compliance on behalf of members. They operate on a similar basis to British advisers networks.

## Stricter regulations

### Adviser qualifications

On 1 January 2013 new regulations for independent financial advisers came into effect. The new rules helped to level the playing field between banks, which had always operated under tighter rules, and financial advisers. While bank advisers were generally trained and educated to higher standards, standards for independent advisers had been substantially lower.

Until the rule change, financial advisers (*Finanzanlagenvermittler*) only needed a §34c GewO registration to distribute funds, for which the only criteria were proof of personal reliability and a stable and sound financial standing. There are no official numbers but government and estimates by the Association of German Chambers of Commerce and Industry (DIHK) put the number of permit holders at around 80,000.

Under the new § 34f GewO, the requirements for registration were set much higher and *Finanzanlagenvermittler* (financial investment intermediaries) need to pass a test to prove their professional competency. There is also mandatory professional liability insurance and financial advisers need to be registered on the Vermittlerregister (adviser register). In accordance with rules for bank advice, financial advisers have to inform clients on the risks of financial products they recommend, hand out information on the respective financial products (KIIDs), and file protocols of sales conversations and disclose commissions. Compliance with these rules shall be proved by submission of yearly reports and audits.

Only half of the estimated 80,000 licence-holders have sat the exams and re-registered. But there are several reasons for the huge drop-off in numbers. The first is that many were working as advisers in a part-time capacity and for them the cost of qualifying and the additional compliance was hard to justify. There is also the demographic factor with many in the profession being older and close to retirement age also opting not to sit the exams. Despite the shortfall, the industry will be more professional with higher standards and better qualifications. While the new certification process has had a severe impact on independent advice, changes do not affect advisors at banks who already have a high standard of training and education.

### **Fee-based advice**

Germany's Fee-Based Investment Advice Act, which came into effect on 1 August 2014, is the first time that Germany has marked the difference between commission- and fee-based advice. Some believe that it is the first step on the path to moving towards an RDR style regime where commission-based advice is banned, while others believe that the two systems can co-habit and complement each other. Under the new law, the adviser can only be remunerated by the client and must have access to a sufficient range of financial instruments.

BaFin, the regulatory authority, has created a register of fee-based investment advisers, which consists of advisers that have submitted an audit certificate as proof that they meet the requirements of the new regulations. Those failing to comply with the requirements on an ongoing basis will be removed from the register and barred from carrying the legal designation of fee-based investment adviser. Advisers must declare on their own websites which of their branches offer fee-based advice, which will enable clients to specifically request fee-based advice.

### **Impact of MiFID regime**

#### **Winners**

Under the more diluted MiFID regime, and current German regulation, distributors would need to decide to offer commission- or fee-based advice, or both. If both,

distributors need to implement a chinese wall and keep the two services completely separate. This should have very little real impact on the distribution landscape in Germany. In this environment, banks would remain the dominant distribution channel. They are likely to continue to offer fee-based advice through private-banking / wealth management units, while maintaining commission-based advice through branch networks for mainstream investors.

Advice — the two regulatory moves in the adviser channel (increased qualifications and the new fee-based adviser) should encourage a greater professionalism in the industry. However, advisers may struggle to convince clients to pay so orphans are likely to migrate back to banks.

Fund managers — creates opportunities for fund managers to work more closely with distribution partners, particularly generalists with large fund ranges. Fee-based advice could create opportunities for smaller, boutique players to play alongside based purely on the power of their performance as they will no longer be inhibited by the lack of rebating capacity.

### Losers

Being a boutique manager in this environment could be a weakness if the market is too biased towards commission-based advice. It could potentially lead to a glut of larger fund managers with broader fund ranges and fewer niche products. The ongoing move from open to guided architecture, which has already been a feature of the German fund market, will restrict opportunities for all types of fund groups.

Given the silo approach to investment regulation in Europe, a key area of concern is the delay in implementing similar measures in the insurance arena. Such an unlevel playing field is likely to encourage advisers of all colours to favour products that are out of scope.

### Impact of harsher RDR-style regime

A move to a full commission ban would have similar repercussions to the impact of RDR in the UK and the inducement ban in the Netherlands in that the more modest end of the market would be either priced out of the market or orphaned by distributors no longer able to offer a cost-effective advice proposition. A substantial advice gap would be likely to open up.

Banks are likely to go back to closed architecture offering their own product, or sub-advised funds for mainstream investors. In banks' mass-affluent and private banking divisions, a likely strategy would be to incorporate advice into a wealth-management product with regular payments.

Reactions at the independent adviser level would depend on the price advisers are able to dictate for their services. However, the market would consolidate and there would be fewer advisers overall. Large firms with a variety of products would be able to offer cheaper and more flexible rates, and would grow to the detriment of other types of advisers.

A large number of experienced investors have already been making their own investment decisions and in a fee-based environment, the self-directed route would grow quickly. In the main these investors invest in stocks, structured products and ETFs and are mostly aged between 45 and 60 years of age. This would therefore benefit D2C platforms.

Younger investors appear to have little interest in investments altogether, but interest tends to grow with higher income, setting up households and advancing age. There is no doubt that the iPhone generation will educate themselves via the internet so distributors should develop scenarios for online offerings.

## Chapter 14: Potential impact on Italy

**W**ith assets of €370bn, the Italian fund market is one of the top four markets in Europe by assets at the end June 2014<sup>1</sup>. Ten years ago, however, the fund market had been much larger and more vibrant, but it fell into almost permanent net outflow for the years 2006-2012, with withdrawals amounting to a breathtaking €250bn. However, not all funds were out of favour — cross-border funds by well-known brands attracted positive flows for much, if not all, of this period.

The industry consistently blamed unfair tax treatment for the lack of investor support and the mass exodus from Italian-domiciled funds. This meant that while Italian-domiciled funds were taxed at a product level, foreign-domiciled funds were taxed at the investor level when, for example, investors crystallised gains. This was eventually harmonised during the Government's post-crisis austerity measures in July 2011. But interestingly, while new legislation put domestic and cross-border funds on a level pegging, the increased taxation of some types of investments (including funds) made saving in cash, deposits and government bonds more favourable. Some say deliberately so.

