Polarisation: research into the effect of commission based remuneration on advice

Prepared by
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Final report

The effect of commission based remuneration on financial advice

Submitted to:

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Executive summary

Do financial advisers display "commission bias", recommending the products or providers that pay them the largest commissions? Does this damage the interests of buyers of packaged investment products? While everyone knows individual cases or has their own hunches, previous research has been inconclusive on whether there is bias, and economic theory is ambiguous about whether bias would necessarily be harmful.

Charles River Associates (CRA) was commissioned by the FSA to undertake a full-scale investigation to show whether or not there is any evidence of bias or detriment, using both statistical and market research data. The aim has been to move the debate to a new level, by producing high-quality empirical results.

CRA has been careful to allow for the many other factors that could influence advisers' recommendations, since these could give an appearance of bias where it does not exist, or remove the appearance of bias where it does. We have been equally careful to take account of the many ways in which the harm that consumers might suffer from any bias that exists can be neutralised. We thus start from a presumption that the advice market is working effectively. If, after making all these allowances, we do detect bias or detriment, we can be reasonably sure that they really do exist.

Our research and findings are confined to the facts of the case – does bias occur, and if so how much detriment does it cause? We do not in this report try to reach any conclusions about what regulators, providers, advisers or consumers ought to be doing about it. Clearly these issues will be the focus of the next stage of the debate which will be informed by our findings.

MAIN FINDINGS

We have six main findings, which fall into two groups. The first four findings relate to the bias and detriment that our research did discover:

Finding 1: There is significant bias in the advice on a small number of single-premium products. The statistical evidence shows that there has been significant provider bias in the advice given on distribution bonds and with-profits bonds. The market research evidence on current practices shows that there is some product bias in the advice given on ISAs. Other single-premium products seem to be clear of bias. These findings accord well with anecdotal evidence in the industry.

Finding 2: Bias appears to be more serious in the independent than the tied sector. Our market research findings suggest that the tied sector displays little, if any, evidence of bias.

Finding 3: Where there is bias, it is causing consumer detriment. Advisers sometimes give rebates to their customers, but they do not dispel bias. Where there is bias, it leads advisers to recommend products that are unsuitable in terms of taxation, access and possibly charges. Consumers' interests are damaged as a result.

Finding 4: The amount of detriment caused is appreciable. Aggregating the provider bias we have identified (with profit bonds, distribution bonds) with the product bias (ISAs) we estimate this results in consumer detriment of £140 million per year. This figure is not exhaustive – there may be detriment from biases in other product categories, and from other types of bias that we have not sought to identify.

The final two findings are equally important, and relate to the situations where we did not find bias. Since this covers the bulk of the industry, it is vital that they be given at least equal prominence in the debate on commission bias.

Finding 5: The advice market is not riddled with bias. We do not find any evidence of significant bias in the advice given in the remainder of the market for investment products. This suggests that for the most part the advice market is working reasonably well, and that adviser recommendations are not dominated by self-interest.

Finding 6: There is no detectable bias on regular premium products. The statistical evidence shows that there has been little significant bias in the advice given on any regular premium product. The market research evidence suggests that there is no bias currently. Rules on personal pension advice are now so tight that there is little room for advisers to make biased recommendations.

EVIDENCE

The statistical evidence we have used comes from providers. Its main aim was to throw light on historic provider bias, though some evidence was also gained on product bias. We collected data on new business and commissions (both before and after rebates), by provider and product, for 25 calendar quarters. To allow for the impact on advisers' choices of factors such as provider reputations, which remain relatively fixed over a period of time, the econometric analysis has been carried out on deviations from the average. That is to say, we only conclude that there is evidence of bias when we find a relationship between deviations in commission rates and those in market shares.

This means that we draw no deductions from our statistical evidence about bias in situations where different providers pay different average levels of commission and there is a trend in their relative market shares, for example. There may be biases of this kind, but we do not have the evidence necessary to allow for reputational and other fixed factors, as would be necessary to estimate their size. Accordingly, our estimate of detriment arising from provider bias is based on an extremely cautious methodology.

Our market research evidence comes from a sample of 250 "mystery shopping" exercises undertaken with financial advisers during August-October 2001. This resulted in 170 fully documented shops, which form the basis of our results. Both tied and independent advisers were surveyed. The main aim was to discover whether there is product bias currently, though some information was also gained on provider bias. The interviews were designed to elicit adviser recommendations in two stylised scenarios where there was a possibility that bias would be displayed. One of these related to a lump-sum investment, and the other to an ongoing stream of investments.

1 Introduction

In May 2001, Charles River Associates (CRA) was asked by the Financial Services Authority to investigate whether there is any evidence that remuneration structures affect the recommendations given by financial advisers on packaged investment products, and if so whether this leads to consumer detriment.

The possible problems of commission-based sales have been a source of debate and controversy in the financial services industry for many years. Regulators have sought to minimise the potential effects of commission through a number of initiatives. These include:

- Rules on commission structure, such as those preventing the use of volume over-riders and some indirect benefits, banned since 1988;
- The suitability requirements introduced in 1988;
- The maximum commission rules (for example, the LOA agreement[1] and its successor, the LAUTRO maximum commission rules[2]) abolished by the OFT in 1989;
- Disclosure of the proportion of an intermediary's sales of a particular provider's products, where that proportion exceeds 20%; and finally
- Compulsory disclosure of salesmen's remuneration to the purchasers of packaged investment products, introduced in 1995.

CRA however started this research with a completely open mind about the existence of bias or its possible effect on consumers. This reflects the state of both the existing evidence and the theory on the topic.

Though there is a widespread belief that commission has an impact on adviser behaviour, little research has been undertaken to confirm or deny this. As part of a report for the FSA on the impact of the polarisation rules in July 2000, econometric analysis was undertaken using PIA data on new business and commissions. This found a positive, but statistically insignificant, relationship between the commission rates providers pay to advisers and the volume of new business providers gain in the markets for unit-linked and with-profit personal pensions and for unit-linked endowments. This was consistent with anecdotal evidence of commission affecting advisers' provider selection, but far from conclusive. It threw no light on the effect of commission on advisers' product selection.

The economic incentives on advisers are complex, and theory does not establish a clear case for expecting bias or detriment. While advisers stand to gain in the short term from

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1 The LOA or Life Offices Association was a self regulatory organisation that became part of the ABI.

2 The LAUTRO rules operated from 1st July 1988 to 31st December 1989 although they had been largely removed in May 1989. They were abolished due to objections from the OFT. The OFT paper considered the maximum commission agreement (MCA) and decided that although commissions did need to be bridled, the MCA went beyond what was necessary and was likely to distort competition. In particular, MCA limited information to consumers and served to restrict and distort price competition. Instead the OFT favoured the use of LAUTRO rates as a yardstick, with full disclosure.

recommending providers or products that offer them high commission rates, they may lose in the longer term if they recommend unsuitable products that damage their relationships with customers.

Finally, even if the products they recommend have higher commissions than alternative products, as long as the products they recommend are suitable and have similar charging structures to other products there need not be any detriment to customers. Accordingly, if it found bias, our research needed to examine the existence of detriment as well, in order to throw light on the appropriate regulatory response.

1.1 DEFINITION OF BIAS

In this research, we investigated whether the following types of bias exist in adviser behaviour:

- *Product bias*: In advising across the range of product types, tied advisers or IFAs could recommend a product type that provides them with the highest commission;
- *Provider bias*: Within a particular product type, IFAs could recommend the provider that pays them the highest commission, even though other providers' products offer better terms to the consumer.[3] This can arise if the advisers choose from across the whole market or if the adviser uses a recommended panel that maximises commission, even if he is then unbiased in selecting from the panel.[4]

While our estimates are limited to these types of bias, they are not the only biases that could occur. There could also be biases in:

- Consumers' decision to purchase or not. Commission provides incentives for intermediaries to sell a product, even where the "best" advice might be to use the money for current consumption or payoff existing debts. It may also give advisers an incentive to "churn", and sell customers a new product, even when they would be better advised to continue holding the product they already have.
- The term structure of the product. This could take a number of forms, for example, the choice between single and regular premium or the length of the policy.
- Commission structures at the point of sale. Advisers may be able to choose the type of commission structure – for example the balance between initial commission and renewal. It is possible advisers choose the commission structure based on their beliefs about the likely behaviour of the consumer, e.g. they may sell products with high upfront charges to consumers who they believe will lapse, in order to maximise their own revenue.

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3 Until the recent changes in the Polarisation regime, tied advisers were only able to recommend packaged investment products from within their marketing group. Therefore, provider bias was not possible for tied providers.

4 We do not try to determine the source of the bias in our analysis only whether there is bias and its materiality.

In addition to bias at the point of sale, commission could affect the behaviour of the intermediary after the sale. For example, it could influence the level of customer service or follow-on sales.

The "dance ticket" effect

It is sometimes alleged as evidence of bias that commission-based IFAs rarely sell products or providers that do not normally pay commission. We do not believe that this proves there is commission bias - instead it reflects the way that all commission-based distribution systems have to work.

In our view, there is a "dance ticket" – a minimum level of commission that is required to remunerate the level of effort put in by advisors, without which advice could not be given at all. Only at commissions above this dance ticket level can one begin to look for commission bias.

It is simply not a sustainable business activity for IFAs remunerated through commission to advise on products (such as investment trusts) that have not conventionally paid commission, or on those providers (e.g. historically, Equitable Life) who do not pay commission.

1.2 IDENTIFYING CONSUMER DETRIMENT

Showing that there is a relationship between new business and commission rates would prove that there is bias, but would not prove that consumers suffer detriment. In order to determine whether the relationship between commission and new business produces consumer detriment, we need to consider:

- whether the consumer suffers detriment from buying unsuitable products;
- the relationship between commission and charges;
- the level of commission rebating; and
- the motivational effect of commission.

Unsuitable products

Where commission leads to the consumer being advised an unsuitable product based on their financial needs it is clear that there is consumer detriment. For example, this could include a consumer being sold a long-term saving instrument with little provision for access, when they in fact need access to a 'rainy' day source of funds.

The relationship between charges and commission

Consumers suffer detriment if – other things equal - they are recommended products that have a high level of charges, since this erodes product performance. So if a consumer is advised a comparable product (i.e. the same product features) with a higher commission, but the same overall product charges, it is not at all clear that they suffer detriment.

The level of commission can be seen as a margin that providers pay to intermediaries for distributing their products. On the face of it, providers have to pay this margin out of their total costs, and one would expect to find that levels of charges and commissions paid by different providers are strongly correlated. If this is the case, then higher commissions would be associated with consumer detriment.

We know of no quantitative research demonstrating this to be the case, however. What is more, there are also a number of reasons why different providers may choose to pay different margins, quite independent of commission:

- some providers enjoy brand advantages with customers, perhaps as a result of their financial strength or past performance;
- some providers choose a high margin/low volume business strategy, while others pursue a low margin/high volume strategy; and
- some providers have better cost efficiency than others.

If charges and commission vary independently of each other, the level of commission will be little guide to the amount of detriment to the customer. To allow for this where we have discovered evidence of bias we have, where possible, considered the corresponding level of charges.

Commission rebating

A particular area of interest in assessing the amount of consumer detriment is the value of rebates. Advisers sometimes offer to forego part of their commission payment in order to offer the consumer a better deal, and the difference or rebate is then often re-invested in the product. This posed a number of analytical problems for this research:

- It may be most appropriate for an adviser to recommend a high-commission, high-charge product to their customer, but then to rebate some of the commission, resulting in low overall product charges. In this situation, despite high charges, there would be no detriment. To allow for this possibility, we needed to take rebates into account to see if the adviser is acting against or protecting the interests of their customer.
- It may be that rebates are more frequently offered to customers offering larger amounts of new business premium, and/or to those displaying more sophistication. Unless we differentiate average rebates by premium size and customer sophistication, we may underestimate the effect of bias on less well off and less sophisticated consumers.

Only with detailed rebate data is it possible to conclude whether any commission bias identified leads to consumer detriment.

Motivating sales effort

A final reason to be careful in assessing whether bias in the advice process has a detrimental effect on customers is that some biases can be beneficial. In particular, the role of commission in stimulating the sale of savings products may be socially beneficial in the current UK situation, because many customers and potential customers are thought to make insufficient savings.

1.3 CRA'S ANALYSIS

In the present project, CRA undertook a much more detailed statistical and econometric investigation than previous research, spanning a larger number of products, using quarterly rather than annual data, and covering a number of definitions of commission to examine the provider bias issue in more detail. To complement the historical picture that econometric analysis provides, and to throw more light on the issue of product bias, CRA also undertook a "mystery shopping" exercise.

This report sets out the results of these two investigations, detailing how the research was undertaken and the conclusions that can be drawn. The report is organised as follows:

- Section 2 describes the commission-based advice market;
- Section 3 describes the results of our econometric analysis;
- Section 4 provides evidence from the mystery shopping; and
- Section 5 presents our conclusions.

CRA would like to thank the large number of industry participants who devoted considerable resources to discussing the method of data collection, provided detailed data and advice on the analytical methodology or helped with the design and assessment of the mystery shopping exercise.

2 Commission based advice

The great majority of the sales of advised packaged investment products are sold on the basis of commission. Throughout this report we define commission as payment to an intermediary conditional on the purchase of the product. It is important to note that the structure of commission payments varies considerably between independent financial advisers (IFAs) and tied agents.

2.1 COMMISSION BASED INDEPENDENT FINANCIAL ADVICE

Commission can take a number of different structures:

- Initial commission – commission paid to the adviser in the initial period, this can take two forms:
  - non-indemnity commission, this is not subject to any clawback and is paid on an "as earned" basis as the premium is received; and
  - indemnity commission, this is paid upfront but is then subject to clawback by the provider should the consumer lapse. Indemnity commission is calculated as the initial commission discounted back.[5]
- Renewal commission - this is payable after the initial period and rewards the intermediary for persistent business; and
- Trail commission – performs a similar function to renewal commission for single premium business.

The initial commission is written as a percentage of the value of new business, whilst renewal commission is often written in terms of subsequent premiums. For single premium, trail is most commonly written in terms of the size of the fund.

Although the LAUTRO Maximum Commission Agreement (MCA) scale ceased to be effective from December 1989, its terms are still commonly used to describe the structure of commission.

The LAUTRO rates are applicable to products of different terms, the longer the duration of a policy, then generally the longer the initial period will be. The following are the LAUTRO maximum commissions for each type of policy:

[5] The rate at which initial commission is discounted varies between providers. The LAUTRO rules set this as 1% per month.

