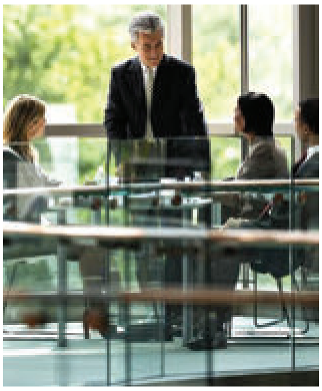


Information for Financial System Inquiry submission

26 August 2014

TOWERS WATSON

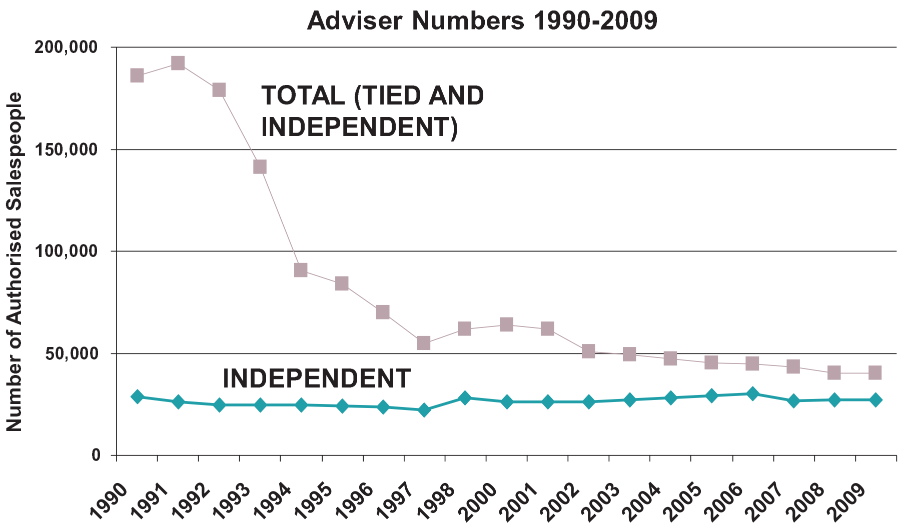
Section 2: Vertical integration in the UK life and retail investments market

The purpose of this section is to provide some perspectives on the following aspects of vertical integration and industry regulation of financial advisers in the UK:

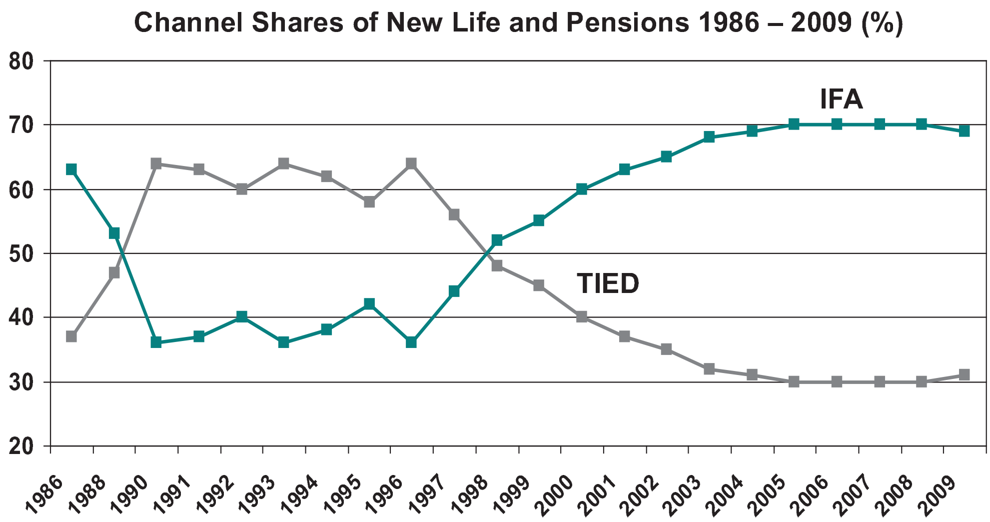
- The evolution of vertically-integrated businesses in the UK.
- The debate about structural separation between independent and non-independent advice considered as part of the development of the Retail Distribution Review (RDR) in 2008.
- The current approach to regulation of different types of advisory business models.
- Strategic arguments in favour of vertical integration.
- Examples of vertically-integrated models.

