

2.2. Theme 2: Investments

This theme focusses on those RDR proposals impacting on the distribution of investment and savings products, including those offered through long-term insurance policies – whether structured as lump sum investments, recurring contribution products, or income generating annuity products⁹. This includes proposals relating to adviser remuneration in relation to these products, proposals relating to investment platform administration and remuneration, and proposals relating to outsourcing of investment management to advisers. The theme also covers proposals relating to improving customer outcomes on certain “legacy” insurance investment products and related remuneration practices.

2.2.1. Key stakeholder feedback and initial responses for Theme 2

(a) Investment platforms:

Where investment platform administration is concerned, commentators suggested that the scope of the activity concerned be more clearly defined. Suggestions were made that frameworks for different types of administration activities over and above the activities of administrative FSPs (LISPs) as defined in FAIS – for example certain pension fund administration and insurance administration models – should be better aligned. The FSB agrees that it would be helpful to ensure consistency of general standards for administration services, but points out that the “bulking” activities of administrative FSPs require specific focus.

It was also highlighted that clarity is needed regarding the distinction between system-based tools that generate possible investment options for customers, and the actual provision of advice. The FSB agrees and will consider this as part of our work on developing standards for non-advice execution only sales and so-called “low advice” distribution models (see the discussion of Theme 5 later in this document).

There was general support for the proposal that investment platform administration services should be remunerated only through a platform administration fee that is

⁹ The FSB has noted that some stakeholders see the term “investments” as referring only to lump sum / single contribution products, while “savings” refers to recurring or regular contribution products. We confirm that the term “investment” as used in the RDR and (unless clear from the context or specifically stated otherwise) in this update document includes both types of product.

disclosed, agreed to and paid for by the customer, with rebates and other payments from product suppliers or investment managers to LISPs being prohibited – in other words, a shift to a “clean pricing” model (Proposal YY). One commentator however felt that platform fees should be carried by the “seller” of the investment offerings (i.e. the funds whose offerings are placed on the platform) as opposed to the “buyer” (customer). Some views were expressed that, provided rebates are passed on to customers (as currently required by FAIS), they are in fact beneficial to customers. Although the FSB agrees that such rebate structures may not have a direct detrimental financial impact on customers, we remain of the opinion that a “clean pricing” approach will improve customer understanding and that greater transparency and comparability of charges in a “clean pricing” model will promote more competitive pricing.

Some concerns were raised that it is not feasible for a LISP to offer all available funds on its platform. The FSB takes this opportunity to point out that we did not suggest this in the original RDR discussion document. Instead, the RDR proposed that featuring specific funds more prominently than others on the platform menu should be prohibited – in other words, those funds that are offered on the platform should enjoy equal prominence¹⁰.

(b) Outsourcing investment management to financial advisers:

The proposed prohibition¹¹ on a collective investment scheme manager outsourcing investment management to “authorised agents” (as defined in the Collective Investment Schemes Control Act) or intermediaries that are also financial advisers, attracted extensive comment. A number of commentators argued that this effective abolition of so-called “white label” funds would have negative consequences for both advisers and customers. Arguments in favour of retaining “white labeling” included the fact that this model facilitates market entry for potential new investment managers (as a form of “incubator”) and also that this is a mechanism for offering customers “model portfolios” through which they are able to access risk-profiled, customised investment options that pose a less bewildering choice than selecting from the full range of funds available on the market.

The FSB confirms that it is not the intention to disallow outsourced investment management for purposes of operating so-called “incubator” funds, as currently permitted. We do however remain very concerned that there is an inherent conflict of interest in

¹⁰ See RDR page 60.

¹¹ Included in Proposal Z.

allowing a financial adviser to recommend funds to a customer (and earn related advice fees) while also being remunerated by the investment manager concerned for outsourced investment management on those same funds. We are also concerned that, in a number of cases, the advisers in these models are not necessarily competent to carry out actual investment management services and are therefore potentially being rewarded for services without adding meaningful value to customer outcomes.

Some commentators pointed out however that an outright prohibition on advisers performing outsourced investment management was not consistent with the approach proposed in RDR for other outsourced administration services. For example, in the case of outsourced insurance administration, RDR recognises that such services may be carried out by financial advisers subject to specific controls. Others argued that there should be no objection to permitting such services to be outsourced to advisers on the understanding that this could mean classifying the adviser concerned as a "tied" adviser. The FSB agrees that these arguments warrant consideration.

Decisions on the final approach for Proposal Z, insofar as it relates to outsourcing of investment management to financial advisers, also needs to take into account the final adviser categorisation model. For example, the question whether a financial adviser should be permitted to provide such services on a "tied" basis and, if so, whether additional conflict of interest controls are required, needs debate. The question arises whether, in such outsourcing scenarios, the investment managers concerned should be regarded as equivalent to product suppliers for these purposes.