Table 1: LAUTRO terms for regular premium policies

Endowments:	Initial: 25% of new business value during initial period Renewal: 2.5% of premiums after initial period Maximum initial period: 38 months
Whole life policies:	Initial: 25% of new business value during initial period Renewal: 2.5% of premiums after initial period Maximum initial period: 48 months
Personal pensions:	Initial: 25% of new business value during initial period Renewal: 2.5% of premiums after initial period Maximum initial period: 27 months
Term assurance:	Initial: 35% of new business value during initial period Renewal: 2.5% of premiums after initial period Maximum initial period: 48 months
Permanent health insurance:	Initial: 30% of new business value during initial period Renewal: 2.5% of premiums after initial period Maximum initial period: 48 months

Source: LAUTRO "Information for investors", 28 July 1989.

Table 2: LAUTRO terms for single premium policies

Insurance bonds:	Initial: Bonds purchased during 1988, 4.8% of new business volume, bonds purchased during 1989, 4.2%
Pensions:	Initial: New business, 4% of new business volume, transfers, 1%
Annuities:	Initial: 2% of new business volume
Unit trusts:	Initial: 3% of new business volume

Source: LAUTRO "Information for investors", 28 July 1989.

In addition, over recent years intermediaries have been offered a wide variety of further choices. For example, some providers allow intermediaries a range of options trading off lower levels of initial commission for higher levels of renewal commission. There has also been a recent trend for level loaded commission, with equal commission payments each year. This is likely to have been driven by the trend for level loaded charging structures.

Moreover, these rates only reflect the standard terms. Providers may offer different IFAs different terms, in a number of ways:

- Providers can offer IFAs "enhancements" or "uplifts". Although regulation prevents a higher commission being offered depending on the level of new business premium (i.e. volume over-riders are not permitted), different rates can be offered to different intermediaries; and
- Earnings period may be reduced to limit the exposure of intermediaries to the repayment behaviour of the customer.

2.2 COMMISSION BASED TIED ADVICE

The structure of commission for tied advisers varies from company to company, so for the purposes of this project we undertook a review of the methods by which different tied sales forces are remunerated. There is considerable variation in the means by which remuneration is related to sales. There are instances of sale forces remunerated by:

- a fixed salary and constant fee for sales independent of the size of the sale;
- zero salary and a credit for the sale of each product based on the type of product and premium size; or
- a bonus over a sales threshold target based on effective income.

The existence of largely salary-based remuneration structures means that at least some tied sales forces have different incentives from commission-based independent advisers. The focus of our analysis was whether sales related remuneration in the tied sector influenced sales in a similar fashion to commission.

2.3 COMMISSION REBATING

Intermediaries sometimes rebate part of their commission to the consumer. In such cases, the intermediary forfeits some of the commission, and although it is possible that this is given back to the customer in cash, it is more likely to be:

- rebated into an account from which the intermediary can subsequently draw his or her fees; or
- rebated into the customer's policy by allocating additional units i.e. increased allocation rates.

Rebating by IFAs appears to have become more prevalent in the period 1997-99, as shown in Table 3. It appears that approximately 30% of sales through IFAs are written on reduced terms.[6] Evidence from the PIA disclosure report suggests that rebating through tied sales forces is negligible.

Table 3: The extent of commission rebating (percentage of new regular premium personal pension business written)

	Commission terms		
	Full	Reduced	Zero
1999	68%	17%	15%
1998	68%	17%	15%
1997	76%	15%	9%

Source: 1999 PIA Disclosure Report.

6 Evidence from providers collected for the purposes of this project supports the conclusion that rebating has become more prevalent over the last five years. However, we also find evidence that the degree of commission rebating has declined recently to reflect the reduction in product charges and commission resulting from the introduction of stakeholder and RU64.

2.4 COMMISSION DISCLOSURE

The disclosure requirements on intermediaries have increased dramatically since the mid 1980s. Before 1988 there was no compulsory disclosure of commission terms. Firms that chose not to adopt the LOA agreement did not need to disclose this was the case. LAUTRO required firms to disclose whether they were within the LAUTRO terms, if this was not the case, they had to declare the rate of commission.

The current disclosure regime introduced in 1995 made it compulsory for independent intermediaries and tied agents to disclose the cost of the advice to the customer. In the so-called “key features documents” they must disclose commission as a monetary amount. For IFAs this corresponds to:

- commission in cash terms received by the company; and
- fees received for acting as investment adviser to a broker fund.

For tied agents this corresponds to:

- payments made to designated individuals and appointed representatives;
- the value of additional benefits in kind; and
- the value of the life office’s services.

3 Econometric analysis

As discussed in the introduction, we used two complementary approaches to investigate the effects of commission payments. The first was a statistical analysis of the historical relationship between commission and new business, which we discuss in this section. The second was a mystery shopping exercise, which is discussed in Chapter 4.

While both types of analysis provide evidence on product and provider bias, the econometric approach focuses more heavily on the issue of provider bias (and therefore concentrates on the IFA market) and the mystery shopper focuses more closely on product bias.

3.1 A STATISTICAL ANALYSIS

Our methodology involves a detailed statistical analysis of evidence on commission levels and sales across different products and brands. This is a “revealed preference” approach, because it is based on actual choices made in the market. If feasible, it is the most attractive approach to follow, because it avoids the problems inherent in a “stated preference” approach where advisers say what they would do in a hypothetical situation.

To support our analysis, we collected quarterly data from twenty-five product providers.[7] This data included:

- New business volumes over a five-year period for fifty-three product categories (both the list of products and the definition of new business are reported in the appendix).[8] The product categories include a range of products including non-regulated products such as protection products. Although, these are not subject to the Polarisation regime, they are included as they form possible substitutes for regulated packaged products.
- Data on the level of commission, in terms of:
    - standard rates;
    - average rates taking into account enhancements given to particular IFA groups; and
    - average rates after taking account of rebates given to customers.
- The structure of commission, in terms of:
    - the level of initial commission;
    - the initial period; and
    - the renewal commission or trail commission.

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7 The providers were chosen by the Financial Services Authority because they were existing members of commercial data exchanges. This was intended to minimise the costs in providing the new business data required for the project.

8 Given the choice of providers it was inevitable that the data on unit trusts would be significantly weaker than on other market segments. As this product area was partly covered through the mystery shopping approach we did not try to collect additional data on the unit trust market.

It is clear that the commission structure depends on the characteristics of the product. For example, the commission will vary depending on the term of the product or whether the product is written on single or regular terms.[9] In order to account for this we have collected data on whether the product is single or regular premium, and the average term of the product.

Not all of the 25 providers were able to provide all the data requested, but between them they gave us a high degree of coverage in a wide variety of markets.[10]

We have not included providers or products that do not pay commission. We are interpreting commission as the "price" of the advice. This means that commissions have to be above a certain level to allow IFAs to support themselves, so IFAs rarely recommend products or providers that do not pay commission. We wish to exclude this "dance ticket" effect from our analysis.

Where possible we have compared the new business data given by providers with the data the ABI collects for its Market Statistics Exchange. Though there are some differences due to varying product and market definitions, it is possible to cross check in most cases. On the basis of this cross check, we find that the 25 providers give us an average market coverage of 70%, though the level of coverage varies considerably between market categories and over time. For example, our sample covers over 90% of the market for regular premium endowment saving plans, but for group income protection covers only 30% of the market.

In order to examine the relationship between commission and new business we have chosen to focus on *changes* in commission rather than the *level* of commission. This approach does have disadvantages. In particular, it does not draw any evidence from differences between the level of commission paid on different products, and thus, it could be argued, wastes data that could potentially have thrown useful light on the bias issue. For example, conventional pension annuities and income drawdown products have very different levels of commission, averaging 1% and 5% respectively. Our approach does not draw any conclusions from this because it is impossible to associate any relationship between the level of new business and the level of commission to bias with any certainty. The differences in levels may be due to any of a number of factors, including:

- the larger amount of effort an adviser has to make in the sale of a drawdown product;
- the increased complexity in the administration of income drawdown;
- the fact that income drawdown is a relatively new product; or

9 It is also possible to have a product that accepts single and regular premium contributions. For the purposes of our analysis we assumed the product type was based on the nature of the first contribution.

10 There is a possibility of survivorship bias from this approach, i.e. it is possible that products or providers that paid insufficient commission were removed from the market as they were not successful. Therefore, we might not observe in the market today those products that lowered commission dramatically in the past. Nonetheless, the data we are using records products of the majority of companies currently serving the market. Many companies were purchased and their results consolidated in those that currently survive.

- an attempt on the part of providers to induce product bias.

We have no way to make evidence-based conclusions by simply comparing the level of commission paid. So, instead we focus only on changes in the level of commission and new business.

3.2 PRODUCT BIAS

The simplest test to undertake is a descriptive analysis of how commission levels for different products have changed over time, and whether this has been associated with changes in sales volume.

To do this we have segmented the market into the following eight "market segments":

- Mortgage related products;
- Personal pension products;
- Protection products;
- Regular Premium Group Pension products;
- Single Premium Group Pension products;
- Regular Premium Savings and Investment products;
- Single Premium Savings and Investment products; and
- Retirement products.

The group of products contained in each of these segments is shown in the annex. Clearly this is not the only possible way of dividing the market into segments, and equally the product groupings do not correspond to economic markets in any rigorous sense. Markets are normally defined for the purposes of economic analysis when the products within them are close substitutes with one another, but not with other products. Our grouping is based on a commonsense view of what products are likely to be substitutes, but not a formal analysis.

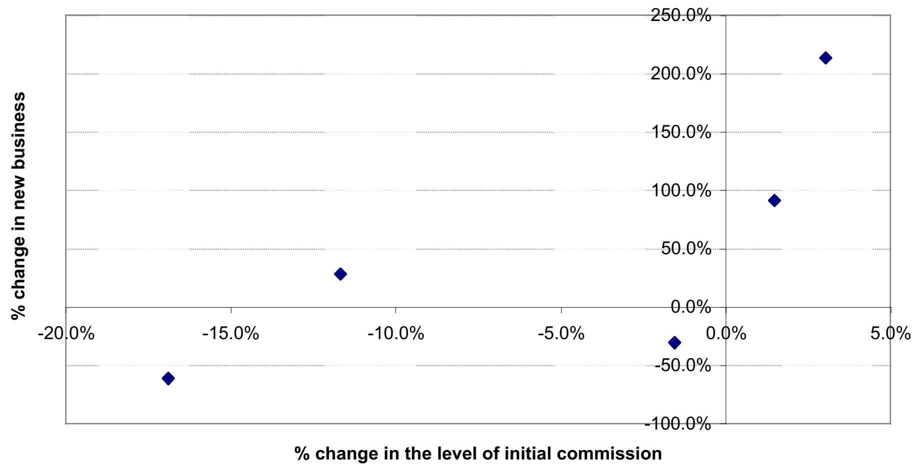
We do not show the results for mortgage related products, regular premium savings and investments and retirement products. This is because in these markets there has been very little change in the level of commission, so any conclusions drawn from the relative changes would be highly spurious. The results we discuss are thus confined to the other five product segments (Personal pension products, Protection products, Regular Premium Group Pension products, Single Premium Group Pension products; and Single Premium Savings and Investment products).

In the figures that follow, we have plotted the percentage change in the commission level[11] **over the five years** of our data against the percentage change in new business over the same period for different products. Each data point represents one of the products in the grouping. If there were commission bias we would expect a positive

[11] This represents the percentage change not a change in percentage points. For example, an increase of 10% would reflect an initial commission of 5% going up to 5.5%.

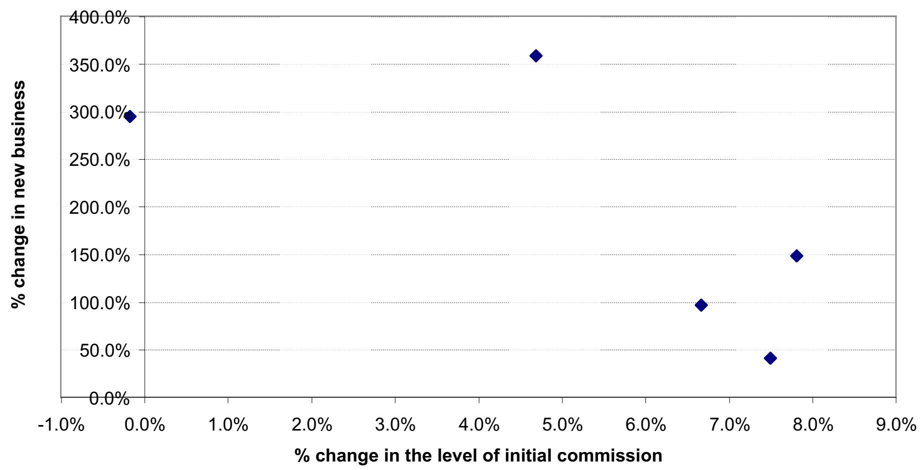
relationship between changes in commission levels on each product and changes in new business. The first point to note, it that although we have seen significant change in the volume of new business, there have only been relatively small changes in the level of commission. For example, a 10% change in the level of commission over five years, only reflects a 1.9% change in each year.