2.1 The evolution of vertically-integrated businesses in the UK

Distribution channel shares have varied considerably over the last 25 years, mainly in response to regulatory changes and resulting business pressures. The following charts show the evolution of seller numbers and channel market shares, split between tied and independent financial adviser (IFA) channels:



Source: Towers Watson estimates



Source: ABI

Tied distribution in the above charts includes direct sales forces and tied agents and banks, where applicable.

The key stages in the above evolution were:

- A scramble for tied distribution to secure market access in the period up to 1988, when polarisation of advisers between independent and tied was introduced for the first time.
- Subsequent rationalisation and closure of direct sales forces and tied agency channels in response to:
  - Poor performance in direct sales forces, which challenged the viability of existing models.
  - A series of industry-wide and company-specific business conduct problems which necessitated extensive reviews of past business and rectification of problems identified, further undermining viability and introducing unplanned volatility into financial results. While not confined to tied companies, much of the highest profile activity was concentrated in that sector.
  - Diminishing provider appetite for distribution and conduct risk, in the light of the above costs and reputational problems, which led to closures and divestments.
- The migration of capacity from sales forces to IFA firms as sales forces downsized and closed.

Currently, we estimate that there are around 32,000 financial advisers in the UK market, of which we estimate around 3-3,500 are working in direct sales forces. Most of the remainder are IFA or multi-tied distribution businesses with smaller numbers of Discretionary Fund Manager (DFM) and stockbroking advisers.

2.2 The 2008 RDR debate about structural separation between independent and non-independent advice

The objective of the RDR was to improve consumer trust and confidence in the retail investments industry by addressing a number of deep rooted problems, particularly:

- Lack of clarity about products and services and the status of advisers.
- Conflicts of interest (including incentives).
- Lack of robust professional standards for financial advisers.
- Consumer access to sources of advice.

In relation to the first of these objectives, during 2008, as part of the development process for the RDR, the Financial Services Authority (FSA), which regulates all providers of financial services in the UK, considered a radical structural separation of distribution business types, under which only firms satisfying independence criteria would have been able to offer regulated financial advice (personal recommendations). Tied or multi-tied companies, including vertically-integrated companies, would have been banned from providing advice and would have had to sell products only on a non-advised basis. This proposal was abandoned in late 2008 for the reasons described in 2.4 below.

For reference, the key FSA publications relating to this issue were:

- The Retail Distribution Review – Interim Report (April 2008) – proposals.
- Feedback Statement 08/6 (November 2008) – abandonment.

2.3 The April 2008 Proposals

The Interim Report followed on from previous consultations. It proposed a simplified landscape with three distribution components:

- Advice:
  - All advisers to be independent in status and operationally independent of providers.
  - Adviser remuneration to be determined without provider input.
  - Advisers must advise from across the whole of the market.
  - Advisers to meet minimum professional standards.

- Sales: A strictly non-advised service, either execution-only or guided sales without a personal recommendation being given. Providing access to the products of one provider only or a limited number of providers.

- Money Guidance: A proposed initiative to improve consumer education and capability with the aim of stimulating more consumers to seek advice and sales services.

The aim of these proposals was intended to clarify the status of different types of service by forcing a separation between independent advice and sales-advice provided by tied and multi-tied distributors. Had the split between advice and sales been implemented the latter would only have been able to sell without advice – i.e. without advisers making personal recommendations about the suitable course of action for individual customers.

It is likely that this would have reduced the appeal of tied models to consumers and that the reduced levels of sales persuasion (relative to fully advised models) would have reduced sales conversion and productivity. The viability of these sales-advice channels would therefore have been reduced and providers dependent on captive or multi-tied distribution would have had to modify their distribution strategies in order to sustain new business inflows.

