The Financial Inclusion Centre

Financial markets that work for society

THE FINANCIAL ADVICE 'GAP'- IT'S THE ECONOMICS, STUPID

Summary

HM Treasury and the Financial Conduct Authority (FCA) have recently launched the Financial Advice Market Review (FAMR)[1] to address the so-called 'financial advice gap' in the UK – concerns that large numbers of consumers are unable (or unwilling) to access good quality, appropriate financial advice.

Good advice is critical for promoting financial inclusion, financial resilience and security amongst households – particularly lower-medium income households which are the focus of our work at the Financial Inclusion Centre. So, we welcome the FAMR. But, it is important that we understand the real causes of the advice gap. Claims that the advice gap is caused by or has *emerged* because of over-regulation are wrong - or disingenuous and used to try to reduce much needed consumer protection. Remedies based on false analysis would exacerbate rather than improve the situation.

A more accurate assessment is that robust, better regulation has *exposed* a long established advice gap. Of course, many lower-medium income consumers were 'advised' on and sold insurance, investment and personal pension products in the past. But, as we now know from the litany of misselling scandals, these products were all too often unsuitable and represented poor value for consumers due to high charges and commission payments to advisers/ intermediaries. In effect, consumers were cross-subsidising the sale and distribution of these poor value products.

Therefore, when thinking about the concept of an advice gap, it is important not just to think of access to advice *per se* but whether it produces the right outcomes for consumers. It would be easy to close the advice gap if we just allowed the industry to go back to advising on and selling poor value, unsuitable products. But, of course, that would be unacceptable.

The real reasons for the advice gap in our view are:

- growing numbers of consumers simply cannot afford to save and invest, or pay for for-profit advice; and
- large numbers of consumers are 'underserved' by the financial services industry because the industry is still too inefficient to meet their needs.

In other words, it's all about the economics of access and distribution.

Reducing consumer protection to encourage the industry to serve more consumers is not the way forward. Instead the industry would continue to serve medium-higher income consumers but with weaker constraints on its behaviours. The overall effect would be to just transfer the risk of misselling to consumers thereby undermining confidence and trust in financial services. Closing the advice gap, therefore, means focusing on making the financial services industry more efficient so it can extend its reach to more consumers and providing alternative provision for consumers who are not commercially viable for the for-profit advice sector.

[1] https://www.fca.org.uk/firms/firm-types/financial-adviser/financial-advice-market-review

The Financial Advice Markets Review (FAMR)

Before going onto examine the causes of the advice gap, it is worth looking briefly at the FAMR, as the outcome of the review will have a major impact on the how the advice gap is approached.

The FAMR will examine the effectiveness of the current regulatory and legal framework governing the provision of financial advice and guidance to consumers. In particular, the review will look at:

- whether an advice gap exists for those consumers who don't think they can afford to get financial advice and the barriers consumers face in seeking advice;
- the value consumers place on advice and how easy it is to understand where advice can be found and what it means;
- the regulatory or other barriers firms may face in giving advice, how to overcome them, and the interaction between the regulatory framework for advice and the role of the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS) in redress;
- how to give firms the regulatory clarity and create the right environment for them to innovate and grow and opportunities and challenges presented by new and emerging technologies to provide cost effective, efficient and user friendly advice services; and
- how to encourage a healthy demand side for financial advice, including addressing barriers which put consumers off seeking advice.

Which consumers are affected by the advice gap?

It is important not to oversimplify but we consider there are two groups of consumers who don't have access to appropriate financial advice:

- consumers who are permanently financially excluded and who will never be commercially viable for the for-profit financial services industry - this group needs alternative solutions provided by the state and/ or non-profit agencies; and
- consumers who could benefit from access to good financial advice and guidance but are prevented from doing so by a range of barriers (economic, structural and supply side, and demand side barriers, see below) - this group is 'underserved' rather than excluded in the conventional sense but if the market was working better could be better served.