Figure 1: Changes in initial commission and new business - Personal pension products



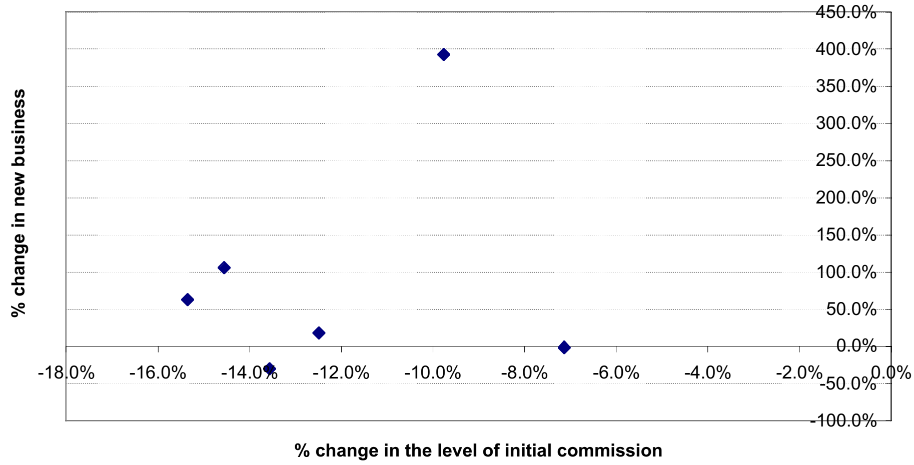
Source: CRA

Figure 2: Changes in initial commission and new business - Protection products



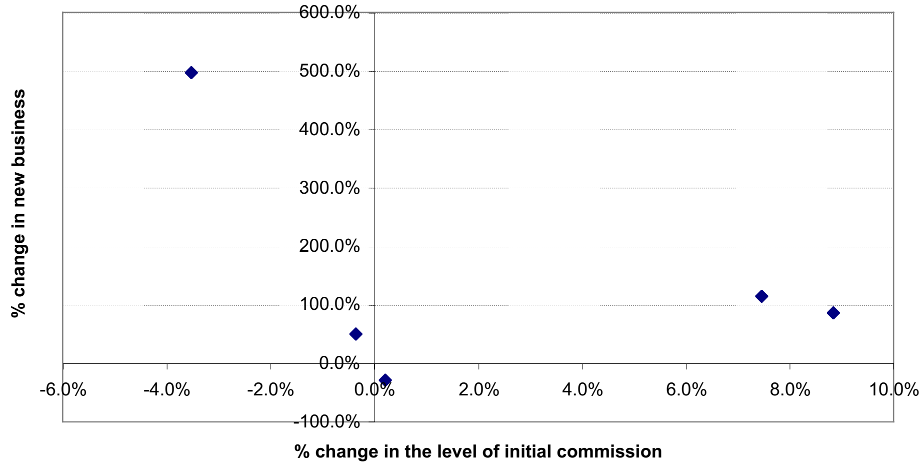
Source: CRA

Figure 3: Changes in initial commission and new business - Regular premium group pension products



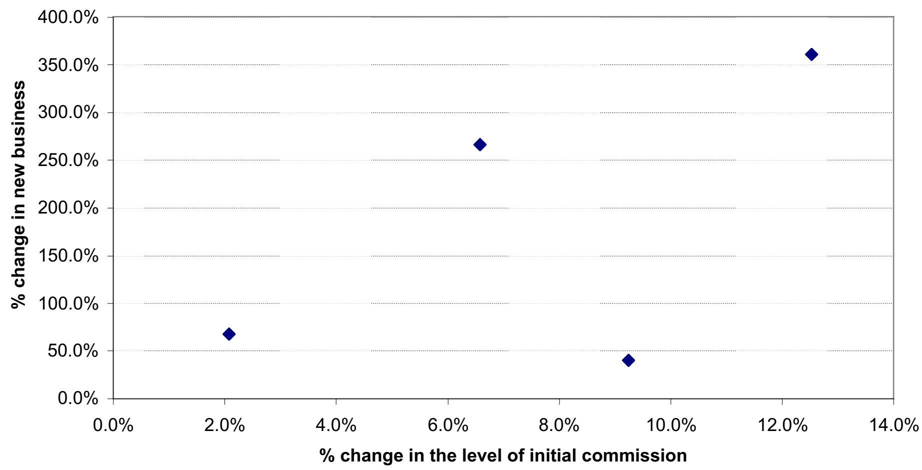
Source: CRA

Figure 4: Changes in initial commission and new business - Single premium group pension products



Source: CRA

Figure 5: Changes in initial commission and new business - Single premium savings and investment products



Source: CRA

The evidence above is purely descriptive, and thus we need to very cautious making deductions about product bias.[12] Changes in new business volume will be affected by many other factors, including regulation, product innovations and demographic changes. Moreover, due to the very small number of observations it is unsurprising that even where there is an apparent relationship it is not statistically significant.

However, this provides some additional evidence to add to the product analysis conducted in later sections of this report. There is no general tendency for commission and new business to show a positive relationship. In fact, there are as many negative relationships (which are at first glance inconsistent with commission affecting advice) as positive ones among these market segments.

Nonetheless in the cases of single premium saving and investment products and personal pensions, this evidence might give grounds for believing that there is product bias. We investigate these product segments in the mystery shopping exercise.

3.3 PROVIDER BIAS

The main purpose of the econometric and statistical analysis is to test how important commission is in terms of the provider chosen, and the dataset was designed with this in mind. Accordingly, a much more sophisticated set of analyses has been undertaken for provider bias than for product bias.

[12] In particular, these results do not control for the fact that a number of providers were only able to provide data for some of the period and that providers merged during this period. This will exaggerate the level of growth. These effects were explicitly allowed for in the econometrics that follows.

At any point in time, it is unlikely that there is only a single provider that is best for a particular consumer. Instead, there is likely to be a number of providers that would satisfy suitability based on a selection in terms of:

- risk factors;
- financial strength;
- investment performance;
- charges and expenses;
- customer service; and
- flexibility of the product.

In order to isolate the effect of commission, we need to control for these factors. To do this, we have adopted a "panel" approach, using data from the same set of providers over time. This approach isolates whether, after allowing for provider specific effects, changes in commission led to changes in market share. It is therefore conceptually similar to the product analysis looking only at changes.

The alternative would have to been to use a cross-sectional approach. This would try to explain the success of different providers (i.e. the level of market share), taking into account their product terms and the level of commission they offered compared to the average for the market. Its main disadvantage in the present context is that product terms are so diverse that it would take a great deal of data to control for them. Even then, immeasurable factors such as provider reputation are so important that they may dominate the results. If providers with better reputations have larger market shares and lower commissions, we might well find that commission and new business levels are negatively related at any given point in time, and the relationship throws no light on the effect of commission on adviser behaviour.

The panel approach takes a single product "market" and looks at how the market shares of each provider have changed over a period of time, during which one or more providers' average levels of commission on that product have changed.[13] As the analysis is based effectively on changes in market share and commission, this makes it unnecessary to include additional data to reflect provider characteristics that explain differences in the level. However, implicitly it is assuming that other factors do not change significantly over the period.

In specifying the data we have used the product descriptions adopted by commercial data providers – Touchstone and the Market Statistics Exchange of the ABI. We have then calculated market shares of product providers and how they have changed over the last five years. As well as this, account has been taken of:

- consolidation of product providers during the period;
- periods when not all providers have submitted data;

[13] As before, we use markets based on product definitions, not rigorously-measured economic markets.

- exceptional circumstances, such as the impact of demutualisation, exceptional product terms, very significant product launches, and restructuring as a result of the 1995 Pensions Act.

For meaningful analysis, we needed consistent data on new business and commission over the time period. From our initial range of 53 products we selected 24 (11 regular premium and 13 single premium) for which data was consistent enough to support a detailed investigation. This selection was made by including only those product markets for which:

- more than one provider submitted both new business and average pre-rebate commission data;
- there is MSE data to check the validity of the new business statistics; and
- our data cover a reasonable proportion of the market.

The products that survive this selection are shown in the annex to this paper.

Our analysis focuses on average commission data after uplifts but before rebates. This was for two reasons: firstly, we had a much larger sample of submissions on this data than post rebate data; secondly, we want to understand both whether commission affects new business levels and the degree of detriment if such a relationship existed.

We apply the same methodology for individual and group products. Our new business data is with respect to new business from all IFAs. This therefore includes fee based and commission based transactions. While the amount of fee-based business is likely to be small for most products, it will be larger for group products. However, this should mainly affect the size rather than the significance of any effect we find on new business volumes.

Single premium products

Single premium products are the most straightforward to analyse. We examined whether changes in the market share of particular providers over our five years time series were correlated with changes in the commission rate they pay, relative to the rest of the market.[14]

As shown in the table below, initial commissions vary considerably between providers. This is in contrast to the small changes in average rates by product considered above. There is very little variation in trail commission rates, so in our analysis we focused on the level of initial commission where trail commission has not been paid.

[14] It is still possible that changes in market shares are driven by factors other than commission, however, this would not explain a significant correlation between new business and commission. We therefore do not believe this is a substantial problem.

Table 4: Single premium products – Pre-rebate initial commission variation

Product category	Average initial commission	Range across providers
1. Distribution bonds	5.9%	5.1%-6.8%
2. Executive pension	5.2%	3.9%-9.1%
3. FSAVC	5.3%	2.6%-7.5%
4. Group money purchase	5.2%	4%-5.9%
5. Group Personal Pension	5.3%	4%-7.5%
6. Income drawdown	5.3%	1.5%-6.5%
7. Individual pension transfer	5.3%	2%-5.8%
8. Pension annuity	1.1%	.5%-1.8%
9. Personal pension	5.3%	1.6%-5.9%
10. SSAS	5.4%	2%-7.5%
11. Section 32 buy-out	5.4%	3.5%-6.4%
12. Unit-linked bonds	5.7%	3.9%-7.6%
13. With-profit bonds	5.9%	5.1%-6.7%

Source: CRA

In the results below, market shares are defined in relation to the observed market (the sum of the new business reported by providers who submitted both new business and commission data) rather than the total observable market (the amount of new business reported by the ABI MSE). Our econometrics thus test whether providers' shares of the observed market depends on relative commission levels. This ensures that the new business and average commission data are consistent, but has the drawback that shares depend on the number of providers submitting data.[15] To forestall problems, we have used dummy variables to control for changes in market share brought about by changes in the number of reporting providers.[16]

We have also tested the robustness of our results to using alternative definitions of market share:

- including new business data for those providers that submitted new business but not commission data; and
- using new business data from the ABI's Market Statistics Exchange.

[15] As the results are based on a smaller definition of the market, this will inflate the market share of providers and increase the estimated elasticity between the market share and relative commission. This will change the size of the effect but not the sign or significance. However, since we have a high level of coverage in most markets this should not materially change the results.

[16] A dummy variable takes the value of one or zero and is used to control for an event in the data that would otherwise distort the results.

Below we report the results of our econometric analysis. The detailed regression results are included in the annex. In order to maintain confidentiality over the commission levels of individual product providers, we can only show limited descriptive analysis.

The first column of numbers measures the strength and direction of the relationship between changes in commissions and changes in new business market shares. A positive number implies that a rise in a provider's commissions is associated with an increase in its market share. The second column reports on the statistical significance of the relationship, that is to say whether it might have arisen by chance. A relationship that is significant at the 5% level is one that only has a 5% probability of having arisen by chance. This is the level of statistical significance that is typically required when trying to establish whether a statistical relationship exists.

Table 5: Single premium products – Size and strength of the relationship between commission and market share, by product

Product category	The % points change in market share for a 1% change in commission	Significance at the 5% level
1. Distribution bonds	0.62	Yes
2. Executive pension	0.03	No
3. FSAVC	0.09	No
4. Group money purchase	0.5	No
5. Group Personal Pension	0.03	No
6. Income drawdown	-0.01	No
7. Individual pension transfer	0.01	No
8. Pension annuity	0.06	Yes
9. Personal pension	0.02	No
10. SSAS	0.01	No
11. Section 32 buy-out	0.13	No
12. Unit-linked bonds	0.06	No
13. With-profit bonds	0.71	Yes

Source: CRA

Twelve of the 13 relationships are positive, suggesting that higher rates of commission are generally associated with larger market shares. Much the strongest relationships are those for distribution bonds (category 1) and with-profit bonds (category 13). These two relationships are also statistically significant. This implies that there is a reasonably strong positive relationship between new business market share and relative commission level for these products, which is unlikely to have arisen by chance.

How are we to interpret the magnitude of the numbers in the first column? In the case of the distribution bond, with a coefficient of 0.62, the results are saying that a 10% increase in the rate of initial commission (say from 5.0% to 5.5%) by one provider is associated with a 6.2% point increase in market share, say from 10% to 16.2%. This assumes other providers do not change their level of commission in response. Finally, this result is the average relationship across providers, for a particular provider the relationship could be either smaller or larger. Just to be clear on the interpretation of these coefficients, if we assumed a 20% increase in the rate of initial commission (say from 5.0% to 6.0%) in the example above, this would be associated with an increase in market share of 12.4% points, say from 10% to 22.4%.

There is also a statistically significant relationship in the case of pension annuities, but this is much weaker with a coefficient of only 0.06. This is saying that a 10% increase in the rate of commission on annuities (say from 1% to 1.1%) is associated with a 0.6% point increase in market share, say from 10% to 10.6%. However, this relationship is not robust, and the magnitude of the result varies considerably under alternative definitions of market share.

The nature of statistical significance is such that, if we were to look at enough product groupings, we would expect to find that about 1 in 20 showed significant positive or negative relationships simply through chance. In addition, we would expect to find an equal number of positive and negative results if the relationship was purely random. In fact, we find 3 significant results in 13 product groupings and all but one of the results are positive.

We conclude that our results represent *prima facie* evidence that there is some provider bias in the single-premium packaged savings and investment products categories.

Regular premium products

For regular premium products the analysis is more complex, as the structure of commission can depend on factors such as:

- whether the commission was taken on an indemnity or “as earned” basis;
- the term of the product; and
- the length of the initial period.

A higher level of commission could be offered through generous discount terms on the indemnity commission, a higher rate of initial commission during the initial period, or a longer initial period at the same rate. Longer-term products will be paid a longer initial commission.

To standardise this we have examined the relationship between market share and the total initial commission (non-indemnified) over the first year’s new business premium, taking into account the term of the product.

Again, unlike the product level, we find that there is considerable variation between different providers and variation in their relative commission level over time.

Table 6: Regular premium products – Pre-rebate initial commission variation

Product category	Average initial commission	Range across providers
1. Endowment savings plan	59%	52%-64%
2. Executive pension	55%	40%-73%
3. FSAVC	57%	37%-74%
4. Group money purchase	53%	40%-82%
5. Group personal pension	59%	41%-81%
6. Mortgage term	155%	114%-188%
7. Personal pension	60%	47%-75%
8. SSAS	59%	39%-80%
9. Term assurance	152%	109%-183%
10. Unit-linked endowment (mortgage)	84%	74%-95%
11. Whole of life	96%	79%-108%

Source: CRA

Table 7 below reports the results of the econometric analysis. Unlike the single premium products we find 7 relationships that are negative, meaning that an increase in commission is associated with a fall in market share, as well as 4 results that are positive. The strongest relationship, and the only one that is significant, is the positive result for unit-linked endowments.

The rate of occurrence of significant relationships is only 1 in 11, and there is a balance of positive and negative relationships. Both of these contribute to the impression that the results could well have arisen by chance. Overall, the regular premium results do not lend much support to the existence of provider bias.

Given that the only market where we do find a significant positive relationship is the unit-linked endowment market, and that sales in this market have declined rapidly, any estimate of consumer detriment at the present time will be considerably smaller than would have historically been the case.

