States

Guernsey Financial Services Commission

Retail Distribution Review
Position Paper

9 May 2012

1. Overview

1.1. The UK Financial Services Authority's ("FSA") Retail Distribution Review ("RDR") is a response in the UK to long-standing problems in the retail intermediary sector, especially around mis-selling. This paper outlines key aspects of RDR as well as the current equivalent position in Guernsey.

1.2. The Commission has been actively and closely monitoring policy developments both in the UK and in the other Crown Dependencies. It has also carried out surveys with both insurance and investment intermediaries in Guernsey, as well as undertaking an extensive internal policy discussion.

1.3. The Commission remains vigilant in its oversight of intermediary business in Guernsey. Indeed, given the need to take a continuous view on RDR, it will in the future intensify its oversight of insurance intermediaries. In addition, the Commission considers that further consideration should now be given to creating a regime in Guernsey that is more transparent than at present with regard to commissions for insurance retail investment products.

1.4. However, the Commission notes that there remains some doubt as to whether RDR will successfully achieve its aims in the UK. In addition, there is no pressing reason to adopt RDR immediately in Guernsey. Accordingly the Commission is of the view that a prudent approach is to wait to see as to how RDR develops in the UK and how other jurisdictions develop approaches to these issues rather than to implement RDR in Guernsey now.

1.5. The Commission in the immediate future will also pay particular attention to any evidence of abusive sales practices in Guernsey, whether there are signs of any regulatory arbitrage between Guernsey and the UK, as well as to how the RDR develops in the UK. These observations will be used in a further reassessment of the position by the Commission in due course.

2. The UK and RDR

2.1. The FSA's three key proposals are to:

- Replace commissions with fees
- Increase educational standards
- Improve the clarity with which firms describe their services to consumers (e.g. many will no longer be able to say they are 'independent').

2.2. The RDR will be implemented in the UK from 1 January 2013.

2.3. The constituency in the UK is all firms licensed as stockbrokers, investment managers, investment advisers (together "investment firms") who act for retail clients and insurance intermediaries who undertake long term (not pure protection) insurance business. In addition, individual investment advisers within those firms, existing clients of those firms; and members of the public who seek investment advice will also have an interest. Simple life assurance and general insurance are excluded. For clarity, RDR applies only in the UK and to the UK retail community; and all products under the aegis of RDR are termed below 'retail investment products'.

2.4. The background to the FSA's actions relate to the widespread use of intermediaries to sell retail investment products to the UK public. Traditionally intermediaries have been compensated by providers through sales-led commissions. In the view of the FSA this can lead to intermediaries selling products to the UK retail public that are not to its advantage. Despite recent moves towards increased transparency around commissions, closer supervision by the FSA itself, a campaign to ensure that all parties 'Treat Customers Fairly', and large mis-selling fines, the FSA has decided to ban entirely the commission model from 2013.

2.5. Instead the FSA has decided to require intermediaries to charge customers fees for their services. The idea behind this approach is that intermediaries will recommend the best provider for the customer, and will be judged on the quality of service provided. This is part of an attempt by the FSA to make intermediaries more like professional experts who are paid for their services.

2.6. As part of this process, educational qualification requirements for intermediaries will be raised. At present the educational requirement is at A level standard; but will now be at first year university level.

2.7. Finally, intermediaries will have to be clearer as to the basis on which they give advice. For 'restricted' advice, the intermediary will have to make it clear to the customer that, in exchange for a fee, he is not providing a 'whole-of-market' service but is in fact offering products from a limited number of providers or a limited number of sectors. The alternative to this is the 'independent' adviser where the scope of advice will be unlimited. There is a sub-section of 'restricted' advice called 'simplified advice' using a call centre or the web and 'basic advice' using decision trees.

3. Arguments against RDR in the UK

3.1. In contrast to the view of the FSA, several parties have argued that mis-selling is not specifically linked to commissions. Instead it reflects the fact that the market is supply rather than demand led. That is, those suppliers are selling a long-term product that consumers, with an eye only on the short-term, are disinclined to buy, even if it is to their long-term advantage. In this environment, all sales techniques are problematical.