Unfortunately the industry was also known for its less than salubrious business practices with high levels of churning by advisers to generate upfront fees. This self-interest was less obvious when stock markets were in the ascendancy, but in more adverse conditions, investors paid the price and ultimately the industry suffered the consequences. High levels of mistrust quickly developed and worsened the exodus from Italian-domiciled funds.

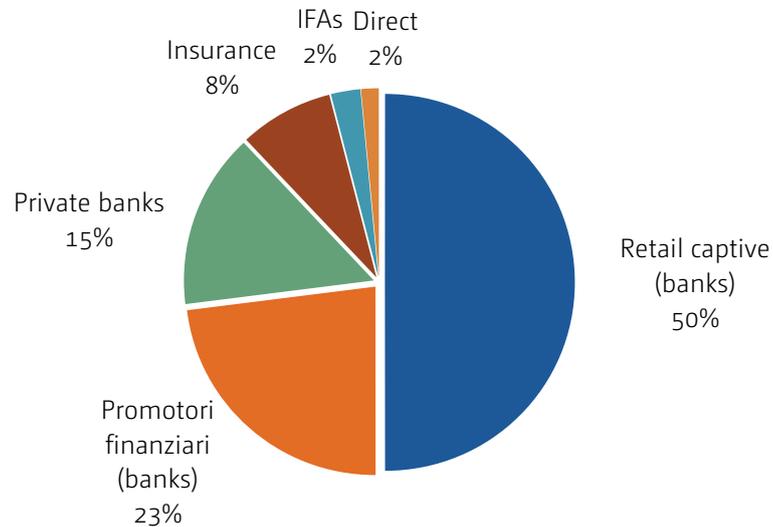
Having corrected its uneven playing field, the credit crunch continued to be a thorn in the industry's side. A deep thirst for cash in the bank sector kept Italian savers in balance-sheet products for another two years and it was not until the start of 2013 that flows started to filter back into domestic product. The turnaround has been nothing short of spectacular with the industry recording net flows of €50bn in two years, ranking it the best domestic market in Europe, beating the likes of the UK, Sweden and Switzerland<sup>1</sup>.

### Italian distribution model

As a result of a considerable consolidation, take-overs and defensive mergers over the years, Italy is now dominated by a few very large bancassurance groups with vast captive distribution possibilities but, as a consequence of the merging of the various investment divisions, also with large in-house investment capability.

---

<sup>1</sup> Lipper FundFile.

**Fig 14.1: Italian assets by distribution channel (%)**

Source: Fundscape estimates based on Assogestioni and Assoreti data.

Altogether, Italian banks control almost 90% of the market. Their stranglehold on the market is split into three key distribution channels. The traditional captive branch networks represent approximately 50% of Italian assets under management and distribute mainly banks' in-house fund products. For example SanPaolo (Eurizon), Unicredit (Pioneer), Monte dei Paschi/BPM (Anima), UbiBanca (UbiPramerica), and Banco Popolare (AlettiGestielle). *Promotori finanziari* networks (tied financial advisers) are another important banking distribution channel. Overall, these networks distribute more third-party than in-house funds — despite the strong in-house orientation at some networks such as Azimut Consulenza and Banca Mediolanum. In these two channels, funds of funds are the main packaged solutions on offer, and as a result, the two channels account for the bulk of funds of funds net sales.

The private-banking and high-net-worth divisions of the large banks are the third feather in banking's cap, with roughly 15% of the distribution universe. These are usually fee-based services. In particular, the GPM and GPF services (*Gestioni Patrimoniali Mobiliari* and *Gestioni Patrimoniali in Fondi*) that used to be prevalent in private-banking units have been fee-based and clean of rebates since the Italian regulator, the Consob (*Commissione Nazionale Per Le Società E La Borsa*) applied the very strictest interpretation of the law and banned rebates from the outset.

The remaining three channels (insurance, independent financial advisers and online platforms account for 12% of the market. Unit-linked life and pension products have a relatively stable share of the market which is more difficult to quantify as these products are also sold through bank branches.

Finally, independent financial advice and online platforms represent comparatively small but stable shares of the industry, but while independent advice has modestly increased in recent years, platforms are expected to grow rapidly. A number of platforms have introduced low-cost online advice propositions where investors can access online advice or asset allocation from as little as €10 a month. Moneyfarm is similar to UK platform Nutmeg in that it offers a fee-based asset allocation service that uses ETFs as underlying assets. It is expected to grow at a yearly rate of 200-300%.

### Impact of MiFID regime

A ban on inducements would mostly affect tied financial advisers (*promotori finanziari*) because their business models are completely reliant on retrocessions and because 90% of their revenues are generated by fund distribution. Tied financial advisers should be able to escape the ban and continue to receive retrocessions on the basis that they are tied and not independent.

Retail banks should be partially affected by a ban of inducements for independent advisers for the same reason. Some of their high-net-worth units are already largely operating as fee-based business models. Banks would therefore continue to dominate. A reduction in advisory services for banking retail clients is highly probable. This results in an increasing share of pre-packaged (wrapped) products.

### Winners

High-net-worth services such as GPM and GPF are in general already on a fee-based model as rebates were banned when MiFID1 was introduced. Some tied financial advisers have also been experimenting with fee-based solutions and so these two channels would be best placed to benefit from a ban on inducements for independent advisers. Retail bank services should be able to hide behind their non-independent status and continue to promote their packaged solutions.

A ban on inducements would create opportunities for ETFs, and wrapped solutions such as funds of funds and unit-linked insurance policies. The latter would particularly benefit if insurance products remain out of scope.