Table 7: Regular premium products – Size and strength of relationships between commissions and market shares, by product

Product category	Coefficient on the log of initial commission	Significance at the 5% level
1. Endowment savings plan	0.13	No
2. Executive pension	-0.03	No
3. FSAVC	-0.00	No
4. Group money purchase	-0.16	No
5. Group personal pension	-0.04	No
6. Mortgage term	0.14	No
7. Personal pension	-0.02	No
8. SSAS	-0.02	No
9. Term assurance	0.03	No
10. Unit-linked endowment (mortgage)	0.45	Yes
11. Whole of life	-0.04	No

Source: CRA

3.4 EVIDENCE ON DETRIMENT

Above we have shown econometric results showing the relationship between pre-rebate commission and new business volume. Although some providers gave us data on commission levels before and after rebates we do not have a sufficient sample on which to undertake the same sort of statistical analysis. Instead, we rely on simpler descriptive statistics.

In order to identify consumer detriment, we need to examine whether changes in pre-rebate commission lead to changes in post-rebate commission levels. If an increase in commission led directly to an increase in the level of rebates (i.e. was passed directly to consumers by the financial adviser) resulting in the post rebate commission remaining unchanged there would be little evidence of detriment.

For the providers who have submitted pre and post rebate data (approximately 50% of our sample) we calculated the correlation coefficient between changes in commission on the three products where there is statistical evidence of material bias (with-profits bonds, distribution bonds and mortgage related unit-linked endowment).

Table 8: Correlation coefficient between changes in pre and post rebate commission[17]

With profit bonds	0.87
Distribution bonds	0.79
Unit linked endowment (mortgages)	0.85

Source: CRA

These correlation coefficients are close to one, suggesting that whenever there is a change in pre-rebate commission on these products, there is a corresponding change in post rebate commission as well. This evidence suggests that changes in new business are likely to be related to post-rebate changes in commission, as well as to the pre-rebate changes in commission that we have examined. Thus it seems that changes in commission are kept by advisers and are not passed on to consumers in the form of rebates.

Conclusion of the econometric analysis

This analysis supports the conclusion that changes in commission levels do affect new business volumes and result in consumers paying a higher level of commission. This is consistent with the provider bias due to commissions resulting in some consumer detriment. However, the data available in this project is not sufficient to throw light on two further questions:

- whether this results in consumers being advised a materially inferior product; or
- whether the overall level of commission is "too high".

Rigorous conclusions on these questions will have to await further research.

[17] The correlation coefficient measures the degree to which variable move together and whether they move in the same direction.

4 Mystery shopping

The other part of our project was a "mystery shopping" exercise, testing for the existence of product bias (and to a lesser extent provider bias) in the current market. Providers often use mystery shopping, for example to assess sales performance and test compliance. The FSA has also used them in its reviews of regulation. For the most part, mystery shopping exercises aim to document how adviser-customer interactions work.

Our aim, by contrast, was to compile a dataset of the advice provided by different types of advisers to consumers with known characteristics at a point in time. This was then compared to a baseline, designed to represent best-practice recommendations for the type of person concerned. Potentially inappropriate advice shows up as differences between the baseline and the actual advice given. If inappropriate advice is associated with recommending products with above-average commissions, this would provide evidence for the existence of bias.

4.1 DESIGNING AND IMPLEMENTING THE EXERCISE

Setting the baseline

There are a number of ways to set the baseline, showing what advice is appropriate for an individual in a given situation:

- to use a theoretical model;
- to use filtering techniques such as those available from Synaptic or Aequos;
- to use actual recommendations from fee-based IFAs; or
- to rely on the judgement of a group of advisers assembled to determine the group of products that would satisfy "best" advice.

The first of these is ruled out because there is not a clearly-defined theoretical prediction for asset allocation. Even the recommendation of low-charge products over high-charge ones in the same category can be controversial (e.g. because of the possible association between past and future performance, and the security benefits to customers of big-name providers).

Filtering techniques, although useful, do not provide sufficiently specific results in themselves to be used without the input of a financial adviser.

Comparing the advice given on a fee and a commission basis is a potentially interesting approach, but is complicated by the fact that commission-based and fee-based advisers draw on a different selection of products.

Thus it was decided that the most practical approach was for the FSA to assemble a small group of financial advisers who can define what would constitute "best" advice. As a separate task, CRA examined the remuneration structure of tied advisers.

Mystery shopping gives a good basis for estimating the degree of bias in adviser recommendations but, as with all stated preference methods, customers will not always follow the advice they receive. They may allow for the possibility that the advice they get is biased. If they do this appropriately, it could reduce the amount of detriment they suffer.[18]

Our mystery shopping exercise was also designed to elicit information about the advice process that was not readily available from the statistical work. In particular, it was hoped to be able to draw clearer conclusions on:

- product bias; and
- rebates – in particular whether they are given on the basis of premium size or financial sophistication.

As well as obtaining information on these issues, it was hoped that further information would be forthcoming on provider bias.

Designing the scenarios to be tested

To obtain a reasonable number of comparable results from the mystery shopping CRA decided, in close consultation with NOP who performed the exercise, the FSA, industry practitioners and financial advisers, that shoppers would seek advice under just two basic scenarios. These were:

1. A customer needing to make a lump sum investment for the medium term; and
2. A self-employed individual looking to invest in a pension plan.

The scenarios were chosen to throw light on reasonably large product markets where there are anecdotal or regulatory concerns regarding product or provider bias, and to give information complementary to the econometric analysis.

The questionnaires and scenarios were tested with FPC3 qualified staff at the FSA and in a pilot study, to ensure that the scenarios were well understood and would lead to a consistent advice process. The FSA and CRA provided constant feedback to NOP and the mystery shoppers on issues and concerns as they arose throughout the process.

Scenario 1 – Lump sum inheritance to invest

In this scenario, the shoppers explained to the adviser that they had a lump sum inheritance available for investment. They displayed the following characteristics:

- salary of £25,000-30,000 (basic rate taxpayer);
- repayment mortgage (no other debt);
- occupational pension (with some life cover);
- a willingness to take some risk;
- a willingness to monitor the performance of their portfolio over time; and

[18] Though the converse is also possible – customers may over-discount the recommendations of advisors because they suspect commission bias where it does not exist.

- objectives of long term growth, together with the option of access "just in case".

Scenario 2 – Self employed person looking for a pension

Here, the mystery shoppers were newly self employed people with either 5% or 10% of their salary to invest in a pension. They have the following characteristics:

- salary of £30-40,000 (basic or higher rate taxpayer);
- repayment mortgage (no other debt);
- £3,000 in deposit account;
- £7,000 UK index tracker ISA for this year;
- 10 years history of a DB occupational pension scheme;
- 3 times salary life insurance cover;
- a willingness to take some risk; and
- their objective is that they are looking for a pension.

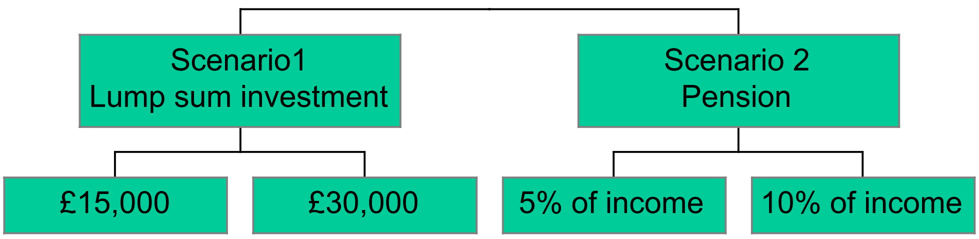
By standardising the mystery shoppers on these key characteristics, and standardising the form of response expected, we were able to compare the responses in detail. Several shoppers assessed more than one advisor, improving the consistency of responses.

Variants

The exercise also aimed to throw light on the amount of consumer detriment resulting from commission bias, and whether this depends on customer features such as the amount they have to invest, and the degree to which the customer is "captive" to the adviser (clearly both effects may be in play at the same time).

To test these, we investigated two variants within each scenario in which, as shown in Figure 6, the mystery shopper had different amounts to invest.

Figure 6: Scenarios and variants



One hypothesis is that rebates are offered only, or mainly, to customers making larger investments, because the cost of providing advice is broadly fixed, and advisers only have "free income" to rebate for larger investments.

The hypothesis behind the "captive customer" effect is that rebates are offered to customers who are aware enough to shop around. In this case we would expect to see rebates offered mainly to those who ask for them, and maybe less to customers who come to advisers through personal recommendations.

Choosing the financial adviser

Since financial advice is a reasonably complex process, NOP used its most financially sophisticated mystery shoppers to undertake this exercise. 250 mystery shops were performed in August to October 2001. The shoppers obtained the contact details of IFAs and financial advisers in a number of ways. For IFAs these included:

- obtaining a recommendation from a friend;
- contacting IFA Promotions for the nearest 3 IFAs; and
- consulting the local Yellow Pages.

For tied advisers they included:

- going into/calling a bank branch; and
- calling a direct sales force.

The samples used to ensure fair representation across these channels, scenarios and variants are shown in Table 9.

Table 9: Number of shoppers in each scenario

Type of adviser	Method of identifying a financial adviser	Scenario 1		Scenario 2		
		£15,000	£30,000	5%	10%	**Total number**
IFA	A recommendation from a friend	15	23	9	12	**59**
IFA	Via IFA Promotions	12	17	28	20	**77**
IFA	From local Yellow Pages	18	7	12	8	**45**
Tied	Contacting a bank	7	9	6	11	**33**
Tied	Contacting an insurers direct sales force	11	9	5	11	**36**
Total		**63**	**65**	**60**	**62**	**250**

Source: CRA & NOP

Advice process

The shoppers' main aim was to get product and provider recommendations, and to discover the level of commission that the adviser would earn (or the total cost of the sales process in the case of tied advisers). They also recorded information on:

- length of appointment;
- requirement for a second interview with the adviser;

- requirement for a follow up call with the adviser; and
- whether the adviser offered a rebate spontaneously or after the shopper asked if this was possible.

Details on this background information can be found in the annex.

Number of complete results

Most, but not all, advisers provided complete recommendations in response to these scenarios. Full recommendations and documentation were provided in a timely fashion in 167 of the 250 cases.[19] In 12 of the remaining cases, the advisers agreed to provide recommendations only if the shopper would switch to paying fees (see annex for further details). These cases are also regarded as being completed satisfactorily, giving 179 results in total, a completion rate of about 72%. This is slightly less than the rate in previous FSA mystery shopping exercises, where about 20% of advisers have failed to make a recommendation. Part of the difference is explained by the more compressed timetable of our exercise.

Some of the reasons why recommendations remain incomplete might be a cause of regulatory concern. Firstly, as indicated, some advisers swapped to using a fee basis for remuneration part way through the process, despite having responded to original checks by saying that they would use commission. This may indicate a somewhat opportunistic approach to different remuneration structures. Secondly, a number of advisers indicated that they would only be prepared to disclose commission details once the shopper had decided to buy the product. This is a deviation from FSA rules, which stipulate that disclosure must take place before the purchase.

In addition to these responses, we collected all the information given to mystery shoppers including the personal illustration and Key Features Documents. This provided a useful cross-check, and increased the accuracy of the exercise.

Assessing the results: The baseline recommendations

CRA and the FSA asked a group of IFAs and FPC3 qualified FSA staff ("the IFA group") to assess the outcomes of the mystery shopping exercise.

The IFA group examined the recommended product combinations that were reported from both tied advisers and IFAs. Identifying the most commonly recommended combinations enables us to see whether or not the industry as a whole shows any systematic evidence of commission effects within the scope of generally suitable advice. Examining outliers shows whether there are a small number of advisers who give bad advice (checks were made to identify the factors and characteristics that would make the recommendations consistent with suitability). It is unlikely to be possible to discover

[19] In some cases, advisers have given a choice of providers of any product – these provider options are used for the provider bias examinations, but only count as one recommendation for the product recommendations. However, in a small number of cases, multiple options of products have been recommended. Since these represent different product combinations, they have been treated as if they represented a separate visit.

whether outliers are giving bad advice as a result of commission bias, since they are very few in number. A much larger-scale investigation would be needed to throw light on this point.

The IFA group stated what advice they would provide to the shoppers on the basis of the information in each scenario. In Scenario 1 (lump-sum investment), their order of priorities was:

- to meet short-term needs through some kind of cash savings account;
- to buy an ISA; and
- to buy a unit trust or with-profits bond.

The IFA group agreed that there would be no reason not to recommend an ISA, and as the individual was a basic rate taxpayer, no particular reason to advise a unit-linked bond product ahead of an ISA or unit trust.

The IFA group also considered it reasonable for advisers to recommend a with-profits bond on risk grounds, despite possible concerns over access. This was because the recommended portfolio should already include some funds (e.g. short-term deposits or an equity ISA) which could be used as the first port of call for an emergency.

Along with these investment products the IFA group felt that protection products such as life assurance (since the amount through the occupational pension scheme would not be sufficient), critical illness cover, permanent health insurance etc. would also be suitable recommendations where the individual had dependents.[20]

In scenario 2, the pension investment, the group felt that suitable recommendations would include:

- a personal pension with "mono-charging" price structure to be stakeholder-compatible; or
- a stakeholder pension.

Again alongside the pension recommendation, various protection products were also be considered to be suitable advice.

4.2 RESULTS: SCENARIO 1 - LUMP-SUM INVESTMENT

When examining both scenarios, we first report all of the product combinations that were recommended. We then use the baseline from the IFA group to identify those areas where advice was not suitable given the shoppers' characteristics. We compare this information with commission data to identify whether there is any evidence of product bias in the recommendations. Finally, we examine whether there is any evidence of provider bias.

[20] Although we standardised many of the mystery shoppers' characteristics, some circumstances e.g. number of children depened on shoppers actual own circumstances.