3.2. Another issue is social exclusion. The argument here is that, without commissions, it will no longer be profitable for intermediaries to provide any sort of proper advice to the less wealthy. The latter will therefore be left to make significant investment decisions on their own and without advice.

3.3. Another issue has been the likely reluctance of the public to pay directly for advice through fees. Instead, there is a concern that the public will simply buy fewer long-term financial goods. This will make the savings/GDP ratio, already low in the UK, even worse.

3.4. Several commentators have argued that mandatory disclosure is a better solution than RDR. So long as customers clearly understand the costs of what they are buying including the commission, then the choice is theirs. Indeed they might even negotiate to take part of the fee. On the other hand, there are issues relating to this argument given that the level of financial literacy among the general public is low.

3.5. Another concern is that RDR does not cover all products. Therefore, arbitrage will occur as the industry seeks to exploit less closely regulated products.

3.6. There are also concerns about the transparency of fees as opposed to commissions as intermediaries seek to reproduce the same opacity as has existed around commissions. This raises questions as to how the FSA will effectively police this.

3.7. Several doubt whether raising educational standards will have a material impact. It could be argued instead that past mis-selling is more related to ethics than product understanding by intermediaries.

3.8. A recent concern is whether the new Financial Conduct Authority will be as committed to the RDR as the soon-to-be-abolished FSA.

3.9. In essence, although RDR will go ahead in the UK, it remains controversial.

4. The Position in Guernsey

4.1. Under current rules and regulations, commissions are allowed for insurance. They have to be declared to the customer either on request by the customer or on a mandatory basis for single premium, traded endowment policies and any transaction that involves gearing. Commission does not have to be declared at all for regular insurance savings and pensions, unless requested. As outlined later, this seems an anomaly. In contrast, for investment services, while commission is allowed, disclosure in the form either of amount or commission is mandatory for all products. However, most charge fees.

4.2. In Guernsey, under the Insurance Code of Conduct, the intermediary is required to ensure that the product is broadly suitable for the customer. In practice this is delivered through a 'customer fact find'. This is obligatory for investment advisers.

4.3. There appear to be relatively few cases of mis-selling by intermediaries in Guernsey; at least as evidenced by the level of complaints to the Commission. On the other hand the

Commission cannot feedback to clients on complaint resolution and this reduces the likelihood of complaints. In addition, the failure of a retail investment product to meet expectations can be only demonstrable over decades and even then assuming a degree of financial knowledge by clients.

4.4. In terms of education, Guernsey insurance intermediaries have to hold the Guernsey Insurance Certificate (GIC) as well as a UK Chartered Institute of Insurance Financial Planning Certificate or an acceptable equivalent. These are roughly A level standard.

4.5. Guernsey investment advisers are not required by the GFSC to have any qualifications. However the Commission's Investment Division's minimum criteria for licensing do require the Commission to consider an individual's education and qualifications. Most investment advisers hold qualifications.

4.6. Guernsey does not regulate pension advice unlike the FSA.

4.7. In terms of nomenclature, there are no specific rules, although the Commission has sometimes intervened to ensure that intermediaries are clear on their scope of offer. Non-bank intermediaries usually call themselves 'independent' though in practice most will be 'restricted' under RDR.

5. Industry Discussions

5.1. Following a series of informal meetings with individual advisors and their trade bodies, the Commission issued questionnaires to establish, inter alia, how many advisers already held the necessary qualifications, or were in a course of study to obtain them, and how many firms had already begun to move to a fee-based business model. As these were questionnaires rather than consultation, intermediaries were not asked point blank at this stage whether or not they supported RDR. However the most recent GIBA annual report includes a section in which Guernsey Investment Managers of Stockbrokers Association (GIMSA) proclaims its broad support for RDR.

5.2. Almost all insurance intermediaries responded to the questionnaire. The majority believed that they already in practice operated a fee-based approach either explicitly – as in most cases - through fee-based charging or implicitly – in fewer cases - though taking care to ensure that customers understood the commission the intermediary was taking; or were at least moving towards a fee-based approach.