### Losers

The Italian market is a fickle one and fund managers are still excessively reliant on banks for distribution. The financial crisis meant that banks stayed away from funds and instead distributed cash and deposits to help boost their cash reserves. Similar difficulties in the future could have the same impact. Both distributors and manufacturers are at the mercy of Italian government policy and fiscal changes that could have a positive or negative impact on the industry.

Investors are likely to react negatively to the idea of fees and will have the view that costs are going up rather than simply being unbundled. Already highly cautious and risk-averse, investors would react almost immediately to any changes in the economic outlook or stock-market shocks.

On the assumption that insurance-based product regulation had not caught up, an unlevel playing field would encourage greater distribution of insurance-based products through bancassurance channels. This could be seen as both a threat and an opportunity since unit-linked pensions and life policies should create opportunities for third-party fund managers.

### **Impact of harsher RDR-style regime**

A move to a complete retrocession ban in Italy would be difficult for banks and advisers alike. With the exception of fee-only services for high-net-worth investors, bank customers would be unhappy to pay fees. This is partly to do with the fact that distributors have generally sold funds on the basis that there are no costs involved. By that they mean 'no entry fees', and management fees are played down or ignored. As a result, a ban of inducements could be perceived (at least at the beginning) by most investors as additional cost.

DIY-investing would increase particularly among the mass-affluent investors who would be able to turn to numerous online platforms such as Fineco, FundStore, CheBanca, MoneyFarm for instance. The main driver would be the persistence of an ultra-low interest rate environment which is currently forcing conservative investors to find alternatives to domestic treasury bonds and deposits. A stock market downturn would have a negative impact on investor sentiment. Nonetheless, there is €3trn of household financial assets, which need to be allocated somehow.

## Chapter 15: Potential impact on Spain

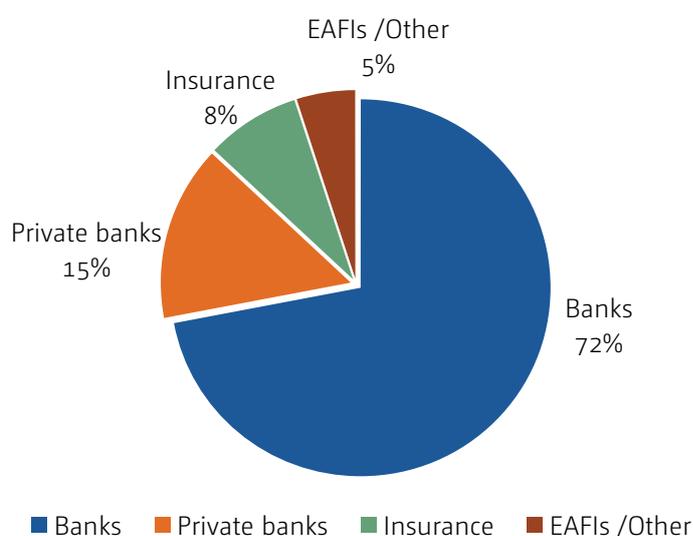
The Spanish fund market is ranked eighth in Europe with €167bn in funds at end June 2014<sup>1</sup>. The industry spiralled into negative territory with the onset of the financial crisis in 2007 and remained in negative territory until the beginning of 2013. Since then it has enjoyed robust sales and for the year to date it was the second best domestic market for net sales.

One reason for the marked turnaround in the industry's fortunes is that banks' balance-sheets were no longer under intense capital pressure, and the deposit war that had raged since the onset of the crisis, had finally come to an end. Rather than pushing investors into balance-sheet products, banks were once again encouraging them into higher revenue generating products such as funds.

### Spanish distribution model

Spain is among the most densely banked countries in the EU and domestic banks' dominance of fund distribution is marked, even by European standards. It is founded not only on the extent and high density of their branch networks but also their ability to satisfy large customer bases with in-house products, often heavily promoted in intensive sales campaigns. This characteristic of the Spanish market is exemplified in the two leading domestic institutions Santander and BBVA, which between

**Fig 15.1: Spanish assets by distribution channel (%)**



Source: Fundscape estimates based on CNMV data and anecdotal evidence.

<sup>1</sup> Lipper FundFile.

them control more than 30% of Spanish fund assets. Before the banking crisis, the percentage had been significantly higher but the impact of their liquidity needs has reduced the overall share of the top two groups and also banks as a whole. The private-banking and EAFI shares have risen to compensate.

### **Independent financial advice**

Growth of the Spain's developing IFA sector (EAFI) (Empresas de Asesoramiento Financiero) has been steady but slow since the launch of the first EAFI company in 2009. The number of firms on the Spanish regulator's list had reached 130 in June 2014, although many of these firms are sole-traders or small companies.

The process of being vetted by the Spanish regulator, the Comisión Nacional de Mercado de Valores (CNMV), for entry onto the regulator's official list of EAFIs is lengthy. Many would-be candidates are put off by the complications involved in meeting all the acceptance criteria (mainly financial). These do not as yet include the need to have passed any formal examination, however. Some in the advice sector feel that an exam or at least, a more standardised approach to the level of required knowledge, would simplify the vetting process.

### **Impact of MiFID regime**

Under a MiFID regime, Spanish fund distribution via banks (the dominant channel) would bifurcate into fee-based advice and discretionary services for high-net-worth customers on the one hand, and packaged solutions for mainstream investors on the other. How they structure mainstream packaged solutions would depend on interpretation of MiFID2. Assuming that banks can continue to receive rebates, there is likely to be no change, but if banks are forced to charge fees in order to include third-party funds then they have the option of moving to closed architecture and only offering in-house product or combining that with sub-advised mandates for third-party providers.

### **Winners**

Many of the newly created EAFI firms are fee-based companies and so are well positioned to benefit from a change in the market. The channel is still very immature so there is a relatively small proportion of commission-based assets. Looking at the EAFI sector as a whole, 20% of EAFIs' combined income comes from retrocessions. However, according to the CNMV, the number of EAFIs earning retrocessions represented about 40% of the total number in the sector in 2013, while about 60% of firms said they didn't take retrocessions at all.