Barriers to financial advice

There are a number of barriers that prevent excluded/ underserved consumers from accessing financial advice. We group these into the following categories:

- **External economic factors:** growing numbers of households simply do not have enough spare income to save or invest for the future, or cannot afford to pay for regulated financial advice. In other words, they are not economically viable for commercial, for-profit financial services providers.
- **Structural and supply side barriers:** due to supply side inefficiencies, the financial services industry is limited in the numbers of households (particularly those on lower-medium incomes) it can serve on terms that make sense for those households[2]. These barriers include: oversupply of providers and products, poor product design, weak competition and innovation (from consumer perspective), inefficient business models and supply chains, and conflicts of interest caused by remuneration policies. Some people assert that the current

[2] This is an important distinction. The financial services industry could profitably serve lower-medium income households if it sold them poor value, high cost products and services. But this would not make sense for consumers. This was a feature of old style personal pensions and insurance based investment products that used to be sold in the UK and the 'man from the Pru'.

regulatory system acts as a supply side barrier. We think these claims are much overstated – see below.
- **Demand side barriers:** this can include low levels of financial capability, confidence and trust. Or consumers may just not recognise the need to take advice, plan for the future, or just do not value paid-for financial advice.

Overcoming the barriers to advice

The FAMR is very important and timely. Identifying genuine barriers to advice and ways of overcoming those barriers is critical.

The external economic barriers are to a large degree outside of the control of the FAMR. Many households simply do not have enough income to save or pay for advice. But, it is worth noting that if the financial services industry becomes more efficient and innovative this will reduce the unit costs of selling and advising on financial products. This should then allow the industry to extend its reach further to larger numbers of previously commercially unviable consumers.

It may be possible to overcome the demand side barriers to some degree. Sustained public awareness campaigns and efforts to improve levels of professionalism in the industry could increase consumer confidence in the sector. This in turn might encourage more consumers to proactively seek advice – which again would reduce unit costs of distribution as firms would need to spend less on 'prospecting' for and acquiring new business (see below). But it is worth noting that financial capability interventions have not been effective at actually changing the long term behaviours of consumers.

But, we think that the most productive approach is to look at the structural and supply side barriers to see where efficiency gains might be made. We must also deconstruct the supply chain and understand the basic economics of distribution to identify whether regulation per se represents a real barriers to advice.

There is no guarantee that reducing consumer protection would encourage for-profit firms to reach out to underserved households. These consumers would still be less profitable than medium-higher income consumers. What is more likely is that those consumers who are targeted by the financial services industry would end up having reduced regulatory protection. In other words, there would be a transfer of risk from the industry to consumers which could undermine long term confidence in financial services.

The economics of financial advice and distribution

Much of the debate around the advice gap is based on the assertion that regulation pushes up the costs of distributing and advising on products and/or inhibits the ability of the financial services industry to develop innovative, efficient ways of providing advice to consumers.

To examine whether this is the case, we need to break down the end-to-end process of manufacturing, distributing, and advising on financial products into its component stages.

The main stages are as follows.

<u>Pre-sale</u>

- Product design and manufacturing

- General marketing and promotion
- ‘Prospecting’ for and acquiring new customers
- The ‘know-your-customer process - information gathering, fact finding, assessing attitude to risks and so on
- Advice and recommendation – the stage at which the adviser/ intermediary makes a recommendation to the consumer
- Executing the recommendation – the administration process to set up new product etc

Post-sale

Once the advice has been given and sale been made, there are a number of post-sale stages and costs.

- Ongoing relationship management, administration, regular communications
- Redress – firms and advisers/ intermediaries may be liable to paying redress if consumers have been badly advised/ missold.

There are, of course, direct regulatory costs such as the levy firms are required to pay to fund the regulators and compensation scheme. But, we are concerned here with the manufacturing, distribution and advice costs.

Each of these stages have associated costs of doing business. Firms spend large sums of money on: product design and development; marketing, advertising and promotion; prospecting for new business; gathering information and getting to know their potential customers; training staff so they can provide good quality advice; and research and analysis on products available on the market (for advisers/ intermediaries/ distributors).

