TREAD LIGHTLY BUT CARRY A BIG STICK

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SUBMISSION

1. BACKGROUND

For 13 years from 1993 I acted as a voluntary director of the CAI, co-opted to its board to advance financial consumer protection at a time of self-regulation (under the aegis of the DETE) and with no statutory consumer rights to disclosure. This only came about after the IIF Remuneration Agreement was declared offensive under Competition law in 1998 two years after I'd lodged a detailed objection to it. Later I acted on the NCA. This point is made not as a history lesson but to frame the input that follows. Over this period, I'd also managed a financial advisory firm which has been based on **not** taking upfront sales commission which I believe acts as a pernicious influence in the marketplace.

1.1 Over the past 20 years we have been arranging investment in UCITS products i.e. open-ended investment companies (SICAVs) at the Luxembourg financial services centre receiving in an open and transparent way on our Terms of Business a rebate of the fund management fee at a level of 0.5% per annum. Entry points are as low as €5,000 so available to all. We have never advised a client to cash out but we have frequently advised to ride out cycles and to undertake free internal fund switches. UCITS provided financial consumers with superior transparency, disclosure and data when compared to retail financial products produced by domestic life insurance industry. It means fund charges of 1% p.a. for bonds and between 1.25% and 1.5% p.a. for mixed funds and equity funds and includes TER data (now OFC) as a matter of routine.

1.2 This meant audited financial accounts, custodians ring- fencing securities from asset manager balance sheets, clear charges and data represented at international standards which included the performance data in a calendar year basis, volatility data, Sharpe ratio, alpha, beta, and clear statements of information. It is against this background that this paper is produced.

2. AVOIDING AN ADVICE GAP TRAP

Care must be taken not to throw the baby out with the bath water, designing idealised regulations that have the **unintended effect of alienating the weakest consumers** from advice and service and hurting Irelands requirement to repair private financial strength and bridge the long-term savings gap especially. Auto-enrolment, just around the corner stands no chance of being delivered on the ground if there is a migration of advice out of the marketplace. This paper proposes a **precision intervention** to eliminate "**bad**" commission but keep the good parts.

2.1 The distribution of financial investments in the Irish market is overwhelmingly still conducted on the basis of the commission system, this is just a statement of fact. Over the past 20 years in providing financial consumers with a choice between paying fees or paying through a share of the annual fund management charge in retail share classes, I have only experienced small number of instances where consumers choose to pay fees. This is reflective of the market in general.

2.2 There is an expectation from financial consumers that financial investments will outperform the **Risk-Free Rate of Return,** in short get a higher return over the medium and long-term compared to keeping their money in a bank and thus consumers are prepared to remunerate on the basis of the expected excess over the risk-free rate of return. This is a different mental equation to writing a cheque from existing capital or income. This cultural attitude needs to be recognised in any change in the remuneration system.

3. WHAT DOES THE FINANCIAL CONSUMER WANT?

Any thoughts on this ought to begin by grasping that there is still a huge **education** gap. So long as investment and financial planning does **not** feature in the education system, few consumers will be financially fluent enough to navigate economics and investments, picking products with confidence. Consumers, I believe want transparency, good data to help make informed choices and good service in what most believe is an unfathomable labyrinth of jargon, complexity and a blizzard of documentation. What they ought to expect of regulation is that it minimises harm to them whether from excessive costs, poor advice or fraud.

3.1 Disclosures in a manner that consumers can grasp helps drive competition and process innovation as players attempt to win consumers from competitors, but such a perfect outcome is hindered by a pernicious sales commission system, exposing instead the consumer to **churning,** which I observed, to be a conspiracy between Life Offices and Financial Brokers who've adopted arcane and opaque constructions that include special unit allocations, overrides for volume, back end loads and even commissions on credit, all designed with one purpose in mind, to distract consumers from the effect of upfront sales commission in particular.