Product recommendations

Table 10: Scenario 1 - Different product combinations recommended by IFAs and Tied Advisers

Product combination	IFA	Tied
ISA, unit trust	6	7
ISA, with-profits bond	4	3
ISA	3	3
Two ISAs	3	3
ISA, unit linked bond	4	2
With-profits bond	4	1
Two ISAs, unit trust	3	1
Two ISAs, with-profits bond	1	3
Two ISAs, unit linked bond	2	
ISA, four unit trusts	2	
Unit trust	1	1
Critical Illness and life cover, ISA, with-profits bond	1	
Critical Illness, life assurance, unit linked bond	1	
Distribution bond	1	
Distribution bond, ISA	1	
Distribution bond, two ISAs	1	
Distribution bond, ISA, with-profits bond	1	
Guaranteed equity bond, ISA		1
Guaranteed equity bond, ISA, unit trust		1
Guaranteed equity bond, with-profits bond	1	
Income protection, stakeholder, unit linked bond, unit trust		1
Two ISAs, stakeholder	1	
Two ISAs, unit linked bond, with-profits bond	1	
Unit linked bond	1	
Unit linked bond, with-profits bond	1	
Five unit trusts	1	
Total	**45**	**27**

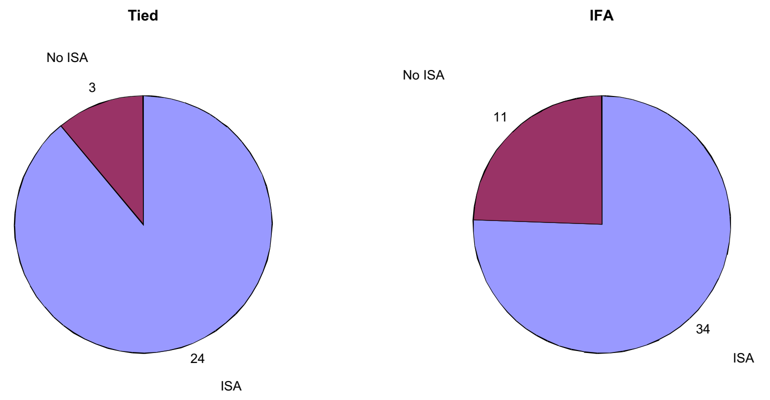
Source: CRA

Table 10 above shows how frequently tied advisers and IFAs recommended different product combinations. Many product combinations were recommended only once, but in the more frequent combinations, there is considerable overlap between the recommendations of IFAs and tied advisers. In addition to the products mentioned in Table 10, a number of advisers also recommended keeping some money on deposit. Whether or not this was the case has a particular bearing on the recommendations of products that are usually considered to be long term products, where access before the end of the term of the product could be quite expensive.

Did advisers recommend an ISA?

As we have seen, one of the main conclusions of the IFA group was that (after cash deposits) the first savings and investment product that an adviser should recommend in this scenario was an ISA. As Figure 7 shows, 81% of all advisers did recommend an ISA.

Figure 7: Scenario 1 – Did advisers recommend an ISA to mystery shoppers investing a lump sum?



Source: CRA

However it is of some concern that 1 in 5 advisers failed to make this recommendation. More IFAs did not recommend an ISA (24%) compared with tied advisers (11%), and slightly more advisers did not recommend an ISA when the larger sum was available for investment (26%) than when the smaller sum was available (15%).

The group least inclined to recommend ISAs were IFAs recommended by friends of the mystery shoppers: 31% of them failed to recommend an ISA. This lends support to the idea that where advisers do not believe that they have to compete for the business of their customers, they may give less good advice.

The fact that an appreciable proportion of advisers failed to recommend an ISA in scenario 1 is a potentially serious problem with the quality of advice, but is not necessarily evidence of commission-induced product bias. To see if there is bias, we examined the commission levels on the investment products that were recommended instead of ISAs. Of the 14 cases where ISAs were not recommended, 3 were from the tied sector and 11 from the IFA sector.

Relative commission rates on ISAs and other products: Tied advisers

There was no evidence of any potential commission bias among tied advisers. In combination with the fact that a smaller proportion of them failed to recommend an ISA in the first place, this suggests that consumers are facing little if any detriment in the tied channel.

Relative commission rates for ISAs and other products: IFAs

Where IFAs did not recommend ISAs, they recommended the following products instead:

- unit trust;
- five unit trusts;
- distribution bond;
- with-profits bond (4 cases);
- guaranteed equity bond, with-profits bond;
- unit linked bond and with-profits bond;
- critical illness, life assurance, unit linked bond; and
- unit linked bond.

We examine each of these cases in detail, either individually or by grouping the products, to see whether the recommendations were induced by commission.

Case a) One unit trust – no bias. The initial commission was considerably higher than the average for equity ISAs, (6.1% compared to 2.8%). However, this adviser spontaneously offered a substantial rebate of commission, which reduced the level of commission to 1.3%. Thus whilst the advice led to a loss of the slight tax advantage of ISAs, it does not appear to have been induced by commission.

Case b) Five different unit trusts – no bias. The initial commission paid (3%) is the same as the average equity ISA and thus again while the advice led to a loss of the slight tax advantage of ISAs, it does not appear to have been induced by commission.

Case c) Distribution bond – possible bias but no detriment. The level of initial commission was 4.75% and thus clearly greater than the average that was paid on equity ISAs. However, when asked, a rebate was given bringing the level of commission down but still not as far as the average equity ISA since initial commission was still at 3.5%, although it is notable that the distribution bond did not have trail commission whereas the average equity ISA does. Although the ISA has tax advantages and should therefore have been recommended first, the reduction in yield (RIY) at 10 years on this distribution bond was in fact less than that on the average ISA and thus comparing products at 10 years suggests there is no detriment.

Case d) With-profits bond – possible bias and detriment. Advising a with-profits bond with no ISA does not seem to be best advice – the tax benefits of an ISA are not being used, and the product characteristics are different since the with-profits bond had high access charges. Furthermore, in only one of the 6 cases where a with-profits bond was recommended and no ISA was recommended, did the adviser recommend putting money aside into a deposit account for short term needs.

Bias. In the 6 cases where with-profits bonds were recommended, the average initial commission was 6.8%. Though 3 of these advisers rebated some of the commission (2 spontaneously and 1 when asked), the average commission on with-profits bonds was 6.1% and ranged between 4.8% and 7.1% (note that this only compares the initial commission of these products: in contrast with most equity ISAs, none of these advisers would receive trail commission). Thus there is a substantial difference in the level of upfront commission received on these products compared with the average commission received on an equity ISA and therefore there is some evidence that commission has influenced the advice process.

Detriment. Detriment to the consumer could arise in a number of different ways: losing the tax advantages of ISA; high access penalties of the with-profits bond; and high commission causing higher charges leading to lower growth. While the first two of these are likely to be serious, the RIY after 10 years on the with-profits bond (1.1%) is in fact lower than that for the equity ISA (2.1%). If the with-profit bond is held for this long, detriment will be limited.

Case e) Unit linked bonds – possible bias. Unit linked bonds have similar characteristics to unit trusts, which underlie nearly all the ISAs that were recommended. In these cases, not only are tax advantages of the ISA foregone, but the unit linked bond has additional tax disadvantages for basic rate taxpayers, compared to a unit trust (as the gains being taxed in the hands of the insurance company rather than the individual).

The initial commission on the unit-linked bonds that were recommended averaged 6.8% with the lowest being 6.5%. Again we note that there was no trail commission on these products. Given the substantial difference in the initial commission received on the unit linked bond compared with the average equity ISA, there is some evidence that these recommendations may have been biased by the level of commission paid. The possible detriment caused from this is examined below when the recommendation of unit-linked bonds in general is examined.

Table 11: Scenario 1 - Commission rates on equity ISAs and alternative products recommended by IFAs

Product category	Initial commission as a proportion of new business
Equity ISA	2.8%
Average for bond products when no ISA recommended (post rebate)	6.5%

Source: CRA

Table 11 above shows the average commission paid on the products recommended instead of an ISA are significantly above those on equity ISAs. Thus commission may be driving the recommendation of bond products. However, this comparison compares only the initial commissions paid and does not consider whether or not there is any trail commission paid on the separate types of products.[21]

[21] In addition, one adviser recommends critical illness, since this is no way substitutable product for an ISA, and given that critical

Table 12: Scenario 1 – Trail commission paid on equity ISAs and alternative product recommended by IFAs

Product category	Proportion of recommendations on which trail commission was paid
Equity ISA	66%
Alternative products	0%

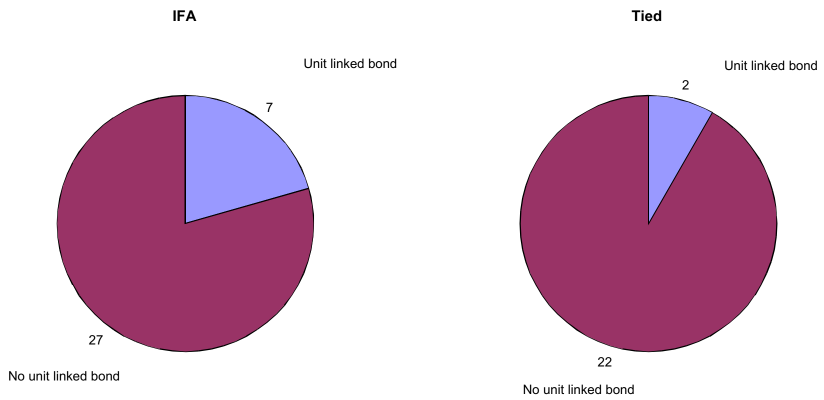
Source: CRA

It is very clear from Table 12 above that the payment of trail commission is much more prevalent for equity ISAs than it is for those products that were recommended when ISAs were not recommended.

Did advisers recommend a unit-linked bond?

The second area of advice that the IFA group focussed on was that of a unit-linked bond, which given the slight tax disadvantage for basic rate taxpayers, it did not believe was the best recommendation. We now look at cases where ISAs were recommended and see many advisers also recommended unit-linked bonds.

Figure 8: Scenario 1 - Were unit linked bonds recommended alongside ISAs?



Source: CRA

As can be seen from Figure 8 above, fewer tied advisers than IFAs recommended unit linked bonds, with tied advisers only recommending them in 8% of cases, while IFAs recommended them in 21% of cases.

Bias. Were these IFA recommendations induced by higher commission levels? To find out, we have to consider which product(s) should have been recommended in its place. The closest substitute for a unit-linked bond is a unit trust, since they have similar characteristics. (A with-profits bond is not a close substitute in this case because it

illness was seen as an acceptable recommendation by the IFA group, this is not included in the calculation in Table 11. The initial commission for the critical illness product recommended in this case was 130% of annual premium.

provides customers with some smoothing of returns.) We compared initial commission as a percentage of premium, with the results shown below.

Table 13: Scenario 1 - Initial commission as a proportion of premium size for unit linked bonds and unit trusts recommended by IFAs

Product category	Initial commission as a proportion of premium size
Unit linked bonds recommended with ISAs (Pre rebate)	5.0%
Unit linked bonds recommended with ISAs (Post rebate)	4.0%
Unit trusts[22]	3.0%

Source: CRA calculations

The evidence in Table 13 shows that pre rebate commissions on unit-linked bonds are considerably greater than those on unit trusts, and rebating reduces, but does not eliminate, the difference.

Along with the results from above where unit linked bonds were being recommended in the absence of ISAs, this result lends more support to the view that the sale of unit linked bonds is being influenced by commission.

Detriment. The reduction in yield after 10 years for a unit-linked bond (1.3%) is lower than that of a unit trust (2%) as well as an equity ISA. If the product is held for this long, the detriment to customers caused by this recommendation is therefore limited.

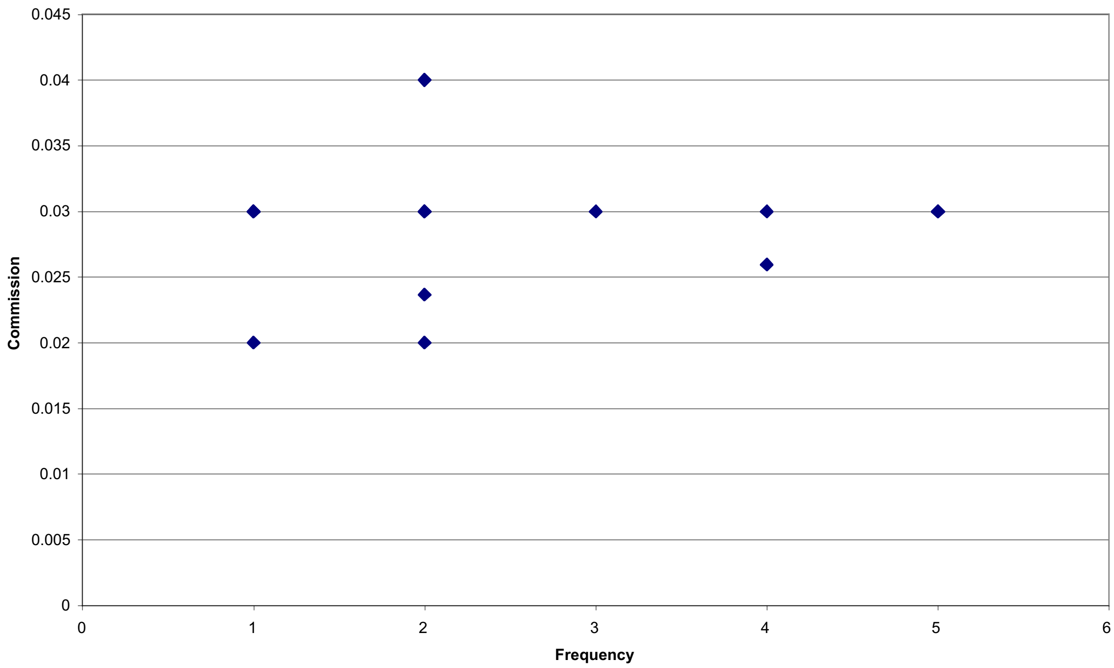
Provider recommendations

We examined which providers were recommended by IFAs for different types of products. This is to identify whether there is evidence that those providers paying high commission are recommended more frequently than those paying lower commissions.

We looked at this question for the main product categories recommended to mystery shoppers, namely ISAs, unit trusts, unit-linked and with-profits bonds. The number of distribution bonds recommended is too few to draw any conclusions regarding the provider choice. The graphs that follow show how frequently different providers were recommended to mystery shoppers, and the average commission they paid to advisers. A strongly upward-sloping relationship would be consistent with advisers more frequently recommending higher-commission providers. Each point on the graph represents one individual provider.

[22] Very few rebates were offered on unit trusts.