Post sale firms also spend large sums on administering accounts and regular communications with consumers.

There are also regulatory requirements associated with each of these stages – for example, specific rules relating to product governance, marketing or the ‘know your customer’ process. And, of course, if firms, advisers, or intermediaries have breached regulatory standards, they may be liable for redress costs - which as we know from experience can be huge.

Does regulation push up the cost of distribution, and cause the advice gap?

The claims we want to examine are: the fear of potential future redress costs makes firms reluctant to advise and sell products to certain groups of consumers; and regulation has pushed up the costs of advising and selling at each of the stages outlined above.

But do these claims stand up when looked at objectively? There are two points we have to remember.

Firstly, it is important to remember that even if regulation didn’t exist, firms and advisers would still be subject to duties of care in law. The fundamental reason for financial regulation is that society does not trust the financial services industry to abide by these general legal principles and that expecting consumers to challenge firms (and therefore constrain their behaviours) through the courts is not effective, nor acceptable. Therefore, regulation can be thought of as codifying legal principles which can then be supervised and enforced against and provide the basis for redress through the Financial Ombudsman Scheme rather than the more costly, less accessible court system.

Secondly, we need to ask: are the behavioural standards required by regulators during the advice and selling process are any more onerous than would be expected of a firm that already had the interests of its customers at heart? To put it another way: does regulation imposes ***unnecessary*** constraints or costs on firms at each of those stages outlined above?

If it is truly the case that regulators demand higher standards than would be expected from a well-run business, then the FAMR could safely reduce or clarify regulatory requirements for the industry which could then:

- lower the total end-to-end costs of advising on and selling products to consumers; and/or
- reduce the inhibitions firms have about selling products to underserved consumers due to the fear of unknown future redress costs.

Objective examination would suggest this is not the case.

We have been through each of the pre-sale stages of the process and considered the relevant regulatory requirements associated with each of those stages. But, we cannot identify any significant regulatory requirements which demand standards of behaviour over and above those that would be expected of a well-run firm that sought to understand the needs of its prospective customers, communicate fairly and openly, and provide a professional, quality service.

Regulators provide a degree of flexibility for firms and advisers as to how they interpret and apply the regulations. It seems to us that any 'belt and braces' approach to regulation may be more down to firms not trusting their own compliance and risk management safeguards rather than zealous regulators.

There are claims that regulation inhibits the ability of firms to use innovative technology to improve the efficiency of the advice process – particularly at the 'know-your-customer' stage. But, we cannot identify any particular regulatory requirement which prevents firms and advisers from using technology to improve the efficiency of the process as long as the firm still complies with the general principles relating to know-your-customer. Again, regulations allow a significant amount of discretion as to the steps the firm/ adviser should take to satisfy itself before providing regulated advice.

One solution proposed is to allow a suite of simple financial products to be distributed using a reduced or more restricted advice process. The theory here is that these simple products would be 'safer' to sell so consumers do not require the same level of protection provided by 'full' advice. Again, looking at the existing regulations, it is difficult to see what prevents firms and advisers from using a streamlined advice process to distribute simpler products *on their own initiative.*

Therefore, we would conclude that the existing regulations do not:

- require standards of behaviour higher than would be expected from a well-run business;
- overly restrict flexibility in the advice process;

- prevent firms and advisers from using innovative technology to improve the efficiency of the advice process nor advising on simpler financial products using a streamlined process if they choose to do so.

Indeed there would seem to be much scope for the industry to improve the efficiency of the advice process and cut distribution costs – but this could be done within the existing regulations. The critical point from the consumer perspective is that the firm/ adviser should retain responsibility for the recommendation/ advice.

But, the problem seems to be more to do with the lack of confidence certain firms and advisers have in their own business processes and the reluctance to advise on products without first following a 'belts and braces' approach to complying with regulatory standards.

