

## **Retail Distribution Review**

### ***The return of***

### ***"The man from the Pru"?***

**Exaxe White Paper  
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The results of the FSA's Retail Distribution Review (RDR) are now finalised. The main recommendations of the consultation paper have been left intact and it is clear that life and pension providers are going to have to make significant changes in order to implement it.

The Retail Distribution Review covers a number of areas, many primarily effecting IFAs and networks. There are however some key recommendations of the review which will have a direct and immediate impact on the market for investment products.

These recommendations are:

1. Change from commission to adviser fee charging
2. Higher levels of qualification for advisers
3. Unwinding of charging cross-subsidy for smaller investors

These recommendations proposed by the FSA will create changes within the market for regulated investment products and as a result will require product providers to react. Already, providers are reviewing the market and looking for opportunities to capitalise on

their strengths in the new marketplace that will emerge post RDR.

It is vital for insurers to organise their strategy for dealing with the post RDR market, as the regulations are due to come into full force by the end of 2012 and many may come into force earlier.

While the focus of discussion about the RDR proposals has been on the affect of the changes on the IFA community, the fact that these proposals are likely to leave the mass market for financial investment products without financial advice has been glossed over.

This whitepaper looks at what we believe will be a key outcome of the RDR changes; the removal of independent advice from the mass market segment, the options that will remain to service that segment of the market and the possible re-emergence of a distribution channel that has been in severe decline for the last two decades – the direct sales force (DSF).Effect of Key RDR recommendations on the market

The Retail Distribution Review proposes a number of changes which will lead to a radically different environment and will give rise to opportunities for providers to re-position themselves for success within the new investment product retail environment. Some of these changes will dramatically change the market for advised sales, disrupting the current landscape. If we look at the main changes we can see how a whole segment of the market is being left to its own devices, giving a big opportunity to any provider who is willing to plug the gap.

### **Switch from commission to fee charging**

The devolution of the responsibility for adviser charges from product providers to the advisers themselves is one of the key changes that the Retail Distribution Review is making. This is a transformation for the industry, giving providers a new freedom to compete purely on their quality of their products, while the IFAs take responsibility for charging the consumer.

The effect will be to radically change how consumers perceive IFAs. The charges from the IFA will be very clear and it is widely forecast that the result will be to reduce the number of people getting advice. This is because the up-front cost will be deemed to be excessive, and is payable even if no purchase is made. Even when finance terms are available, the disclosure of the up-front cost will make the customer fully aware of the cost involved and may well put them off proceeding with the advice session.

At present, IFAs generally service the higher socio-economic sectors. The effect of more explicit charging is likely to be to move the IFAs' focus on to a customer base further up the socio-economic spectrum than at present, leaving an even larger segment of the population to purchase financial products without advice.

### **Increased adviser qualification requirements**

The RDR calls for a significant increase in the level of qualification level held by advisers. As the majority of advisers do not currently hold this level of qualification, they have significant work to do to achieve this level. Undoubtedly, this will lead to a certain proportion of the IFAs leaving the industry rather than putting in the work to achieve the qualification, work which

is estimated as being in the order of several hundred hours of study and costing between £4000 and £8000<sup>1</sup>. For IFAs nearing retirement in particular, this would not be an attractive option.

This reduction in the number of IFAs, estimated by the FSA to be in the order of 20%<sup>2</sup>, will make it harder to get advice and the resulting reduction in competition will likely lead to increased fees, exacerbating the movement of IFA services up the socio-economic chain.

### **Unwinding of cross-subsidy for small investors**

The final nail in the coffin for the mass market is that the need to charge for advice based on the service given, rather than as a percentage commission on the premium amount, will lead to an unwinding of the current cross-subsidy for small investors. There will be, in effect, reduced but fairer charges for larger investors and increased charges for smaller investors, more reflective of the true cost of advice.

This will also re-focus the IFAs on the higher net worth individuals, as they are likely to see the costs of their financial advice fall. Meanwhile, the barrier to getting advice for smaller investors will rise. This is also the segment that is doing the least saving and making the least provision for the future.

### **Mass market options**

As the changes drive the smaller IFA service into the high-net-worth and ultra-high-net-worth segments, the question remains; what will happen to

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<sup>1</sup> RDR Feedback Statement 08/06, FSA, 2008

<sup>2</sup> Distribution of retail investments: Delivering the RDR, 09/18. FSA, 2009

the mass market segment? This is the area that is least provided for by the current set-up and the RDR changes will only make this worse. As the cost of advice is driven upwards, it will become the prerogative of the wealthy, those who are usually well educated regarding financial products. Consumers on average incomes, whose knowledge of financial products is usually slight, will not be able to afford advice. In effect, those most needing advice will also be the least likely to get it.

The FSA assumption is that this market segment will be serviced by a basic advice process. This is a guided sales process, usually automated, with advisers able to assist with consumers the completing the process itself but not allowed to provide advice, even when they know that the client is more suited to a different product than the one the system is recommending.