A slowdown in the banking environment or a marked move to closed architecture by banks could create opportunities for innovative product offerings by EAFIs. Wealth solutions that offer cost-effective advice and investments in one product are likely to benefit. How investors would react is still open to debate; they are largely used to high banking costs, and as a result may shrug off the additional expense at their banks.

### Losers

Being a boutique manager in this environment could also be a weakness if the market is too biased towards commission-based advice as they generally cannot pay the kind of rebates that bank distributors demand. It could potentially lead to a glut of larger fund managers with broader fund ranges and fewer niche products. The ongoing move from open to guided architecture, which has already been a feature of the German fund market, will restrict opportunities for all types of fund groups.

Spanish banks should remember the lessons of the technology years. Dissatisfied with mediocre in-house product, investors demanded third-party products from Spanish banks, who were forced to introduce guided architecture as a result. A kneejerk move to closed architecture could lead to customers voting with their feet. This would be an opportunity for EAFIs, or would create an advice gap in the market.

On the assumption that insurance-based product regulation had not caught up, an unlevel playing field would encourage greater distribution of insurance-based products through bancassurance channels. This could be both a threat and an opportunity as unit-linked pensions and life policies would create opportunities for third-party fund managers.



Spanish banks should consider how investors might react to any moves back to closed architecture.

### Impact of harsher RDR-style regime

A move to a full commission ban would have much darker consequences for the Spanish market, which, like most of Southern Europe, is built almost entirely on a retrocession-based revenue model and banks have been used to demanding higher rebates in exchange for flows. If banks were to lose this important revenue stream, they are likely to go back to closed architecture offering their own product, or sub-advised funds for mainstream investors, while fee-based advice would be restricted to the private-banking and EAFI market.

Direct-to-consumer investment would not take off as the Spanish prefer to do business face to face — even if they're probably going to be over charged, investors still prefer to deal with people rather than platforms. The other issue is that the

Spanish investors are not really investors, they're savers who are highly risk averse and so would quickly revert to savings and deposits accounts and buying the odd bond here and there.

## Chapter 16: Lessons to be learned from RDR

The RDR has now been in force in the UK for almost two years, and discussions about it and related regulation have been continuing for at least eight years. In the Netherlands, the first major piece of similar regulation in Continental Europe has been put into place, and although the final impact on the UK and the Netherlands is yet to be fully understood, there is sufficient evidence to draw some conclusions on what worked well, what could have been done better, and what is not yet complete.

These conclusions cover matters of style and process as well as substance, and contain messages for all participants in the industry – fund managers, platforms, distributors and regulators. It is also important to recognise some of the more significant differences between the UK and European markets and within European markets and how those differences may have a different effect on the markets.

### Key differences between the UK and Europe

A large part of this paper has concentrated on the UK market and the RDR, because this was the first market to pursue reforms including the banning of bundled commissions, and the experience of the UK can help other countries understand that it is not going to be the death of the industry. But there are lessons that can make the introduction of similar rules elsewhere a smoother experience. That said, there are important differences between the UK and all European markets that need to be understood.

Firstly, not all change in the UK market has been driven by the RDR – other regulation and market trends have also been very important. As noted in Chapter 4, the TCF initiative has arguably had more impact on investment propositions than the RDR did, and other trends in the market such as the growth of multi-manager product were occurring long before the RDR was conceived. Some of these trends are visible across Europe – for example the increased use of guided architecture in captive distribution – but others are caused by the distinctive nature of UK distribution, in particular its large independent advice sector and the far smaller role of the banks.



TCF regulation and the increasing cost of Professional Indemnity insurance to cover mis-selling risk has led to the slow demise of the individual fund picker in the UK, but this model did not dominate in Continental Europe, with the majority of advisers across Europe being directly employed by banks or insurers.

Even where independent advice does exist in Europe, it means different things in different markets. The UK market has historically placed considerable importance on an adviser being independent, meaning free from external influence on things such as product selection, but in Italy labelling *promotori* as independent may simply mean they are not directly employed by the firm or firms whose products they distribute – they may still be tied agents selling a restricted product palette.

One reason that UK flows held up better than many European markets during the financial crisis is the shape of their distribution. Countries with bank-dominated distribution saw outflows as banks focused their distribution efforts on deposit products to mend balance sheets, which was obviously not a factor in the adviser-dominated landscape of the UK.

Finally, the execution-only market is better established in the UK, meaning consumers may be more comfortable switching between advised and non-advised business depending on the specific circumstances or costs involved. Even here though, concern still remains about the potential creation of an advice gap and how that may hinder greater penetration of investments with consumers. In markets where consumers are less likely to be comfortable making their own decisions, regulators and the industry need to be even more careful to ensure reform does not exclude large sections of consumers from the market.

## Positive engagement

Without doubt, the most important lesson to be learned from the UK and Dutch experience is that positive engagement between all parties creates an easier process and regulation that works effectively for all concerned. During the consultation process of the RDR, predictions of impending doom for the entire industry were everywhere, and the FSA was regularly accused of not understanding the market it regulated. Worse still, were comments about how the RDR would impact profitability. Comments such as *'The FSA has to understand we are not a charity'* and *'How are advisers supposed to make a living?'* abounded, were inherently unhelpful and moreover missed the point about the regulator's objective on improving consumer outcomes.

The regulator's first job is to focus on the consumer... and not to think about the profitability or otherwise of market participants. It is easy to be emotive about current market practices and practitioners, but just because something has always existed, and always been done in a certain way, does not make it right. However, this does not mean that the regulator has no interest in the opinion of the market – after all,

if every asset manager and adviser were to go out of business, that would hardly be in the best interest of the consumer. As Keith Richards, Chief Executive of the Personal Finance Society acknowledged, “If you cannot be profitable whilst doing the right thing by the consumer, you shouldn’t be in that business.”

It is critical to engage the regulator from a consumer perspective, and demonstrate why financial services are important for the consumer. Failing to do this creates an adversarial process whereby the regulator sees itself as defending the interests of the consumer against the vested interests of the industry, weakening the voice of the industry when lobbying for change that is in fact in the consumer interest.