5.3. In contrast a sizeable minority did not say that they were transparent on commissions or at least not always so. Some said that that they would only reveal a commission if asked, noting that the customer then would often ask for a retrocession.

5.4. Guernsey insurance intermediary practice in revealing and explaining commission therefore is mixed.

5.5. At least one firm – and at other times this view has been expressed – said that additional qualification requirements would discourage new entrants – of whom they were few enough anyway. Several noted that customers hardly ever ask about the formal qualifications of the insurance intermediary. Of the 70 practicing advisors (AIRs), only 4 claim to hold the necessary qualifications, with a further 2 studying to obtain them. Several expressed the view that further qualifications were unnecessary, given the experience of the intermediaries.

5.6. Most insurance intermediaries regarded themselves as ‘independent’ though, under RDR, many would be regarded as ‘restricted’.

5.7. Nearly 50% of investment firms failed to respond to the questionnaire as many investment firms do not interact with the local retail population and therefore will not be subject to RDR requirements. Of those who responded, remuneration by fee has been the norm and 90% of their 124 advisers already hold a diploma level qualification.

5.8. The domicile of the client bases are equally reversed in that an estimated 90% of the clients of insurance intermediaries are Guernsey resident, whilst 90% of the clients of investment firms that responded are not.

5.9. The investment community demographic, and the percentage already qualified to diploma level, suggests that the number opting for early retirement will not be significant. In contrast the insurance demography shows more people nearer retirement.

5.10. The three High Street banks in Guernsey which hold insurance intermediary and/or investment licences are expected to follow their counterparts in the UK in adopting RDR simply as part of a group-wide roll-out.

5.11. The Commission wrote to several of the largest product providers to the intermediary market asking them if they would stop providing services if Guernsey did not adopt an RDR regime. Four firms replied and all said it would make no difference and that they would simply abide by the requirements of the local jurisdiction. From this it may safely be assumed that RDR outside the UK is not mandatory for UK providers for business reasons.

5.12. RDR does not forbid the inward sale of intermediary services from outside jurisdictions, although it does restrict the local advertising of such services. The danger here is that if Guernsey does not undertake RDR, then it could become the home of brokers selling into the UK with the background of a weaker infrastructure. In practice this danger seems remote. Firstly, there is no evidence that UK providers would support this approach as a way round RDR. Secondly Guernsey insurance intermediaries have expressed no interest in this approach and in fact say that historic UK business is generally winding down. Thirdly, there appears little likelihood that UK intermediaries will move to Guernsey seeking a weaker regime, given housing restrictions etc. Fourthly, UK clients are unlikely to have an interest in a less qualified regime.

6. Qualifications

6.1. In Guernsey, investment advisers already choose to take level 4 exams (e.g. first year university) in the UK for business reasons; not least because they are often part of international groups that are already cognisant of the UK regulations. In contrast very few insurance intermediaries choose to take the level 4 exams. Whilst the FSA has prohibited ‘grandfathering’, this remains an option of course in Guernsey.

6.2. The Jersey Financial Services Commission (“JFSC”) has raised the possibility of a Jersey RDR exam to take account of local conditions but has guided the industry away from it on grounds of practicality.

6.3. In the event that the UK diploma was to be required in Guernsey, then there is an issue as to how long intermediaries need to be given to pass the relevant exams. The Chartered Institute of Insurance does not give study times, emphasising that distance learning allows all examinees to progress at their own pace. However, our estimate is that Guernsey examinees – who will already be qualified at Certificate level – would require up to a year to pass the level 4 exams.

7. The Isle of Man and Jersey

7.1. In July 2011, the Isle of Man Financial Supervision Commission issued a two page statement saying that it was just starting a consultation process. The statement supports higher educational requirement at level 4. The Commission understands that the IOM will implement the level 4 educational requirements and higher disclosure requirements; but not the abolition of commissions.