3.2 This has worsened in recent years to taking upfront commissions and loading on to Annual Management Charges, including Life Offices rebating part of their fees. The issue here isn't just the quantum but its opaque nature but the single biggest issue is upfront commissions that incentivise churning and actively discourages ongoing tactical advice. Had there been no upfront commissions and in an environment of transparency there would be little churning because intermediaries would be incentivised to maintain investment products long term and utilise free switches to up-risk or de-risk as required.

4. MOVING CAREFULLY

A number of principles, I believe recommend themselves in introducing change to market remuneration structures;

4.1 No Regulatory Arbitrage

There is no difference between assets wrapped in a life and pensions unit linked policy, and investment products. The only difference is the bookkeeping, transparency and quality of data. Both types of products are available to financial intermediaries for distribution in the Republic of Ireland however the

overwhelming emphasis amongst intermediaries is on life (and pension) product wrappers -why? The answer is in **what the consumer doesn't see.**

It is vital that, what is sauce for the goose is sauce for the gander, that the disclosure requirements for investment products (MiFID II) should match those of life insurance and pension products (IDD and PRIPS). There should be no difference.

4.2 Upfront Commission Concealment

There is already regulatory arbitrage in favour of life insurance wrappers in particular. This is because of the pernicious **upfront** but **concealed** commissions system. Upfront commission is concealed in various devices including special unit allocations, backend load structures, volume overrides and special deals. What is toxic about these 'deals' is that they are **cross subsidised by existing customers** as life offices divert resources to pump up sales volumes usually hovered from competitors and rarely, during the austerity years, originating from new wealth creation. It is quite clear especially during the austerity years that the vast bulk of sales recorded by life companies was the same capital recycled by the financial broker marketplace to generate upfront sales commissions.

4.3 Resisting the "Life" Lobby

It would be an abdication of responsibility to financial consumers that this opportunity is not taken to create equivalent transparency as between investment and life products. In the event of softer Life Insurance regulation, because of the strength of the domestic life industry lobby, (mirrored throughout Europe), consumers would find themselves in a flow to life wrappers, thus defeating the spirit of the European directives.

5. PRECISION REQUIRED

The target is the pernicious upfront commissions system in the life insurance industry in the retail financial consumer space. Here is why; **the best advice is often to do nothing**, to stick with good financial assets through thick and thin even in the teeth of drawdowns in asset values. The upfront sales commission model however is harmful to this basic principle of good advice. Financial brokers are incentivised and encouraged to churn investments between life offices, a practice clearly detrimental to financial consumers.

Studies have shown that attempting to trade the investment cycle adds and not decreases overall risks and produces poorer outcomes for financial consumers, compared to buying good financial assets and holding them through thick and thin. In the universe of financial investments, rarely can a product provider come up with a unique product offering which provides for sufficient motivation to sell one retail life product and incur the cost of buying another, but this has been endemic to the operation of the life insurance industry.

Sales commission paid to sell a product, positions the intermediary as the agent of the product provider and not the agent of the financial consumer.

Research by the Regulator of **free switching** activity within the life fund ranges would be revealing if compared to churning activity as would research on the persistency of blocks of business presented by financial intermediaries. This is worthy of further examination by the Regulator in identifying serial churning vs real advice (switching).

6. FLAT CHARGING STRUCTURES

A ban on upfront sales commission in favour of products that do **not** have upfront charges or exit charges would go a long way towards cleaning up the market. This would mean products would have a **single unit price** or **net asset value**, and have a **flat annual charging structure** which can be further broken down as between **asset management, custodianship, administration and advice**. This can be presented as percentages or percentages and monetary amount both in upfront, and ongoing reporting.

6.1 Full Look-Through Costs

Any new structure must require life offices in particular to show full look through costs i.e. Ongoing Fund Charges (OFC) which have the benefit of creating a level playing field so that financial consumers can measure the total cost of different products and different distribution channels and see the different bits that make up the total OFC.