“Engage early, and engage in a joined-up fashion as an industry. If you don’t do that there will be unintended consequences for investors and market participants alike.”

Tony Stenning, Managing Director, Head of UK Retail, BlackRock

One further point to note on the style of engagement with the regulator is that it is rarely positive for one segment of the industry to brief and lobby at the expense of the other. In the UK, advisers and platforms, for example, often briefed in public that the initial drafts of the RDR favoured life companies by excluding their products from scope. This kind of internecine fighting gives the regulator the impression that it does not have a partner it can cooperate with, and increases the possibility of the regulator pressing ahead on its own. Of course sometimes narrow points do need to be made, but it is better that they are made in the right forum and ideally not lobbied in public, in a tit-for-tat retaliatory style.

## **Regulation will not kill the industry – demography is on our side**

Chapter 5 looked at the impact of regulation on consumer demand. The short- to medium-term impact of regulation can sometimes be negative, but the long-term effect should ultimately be negligible. The entirety of the RDR reform in the UK was a supply-side reform, affecting how products are made and sold to consumers but having no material effect on investor need for investment products or their ability to invest. In fact, the changing policy and regulation in the UK has been hugely positive for the investment industry, with the recent abolition of mandatory annuities opening up a whole new market that had hitherto not existed for the market. The only risk of this type of regulation is that advice becomes expensive or inaccessible for consumers, making it less likely that they buy products they need. However, we shall explore this more later.

It would be foolish to pretend that regulation does not have an impact. It may not kill demand, or kill the industry, but it can radically change its shape and direction, as it has done in the UK. In fact, it is better to think of regulation as contributing to the ever-changing shape of the industry, and to adapt and evolve business strategy accordingly rather than to rail against regulation from the sidelines. In the longer term, the winners are the groups that look for opportunities that arise out of regulation

## WHITECHURCH CASE STUDY

Whitechurch Securities is a small discretionary management business with wealth planning and investment management expertise, managing money for mass-affluent customers. A separate company, Whitechurch Network, was owned by the same family but managed and controlled independently. Whitechurch chose to be restricted as it only offers a discretionary management service to clients although coverage is whole of market.

The business moved to transparent pricing as soon as it grew big enough to access institutional share classes. It identified growth opportunities for the financial planning business by taking on books of clients from advisers leaving the industry. It paid for its acquisitions through ongoing annuity stream: paying 50-70% of revenues over a 10-year period depending on client quality. In addition, it had good client retention, helped by the attractiveness of its discretionary service. and the pre-acquisition client seminars it held.

### Outsourcing trend

The group was quick to see the opportunity of monetising its investment proposition, with interest from advisers as early as 2005, particularly smaller advisers who liked the model but lacked the scale to cover the market. It initially offered research services to the Whitechurch network, and from there it was a natural step to outsourcing to the broader market. By 2006-7 it had put together a team to target IFAs. Today, two thirds of business is from external advisers rather than the in-house network.

### The results

Whitechurch Network was acquired by the On-line partnership in May 2012, which has helped the group to be seen as independent even though the two companies were never directly linked. Assets almost trebled between 2009 and 2013, growing from £92m to £261m. Around two thirds of growth came from net inflows and acquisition, not market growth. Head count has grown from 24 to 41 in that time, with the number of financial planners trebling.

### Key take-aways

Business success has been a result of consistently adapting the business model to the changing market environment. The group did not see RDR as a single event driving a change in strategy, but more of a contributor to the ongoing evolution of the business. Growth has been organic through market opportunities (IFA outsourcing) and opportunistic (buying of books from IFAs exiting the industry).

rather than taking a negative view. A good example in the UK is Whitechurch Securities, a discretionary asset manager, which consistently tweaked its business model over the last decade and reaped the benefits as a result (see box).

Demographics and the current distribution of savings in Europe represent a huge opportunity for the industry. More consumers will need to save to fund their retirements, and more will require higher returns from their savings than they currently receive from cash. Ageing populations and reduced retirement benefits are long-term Europe-wide issues that create a unique and long-term opportunity to promote the industry and widen the market for our products. For all these reasons, it is better to ask how regulation can help to stimulate demand, rather than worry about the threat it poses to existing business.

### The advice gap and expanding beyond the 10%

That question – what can regulation do to help stimulate demand? – highlights probably the biggest failing of the RDR. Removing the cross-subsidy inherent in ad valorem management fees and advice charges may be fair (after all, does it really cost 10 times as much to advise or manage 10 times as much money, so why should wealthier clients bear that cost?) But the problem with the RDR is that it did not replace it with anything, or consider the downstream impact on lower-value customers. The FSA may have been comfortable with 20% of advisers exiting the industry, but nowhere in the goals of the RDR does it say they would like fewer consumers to access advice or investment product.

In fact, the impact of the ban on commission, when combined with the withdrawal of the high-street banks from mass

market advice, has arguably created an advice gap in the UK and certainly has done nothing to serve as a template to broaden the penetration of investment product beyond the 10% across Europe that already own it. This is an example of the industry and regulator failing to work together, resulting in a final draft that was not as good as it could have been.



The advice gap is an obvious failing of the RDR legislation.

In defence of the FSA, concepts such as basic or simplified advice were introduced at different stages of the consultation period, but the ideas were not fully formed and

<sup>1</sup> GC 14/3, Retail Investment Advice: Clarifying the boundaries and exploring the barriers to market development

were picked apart rather than being treated as a starting point and improved upon. For instance, simplified advice required the same qualifications as full regulated advice, begging the question as to why an adviser would bother to seek the simplified advice designation. Similarly, the paper did not lay out why it would be beneficial to consumers to have a lower standard, or how that might make investment product more accessible rather than more likely to lead to inappropriate investment decisions.

