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3 June 2005

Our ref: Financial Advice

Dear Richard

## **Financial Advice: How should we pay for it?**

The Consumer Panel welcomes the ABI's decision to undertake research on the effect of commission-bias. The third of the five challenges<sup>1</sup> we made to the savings and investment industries was to shift the focus of incentives paid to advisers away from sales. We are concerned that the current commission based culture distorts the market and welcome the information that the research conducted by Charles River Associates (CRA) provides. We believe that it provides a valuable contribution to the debate on the effect of commission on sales and would like to commend the ABI for considering appropriate action to address concerns over this issue. In particular we welcome the decision to hold a series of workshops and informal meetings with stakeholder groups to discuss the issues in detail. This is an example of positive engagement with stakeholders that we would like others to follow.

The CRA report throws some very useful light on the effect of commission on sales. As the work was limited both in scope and sample size, the conclusions must be treated as a helpful contribution to the debate rather than an authoritative study of the effect of commission on all sales of medium and long term savings products. We think that more research is needed in order to identify sectors where commission can cause significant distortions in the operation of the market from the consumer perspective and suggest what can be done to minimise these effects. We give our views of some of the problems with the research, and some suggestions of the areas of further research might cover, in more detail in the attached annex.

However, we strongly support the CRA conclusions that the issues surrounding product bias and the proliferation of structures with no link to service justify public concern. We support the recognition by the ABI that it must take positive steps to address the conclusion that if the industry is to regain the trust of consumers and regulators, it must go further in addressing the underlying causes of concern.

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<sup>1</sup> 'Putting the 'service' back into financial services: five challenges for the savings and investment industries', February 2005

We are aware that there is an inherent unwillingness on the part of consumers to pay a fee for advice which might not result in a product being purchased. If fees were the only method of paying for advice it could reduce sales of investment/savings products particularly amongst consumers with lower incomes and so increase the savings gap. Currently there is an expectation that advice will be paid for through the cost of the product over its life and that the cost of this advice is proportionate to the value of the product. Whilst we agree with the analogy with legal advice, no account has been taken of the increasing amount of business done on a contingency fee basis by the legal profession.

Payment by fees whilst potentially addressing any degree of product bias does not address the bigger issue of ensuring the delivery of good quality advice.

We support the CRA's recommendation for a set of simplified commission structures, which could increase the effectiveness of the menu. One of our conditions for supporting the depolarisation proposals was that the new rules should enable consumers to drive competition by shopping around and making informed choices. Increasing the effectiveness of the menu can only assist with this aim.

In addition we support the proposal that there should be greater transparency and choice for consumers in relation to trail commission. Continuing advice can be as important for encouraging saving as the original advice.

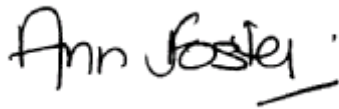
While we support the idea that indemnity commission should not be linked to the financing of small distributors, we agree that the financing of IFAs who depend on it should be considered before it is abolished. Reduction in consumer choice in the IFA market would be a matter of concern.

It is our view that it would be possible to take forward some of these proposals separately without waiting for analysis and agreement on all of them. We hope the ABI will consider this. In summary we welcome this initiative. We set out here our criteria for evaluating the success of any reforms proposed. We believe that any reforms to commission arrangements must move as far as possible in the direction of

- Incentivising the sale of appropriate products provided by appropriate providers; and disincentivising inappropriate sales
- Making product providers pay attention to final consumers rather than compete for distribution channels
- Incentivising good quality advice
- Maximising consumer flexibility by minimising switching penalties during the life of a product
- Making it easier to compare commission based and fee based sales, and give options for consumers to switch from one to the other

- Linking payments made by consumers to services actually received (e.g. no trail commissions where no ongoing advice)
- Making it easier for consumers to understand how they are being charged
- Keeping overall costs down to maximise the amount of consumers' money that is used for genuine investment
- Should not create perverse incentives to sell protection policies, or other products not affected by the reforms.

Yours sincerely,

A handwritten signature in black ink that reads "Ann Foster". The signature is written in a cursive, slightly slanted style. There is a short horizontal line under the end of the name.

Ann Foster  
Chairman, FS Consumer Panel

## Annex

In the econometric analysis the way the data is presented obscures the fact that where statistically significant data was obtained, the commission effect on provider recommendation varied between a 75% uplift in sales for a 10% increase in commission (personal pensions) and a 25% uplift for a 10% increase in commission (income drawdown). Also, the lack of statistically significant results means that it is not possible to establish whether the same level of effect arises in other categories. The fact that there is no statistically reliable evidence does not mean that there is no bias effect. As CRA state in their report, competition in the market place should keep commission differentials small but this is not the same as saying commission has no effect.

A similar problem arises with the mystery shopping where the small sample sizes mean hardly any of the differences observed will be statistically significant at any reasonable level of confidence, although the fact that one set of data closely repeats what was observed in 2001, suggests that the data is more robust than a simple random sample. The evidence we have is that commission does appear to influence IFA's in some cases to recommend unsuitable products since there is a difference (probably not significant due to the small sample size) between tied advisors and those on commission in the level of failure to recommend ISA's in appropriate circumstances. Finally, there is some (again not statistically significant) evidence in the research that IFA's working on commission were less likely to recommend debt repayment than those who were tied.

Given these results, the Panel does not feel that the CRA research gives commission a clean bill of health. The research shows that some advisors, at least, are influenced by commission.