Another concern raised by the industry is that it faces the risk of unknown and unquantifiable future redress costs. In particular, claims have been made that the regulatory system imposes fault and redress retrospectively – that is, that firms and advisers may behave honourably at the time of a product being bought but the regulators then reinterpret the standards at some future stage. But, we are not aware of any cases where regulators have reinterpreted and applied regulations retrospectively. Regulators have made it clear on a number of occasions that firms and advisers are judged by the standards of the time.

There is a trade-off between the quality of the sales and advice process and the likelihood of firms and advisers being exposed to future redress costs and damaging the reputation of the industry. Well-governed firms, with well-trained staff and robust 'quality control' procedures are less likely to develop poor quality, toxic products or mistreat their customers. Therefore, they are less likely to fall foul of the regulators and end up having to pay redress to consumers.

Arguments put forward by certain financial services industry representatives seem to be somewhat disingenuous. Calls for 'safe harbours' for firms and advisers seem to be intended more to protect firms and advisers from misselling claims rather than genuine attempts to close the advice gap. Cutting corners and protecting firms and advisers from potential redress claims simply transfers the risks of and liability for misselling to consumers – an illusory efficiency gain and, ultimately, a false economy.

So what could be done?

It is not all doom and gloom. There are a number of interventions which could improve access to advice without compromising much needed consumer protection.

There is scope for regulators to clarify that:

- firms have discretion to interpret and apply standards to suit their own business models;
- regulation does not prevent firms and advisers from using technology to improve the efficiency of the information gathering and know your customer process – as long as the technology solutions are suitable; and
- regulation does not prevent firms and advisers from using a streamlined process to advise on and sell simple, safer products – as long as the firms and advisers are confident that the products have been subject to robust product governance procedures and a streamlined process does not result in consumers being sold unsuitable products.

These clarifications should at least remove any excuse that regulation is inhibiting genuine innovation and efficiency gains.

One innovation which we think could have potential is 'portable fact finds'. There is a cost involved in collecting basic financial information on a prospective consumer's financial circumstances. If a consumer moves to a new adviser (or from a non-profit adviser to a regulated adviser) there is no point duplicating the collection of that information if his/ her financial circumstances haven't changed much. So we can see merit in allowing consumers to take the 'fact-find' with them to a new adviser. This new adviser should be allowed to rely on that fact-find to provide advice – providing, of course, that the information is relatively current and the consumer has confirmed that there have been no changes in basic financial circumstances.

Ultimately, as we have explained, the main barriers to good quality, objective advice are economic not regulatory – consumers can't afford to save, can't afford to pay for advice, and the industry is just not efficient enough to extend access to under-served consumers.

Financial policymakers and regulators can't do much about the fact that many households are on low incomes and can't afford to save. But, they can tackle supply side inefficiencies and reduce the unit costs of distribution. This would reduce the price consumers pay for products and make products more affordable for hitherto under-served consumers. But, even with major efficiency gains, large numbers of consumers will always be commercially unviable for for-profit financial services firms. Alternative solutions are needed for this group. We support the creation of a National Financial Advice Network to provide advice, guidance, and information to consumers who are not commercially viable for the for-profit financial services industry[3]. This must involve some form of cross-subsidy either from the public purse or from the industry.

Conclusion

We will return to alternative solutions in more detail at a later stage. But we thought it was important first to deal with some of the false arguments about the so called 'advice gap' and explain the real reasons why lower-medium income consumers cannot access to good quality, objective financial advice.

The barriers to advice are primarily economic, not regulatory. We must take great care not to reduce regulatory protection in a misguided attempt to encourage the provision of advice to consumers who are currently not commercially viable for or under-served by the financial services industry.

In our view, the industry would still not be interested in serving lower-medium income consumers. Instead, the industry would continue to serve medium-higher income consumers but with weaker constraints on its behaviours. The overall effect would be to just transfer the risk of misselling to consumers which will undermine confidence and trust in financial services. This would produce illusory efficiency gains, be counterproductive as it would affect confidence and trust in financial services and the advice process and, ultimately, be a false economy.

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[3] This idea was originally proposed by Which? in 2002 http://www.staticwhich.co.uk/documents/pdf/a-national-financial-advice-network-which-response-181710.pdf