These flaws were pointed out in industry responses to the consultation papers, but little was proffered as an alternative, and it was not done with a collaborative industry voice. It would have been better for industry participants, consumer groups and the regulator to get together and work through potential solutions, as is belatedly starting to happen now in the UK.

Organisations such as the Personal Finance Society and the FCA have recognised that better engagement will lead to better consumer and industry outcomes, and are working together on issues such as pension reform. European markets should learn from this experience and ensure they address these issues from the start of any potential reform or review of the market.

### **Education, education, education**

How more people can be persuaded to save more is a key question in every market, and regulatory change is a great opportunity to facilitate this. There is a balance to be struck between consumer protection (cheaper advice can't mean poor or inappropriate) and greater engagement, but to address the advice gap lower-cost, lower-touch advice models also need to be developed.

More generic education and guidance, together with tools to enable lower-value customers to make their own decisions where necessary are to be welcomed. Regulators need to provide clarity to the industry on what is and is not advice, because if market participants believe the risk of selling to these clients outweighs the benefits and as a result these consumers are not engaged, then the industry and regulator will have failed in their desire to improve consumer outcomes. The FCA has started to address this, issuing a guidance consultation that clarifies the boundaries of what does and does not constitute advice<sup>1</sup>.

Good financial planning and well-designed products need to be available to all types of investors. The world wide web was invented 25 years ago and since then we have been in a digital revolution that has radically changed our lives and continues to do so. And yet, the industry has failed to harness the power of this new technology to deliver cost-effective, automated advice and guidance solutions for mainstream cost-conscious investors.

Even in the UK where platforms play an integral role, developments have lagged expectations. One reason for the lag was the confusion around what was information,

guidance or advice. The FCA's most recent thematic review and consultation paper was around this very issue so we may see some a phase of development in this arena.

## What can the regulator do better?

So far, we have focused on how better engagement from the fund industry can help improve the outcomes of regulation. But it is also fair to question what lessons can be learned by the regulator, and what they could do better.

### Regulatory silos

A criticism of regulators across Europe has been that the pace of regulation has been uneven and often conducted in silos without any harmonisation or joined-up thinking on similar legislation for adjacent markets. In the UK, platforms were addressed separately from the rest of the RDR, and timetables for execution-only and advised business (for example in banning rebates to customers) have varied considerably.

In Europe, MiFID has been brought into force ahead of similar regulation for insurance products, leading many to fear that a considerable proportion of business will shift into insurance-based products. That is not to say that any regulation that causes a shift in the shape of distribution is in itself wrong, but if the shifts are caused by differences in timing rather than deliberate policy this creates an uneven playing field, ultimately leading to consumers being sold sub-optimal products for their needs.

There is also a widespread concern among market participants that legislation is rushed through before the full consequences of the legislation can be understood and assessed.

*“Incubate the regulation for a good while, consult with the industry a lot, and then bring in regulation that is nicely framed and quickly implemented.”*

Micaela Forelli, M&G.

### Give people a road map

Based on an assessment of public feedback to the RDR and interviews with representatives from sales, fund management, adviser and platforms, the overriding comment on what the regulator could have done better in the UK is to map out a timeline of what the requirements of the regulation are, what they would achieve and when that burden might start to ease.

### Outline the cost

The overwhelming feedback from advisers has been that regulatory costs (in time and direct costs) have continually risen, firstly through the higher (and ongoing)

qualification requirements and then through increasing reporting and documenting of processes and PI costs, and they cannot see an end in sight.

Although of course regulation is not static and therefore complying with regulation can never 'end', it is not unreasonable for a business trying to define a viable business strategy to have a clear idea of the costs of regulation for the medium term. Regulators considering tightening qualification requirements and/or advice processes should consider the costs they are imposing, and the time frame in which they will be incurred, and communicate this in advance to the industry.

### **Consider downstream effects**

For fund managers, one of the issues in the UK has been the proliferation of share classes, or the confusion about what to do about share-classes. An issue that has still not been resolved is the future of the old bundled share classes. By not clearly specifying a sunset clause or a vision of when these will close, fund managers are faced with the prospect of continuing to run ever-smaller share classes with no end date in sight. As shares in funds can be inherited, there is, in theory, no date when these classes must close. This has been taken out of their hands by platforms imposing their own sunset clause and converting all platform holdings to clean share-classes by April 2016, the date at which platforms can no longer be paid by commissions.

The issue of share-classes combined with clean/superclean pricing created problems for the re-registration of portfolios from platform to platform. For example, platforms that are part of a broader group may have exclusive share-classes for their in-house managers, which only users of the platform will be able to access. But what happens when the adviser decides to move away from that platform? firstly the customer loses his or her preferential deal (which the adviser will have to explain) and secondly the transfer becomes delayed because the share-classes do not exist elsewhere. These are some examples where the industry would have benefited from the regulator doing more to consider the downstream impact of their decisions and which are still being worked on by the industry.

### **Price is not a proxy for quality**

There are two points to be made here. The first is that experience in both the UK and the Netherlands points to an increased focus on reducing the overall cost for the investor, which has manifested itself as a focus on cheaper product — usually in the form of passive investments. Indeed, some have suggested that the next regulatory focus in the Netherlands is to encourage investors into cheaper, index-tracking products.

However, we would caution that cost alone is too narrow a base on which to build an advice model, and distributors need to add value and deliver investment outcomes (through financial planning, risk management, asset allocation etc) to build a long-term, sustainable business model. It is worth noting that in the UK, the issue of price has been a focus of advisers but quality is also important. As a result, fund sales have bifurcated into cheap index-trackers at one end of the spectrum, and the consistent alpha-generators at the other end of the spectrum who can charge a premium for their investment skills.



*Cost alone is too narrow  
a base on which to  
build a sustainable  
advice model*



The second price issue is a broader one, but it is crucial to the effort of broadening the appeal of funds to mass-market investors. Whenever regulators have attempted to put some kind of quality mark on funds in the past, they have inevitably settled on price as the way of identifying appropriate funds, (eg the stakeholder pension initiative in the UK). Treating price as a proxy for quality will constrict consumers to investing in cheap product that is not always the best outcome, and will do little to educate investors about portfolio construction and how they can use investment products to meet their goals. Qualitative assessments of funds is not something a regulator should be getting involved in, but perhaps they should focus on how to teach investors about these issues.