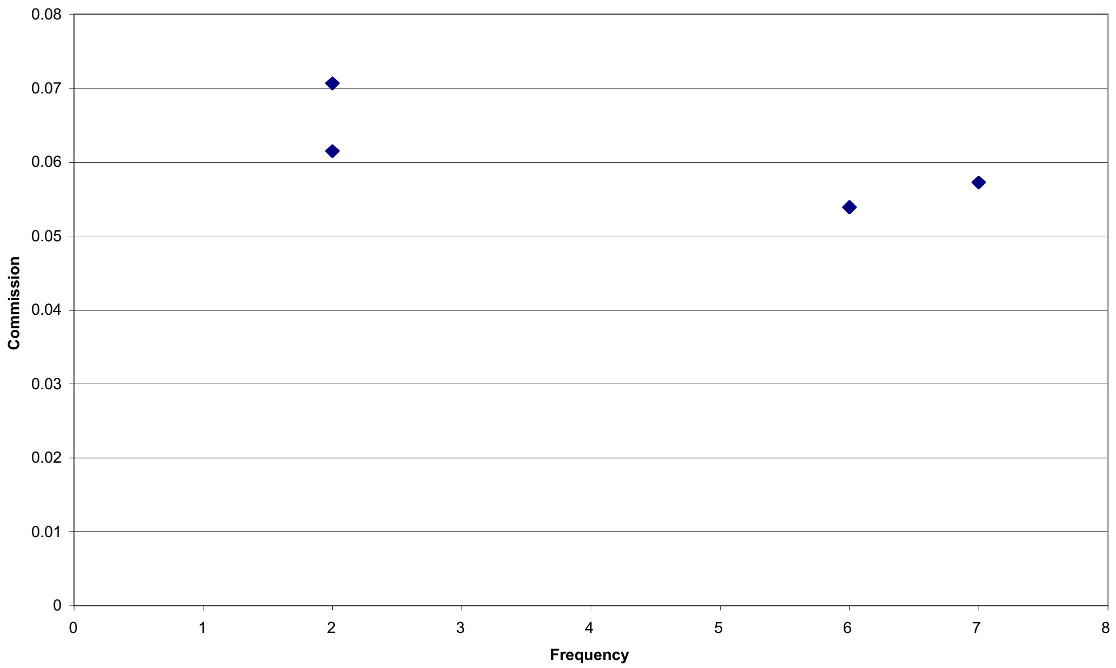
Figure 9: Scenario 1 - Initial commission levels on equity ISAs recommended to mystery shoppers with a lump sum to invest



Source: CRA

It is clear from Figure 9 above that there is not a significant positive relationship between the level of commission paid and the provider chosen for equity ISAs. The average initial commission as a percentage of single premiums for equity ISAs is most commonly 3%, although one provider does pay more than this. As with equity ISAs, unit trusts show little evidence of any commission bias in provider choice and the overwhelming majority of unit trust providers recommended paid 3% initial commission.

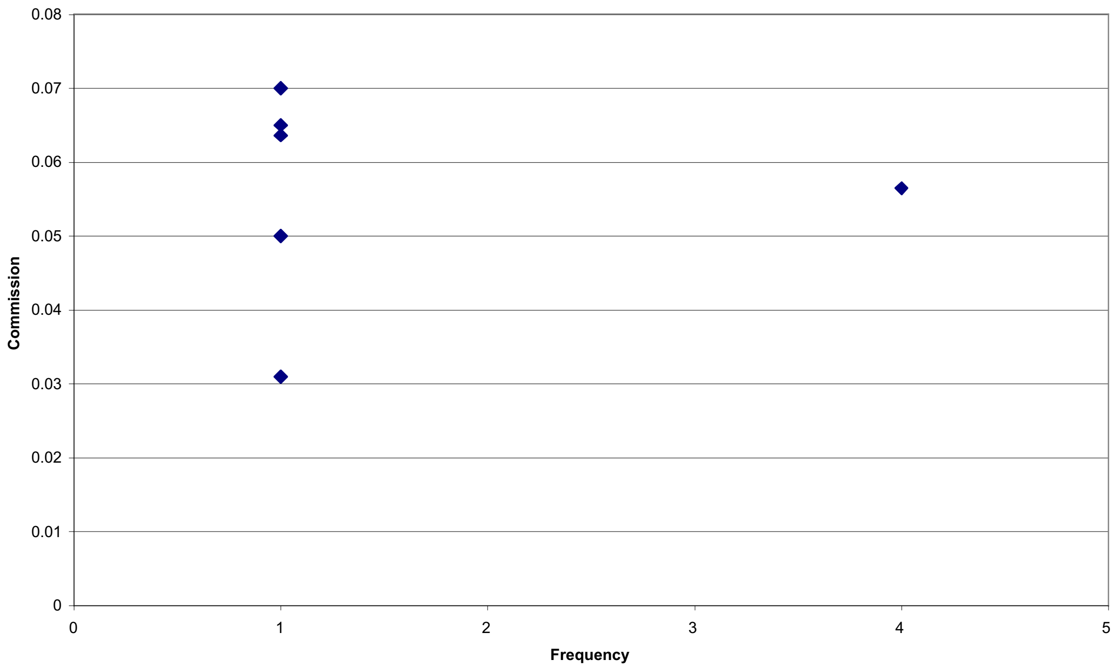
Figure 10: Scenario 1 - Initial commission levels on with-profit bonds recommended to mystery shoppers with a lump sum to invest



Source: CRA

As can be seen from Figure 10, there is, if anything, a negative relationship between the commission paid and the number of recommendations that a particular provider receives for with-profits products.

Figure 11: Scenario 1 - Initial commission levels on unit-linked bonds recommended to mystery shoppers with a lump sum to invest



Source: CRA

With unit-linked bonds, Figure 11 shows that a large number of providers were only recommended once and there is no evidence that high levels of commissions may induce more frequent recommendations.

4.3 RESULTS: SCENARIO 2 - PENSION INVESTMENT

In Scenario 2, mystery shoppers are seeking to take out a pension and have either 5% or 10% of their income available for investment.

Product recommendations

Table 14: Scenario 2 –Different product combinations recommended by IFAs and Tied Advisers

Product combination	Tied	IFA
Stakeholder	14	16
Personal pension	6	16
Income protection, stakeholder	2	7
Pension contribution insurance, stakeholder	0	7
Income protection, personal pension	0	6
Life assurance and stakeholder	3	0
Pension contribution insurance, personal pension	0	3
Critical illness and life cover, personal pension	0	1
Critical illness and life cover, stakeholder	1	0
Critical illness, income protection, ISA, stakeholder	1	0
Critical illness, income protection, life assurance, stakeholder	0	1
Critical illness, income protection, pension contribution insurance, personal pension	0	1
Critical illness, income protection, pension contribution insurance, stakeholder	0	1
Critical illness, life assurance and stakeholder	0	1
Critical illness, MIP	1	0
Endowment savings	0	1
Income protection, life assurance, stakeholder	0	1
Income protection, pension contribution insurance, personal pension	0	1
ISA	1	0
ISA, personal pension	0	1
ISA, stakeholder	1	0
MIP	0	1
Total	**30**	**65**

Source: CRA

As with Scenario 1, there is a long tail of product combinations that were recommended only once by either the IFAs or tied advisers.

In this scenario, the recommendation of a pension – either Stakeholder or similar to Stakeholder to be RU64 compatible – was identified as the first crucial area of advice. The vast majority of advisers did make this recommendation in practice.

Cases where no pension product was recommended

Only three of the mystery shoppers in this scenario were not recommended a pension. Instead they were recommended:

- a regular premium ISA (tied adviser);
- critical illness and a maximum investment plan (tied adviser); and
- either a maximum investment plan, an endowment savings policy or a personal pension (IFA).[23]

None of these combinations were considered to be good advice by the IFA group and each of the recommendations are examined in turn.

The ISA recommendation was unsuitable advice since an ISA was specified as one of the products the shopper already held. However, when we examine the level of commissions that are paid on pensions and those paid on ISAs by this particular provider, it is clear that this advice would not have been induced by commission levels.[24] Regardless of whether this was induced by commission levels, it was nonetheless bad advice.

With regards to the outcome of critical illness and the maximum investment plan (MIP), the recommendation of critical illness was considered by the IFA group to be acceptable given the circumstances of shoppers, but the MIP was deemed to be unacceptable advice. Examining the remuneration structure of the particular company concerned, advisers do in general receive a slightly higher rate of commission on a MIP than on a personal pension for shorter policies. The MIP commission is around 25% greater than the pension commission for policies up to 10 years and the pension commission is greater than the MIP commission for policies longer than 12.5 years. Whether this commission structure affected the advice could therefore be dependent on whether or not the adviser believed the shopper would contribute for a long period of time. It is worth noting that this particular shopper was only aged 35 and could conceivably have contributed for longer than 12.5 years before pension funds would be available to her. It is therefore impossible to identify whether commission has biased the advice in this case.

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23 Because one shopper was recommended a choice of different products, of which two were not pensions, this implies there were four different product recommendations that did not recommend a pension even though there are only three shoppers involved. In general, where different products have been recommended to one shopper, these have been recorded as separate recommendations. Where different providers are recommended with the same product combinations, this has been recorded as one recommendation for the purpose of examining product bias, but the different providers are used when examining provider bias. Hence the number of observations may vary across the two.

24 Some tied advisers have to reach particular targets on individual products and thus it is possible that advisers recommend a particular products in the absence of commission effects on the individual product because of targets on the total recommendations made.

The final example is where an IFA told the shopper to either purchase a maximum investment plan, an endowment savings policy or a personal pension indicating that these could be considered as interchangeable. Although the adviser pointed out that the pension received tax relief, he did not recommend this above the other two options. The difference in commission that the adviser would have received in each of these options is notable:

- Personal pension £780.69
- MIP £1,040.55
- Endowment savings £1,649.02

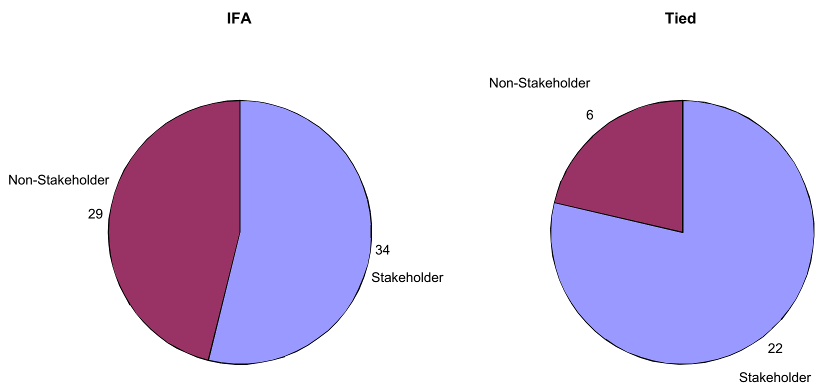
Although, the commission is certainly greater in the options that were not considered to be suitable advice, given the fact that the adviser gave a choice to the shopper the adviser would not have been certain of receiving the higher level of commission.

To conclude, there are only a very small number of occasions where the shopper was not recommended a pension (4 out of 95 recommendations). However, in 2 of these occasions, the purchase of one of the recommended non-pension products would certainly have brought more commission to the adviser than the pension product.

Type of pension recommended

We now turn to the cases where pensions were correctly recommended in Scenario 2. The first question of interest is what type of pension product was recommended.

Figure 12: Scenario 2 - Type of personal pension recommended



Source: CRA

First, we examine the tied sector. For tied advisers, only limited information was available to CRA regarding the incentives from product providers facing advisers. From the information that was available, there was no clear evidence on whether or not any advisers were incentivised to sell Stakeholder or non-Stakeholder pensions. Furthermore, when we examine the 6 cases where tied advisers recommended a non-Stakeholder pension, we find that all of them have a reduction in yield that is close to that of Stakeholder pensions after 10 years, and thus there is no evidence of consumers suffering from these recommendations.

Second, we examine the IFA sector where we observe that far fewer Stakeholder pensions were recommended than in the tied sector. To throw light on the reasons for this, we examined the commission paid on these pensions within the IFA sector.

Table 15: Scenario 2 - Initial commission paid to IFAs on pensions recommended to mystery shoppers

Product category	Average initial commission over annual premium (pre rebates)
Non-stakeholder personal pension	23%
Stakeholder pension	21%

Source: CRA calculations

Table 15 above indicates that the level of initial commission paid on personal pensions is not significantly different to that paid on Stakeholder pensions, and thus on average, commission may not be influencing advice.

However, in some cases, initial commission is paid at a considerably higher rate on personal pensions than is the average for Stakeholder pensions. We identify 7 out of 65 recommendations by IFAs, where non-stakeholder pensions were recommended that had initial commission rates of greater than 30% of annual premium.

If part of the commission is rebated, this could bring the initial commission down to a level that is similar to that for Stakeholder pensions. Indeed, we find that 2 of these 7 recommendations did include a rebate of part of the commission, which brought initial commission down to the same level paid on Stakeholder.

It therefore appears that 5 out of the 65 non-stakeholder pension recommendations by IFAs may have been induced by the higher commission that was available on them compared with the average on a Stakeholder pension.

Examining detriment

Having identified that there may be evidence of initial commission bias in these 5 cases, we then examine whether or not the consumer faces any detriment from these recommendations. This is done through looking at the reduction in yield (RIY) figures at 10 years that are disclosed within the product terms.

Stakeholder pensions are constrained to have a RIY of not greater than 1.1%, and thus we examine the RIY on the 5 non-stakeholder pensions to identify whether the RIY was very different from 1.1%. Of the 5, only one recommendation had a RIY that was substantially different from 1.1% and this had a RIY of 1.9%.

To conclude, in only one of the recommendations by IFAs do we find both that commission may have influenced the recommendation and that the shopper would suffer detriment as a result of this. Since this only occurred once, there is not sufficient evidence to consider this market as suffering from significant commission bias that induces consumer detriment.

Products recommended with pensions

Along with the pension, a large number of other products were also recommended in Scenario 2, including:

- income protection;
- pension contribution insurance;
- critical illness; and
- life assurance.

The IFA group believed that all of these products were suitable, because the shopper had few protection products in their existing portfolio. The fact that these products were recommended therefore, does not in itself give grounds for concern about quality of product advice or whether these product recommendations are driven by commission.

However, it is important to examine whether for example, life assurance is only recommended where the mystery shopper has dependents. This was not found to have been a problem.