2.4 Withdrawal of the proposal

Following consultation, the proposal for structural separation was abandoned and replaced by the arrangements which were implemented and which are described in the following section. The FSA gave the following reasons for not proceeding:

- Concerns about the impact of the proposal on consumer access to advice, especially among less affluent consumers, who were more likely to use restricted advice models and who might lose access if this form of distribution were banned.

- Concerns that the resulting FSA definition of advice would be inconsistent with broader definitions used under EU Legislation (MiFID, the Markets in Financial Instruments Directive).

- Fears that the existing customers of firms would suffer if the firms were required to change their model or withdraw their advice services.

- Lack of industry consensus and perceptions of self-interest on the part of some firms in seeking to exclude others from the advice market by influencing the future direction of regulation.

2.5 Towers Watson's view of the Interim Report proposals

At the time of the Interim Report, Towers Watson undertook analysis of the merits of the proposed structural separation. In summary our view was:

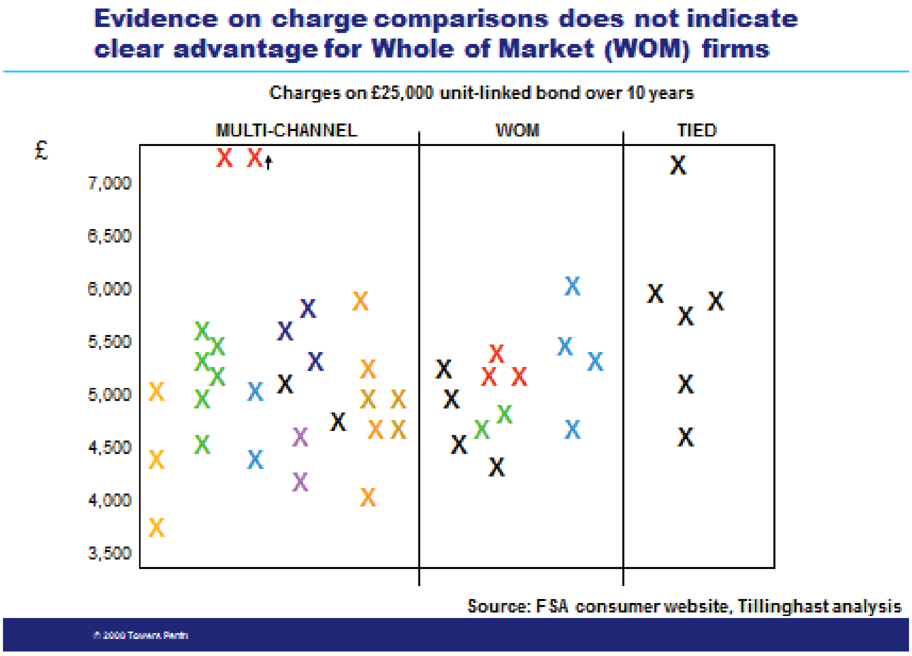
- The proposals did not adequately define "advice" and "non-advised", nor did they define or set out a desired end state in terms of consumer advisory outcomes. They were therefore a poor starting point for upgrading the quality and accessibility of financial advice.
- We emphasised the quality of advice in helping consumers in key strategy areas such as:
  - How to translate life goals into financial plans.
  - How much to save.
  - Risk/reward trade-offs.
  - Which product types and investments to use to meet their goals.

Our view was – and remains - that, in many product areas, competent delivery of the above strategy areas is more important than advice on provider selection, especially where product commoditisation means there is often limited scope for product differentiation. Quality of advice is therefore more important than whether the adviser has access to the whole market, provided that customer charges are not materially different or are justified.