A scheme that recognised funds from a broader range of criteria including a price range (ideally linked to the alpha being generated), liquidity, performance and clarity of objectives and documentation would be better than simply encouraging investors to think cheapest is best. It is also important that a regulator considers risk from both sides of the spectrum, and to try to teach investors to make sure they do not have too little risk as well as too much.

Consumer protection has tended to focus almost exclusively on the (very real) possibility that consumers may be sold products that are racier than they require or are comfortable with, but the reality is that many consumers also hold portfolios that have no realistic chance of achieving their goals because they have not taken enough risk to generate the required returns. This is clearly a complicated area for a regulator, but better education is surely the key to passing on the message.

### **Vertical integration distracts from core competency**

In the UK in the late 1990s the emergence of platforms and the closure of direct sales forces by fund groups seemed to indicate that the market was heading towards a simpler model where groups focused on their core investment competency. But over

the last 10 years, the market seems to have moved full circle, and in the RDR era, more businesses are seeking to control other parts of the value chain to increase their competitiveness or more importantly to buy access to distribution.

While the UK moved away from vertical integration, Europe remained more vertically integrated because of the dominance of the bancassurance distribution model. This has resulted in a mainly closed or guided architecture model in the mass-market arena, although mass-affluent and high-net-worth customers usually have access to broader investment options. The benefits of open architecture are clear and obvious: it encourages competition, increases competitiveness among providers, provides greater choice for investors and keeps everyone on their toes.

A common theme across Europe is that it is getting harder to use vertical integration to push product that would not otherwise merit consideration. Open architecture on platforms and the use of third-party product has increased in all markets across Europe over the last decade, with consumers benefiting from higher returns as a result. It would be a step back for the industry if groups attempted to use captive distribution to push weaker product, and regulators everywhere should see it as a core part of their job to avoid it. Implementing an inducement ban for independent advice without imposing checks and balances on the vertically integrated distribution model could undo much of the good work done in the last decade or so.

### **Change needs to be embraced rather than feared**

As we highlighted at the very beginning of this paper, it is impossible to argue with the basic aims of the RDR. It cannot be bad for consumers to be serviced by more highly qualified and professional advisers, nor can it be unfair for them to have a better view on what fees they pay and to whom. Mistakes were inevitably made by all parties in the implementation of the reform, and the end result is not a perfect piece of regulation. However, there is no evidence to suggest that the RDR has materially affected existing demand for investment product, and there is no reason to think similar rules in other markets would do so either.

In fact, we believe that it is better for the fund industry to see such changes as an opportunity, in particular in the context of the vast untapped potential for growth in the form of cash savings and the significant demographic tailwinds that should increase demand of investment product over the coming decades. Measures that will improve consumer understanding and access to investment product should be encouraged, and the industry needs to do a better job of educating consumers to achieve this. Regulators and the industry need to work together to ensure clients of all sizes can access affordable advice and investment products which can ultimately drive significant growth for our industry, and dare we say it, lead to more satisfied customers.

# *Appendices*



## GLOSSARY

### **Adviser network**

UK adviser company that provides administration and regulatory assistance to underlying individual financial advisers who pay membership fees in return.

### **AMC**

Annual management charge.

### **Association Française de Gestion (AFG)**

French fund trade association.

### **Netherlands Authority for the Financial Markets (AFM)**

Dutch financial regulatory authority.

### **Autorité des Marchés Financiers (AMF)**

French financial regulatory authority.

### **Annuity**

Policy bought to provide a guaranteed income from retirement until death. The obligation to purchase an annuity on retirement was recently abolished by the UK Government.

### **Appointed representatives (AR)**

Advisers directly employed by an adviser company and regulated under their central registration.

### **Auto enrolment (AE)**

UK second pillar pension initiative that automatically enrolls employees in contributory schemes, with workers having to opt out rather than in.

### **Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)**

The German financial services supervision authority that regulates among others the German investment fund industry

### **Basis points (bps)**

One hundredth of one percentage point.

### **BundesVerband Deutscher Investmentberater (BVDI)**

Trade association for fund shops.

### **BundesVerband Deutscher Investment (BVI)**

The German mutual fund trade association.

### **Centralised investment proposition (CIP)**

An investment panel put together by head offices of distribution firms to help direct underlying advisers into appropriate product.

**Comisión Nacional de Mercado de Valores (CNMV)**

Spanish Financial Regulatory Authority.

**Conseiller en Investissement Financier (CIF)**

An independent investment adviser in France.

**Conseiller en Gestion de Patrimoine Indépendent (CGPI)**

Old legal status for independent investment adviser in France.

**Defined benefit (DB)**

Pension scheme where the employer promises a specified benefit to a worker rather than the return being dependent on investment returns.

**Defined contribution (DC)**

Pension scheme where the employee and sometimes the employer make contributions to an individual retirement fund.

**Deutscher Industrie und Handelskammertag (DIHK)**

German Chambers of Commerce and Industry.

**Direct to consumer (D2C)**

A D2C platform sells directly to the end consumer without advice. Also known as an execution-only platform.

**Discretionary fund manager (DFM)**

UK wealth management firms that have traditionally targeted the mass-affluent sector. They have discretionary authority to make investment decisions on their clients' behalf.

**European Central Bank (ECB)**

The ECB is the central bank for Europe's single currency, the euro.

**Empresas de Asesoramiento Financiero (EAFI)**

Spanish fund advisers trade bodies.

**European Securities and Markets Authority (ESMA)**

European financial regulatory authority.

**Exchange-traded funds (ETFs)**

A security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange.

**Execution-only platform (XO)**

An XO platform sells directly to the end consumer without advice. Also known as a direct-to-consumer platform.