7.2. The JFSC has issued a detailed position paper with its draft proposals to the Jersey investment community; covering Jersey based investors. Those proposals are broadly to adopt the RDR requirements. The implementation deadline in Jersey is January 2014; one year behind the UK.

7.3. Several of our impacted licensees – especially the three banks who hold intermediary licences - have operations in Guernsey, Jersey, Isle of Man or the UK and these would naturally prefer a harmonised approach.

8. International standards

8.1. The new International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICPs) are ambivalent in relation to mandatory charging transparency; though it would be easier to prove compliance if such an approach was in place. This means that there is no international case in favour of RDR.

8.2. The EU has issued its proposed second Markets in Financial Instruments Directive (MiFID2). The danger here is that the draft directive still allows commission to be charged by banc assurers. This is because this is the predominant business model in for example France and Germany. If this approach survives to the actual directive then it will pose a problem to the UK authorities on the basis that UK banc assurers are likely to claim legitimacy for the same approach. MiFID2 therefore poses a potential challenge to the sustainability of the UK RDR. However, it is likely that it will take another two years or so for the directive to pass through the EU legislative process.

8.3. The EU is also currently consulting on an updated Insurance Mediation Directive (IMD 2) relating specifically to the distribution of General Insurance products but also touching on the sale of Packaged Retail Investment Products (PRIPs). The core proposals extend the current IMD regime to include the direct sales activities of insurers, a requirement for pan-European minimum qualifications and commission disclosure. It may be that compliance with IMD2 will go hand in hand with compliance with the requirements of RDR. Any final decision is still some way off. In any case, few Guernsey insurance intermediaries are active in the EU.

9. Legislative Changes

9.1. If RDR were to be preferred, then RDR could be adopted in Guernsey without any primary legislative changes. Instead, Commission based changes in the rules and regulations would be sufficient.

10. Conclusions

10.1. The sale of retail investment products in the intermediary sector is fraught with problems. Consumers are often reluctant to buy long-term investment products even if it is to their advantage while it is in the interests of both intermediaries and providers to sell such products. This discrepancy has resulted in a less-than-perfect environment in which mis-selling in the UK has undoubtedly taken place at times. An added reality is that the level of financial literacy among the UK general public is generally low; limiting its ability to assess product quality and outturn.

10.2. It is not immediately clear that RDR will materially improve the overall position in the UK; or that commissions and current educational requirements are themselves contributors to the problem. Even were it to be accepted- and this itself is controversial - that fees and higher educational requirements would improve the position, there are still material issues around social exclusion, fee transparency, simplified advice, the impact on the intermediary sector, the continuing limited financial literacy of the UK public, and the possible future role of the EU. It also remains to be seen whether the new Financial Conduct Authority will be as wedded to RDR as the FSA.

10.3. In Guernsey, there is an absence of current evidence in Guernsey that the status quo has led to major abuses. This may reflect an absence of data though this may be unlikely given the open nature of Guernsey democracy. It may be that the current regulatory system – which requires intermediaries to ensure product suitability, where most investment intermediaries have already adopted the key parts of RDR, and where local reputation is key – has served local residents adequately. On the other hand, it may be that the potential Channel Islands Ombudsman will reveal more evidence of abusive sales practices. The Commission itself will keep a close watching brief for such evidence, not least through an intensification of its everyday monitoring of intermediaries.

10.4. The Commission's consideration of RDR has led it to the view that transparency around insurance retail investment products may need to be enhanced – a view echoed in the Isle of Man. Accordingly, the Commission will now consider in detail whether commission disclosure should be made mandatory for insurance retail investment products and in that case it will bring forward proposals to bring this about.

10.5. The Commission will monitor any potential arbitrage risks between Guernsey on the one hand and the UK and Jersey on the other.

10.6. Given the above general arguments, it is best to wait to see how the RDR beds down and works in the UK and how other jurisdictions approach the issues before committing Guernsey to such change. The Commission, at this moment in time, advises the States not to import RDR subject to further review later on, and subject to potential action on enhancing insurance product disclosure.