The basic advice process is best suited to simpler products. Therefore it will require providers to create a new product set suitable for this type of consumer. This is an approach that has been tried before, notably with the stakeholder set of products and it failed to achieve its objectives.

The problem remains that financial advisers encourage investment where it is in the client's interest, whereas the guided sales approach relies on the individual wanting to make a purchase and initiating the process. Based on previous experience, it is unlikely that this process will increase the number of sales in the mass market segment and it is rather more likely to reduce sales.

If the customer is looking to purchase more complex products but cannot afford the cost of IFA advice, there will be the following options:

1. Execution only purchases – online or via IFAs
2. Bancassurers

3. Provider branch networks / Direct sales forces

The use of these options leaves the mass market open primarily to no advice, in the case of option one or to restricted advice in the case of options two and three.

### **Execution only / Online**

These are non-advised sales carried out directly at the customer's request. The RDR proposals are to leave these sales as they are. Only the financially sophisticated should undertake execution only purchases and so they are not really suitable for the majority of consumers, who do not have the level of financial understanding to differentiate between products.

The growth of online sales of financial products direct to the consumer will continue, but this has two primary defects. It relies on individuals wanting to buy and coming to the site and secondly it requires simplified products that are mainly differentiated by price. Thus the sophisticated products available to the wealthier consumer via IFAs are withheld from this average consumer, irrespective of suitability

### **Bancassurance**

For the consumer, buying products via a Bancassurer gives access to restricted advice based on the range of products provided by the Bancassurer. This could be from one company or from a range of companies.

Banks have the network to penetrate the market but Bancassurance has never taken off in the UK to the extent that it has in continental Europe and there is no reason to believe that it is about to make a breakthrough, other than by default through the abandonment of the market by the IFAs.

## **Branch Network / Direct Sales force**

Providers who have branch networks or direct sales forces have the opportunity to provide restricted advice services directly to the public. However, most providers have abandoned these channels over the last two decades. This was because they were costly to maintain and provided poor value in comparison to direct consumer sales and utilisation of IFA or partner networks.

### **RDR winners**

It is widely held belief among IFAs that it is the Bancassurers that will be the main winners of the Retail Distribution Review. In a survey of IFAs carried out for Pinset Masons<sup>3</sup>, 68% of IFAs believed that the banks were likely to be the biggest potential winners.

But it doesn't have to be this way. Providers have the opportunity to relook at a direct sales force channel which will give them the opportunity to sell their products into this large market segment that is being quietly ignored by the market. The new rules for selling investment products will radically change the way a direct sales force works and will give new opportunities for success through the effective implementation of this channel.

So what makes it likely that a direct sales force or a branch network can be any more successful in the 21<sup>st</sup> century than it was in the last two decades of the 20<sup>th</sup> century?

### **Direct Sales Force**

In the eighties, Direct Sales Forces were motivated by IFA style remuneration packages. While not

giving independent advice, heavy sales-push tactics were used in order to maximise revenue. As the sales forces were motivated by sales targets, high commission levels, and low or zero salaries, this led to many mis-selling issues with inappropriate products being foisted upon unwitting consumers. They were also driven to focus on high-premium sales, in direct competition with the IFAs.

Previously, ordinary people regarded the life insurance industry as the epitome of integrity and trustworthiness, personified in the idea of 'the man from the Pru'. But today, he has been toppled from his position, washed away by a sea of scandals and sharp practice. From 1992 to 2002, the life assurance direct sales force in the UK contracted from 185,000 employees to 15,526, a reduction of over 90%<sup>4</sup>.

The result of this poor reputation among consumers was a decline in sales which meant that the economics of a direct sales force providing face to face advice no longer added up.

The RDR recommended regulations are about to change all this.

The provision of a direct sales force will be a much more focused operation than in the past. No longer in direct competition with the IFA sector, they will be more like a mobile customer sales and services department.

This is because the reward structures of the DSF employees were previously arranged as a low salary with large bonuses which were completely commission based. As commission based remuneration will now be illegal, DSF employees will have to have basic salaries and bonuses driven by the quality of their sales approach as well

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<sup>3</sup> RDR Survey Report 14<sup>th</sup> May 2009. (www.pinsetmasons.com)

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<sup>4</sup> An Insurance Industry lesson for Pharma, ZS Associates, 2006. <http://www.zsassociates.com>

as sales rather than the pure sales numbers used previously. This will give them a completely different focus on their sales as provision of quality advice would become central to their reward, including the provision of advice resulting in 'no-sale' recommendations.

The banks' reputations have taken a hit by the widespread belief that they are the cause of the current downturn. It is unlikely that the banks top priority is restoration of their reputation among smaller retail consumers, given the problems they are facing in restoring solvency and restructuring to meet new regulatory obligations; obligations forced upon them because of the direct government investment they were forced to accept.

There is a clear opportunity for providers to re-enter this market. A direct sales force, motivated by advice quality measurements rather than sales targets, could re-engage with the consumer and re-establish the levels of trust in Life and Pensions providers that existed up until recent decades.

Carefully planned, the 21<sup>st</sup> century could see the re-emergence of 'the man from the Pru' as a major player in the investment product markets.



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