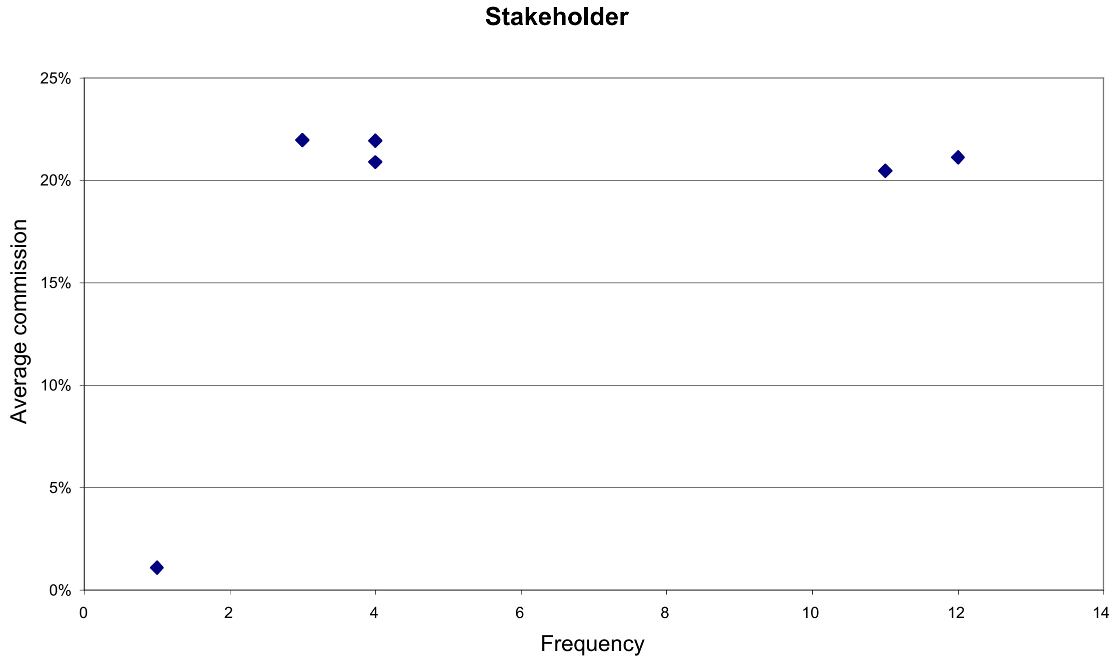
Provider recommendations

Having examined the product recommendations that have been made, we now examine the providers of these products to establish whether the frequency with which a provider was recommended correlate with the commission it paid to advisers. The graphs that follow examine this relationship, and as in Scenario 1, a strong upward trend (more recommendations in favour of providers paying higher commissions) could be seen as evidence of commission effects inducing provider bias.

Pension providers

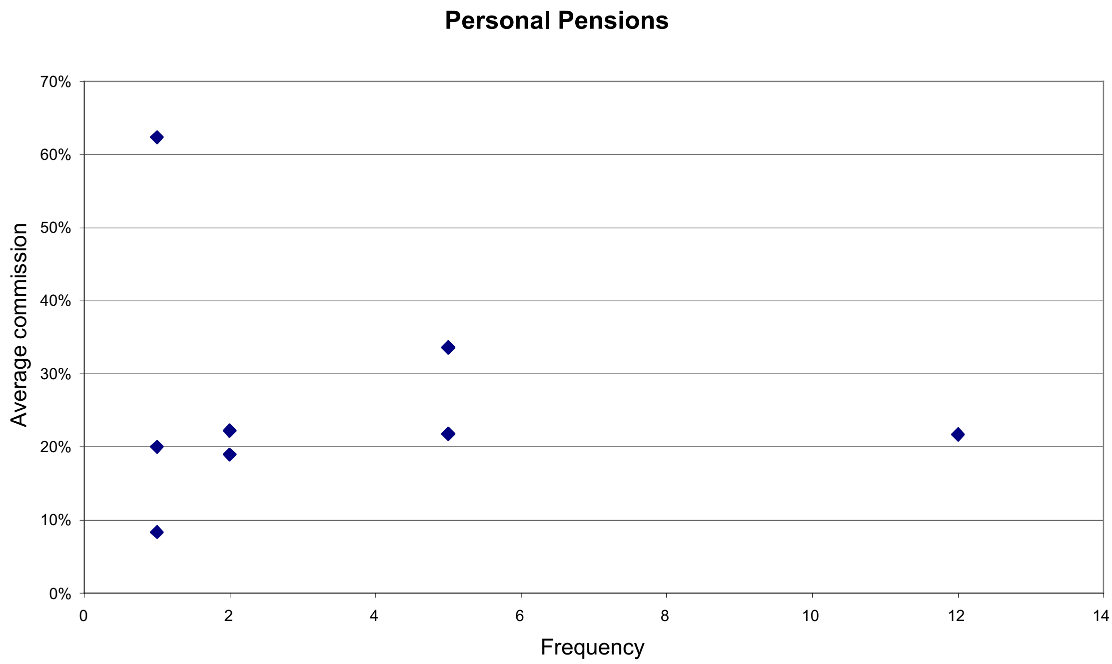
As is clear from Figure 13 and Figure 14, there is no evidence of any provider bias in either the Stakeholder pension or the non-Stakeholder personal pension recommendations. In these figures, each observation represents an individual provider.

Figure 13: Scenario 2 - Initial commission levels paid to IFAs on Stakeholder pensions recommended to mystery shoppers



Source: CRA

Figure 14: Scenario 2 - Initial commission levels paid to IFAs on personal pensions recommended to mystery shoppers



Source: CRA

Income protection

After pension products, the next most frequent product to be recommended was income protection, which was recommended in 21 out of the 95 cases. There was a considerable difference in the likelihood of being recommended this according to whether the adviser was tied or an IFA. Only 3 out of 30 recommendations by tied advisers included income protection (these were for three different providers), whereas 18 out of 65 recommendations by IFAs included income protection.

These 18 recommendations covered 8 different providers and an examination of the data showed there was no obvious link between the commission and the frequency of any provider being recommended.

Pension contribution insurance

Pension contribution insurance was recommended in 13 different cases, and all of these were by IFAs. The number of providers recommended for pension contribution insurance is very small although one particular provider receives a large number of recommendations. The IFA group believed that given the small size of the premiums and the low levels of commission involved, the majority of advisers would simply recommend the pension contribution insurance from the same provider that they were recommending for the pension. When we examined this issue, we found that the provider of the contribution insurance was indeed always the same as the provider of the pension.

It remains possible that the level of commission on the pension contribution insurance actually drives the choice of pension provider. However upon examination of the value of commissions, we found that the initial commission from the pension was many times greater than the initial commission on the pension contribution insurance. Furthermore, using the average level of commission paid on both the pension and the pension contribution insurance, there was no evidence that the large number of recommendations that one provider was receiving was being driven by commission.

4.4 CONCLUSION

Overall the mystery shopping confirms the results of the econometrics that in the majority of cases there is no reason to be concerned regarding whether or not advisers are influenced by the amount of commission they receive on either products or from providers of particular products. However there are grounds for concern in a significant minority of cases in the medium term savings and investment market.

Within the pension market, it seems as though regulation – both of the product in the form of Stakeholder and of the adviser in the form of RU64 – has substantially eliminated the scope for bias and consumer detriment, and there is no evidence of considerable concern regarding the recommendation of either Stakeholder or non-Stakeholder personal pensions.

5 Conclusions and quantification of detriment

This paper uses two very different approaches (econometrics and mystery shopping) to consider the question of whether commission influences the advice process and whether this leads to consumer detriment.

5.1 CONCLUSIONS ON BIAS

We found evidence that commission influences advisers' recommendations in two dimensions, namely at the product level and the provider level.

Generally, we found less cause for concern in the tied market than the IFA market. In particular, we found fewer cases where unsuitable products were advised and we were not able to show that these were commission related.

At the product level in the IFA market:

- In the single-premium investment market, in around 4 out of 5 cases we do not find any concern regarding commission bias. However, in the remainder, we find that commission influences the decision to recommend non-ISA products and in particular, unit-linked bonds and with-profit bonds. This is consistent with statistical evidence relating changes in commission on single premium savings and investment products to growth in new business premium
- In the regular premium market, we do not find any evidence of significant bias from the mystery shopping exercise. In particular, it appears that the introduction of stakeholder pensions and RU64 have lead to a market situation where there is little variation in product terms or commission, and thus little opportunity for commission bias.

At the provider level (which only applies to the IFA market):

- In the single premium market, we find some historical evidence of bias in relation to distribution bonds and with-profits bonds, both of which exhibit a positive relationship between commission and new business. We do not find this result in the mystery shopper, but this is based on a very small sample and does not conclusively show that the bias has disappeared.
- For regular premium products we find a positive relationship for unit linked endowments (from our econometric analysis). However, this is only one product in 11 considered, and given the substantial change in this market, we do not believe this supports a strong conclusion of commission bias in the regular premium market.

Conclusions on detriment

Finding bias is not in itself evidence of consumer detriment. In order to examine detriment we have considered the levels of charges and of commission rebating.

We do not believe that commission leads to consumers buying more expensive products. However, there is evidence that consumers face detriment through loss of tax efficiency, and as a result of buying products that do not meet their demand for access. We conclude that in a small but not insignificant number of cases there is detriment as a result of product bias in the medium term saving and investment market

We find that changes in commissions on with profit bonds and distribution bonds are related to changes in new business and these changes do not get passed onto consumers. We conclude that the provider bias there has been in these particular markets has resulted in some consumer detriment.

5.2 QUANTIFYING CONSUMER DETRIMENT

Using both the mystery shopping exercise and the econometrics we have found evidence that commission affects the advice process. We have also presented evidence that this leads to consumer detriment. In order to determine the relative importance of this problem and the degree of costs that would be warranted in solving this problem, we wish to estimate the quantum of the detriment.

Our estimate uses the difference in commission to estimate the detriment imposed on consumers through:

- loss of tax efficiency;
- higher costs of access to long-term products; and
- higher charges imposed to cover the cost of commission.

Clearly, the difference in commission is only a very imperfect proxy for these effects.

The results below depend on the following:

- They assume differences in commission are paid by the final consumer. This is in line with the FSA's normal CBA approach, but may represent an over-estimate. In particular, we have presented evidence that the differences in commission between products does not appear to determine the reduction in yield. However, other sources of detriment remain.
- We have only included estimates for product and provider bias. Although other sources of bias are examined in our report, it is not possible to quantify their significance with the evidence we have.
- We assume bias only occurs in the markets we have examined and found conclusive evidence. For product bias, in particular, we have only investigated the pension market and the savings and investment market. We have not investigated the income drawdown market for example.

Table 16: Quantification of annual detriment

Product bias	Number of sales	Average premium	Average detriment per customer	Total detriment
Additional ISA sales	500,000	£5,000	3.70%	£92,500,000
Provider bias				
With-profit bonds	368,000	£24,000	0.5%	£46,368,000
Distribution bonds	65,000	£14,400	0.4%	£3,185,000
Estimated detriment				£142,053,000

The detriment from the results where we find evidence of commission bias comes to an estimated annual cost of £140 million. Detailed assumptions can be found in the Annex to this report.

6 Annexes

6.1 ANNEX 1: CONSISTENCY WITH PREVIOUS RESULTS

The panel econometrics approach is similar to the approach we adopted in our work on the Polarisation review last year.[25] The data used were commission levels and corresponding new business premiums collected for the PIA's Disclosure report. To control for product characteristics, we analysed whether changes in commission levels on the products of particular providers were correlated to changes in their new business sales.

We found positive but insignificant correlations between commission levels and sales volumes for three out of four products, and concluded that this did not constitute convincing evidence for or against commission bias.

This was a very weak test of provider bias, for a number of reasons:

- there were relatively few changes in commission, restricting the number of observations and cutting the statistical significance of the results;
- the commission data available covered only average levels and did not include special deals;
- annual data was used and hence much of the variation in commissions and market shares was averaged out;
- it only looked at existing products; and
- there was no data on whether the commission was passed onto the consumer (i.e. rebating).

The following conclusion was drawn. "The opportunity for abuse certainly exists, as IFA consumers largely trust their advisers and take their recommendations. Three arguments are often used to suggest that commission bias is serious:

Provider bias: it is often argued that providers offering higher commission will "buy" market share. We did not find evidence to support this, however. Although the leading providers with significant brands could pay below-average commission, we did not find that changes in commission had a significant effect on market share.[26]

Payment type: it is often suggested that the trend from regular premium products to single premium products might be put down to differences in commission. This is contradicted by the fact that the commission on regular premium is normally larger than the single premium equivalent.

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25 "Polarisation and Financial Services Intermediary Regulation", London Economics, July 2000. The main authors of this report are now at Charles River Associates.

26 This analysis was undertaken using commission rates and new business statistics based on the disclosure reports. This excluded differential commission levels negotiated with the IFA networks.

Product bias: finally, it is suggested that differences in commission could be the explanation for the growth in the investment bond market relative to the unit trust market. However, the RIY in both products appears to be very similar, suggesting that at least on this measure the impact on consumers is limited. Commission differences would therefore appear to be a reflection of how returns are divided between manufacturer and distributor rather than a source of detriment to the consumer.

Despite anecdotal evidence that some IFAs and IFA networks do take advantage of their position to recommend product that yield them the greatest commission, there is little sign that this is happening on a large scale. This view was supported by our interviews with a wide selection of providers using the IFA channel."

6.2 ANNEX 2: DATA DEFINITIONS

New business reflects new contracts written by independent financial advisers. This takes two forms:

- Single premium business – although this is sometimes measured in Annual Premium Equivalent by dividing the premium by 10 we use actual premium contributions; and
- Regular premium business which is recorded as the premium in the first year.

We are interested in the decision of financial advisers that might be influenced by the level or structure of commission.

In order to consider this we have:

- excluded voluntary and compulsory increments; and
- included Group Personal Business.

The justification for this is that incremental business if often contractual and is related to the primary sale. It is possible that the commission on the increment adds to the incentive of the intermediary.

