NEWS

RDR - Nasty and Unintended Consequences

Featured

- • Written by Magnus Heystek

The threat facing financial advisory, and lessons from the UK's mistakes.

The local financial services industry is bracing itself for some more mind-numbing regulations over the next few years - following on a raft of similar regulations in the United Kingdom (the regulatory model we seem to be copying). As such, it would it be worthwhile for all involved to carefully and soberly observe what's happened in the UK over the last year or so.

On January 1 2013, new rules came into force in the UK that require any firm selling regulated retail investment products - such as banks and financial advisors - to charge an upfront fee for advice, or take their charge from a customers' investments.

For years many UK commentators warned that the onerous new rules and prohibitions contained in the Retail Distribution Review (RDR) would have some very nasty and unintended consequences. And that's precisely what has happened.

That is why our regulators need to take a step back before they rush on headlong, urged on by an ill-informed and emotional press corps in some instances, to impose even more bone-crushing regulations and rules on the already beleaguered financial advisory industry.

UK consequences

Previously, UK banks and most advisors were paid commission built into financial products which covered the cost of advice. This raised concerns that unsuitable products with high commission levels were being sold to unwitting customers, who in many cases were unaware their bank or advisor was taking a payment.

Many UK banks and building societies including Barclays, Santander, HSBC and Lloyds have since stopped offering advice, or only offer it to the highest earners, saying it is no longer profitable to service all customers.

Barclays now has a minimum investment level of £50 000 before it will attempt to offer any kind of financial advice.

As a result the number of bank advisors fell 44% this year to 4 800 and the number of independent financial advisors fell 20% to around 20 000. Most claimed, as reported in *The Telegraph* (September 12), that customers were unwilling or unable to pay fees for financial advice.

The website http://www.unbiased.co.uk, a service that links consumers to a range of professional advisors, has found that an initial meeting and financial review now costs a minimum of £500 while investing £50 000 will cost around £1 500. (Previously the fees were built into the price of the investment, either an upfront fee (as a percentage) or on an ongoing basis, once again as a percentage.)

These developments have now become a political issue as lower-income earners and investors with smaller amounts to invest have been priced out of the market and are essentially left to their own devices.

Mark Garnier, Conservative MP for Wyre Forest, is now pushing for the influential Treasury Select Committee, of which he is a member, to review whether the reforms have damaged people’s ability to access affordable financial advice.

Garnier has long been critical of the UK Treasury’s headlong rush into regulatory reforms and in 2011 called for them to be delayed but he was rebuffed by the regulators.

Last October, Garnier accused the regular of making a “pig’s ear” of the reforms. Earlier this month he was quoted in the trade magazine Money Marketing as saying: “This is something I personally feel very strongly about. My benchmark is can the savers who are putting away £50 to £100 per month get access to good independent advice? If the RDR has resulted in people being denied access (to such advice) then clearly the RDR has failed”.

Back home

Local regulators have not clearly stated that they will follow the RDR route in SA, although many have commented that Old Mutual’s recent announcement that it will be not be taking commission in future, is a clear sign about what the industry is expecting coming down the track.

One fiercely outspoken critic of RDR as well as the concept of Treating Customers Fairly (TCF) is highly regarded professor of finance and insurance at the University of Witwatersrand, Robert Vivian.

Writing in the (hardcopy) latest edition of FANews he has the following to say: “The UK introduced TCF and now SA is going to introduce TCF. The UK carried out the RDR ending with the daft idea that commissions should be banned. Now SA is going to carry out a RDR and one can already predict the outcome.

“The daft idea will be that commissions should be banned. SA regulators should at least try and have one original idea and stop following failed regulatory ideas of the UK”.

It is to be hoped that our regulators and the proponents of the scrapping of commissions should at least take the time to read Prof Vivian's lengthy and carefully argued article on this issue. He believes commissions should not be banned.

Micro-lending - A consequence for SA?

Certain members of the SA financial press have long been campaigning for a scrapping of commissions on particularly investment products and also possibly on life insurance products. The arguments normally put forward are emotional and idealistic but do not take into consideration the practical realities on the ground in SA.

If SA were to copy the RDR along the lines of the UK model, then it would have all kinds of unintended consequences, exacerbating an already deeply worrying trend in SA.

As a consequence of certain quirks in the National Credit Act of 2007, whereby creditors could obtain garnishee orders against the employer of debtors, we've seen a massive explosion in the extension of unsecured loans, thereby putting millions of people into debt, from which most will probably not escape.

What a great business to be in: you raise capital at say 8% interest and extend loans where interest, plus admin and insurance charges push up the total cost of the loan to around 60% per annum. If your client doesn't pay, you get a court order forcing his/her employer to deduct money from his or her salary.

At those kinds of margins you can afford a higher than normal bad debt factor and still make a fortune. That's a massive incentive.

As an aside: the unsecured lending business in SA leaves a very distinct and sulphurous taste in my mouth. Hard as the industry tries to put lipstick onto this pig, you know and they know that the ignorance of a largely uneducated people is being exploited. Do not tell me that the average person applying for an unsecured loan has any idea of what they are signing for.

These massive incentives have seen the micro-lending industry in SA explode. Travel through any small dorpie in our country and you will be confronted by a battery of micro-lenders at virtually every street corner.

In the old SA those premises would have been occupied by the Sanlam's and Old Mutual's of the world. There was an incentive to set up shop and run a financial advisory business. The banning of commissions will further reduce those incentives.

Many financial advisors, especially in the lower and middle-end of the market will become micro-lenders.

Make no mistake there were serious malpractices in the local investment industry as far as commissions were concerned. Some examples include extending a ten- year investment to 30 years, taking multiple loans out of one endowment in order to create more commissions or using gearing to create a higher level of commission.
Most if not all of these malpractices have disappeared as a result of better market conduct by the insurance companies as well the stricter regulations imposed by the Financial Advice and Intermediary Act of 2004.

Most large and successful financial advisory practices have long ago abandoned commission-based investment businesses (or never used them in many cases).

It is the young upstart companies, mostly black, servicing the upcoming market that will feel the brunt of the proposed changes in regulations.

As it is the local investment advisory industry is most probably the least-transformed industry in South Africa today. Go to any investment conference and all you will see is a sea of greying white males, with an average age deep in the 50s, with very few black and coloured faces in the audience.

Most advisory firms will continue to survive and even prosper should RDR be introduced in SA. On the other hand, many under-capitalised or start-out financial advisory firms will flounder and close their doors. Obtaining financial advice in the future could be like getting legal advice or decent medical treatment today: only for the rich.

Magnus Heystek is a director at the investment advisory firm Brenthurst Wealth.