FSB releases Retail Distribution Review paper for comment

The Financial Services Board (FSB) today releases a discussion paper outlining the results of its Retail Distribution Review (RDR). The paper proposes a number of far-reaching reforms to the regulatory framework for distributing retail financial products to customers in South Africa.

The review was undertaken in response to concerns that despite comprehensive regulatory requirements dealing with financial advice and distribution, poor customer outcomes and mis-selling persist. The review outlines a more proactive and interventionist regulatory approach to addressing these risks. It proposes the introduction of a set of structural interventions designed to change incentives, relationships and business models in the market in a way that supports the consistent delivery of fair outcomes to customers.

The RDR proposals seek to give customers confidence in the retail financial services market and trust that product suppliers and advisers will treat them fairly. This in turn will support a more sustainable market for financial advice and financial services over the longer term.

Desired outcomes of the RDR are distribution models that:

- Support the delivery of suitable products and provide fair access to suitable advice for financial customers
- Enable customers to understand and compare the nature, value and cost of advice and other services intermediaries provide
- Enhance standards of professionalism in financial advice and intermediary services to build consumer confidence and trust
- Enable customers and distributors to benefit from fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of the service, and
- Support sustainable business models for financial advice that enable adviser businesses to viably deliver fair customer outcomes over the long term.

A total of 55 specific proposals is put forward for discussion and comment. The proposals cover:

- Types of services provided by intermediaries
- Relationships between product suppliers and intermediaries
- Intermediary remuneration

The proposals on intermediary remuneration are shaped by certain key principles, including:

- Intermediary remuneration should not contribute to conflicts of interest that may undermine suitable product advice and fair outcomes for customers
- All remuneration must be reasonable and commensurate with the actual services rendered
- Remuneration structures should strike a balance between supporting ongoing service and adequately compensating intermediaries for up-front advice and intermediary services
- Ongoing fees and/or commission may only be paid if ongoing advice and services are indeed rendered

- All fees paid by customers must be motivated, disclosed and explicitly agreed to by the customer

The application of these principles to different types of products will mean that:

- The payment of commission by product suppliers to intermediaries will be banned in respect of investment products. This will be replaced by an advice fee that must be explicitly agreed up-front with the customer.
- Commission for selling and servicing life risk policies will comprise a mix of up-front commission and as-and-when service fees. 50% of the remuneration payable by long-term insurers in respect of life risk policies may be paid up-front as a sales commission, with the remaining 50% be payable on an as-and-when basis to provide for on-going servicing and maintenance of the risk policy. Further technical work and consultation will be undertaken to determine what the new maximum commission and service fee levels should be.
- Product supplier commission will be prohibited on replacement life risk policies, to address conflicts of interest and mis-selling risks.
- Additional consultation and technical work will be undertaken to determine an appropriate remuneration dispensation for product suppliers and intermediaries serving low-income customers, in respect of life insurance risk products and investment products, so as to support access to financial advice, linked to products that meet certain standards of simplicity and value.
- The as-and-when remuneration model for short-term insurance will be retained. The current provision allowing for additional fees over and above commission (through section 8(5) of the Short-term Insurance Act) will be replaced by an advice fee that must be explicitly agreed with the customer up-front.
- Investment platform administration services (LISPs) will only be permitted to be remunerated by means of a platform administration fee disclosed, agreed to, and paid for by the customer. Payments from product suppliers to LISPs, including any rebates, will be prohibited.
- A general standard will be set to confirm that no financial interests of any kind may be provided by product suppliers to intermediaries unless specifically provided for in the regulatory framework.

The changes will also support the development of more competitive markets and the development of more transparent and fair products, including reduced penalty charges on contractual savings products like retirement annuities and endowment policies.

Implications for the regulatory framework

The proposals outlined in the RDR paper will entail structural changes to intermediary relationships and remuneration and will require extensive amendments to the regulatory framework. These changes will form part of a broader review of the legislative architecture necessary to give effect to a Twin Peaks regulatory model. The changes will be implemented in a phased manner. Some changes will be carried out within the current regulatory framework, while other changes will be implemented as the Twin Peaks legislative framework evolves. Based on current expectations of the legislative and regulatory timetable outlined above, it is not expected that the implementation date will be before mid-2016.

Way forward

These RDR proposals seek give consumers confidence in the retail financial services market and trust that product suppliers and advisers will treat them fairly. They aim to place financial customers in a position to understand more clearly what kind of advice or services they are getting, how much it will cost and how it will be paid for and to provide them with confidence that their adviser is sufficiently qualified to provide suitable advice and is acting in their best interests.

In addition to increased consumer trust and improved customer outcomes, the measures aim to -

- Clarify the types of advice available and empower customers to choose the model best suited to their needs
- Clarify the circumstances in which no-advice or 'low advice' distribution models are appropriate and the consumer protection measures required in such models
- Better align the interests of advisers with their customers by reducing a number of key remuneration based conflicts of interest that can lead to sub-optimal financial advice – including by limiting the extent to which advisers may be remunerated for extraneous services to product suppliers
- Ensure that product aggregation and comparison services and investment platform providers provide unbiased objective support to financial decision-making and transacting
- Enable consumers to better understand the status of advice services, including the level of independence of the advice provided from product supplier influence, including through reducing the scope for conflicts of interest in complex distribution models which disguise the true status of advice
- Strike a fairer balance between the responsibilities of product suppliers and advisers in relation to the delivery of fair customer outcomes
- Provide transparency for consumers in relation to adviser charging. Adviser charging will be clear, product neutral, and directly related to the services provided
- Facilitate customers paying for advice using flexible payment arrangements, such as the deduction of adviser charges from a customer's investments over time – subject to clear disclosure of the impact of such charges on benefit expectations
- Reduce the impact of adviser remuneration on reasonable benefit expectations, particularly through eliminating the justification for penal early termination charges and inappropriate product replacements
- Remove inappropriate incentives toward tied advice models
- Support the efforts of those in the industry who have already adopted business models consistent with the RDR objectives, including by reducing the risk of 'early adopter' disadvantages
- Support affordability and access to financial advice, particularly for low income consumers;
- Build on the professionalism of the industry already achieved through FAIS, by including enhanced competency and conduct standards
- Provide an opportunity for industry to develop more efficient advice delivery models.

The RDR paper is open for comment until 2 March 2015.

The FSB also intends to set up stakeholder feedback workshops on the RDR before the comment period closes. Dates and venues for these workshops will be communicated in due course.

Once the comment period has closed, key stakeholders will be invited to participate in specific consultation structures that will be put in place to develop final legislative and regulatory changes.

Notes to editor:

The review has been undertaken against the background of a new approach to regulating market conduct in the financial sector. Under a "Twin Peaks" approach, that will separate prudential and market conduct regulation of the sector, market conduct regulation and supervision is informed by the *Treating Customers Fairly* (TCF) framework.

The TCF approach focuses on the extent to which regulated financial institutions deliver fair outcomes for financial customers and entails a more proactive and interventionist approach by regulators and policymakers to dealing with market failures. The RDR is a prominent example of this new approach.

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