6.3 ANNEX 3: PRODUCT DEFINITION

Product classification	Proposed segment
AVC final salary (RP)	Regular premium Group Pension
AVC final salary (SP)	Single premium Group Pension
AVC Group money purchase (RP)	Regular premium Group Pension
AVC Group money purchase (SP)	Single premium Group Pension
Distribution bond	Single premium S&I
Dread disease/Critical illness	Protection
Endowment savings plan (RP)	Regular premium S&I
Endowment savings plan (SP)	No data
Executive pension (RP)	Regular premium Group Pension
Executive pension (SP)	Single premium Group Pension
Final salary (RP)	Regular premium Group Pension
Final salary (SP)	Single premium Group Pension
FSAVC (RP)	Personal Pension
FSAVC (SP)	Personal Pension
Group income protection	Protection
Group life	Protection
Group money purchase (RP)	Regular premium Group Pension
Group money purchase (SP)	Single premium Group Pension
Group personal pension (RP)	Regular premium Group Pension
Group personal pension (SP)	Single premium Group Pension
Group section 32 buy out	Single premium Group Pension
Guaranteed growth bond	No data
Guaranteed income bond	No data
Guaranteed investment bond	No data
Income drawdown	Retirement
Income protection (PHI)	Protection
Individual pension transfer	Personal Pension
Investment trust (RP)	No data
Investment trust (SP)	No data
Life annuity	Retirement
Long term care (RP)	No data
Long term care (SP)	No data
Mortgage term	Protection
Offshore bond	No data

Pension annuity	Retirement
PEP / Equity ISA (RP)	No data
PEP / Equity ISA (SP)	No data
Personal pension (RP)	Personal Pension
Personal pension (SP)	Personal Pension
Phased retirement	No data
Private medical insurance	No data
Section 32 buy out	Personal Pension
SSAS (RP)	Regular premium Group Pension
SSAS (SP)	Single premium Group Pension
Term assurance	Protection
Trustee investment bond	Single premium S&I
Unit trust (RP)	No data
Unit trust (SP)	No data
Unit-linked Bond	Single premium S&I
Unit-linked endowment (Mortgage)	Mortgage related
Whole of life	Regular premium S&I
With-profit Bond	Single premium S&I
With-profit Endowments (Mortgage)	Mortgage related

6.4 ANNEX 4: ADDITIONAL MYSTERY SHOPPING RESULTS

Does the amount of commission influence the advice process?

Length of first interview

Table 17: Scenario 1 - (Lump sum) Length of first interview (hours:minutes)

Amount to invest	£15,000	£30,000
Maximum	1:38	1:35
Average	0:47	0:55
Minimum	0:14	0:19

Source: CRA

Table 18: Scenario 2 - (Pension) Length of first interview (hours:minutes)

Proportion of income to contribute	5%	10%
Maximum	1:30	1:50
Average	0:49	0:56
Minimum	0:16	0:15

Table 17 and Table 18 above show that the average time spent in the first interview in both scenarios was around 50-60 minutes, and this does not appear to vary much depending on the amount of money that the shopper was prepared to invest. The maximum time any shopper had to spend in the first interview was around 1 hour and 30 minutes, although one shopper with 10% of income to invest in the pension scenario spent closer to 2 hours with their adviser.

Requirement of a second interview

Table 19: Proportion of assessors being asked for a second interview

Premium size	Overall	Small	Large
Lump sum	21%	21%	22%
Pension	31%	33%	29%

It is clear from Table 19 above that the likelihood of requiring a second interview did vary significantly between the two scenarios, with those in the pension scenario around 50% more likely to have to go back for a second interview than those in the pension scenario.

Requirement for a follow-up phone call

Table 20: Requirement for a follow-up phone call

Premium size	Overall	Small	Large
Lump sum	26%	24%	28%
Pension	34%	44%	23%

Table 20 above indicates the proportion of mystery shoppers that were required to make a follow-up phone call. As with the results regarding the second interview, the proportion of people making phone calls is greater in the pension scenario than in the lump sum scenario.

What is surprising, however, is the very significant difference between those with small premiums and those with large premiums to invest. In contrast to what might be expected, it is those on the small premiums that were required to have a follow up phone call rather than those with large premiums to invest and this does not reflect any significant difference in those making second interviews.

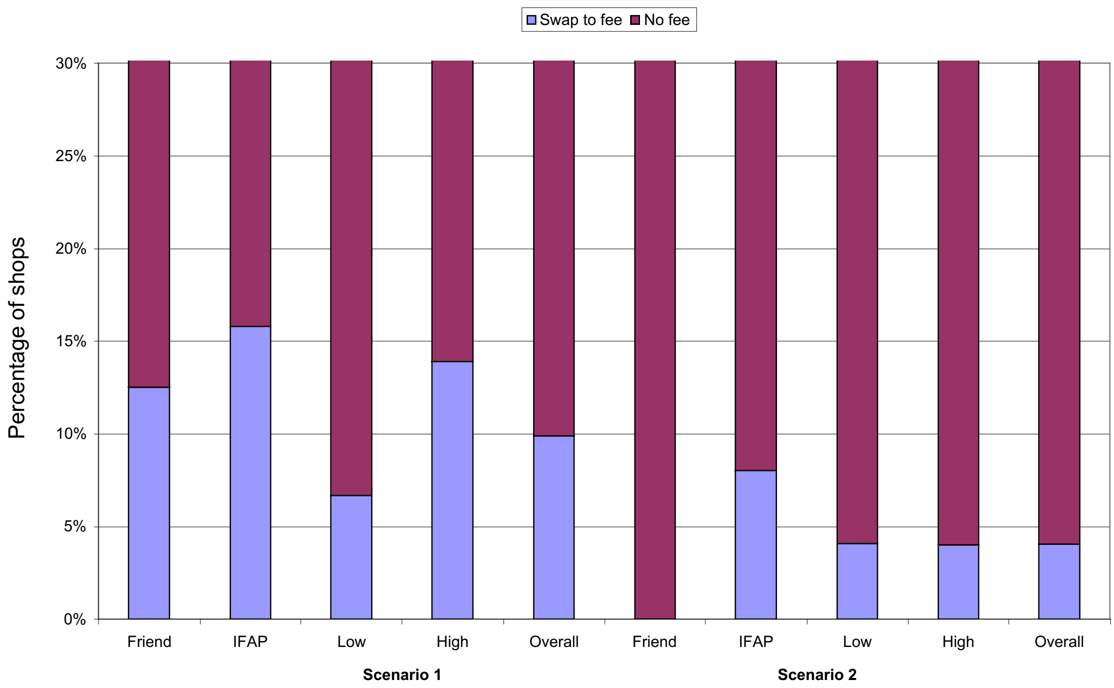
Only a very small number of individuals were required to make both a follow up phone call and a second visit to the financial adviser. Of the 15 that were required to do both, 4 were in the lump sum to invest and 11 were in the pension scenario.

Altering the remuneration structure

One slightly unexpected result that came out of the mystery shopping was that some advisers altered the remuneration structure they required part way through the advice process. Shoppers were instructed to check when arranging the first meeting with the adviser that advisers would work on a commission basis. However, in about 7% of cases, once the fact find had been completed, advisers said that they were only prepared to make full recommendations if the shopper paid a fee.

If this was induced by adviser bias, one might expect advisers to do this more frequently where small premiums and commission amounts were being invested. But in fact, as can be seen in Figure 15 below, in scenario 1 (lump sum) the adviser was more likely to request moving to a fee basis under the larger premium variants than the small premiums.[27]

Figure 15: Scenarios 1&2 – How frequently did advisers seek to change to a fee basis during mystery shopping?



Obtaining recommendations

The total number of visits that led to a recommendation that could be used for the purpose of the analysis was 167 out of 250, with an additional 12 shoppers being told that they would have to pay a fee. A brief examination was done to identify whether there were differences in the rate at which recommendations were forthcoming between either the channels or the scenarios.

Some variation was observed with IFAs recommended by a friend more likely to give a recommendation than IFAs who were cold called through IFA Promotions. Similarly, insurer's sales forces were more likely to give a recommendation than advisers from a bank.

When we examine the scenarios we find that the pension scenario was more likely to receive a complete recommendation – this probably reflects the fact that the scenario

[27] It should be noted that swapping to a fee basis could actually be of benefit to the mystery shoppers in some cases if they decided to purchase the products. However, since actually paying fees within the mystery shopping exercise was not possible, once this had been put forward as the only way of remunerating the adviser, the mystery shopper had to terminate the process.

was much more tightly defined in terms of the products that could be advised (and possibly also by limiting the discussion only to pensions, advisers may have been able to reduce compliance costs). In the scenario with money to invest, far fewer recommendations were given to those with £30,000 to invest than to those with only £15,000.

6.5 ANNEX 5: ECONOMETRIC RESULTS

In order to model the relationship between market share and changes in commission we used a panel econometric methodology. This allows for systematic differences between providers, accounting for differences in brand strength, reputation etc. To account for differences there are two rival methodologies, a fixed effect approach and a random effects approach. The fixed effect approach allows for differences using a group specific constant term in the regression model. The random effects approach specifies a group specific disturbance.[28]

The results below show a random effect model of the relationship between market share of those providers providing data (nmktshare) and the natural logarithm of the initial commission (linitial), the natural logarithm of average initial commission (laverage), and the average policy size (lavpolicy). We have not presented the full set of coefficients including dummies to capture the effect of:

- consolidation of product providers during the period;
- periods when not all providers have submitted data;
- exceptional circumstances, such as the impact of demutualisation, exceptional product terms, very significant product launches, and restructuring as a result of the 1995 Pensions Act.

[28] For the purposes of our analysis we have tested which type of model is appropriate. The with-profits bond fails this test and would therefore be better modelled using a fixed effects model. However, the results from the fixed effect and the random effect model are very similar after allowing for changes in the composition of the data.

Single Premium – regression results:

```
-> product = Distribution bond
Random-effects GLS regression                   Number of obs      =       163
Group variable (i) : prov_id                    Number of groups   =         7
R-sq:  within  = 0.2160                         Obs per group: min =        20
       between = 0.0003                                        avg =      23.3
       overall = 0.0055                                        max =        25
Random effects u_i ~ Gaussian                   Wald chi2(3)       =     42.13
corr(u_i, X)       = 0 (assumed)                Prob > chi2        =    0.0000

------------------------------------------------------------------------------
   nmktshare |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
    linitial |   .6211019   .0999513     6.21   0.000      .425201    .8170028
   laverage |  -.8396545   .1857129    -4.52   0.000    -1.203645   -.4756638
    avpolicy |  -2.70e-07   9.31e-07    -0.29   0.772    -2.10e-06    1.56e-06
       _cons |  -.4640907   .4485387    -1.03   0.301     -1.34321     .415029
-------------+----------------------------------------------------------------
     sigma_u |   .1847965
     sigma_e |  .04613336
         rho |    .941334   (fraction of variance due to u_i)
------------------------------------------------------------------------------

-> product = Pension annuity
Random-effects GLS regression                   Number of obs      =        99
Group variable (i) : prov_id                    Number of groups   =         7
R-sq:  within  = 0.1070                         Obs per group: min =         1
       between = 0.0656                                        avg =      14.1
       overall = 0.0092                                        max =        25
Random effects u_i ~ Gaussian                   Wald chi2(3)       =      9.97
corr(u_i, X)       = 0 (assumed)                Prob > chi2        =    0.0189
------------------------------------------------------------------------------
   nmktshare |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
    linitial |   .0661778   .0212009     3.12   0.002     .0246247    .1077308
    laverage |  -.3898076   .2523058    -1.54   0.122    -.8843179    .1047027
    avpolicy |  -5.18e-07   1.19e-06    -0.44   0.663    -2.85e-06    1.81e-06
       _cons |  -1.235429   1.103991    -1.12   0.263    -3.399212    .9283536
-------------+----------------------------------------------------------------
     sigma_u |  .19801778
     sigma_e |  .15170954
         rho |  .63013083   (fraction of variance due to u_i)
------------------------------------------------------------------------------

-> product = With-profit Bond
Random-effects GLS regression                   Number of obs      =       137
Group variable (i) : prov_id                    Number of groups   =         9
R-sq:  within  = 0.0312                         Obs per group: min =         4
       between = 0.6327                                        avg =      15.2
       overall = 0.2577                                        max =        23
Random effects u_i ~ Gaussian                   Wald chi2(3)       =     14.78
corr(u_i, X)       = 0 (assumed)                Prob > chi2        =    0.0020
------------------------------------------------------------------------------
   nmktshare |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
    linitial |   .7137557   .2551372     2.80   0.005     .2136959    1.213815
    laverage |  -1.610538   .4242754    -3.80   0.000    -2.442102   -.7789733
    avpolicy |  -1.73e-07   1.37e-06    -0.13   0.900    -2.86e-06    2.51e-06
       _cons |  -2.374357    .856179    -2.77   0.006    -4.052437   -.6962769
-------------+----------------------------------------------------------------
     sigma_u |  .05091503
     sigma_e |  .10992713
         rho |  .17663428   (fraction of variance due to u_i)
------------------------------------------------------------------------------
```

Regular Premium – regression results:

```
-> product = Unit-linked endowment (Mortgage)
Random-effects GLS regression                   Number of obs      =       150
Group variable (i) : prov_id                    Number of groups   =         7
R-sq:  within  = 0.0567                         Obs per group: min =        16
       between = 0.2440                                        avg =      21.4
       overall = 0.1641                                        max =        25
Random effects u_i ~ Gaussian                   Wald chi2(4)       =     10.39
corr(u_i, X)       = 0 (assumed)                Prob > chi2        =    0.0344
------------------------------------------------------------------------------
   nmktshare |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
     ltotint |   .4522498   .1730488     2.61   0.009     .1130804    .7914192
renewalacc~o |   .0197936   .0101318     1.95   0.051    -.0000644    .0396516
      lavint |  -.8669429   .3539592    -2.45   0.014     -1.56069   -.1731956
    avpolicy |  -1.99e-06   .0000111    -0.18   0.857    -.0000237    .0000198
       _cons |  -.5207693    .353038    -1.48   0.140    -1.212711    .1711726
-------------+----------------------------------------------------------------
     sigma_u |  .11170071
     sigma_e |  .11576383
         rho |  .48214302   (fraction of variance due to u_i)
------------------------------------------------------------------------------
```

Further details on the econometric results are available upon request.

6.6 ANNEX 6: DETAILED ASSUMPTIONS UNDERLYING THE QUANTIFICATION OF DETRIMENT

In addition we have made the following detailed assumptions:

- In using our mystery shopping results, we have assumed our mystery shoppers are representative and consumers would act on the basis of the advice received;
- We have estimated the number of customers who should have purchased ISAs rather than other saving instruments. This increases the number of ISAs purchased through the IFA channel by approximately 22%;
- The average premium is based on ABI market statistics for the average premium for a maxi equity ISA in 2000;
- The average detriment reflects the difference in initial commission on ISA products and non-ISA savings products in our mystery shopping exercise;
- For the provider bias estimate, the average detriment is calculated as 50% of the difference between the maximum and minimum commission; and
- Average premium for with profit bonds and distribution bonds is based on ABI market statistics.

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