**Fact-find**

A fact-find is an important stage in the advice cycle, which enables the adviser to draw out all pertinent information about a potential client, or update information already held concerning an existing client.

**Financial Conduct Authority (FCA)**

New UK body responsible for regulation in retail and wholesale financial markets.

**Financial Services Authority (FSA)**

Financial Services Authority (replaced by the FCA). UK regulatory body until 2013 when its responsibilities were split between the Bank of England and the newly formed FCA.

**Fund supermarket platform**

Fund supermarkets were originally designed to allow advisers and direct investors a single point of access to a wide range of funds by different providers. Funds were included on condition that they rebated a proportion of their annual management charge (AMC) back to the supermarket.

**Gestioni patrimoniali in fondi (GPF)**

Managed account service using funds only.

**Gestioni patrimoniali mobiliari (GPM)**

Managed account service using funds and other investment securities.

**Independent financial adviser (IFA)**

Independent advisers in the UK market not employed by manufacturers or product providers and offering whole of market investments. The designation covers a wide range of business models.

**Investment Management Association (IMA)**

UK fund industry trade association.

**Insurance Mediation Directive (IMD)**

Initially adopted in 2002 to address sales and disclosure rules for Insurance products. IMD II is an amendment to the regulation that looks to expand the scope to include directly written business.

**Key Investor Information Document (KIID)**

The KIID is the new standard format of providing essential information and key facts about retail investments. It comes in a standardised format and should be free of jargon and complex descriptions.

**Markets in Financial Instruments Directive (MiFID)**

Originally introduced in 2007 with a goal of harmonising the regulatory regime for investment services across Europe. Mifid2 text was agreed in April 2014 and seeks to expand the directive to improve consumer protection and industry governance.

**National advice firm**

UK adviser firm that employs multiple advisers in multiple locations around the country.

**OMT**

Outright Monetary Transfers – an ECB program where the ECB directly purchases government debt from the secondary bond markets.

**Packaged Retail Investment Products (PRIPs)**

European Commission regulation laying out a new pre-disclosure regime for in scope products, which include funds, with profits policies and structured products. The main requirement is for manufacturers to produce a KID (Key Investor Document) which must also be provided by the distributor to a client before sale.

**Plan d'épargne pour la retraite collectif (Perco)**

A French defined contribution pension scheme.

**PFS**

Personal Finance Society

**Professional indemnity (PI)**

Professional indemnity insurance for advisers.

**Platform service**

Platforms are online services, used by intermediaries (and sometimes consumers directly) to view and administer their investment portfolios. According to the Financial Conduct Authority (FCA) a platform service is a service that involves arranging, safeguarding and administering investments, and distributes retail investment products that are offered to retail clients by more than one product provider. However, it is neither paid for by adviser charges nor ancillary to the activity of managing investment for the retail client.

**Primary /simplified advice**

Basic advice concepts introduced by the FSA during the RDR consultation process although ultimately both were dropped from the final legislation.

**Retail Distribution Review (RDR)**

Retail Distribution Review regulation introduced in the UK with the aim of improving adviser qualifications and removing product bias from the advice process.

**Registered individuals**

Advisers directly registered with the FCA, who may or may not be members of a network to provide administrative and regulatory services.

**Self Invested Personal Pension (SIPP)**

UK government-approved personal pension scheme, which allows individuals to make their own investment decisions from the a full range of approved investments.

**Treating Customers Fairly (TCF)**

UK Legislation introduced in 2006 to focus on consistency and fairness of consumer markets.

**Wrap platform**

Wraps were a natural extension of the services offered by fund supermarket, the key difference being that use of the platform was charged directly to the client. This allowed them to be agnostic about the investments and tax wrappers offered on platform and meant that funds and other investment vehicles were not excluded from selection on the basis of their charging structure and/or ability to offer rebates.

## TABLES AND CHARTS

### Chapter 2

- 23 Fig 2.1: UK net flows by asset class 2007-2013 (£m)
- 24 Fig 2.2: UK net flows by month in 2011 (£m)
- 25 Fig 2.3: UK net flows by month in 2012 (£m)

### Chapter 3

- 28 Fig 3.1: Advice in the UK
- 29 Fig 3.2: Evolution of gross and net retail sales
- 31 Fig 3.3: Gross flows by channel post RDR

### Chapter 4

- 34 Fig 4.1: Impact of RDR on advice industry
- 36 Fig 4.2: Evolution of European households' financial assets
- 39 Fig 4.3: Gross retail sales by distribution channel (%)

### Chapter 5

- 43 Fig 5.1: The UK distribution model
- 44 Fig 5.2: Changes in adviser numbers
- 45 Fig 5.3: Bank withdrawal from advice
- 48 Fig 5.4: Nationals v networks
- 50 Fig 5.5: The advice process

### Chapter 7

- 61 Fig 7.1: Adviser squeeze on product and service providers
- 63 Fig 7.2: Passive v active net sales in the UK
- 64 Fig 7.3: Total v funds of funds net sales in the UK
- 65 Fig 7.4: Single strategy v solutions

### Chapter 8

- 67 Fig 8.1: Regulatory requirements v implications
- 68 Fig 8.2: Key influences of fund selection
- 69 Fig 8.3: Sample retail buying model
- 71 Fig 8.4: Platform sales by influence

**Chapter 9**

73 Fig 9.1: Growth of UK funds of funds assets

**Chapter 10**

82 Fig 10.1: Dutch distribution landscape by AUM (%)

**Chapter 11**

92 Fig 11.1: European assets by distribution channel (%)

92 Fig 11.2: European assets by distribution channel (€bn)

**Chapter 12**

101 Fig 12.1: French assets by distribution channel (%)

**Chapter 13**

105 Fig 13.1: German assets by distribution channel (%)

**Chapter 14**

112 Fig 14.1: Italian assets by distribution channel (%)

**Chapter 15**

115 Fig 12.1: Spanish assets by distribution channel (%)