6.2 Adding Value

Financial intermediaries ought to be in a position to demonstrate **qualitative enhancement** by advising at balance sheet level, a client's overall asset allocation, selecting financial products and funds to fulfil the overall strategy and rebalancing where necessary to take account of substantial shifts in economic trend or because overall asset allocation needs to be changed, e.g. de-risking on retirement. This is the bread and butter of financial advice to consumers.

6.3 Zero Loads

No amount of financial regulation can make up for the gulf in financial fluency and knowledge in the education system creating an imbalance in power as between financial consumers and financial intermediaries and product providers. This gulf cannot be bridged by providing further waves of documentation and in my opinion a movement towards zero front-end loaded and zero back-end loaded products would provide a reasonable chance for financial investments to compete on the basis of service quality, performance and price to consumers.

6.4 Passive Funds

While players such as Vanguard and other pure index-linked ETFs would prefer to see their market share gained by an increase in knowledgeable and financially fluent consumers capable of making informed asset allocation timing and bypassing the intermediation of the industry by going directly to them, the truth is somewhat different. Most business which index tracking ETFs receive do not come directly, but come through platforms and other advisory processes which have to be paid for one way or the other.

6.5 Structured Products

These are not fund based and require special disclosure attention not just to deal with remuneration but to deal with counterparty risk and suitability as common or garden variety retail products that are generally illiquid and complex. In terms of disclosure these could be tackled as suggested later in S.8 like BES or EIIS where fees are added to the investment or deducted from capital, signed off by the consumer.

7. INDEPENDENT ADVICE

Independent advice is a bit like the Holy Trinity, we are told it is there but nobody has ever proved it exists. There is always bias and there are as many funds today as there are quoted securities. Until AI arrives in force, restricted advice, advice with boundaries is easier for consumers to grasp.

7.1 It comes as no surprise that firms throughout Europe will be opting for Non-Independent status hoping to pass the test of qualitative enhancement which ought to be clarified after careful thought by financial Regulators. This is because the overwhelming choice for consumers so far has been to pay for the services of the financial service industry through commissions except for the very small minority in Ireland that engage on a pure fee only basis. These are typically at the family office level in my experience but even then, commissions are paid in the form of the percentage of portfolio management services, in investing in property, etc.

7.2 In an idealised world all financial consumers would write cheques to intermediaries for financial advice and financial intermediaries would act openly as the agent of the client consequently, but the overwhelming volume of financial consumers in Ireland do not pay fees and regardless of what might be put on surveys, they will not do so when faced with a cheque book and pen.

7.3 Neither is the fee – charging system without its own problems. Excessive fee charging is endemic to certain professions and at certain vulnerable times like in divorce proceedings by legal firms and accountancy firms alike. Fee gouging is as pernicious as Commission gouging. At the end of the day the service has to be paid for whether by fees or by commissions including rebated fund management charges, the question is how consumers are provided with the choice in a manner which he or she can understand and choose.

8. Zero Load Phase In

Zero front and back loaded products would cause disruption in the marketplace and how a phase-in works, would need careful consideration by the Regulator. There is nothing to prevent a financial intermediary from charging a separate fee to a consumer for advice and this fee can be expressed as a percentage of the investment to be made on the product but collected by the intermediary on the instruction of the financial consumer as a deduction from the investment on the way in the door or added as in BES and EIIS schemes.

8.1 This is different to the existing system since it is an explicit deduction from the investment, and not hidden in the deliberately arcane structures of enhanced unit allocations back-end load etc. Such a disclosure would require the consumer to sign off that he or she clearly is instructing the product provider to deduct X % or a monetary amount from the investment going in the door or to add it the investment.

