Report

Cost benefit analysis of the Defined Payment System and Price List

Submitted to

AIFA & IFA Promotion

Submitted by

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Executive Summary

The Association of Independent Financial Advisers and IFA Promotion commissioned Charles River Associates to undertake a preliminary cost-benefit analysis of the changes that the FSA is proposing to make to the regulation of the independent advice sector. The analysis is preliminary in the sense that it has been carried out at a time when the policy proposals in CP121 have not been developed into a full set of proposed rules. It has also inevitably been undertaken with limited time and resources for primary research, and as with all *ex ante* analysis depends on projections and extrapolations based on current experience.

This cost-benefit analysis (CBA) does not cover all of the CP121 proposals – in particular, it does not consider the potential benefits of the measures the FSA has proposed to liberalise the tied sector. Instead, it focuses on the likely effects of the proposed Defined Payment System (DPS) of remuneration for independent advisers. This is an appropriate topic to analyse, because the DPS can be separated from the rest of the FSA's proposals.

Our work suggests that, taken by itself, the DPS will not be beneficial and could, in fact, be worse in cost-benefit terms than the *status quo*. But the FSA has identified genuine problems in the current independent sector, and they ought, if possible, to be remedied through regulatory change. To that end, this report sets out – as one of several possible approaches – a concept in which IFAs could continue to be remunerated through commission, but would be obliged by regulation to reveal the cost of advice to customers before the start of the advice process. We refer to this alternative as the Price List.

This report includes a CBA of the Price List, which shows that it would have some significant advantages compared with the status quo, and that its benefits are likely to exceed its costs. The Price List is thus better than the DPS proposal, and under some circumstances could be very much better.

Scenarios

We investigate three main scenarios:

1. The DPS proposal is implemented, and the channel of Authorised Financial Advisers with no provider ties ("unrestricted" AFAs) proves to be a sustainable part of the market;

2. The DPS proposal is implemented, but unrestricted AFAs cannot differentiate themselves from restricted AFAs and are not a sustainable part of the market; and

3. The Price List is implemented.

We have made the scenarios as comparable as possible, both in terms of the data we have collected and of the underlying assumptions. For example, we have assumed that both the DPS and the Price List would be confined to Independent intermediaries. It would clearly be possible to extend either or both them to AFAs and tied intermediaries, with further potential gains and costs. As this is not envisaged in CP121 for the DPS, we have not envisaged it for the Price List either - that would not be a like-for-like comparison, and thus would not have been a fair CBA test.

Summary of static effects

Scenario 1: DPS with sustainable unrestricted AFAs: Here the DPS is introduced with effective status disclosure that allows "unrestricted" AFAs to be a sustainable business model. In this scenario:

- Commission-based IFAs largely become unrestricted AFAs. Their business model is unchanged, and there is no benefit in respect of commission bias,
- Unrestricted AFAs continue to choose actively from across the market, allowing new providers to enter and encouraging innovation as in the *status quo*; and
- There are some direct and indirect regulatory costs from changing from IFA to AFA status.

Scenario 1 has a slight negative impact compared to the *status quo.*

Scenario 2: DPS without a sustainable unrestricted AFAs: Here the DPS is introduced, but "unrestricted" AFAs find it difficult to distinguish themselves, and most commission-based IFAs become AFAs with provider ties. In this case:

- There is stale competition between restricted AFAs and tied intermediaries;
- There are some direct and indirect regulatory costs of change; and
- Barriers to entry increase for providers because the restricted sector takes almost the entire market, and innovation by product providers diminishes accordingly.

Scenario 2 has a significant negative impact compared to the status quo.

Scenario 3: Price List: The Price List has benefits that are not achievable with the DPS, and has lower costs of transition. In this case:

- Some IFA customers are lost to AFAs, but competition is maintained by commission-based IFAs;
- Provider bias among commission-based IFAs is largely remedied, with annual benefits of around £50 million in reduced consumer detriment;
- Detriment due to product bias may also be reduced because price lists limit the extent to which advisers can exploit high commissions on different products; and
- Shopping around in the advice market is encouraged, resulting in some reduction in the price of advice.

Scenario 3 has a positive impact compared to the status quo.

The analysis shows there are significant benefits to be had from adopting the Price List in the independent sector. It has more benefits for consumers and is considerably less disruptive for the IFA sector than the DPS proposal, which does not bring significant benefits for consumers but does have substantial risks.

Dynamic effects

Of equal importance, the Price List dominates the DPS (and the status quo) in terms of the long-run direction of the advice market. The FSA wants to see the advice market develop in the longer term into one where payment is not conditional on sale, but its DPS proposal would segment the market into:

- Rich IFA customers paying fees; and
- Mass-market AFA and tied channel customers paying commission.

If AFA customers want to move to paying fees, they would have to incur the cost of changing to an adviser of a different type. This would tend to restrict the size of the fee market in the longer term.

By contrast, the Price List moves independent advisers and their consumers towards a market where consumers understand the costs of advice, and should reduce resistance to paying fees in the medium term. It does not erect any new barrier to a customer wishing to use their adviser on a fee basis. Accordingly it would favour the FSA's objective more than the DPS.

Conclusions

Table 1 summarises the costs and benefits of the scenarios. The overall balance between the figures depends on when the rules under the two scenarios are brought in, how long they last, and what discount rate is used to translate future costs and benefits into today's money. But whatever values one chooses for these parameters, the Price List will be better than the DPS proposal because it has lower costs and higher benefits in all categories.

Summary CBA comparison of scenarios

Scenario	One-off Costs	Ongoing Costs	Benefits	Dynamic Effects
1. DPS with unrestricted AFAs	£77 million	£65 million pa	Likely to be small	Neutral
2. DPS without unrestricted AFAs	£77 million	£71 million pa	Likely to be small	Adverse
3. Price List	£47 million	£41 million pa	£95 million pa	Positive