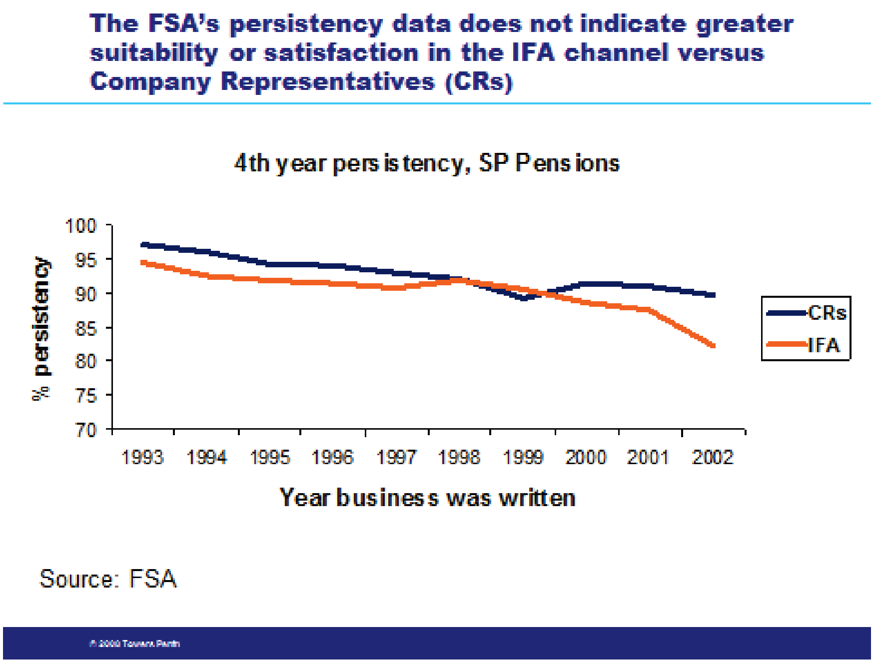
- We also emphasised the quality and consistency of the customer experience and the potential role of large, robust organisations in its delivery, including provider-owned distribution channels.
- Our view therefore was that advice could be provided as effectively by tied firms as by independent firms, and that large vertically integrated firms could have advantages over smaller, poorly resourced IFAs whose capacity for investment and scaling up may be limited.
- The concept of independence used by the FSA (whole of market product access) was not aligned with more intuitive customer views of independence such as impartiality. This might lead to customer confusion and potentially poor purchasing outcomes.
- Whole of market access was already becoming less relevant due to some convergence of product availability at point of sale across independent and tied channels:
  - IFAs increasingly offering a limited range of products through the use of panels (albeit based on some form of whole market due diligence from time to time). Other factors in the IFA market included the growing use of platforms and Discretionary Fund Management services.

– Increased use of open architecture and best of breed multi-tied/gap-filling in the non-independent sector, which had the effect of increasing consumer choice, especially in relation to investment funds.

- Limited comparisons of product charges that we carried out in 2008 did not indicate that charges were higher in tied channels compared with multi-channel and whole of market firms.



- Limited analysis of persistency data published by the FSA indicated equivalent or slightly better 4th year persistency rates in tied channels than for the IFA channel in respect of single premium (SP) pensions.



- The realignment of the industry needed to implement the structural separation would result in considerable disruption including the loss of advice capacity from the non-independent sector.

- Our prescription was that the FSA should:

  – Focus on the quality of advice provided, not just the status of the adviser (though clarity about the latter is important as well).

  – Recognise that the quality of advice is different from, and independent of, the breadth of the product range being sold.

  – Recognise the steps towards convergence between point of sale product and investment availability in different models.

  – Avoid structural changes which might inhibit capacity development, innovation and investment in advice provision and market development.

  – Therefore, retain the concept of financial advice in tied and multi-tied businesses.

2.6 The current approach to regulation of different business model types as implemented in 2013

Advice is available from both independent and restricted firms. Restricted firms include tied and multi-tied firms, including vertically integrated firms.

The following requirements apply to all advisory firms:

- There is a commission ban on advised sales of retail investment products. Instead, advice charges must be agreed between the adviser firm and the client. Providers can facilitate advice charge payments but must not influence the level or structure of the advice charges. Advice charges are, in practice, often structured in such a way as to look like pre-RDR commissions.