8.2 The advent of zero load products as the only allowable product in the Irish market would have a dramatic impact on improving the relationship between financial intermediaries and financial consumers. So long as the existing commission system remains in place intermediaries are acting as the agent of the product provider, (notably for four large domestic life offices). Zero loaded products would also encourage a greater penetration amongst financial consumers of **UCITS products**, the entry point for which can be as low as a couple of thousand euros. The reason why UCITS products have not penetrated the market is because of their higher disclosure and transparency. Instead domestic life companies have accessed international asset managers through their wrappers, adding an unnecessary intermediation cost and opaqueness between Irish financial consumers and choices that are routinely available throughout the EU from financial services centres.

8.3 Trading platforms now compete against Life wrappers but it is an uneven playing pitch where one is transparent on total, look-through costs, the other transparent just to policy level.

9. Protection Products

Pure protection products which do not have an investment account of any kind should be exempt. This is to ensure that financial consumers continue to be market life insurance cover, serious illness and permanent health insurance much as they would general insurance. These products compete against one another on a price and quality basis and under the Consumer Protection Code financial intermediaries are already required to ensure that the financial consumer gets the best value for money.

Unlike investment products, protection products can be replaced periodically if the financial intermediary is in a position to get equivalent or superior cover for a consumer at a cheaper price. This encourages competition in the market between product providers.

10. INFORMATION BLIZZARD – IS MORE STUFF WORKING?

It is arguable (but can be validated through research) that **the advisory gap has already started**. This is because of the advent of compliance costs and associated information blizzard which will now increase as new Directives come into force. Financial firms every day are making decisions about whether or not to take on a new client, whether engaging with a potential new client will in reality lead to losses because of the costs associated with formal "**Know Your Client**" compliance before assessing an advisory engagement. Make no mistake, financial consumers are being shown the door, politely by disengagement. This is not the intention but it is a by-product of regulation, not only are costs passed through but low-income earners and those with weakest balance sheets are being left marooned. In terms of stuff, consider for example what a financial consumer receives today;

- A fact find/balance sheet or Statement of Affairs to complete
- A Risk Tolerance Questionnaire to run through and sign off.
- Several Key Investor Information Documents (KIIDS) each relating to the funds suggested by financial intermediary.
- Fact Sheets about each fund.
- Terms of Business.
- Application forms.
- AML documents.
- Bank credit transfer instructions.
- Customised report, (a.k.a. "reasons why" letter).
- FAQs.
- Follow-up communications.
- PowerPoint presentations.
- Economic analysis and commentary.

10.1 There is a blizzard of documentation presented to financial consumers, accelerated by the switch from physical post to electronic communications. These are overwhelming consumers, there is already way too much 'stuff'. More importantly, the arrival of large bodies of fresh compliance in the Credit Directive, Insurance Mediation Directive, PRIPS, MiFiD II and GDPR all arriving during the one window is overwhelming financial intermediaries and consumers creating a greater amount of paperwork.

10.2 A Regulator in my opinion ideally ought to learn what it is like to be a financial consumer, not just by mystery shopping to find holes in the marketplace, but to internally set up both a dummy financial intermediary firm, and a dummy financial consumer, with the task of regularly feeding back to the Regulator what is working and what is not in effective financial data for consumers.

11. WHY "RIY" IS NONSENSE

Sometimes things take legs, carry on over from past regimes without anyone asking if it makes any sense. This happened when the UK standard illustration for Endowment Mortgages carried into the Irish market. It was a bogus comparison as between annuity and endowment methods. RIY is the same. This presupposes the existence of

a service that doesn't exist much like a Supermarket without walls, shelves, staff, heating, lighting, security and car parking doesn't exit. Let's call the retail chain **Lidless.**

11.1 In comparing financial products, one should compare against each other and not some myth instead comparing against the likely premium over the risk-free rate of return. Media analysis and some poorly thought through regulations dealing with RIY compare the drag effect of charges with **Lidless financial products.** This is the financial firm that has no walls, no staff, no computers, no administration, no custodianship, no advice and no asset management.

11.2 If you are comparing the cost of legal advice in prosecuting an action for compensation for losses you would compare the service and value of various firms, also taking account of the price to be paid. You would not compare the price against the price of engaging with a legal firm that does not exist, one which will take the case at absolutely no cost to you.

11.3 What is important for the financial consumer is to understand the value for money against equivalent service within the financial area. It is illogical to use a method of comparison which compares shopping on the basis of picking up goods in an empty car park that doesn't exist in nature but this is how RIY is presented. Advice, Asset Management, Admin, Custodianship, Travel, Meetings and Compliance has a cost, and it all adds up.

11.4 What is required is that there is the highest level of competition possible as between firms for process innovation to drive down costs and that these are passed through to consumers in the normal process of the market through competition. What is deeply wrong is presenting to financial consumers, comparisons which present celestial products not available in earthbound distribution channels. It is meaningless.

11.5 Financial consumers are best served by a comparison which takes what they are paying for their products measured against the bargain operators in their part of the financial services industry.

Where costs are to be presented to consumers then total costs should be presented and not just part of the costs which means breaking down as between asset management, custodianship, administration, financial advice and any other ancillary charges such as deductions for associated insurances.

11.6 Financial consumers could give an indication of likely range of premium return in the medium and long-term over the risk-free rate of return and how much the totality of charges impacts that margin. This is valid data. RIY has about as much validity as comparing the cost of the Central Bank of Ireland against having no regulation at all, zero, not a sausage instead of comparing it against peers across the EU.

12. ANNUAL REVIEW

Care needs to be taken in an application of annual reviews which would be too rigid and does not reflect how consumers in the market operate.

Firstly, many financial consumers are not responsive to or happy with electronic communications. This is not just an age matter, it is a privacy matter, despite encryption. Secondly there is an assumption that annual meetings are universally possible. This is not the case. Not all financial consumers engage or want to engage on an annual basis unless they believe it has a benefit for them. Therefore, any regulation needs to allow for non-engagement by the consumer. It should be sufficient for financial intermediaries to write letters, send emails, make telephone calls and send out reminders, in other words, make best efforts to undertake reviews.

12.1 Reviews themselves are not a panacea. Many financial consumers operate through multiple channels, directly to product providers like banks as well as through various financial intermediaries. It is only when a financial intermediary has an exclusive financial advisor who has knowledge of their overall financial position i.e. their balance sheet, risk tolerance etc is there an effective review since it contains a holistic view, otherwise it is just more blizzard.

Annual suitability reviews that cannot take account of the fit into the overall position for a financial consumer are of limited value. Compulsory annual reviews will create mountains of additional paperwork and electronic communications going to consumers' inbox who will dump them as they do the voluminous reams that arrive by post from banks and pension offices on foot of regulations.

CONCLUSION

In conclusion, the overwhelming distribution of financial products in the Irish market operates on a commission system. Aspects of this commission system are pernicious and damaging to consumers. This is what needs to be targeted.

A ban of the commission system itself including applying it to legacy products would have an immediate and very detrimental effect on financial consumers and create an advice gap.

There must be the same sauce for the goose as for the gander, no regulatory arbitrage, that means equivalent disclosures whether assets are recorded in unit-linked policies or by shares in UCITS.

New regulations ought to instead ban the sale of products that have front-end or back-end loads. All products should move towards a flat charging structure and which will allow proper inter-comparisons to take place between product types. Upfront fees can be deducted from capital invested but at Single Unit Pricing or NAV.

Charges can be broken down into the constituent parts as between asset management, custodianship, administration and financial advice.

A phase-in period needs to be designed so that existing remuneration systems are eased out without triggering an advice gap.

Credit products and protection products do not require the same regulatory attention but credit products in particular need other types of regulation to ensure that the market does not overheat.

Choices as between paying fees or paying through flat fund charges is the way to go. Targeting the pernicious aspects of the commission system will vastly improve the market for financial advice, position financial intermediaries as agents of the consumer and not the product provider and enhance the forces of competition in the marketplace leading to a more efficient and orderly market for financial services.

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