- Higher professional standards apply to all advisers, roughly equivalent to year one of an undergraduate degree.

- Improved disclosure of adviser status and the scope and limitations of the service available from the firm.

- The following apply in addition to independent advisers:

- The requirement to advise on a wider range of products, not just packaged investment products. In practice this may include products such as Investment Trusts and Exchange Traded Funds.

- The requirement to undertake “comprehensive and fair” analysis of relevant markets from which products may be recommended.

The following applies to vertically integrated firms:

- There must be no material cross subsidy between the product manufacturing and advisory parts of the firm. This means that advice must be financially viable in its own right.

2.7 Strategic arguments in favour of vertical integration

Generally, we believe the following to be arguments in favour of vertical integration in financial services distribution:

- It enables a more consistent customer centric approach to be applied to product management and customer treatment. The provider has greater control across the value chain from definition of the target market, through product development, distribution strategy, sales process and service delivery. There is less chance of the conflicting priorities of third party intermediaries weakening the integrity of the provider's customer proposition. Specific examples might include the development of products and services to meet the needs of customers rather than third party distributors and associated savings in servicing infrastructure. Overall, a more customer centric approach can deliver a number of benefits, including reduced conduct risk, improved customer satisfaction and lower unit costs.

- It facilitates market development and innovation. Providers are more likely to innovate if they have a more certain route to market, such as that provided by in-house distribution or specialist distribution controlled by business partners. The sales channel can be configured to address the situation and needs of the target market and the provider can work closely with the sales channel to maximise the effectiveness of the service provided to the end customer. In contrast, in established third party channels innovative ideas may not fit with the adviser's business model and may take considerable time to gain acceptance. New products and propositions often take off more slowly where providers have to rely on broker-type distribution – for example long term care in the US or Variable Annuity type products in the UK.

- It may enable greater levels of customer access to advice compared with reliance on IFAs alone.

- From the provider's point of view vertical integration may help reduce price competition at point of sale compared with broking models. Furthermore, greater control over the customer experience, enhanced customer data and insight and customer access should enable improved cross and up-selling and the realisation of brand recognition and loyalty.

Recently in the UK we have been involved in market research among consumers which indicated a high degree of willingness to seek advice and support from providers, rather than from IFAs: for example, 55% of affluent customers indicated they would prefer to receive advice from a provider.

Although conditions will vary from case to case, in general our experience when modelling different types of distribution structure is that the expected benefits of streamlined operations, improved control and business integration outweigh the potential disadvantages which might arise in relation to reduced customer appeal of narrower propositions and the associated risk of reduced share of customer wallet.

2.8 Examples of vertically integrated models

Life companies in the UK which currently operate direct sales forces include:

- SJP – around 2,600 advisers: Self-employed partnership model with experienced advisers, including many former IFAs. Wealth management proposition focussed on affluent clients, with extensive open architecture investment proposition. Strong business generation focus via personal prospecting (referrals, seminars, etc) and a fairly visible brand by the standards of UK advisory companies.

- Wesleyan Financial Services: Operates via professional affinities: doctors, dentists, lawyers, teachers with segmented sales force aligned with these segments. Employed, salaried sales force.

- NFU Mutual: Composite focussed on the farming and rural markets. Sales force is driven mainly by referrals from general insurance agents. Believed to demonstrate high productivity and business quality, presumably due to strength of affinity, quality of customer base and high quality of sales execution. Salaried employed sales force.

- Prudential Financial Services: New sales force established several years ago, understood to serve maturing Prudential customers that otherwise lack a financial adviser.

Common themes in the above examples are:

- Focus on clear target market (and relatively affluent target customers).

- We believe, relatively high productivity generated by lead generation and wider company support.

- In some cases (eg Prudential and NFU Mutual), we assume that the lead generation model used is capable of identifying customers with a high probability of taking action soon, either because a policy is maturing or because an introducer has identified a clear customer need.

We are not aware of any old-style mass market prospecting commission–only sales forces of any size operating in the UK.

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