Related to this, the FSB has noted that a review of the role of "Category II" FAIS licensed intermediaries is required. Currently, the scope of this category is wide, including both fully fledged investment management firms, but also intermediaries whose main function is to provide FAIS "Category I" product advice but who also hold different forms of (sometimes very limited) discretionary mandates from customers. In many cases, fully fledged Category II investment management firms also hold Category I licences "in case" their activities could be construed as constituting advice. This gives rise to distribution models comprising potentially confusing "layers" of multiple Category I and Category II intermediaries, with increased risks of conflicts of interest and unwarranted layers of costs.

(c) Prohibition of product supplier remuneration on investment products:

Another key proposal under Theme 2 that attracted substantial comment was Proposal MM – the prohibition of product supplier remuneration for selling and servicing investment products, and the proposal that intermediary remuneration for such services be restricted solely to advice fees payable by the customer (but able to be facilitated by product suppliers). A number of commentators voiced strong support for this proposal – in particular insofar as it relates to lump sum investment products. Views regarding recurring contribution investment products (described by some as “savings” products) were mixed, with some arguing that recurring contribution products should be excluded from the proposal and remain eligible for product supplier commissions. Negative responses to the proposal centred mainly around two concerns: (i) That it would have a negative impact on adviser sustainability due to reduced cash flows and create a barrier to entry for new advisers; and (ii) That it would lead to an “advice gap” for lower and middle income consumers who were either unwilling to pay advice fees or where it would not be profitable for advisers to serve them in view of the relatively small investment amounts concerned. Commentators also correctly pointed out that the full impact of the proposal can only be assessed once there is greater clarity regarding Proposal TT – the proposed special remuneration dispensation for the low income market (see further the discussion of Theme 6 later in this document).

The FSB remains of the opinion that Proposal MM should apply to both lump sum and recurring contribution investments, subject to the low income market dispensation, in order to ensure a level remuneration playing field between products sold through long-term insurance policies – where commission has been the traditional form of remuneration – and other investment products. We do however propose that these changes be effected in a phased manner (see below).

Consultation with industry reference groups on the proposals under this theme will continue during the first half of 2016, with a focus on the feedback areas summarised above. The FSB recognises that full implementation of Proposal MM (the prohibition of product supplier commissions for advice on investment products) needs to coincide with implementation of Proposals TT (the low income market dispensation) and Proposals JJ, KK and LL (related to standards for advice fees).

2.2.2. Implementation phases for Theme 2

(a) Phase 1

The RDR Phase 1 Status Update provides details regarding implementation of Proposals PP and QQ, which address certain “legacy” practices in relation to investment products. These include resolving commission regulation anomalies in relation to variable premium increases on investment policies sold by long-term insurers, and conflicted remuneration on retirement annuity transfers.

Engagement with the long-term insurance industry in relation to broader measures to reduce termination charges on legacy policies will continue in Phase 1. Implementation of such measures will be phased in to appropriately align with the stepped decline in maximum termination charges that will apply to new investment policies (see below), with due regard to both the interests of existing customers and the potential financial impact on insurers.

(b) Phase 2

Implementation of proposals in relation to investment platform administration and related platform remuneration, will be addressed in this phase (Proposals G and YY).

Phase 2 will also include the prohibition of outsourcing of investment management functions to financial advisers, with possible exceptions where warranted and where potential conflicts can be acceptably mitigated.

Consideration will also be given to introducing a prohibition of product supplier commissions for lump sum investment products, including annuity products¹², during Phase 2. The FSB considers that the possible negative impacts of disallowing commissions – such as the cash flow impacts for advisers and the potential for an “advice gap” for certain customers – are less likely to materialise for these products than for recurring contribution savings products. We note in this regard that a considerable number of lump sum investments are being placed in collective investment scheme based products outside long-term insurance wrappers, and that advisers in these cases are therefore already typically remunerated through advice fees rather than commissions. Also, the dependency on implementation of Proposal TT (low income market dispensation) is lower in respect of lump sum investments as lump sum long-term insurance investment policies are not

¹² The FSB has however noted that prohibiting commission on conventional life annuities (if they are classified as investment products) may have unintended consequences. Ongoing advice fees will be difficult to justify, discouraging recommendation of these products. On the other hand, we need to avoid the risk of undue bias in favour of these products if they remain eligible for product supplier commissions. The position will be reconsidered to seek a level playing field between these alternatives.

common in this market segment¹³. Also, both new and existing advisers operating in the low income market are relatively less dependent on commissions for lump sum insurance investment sales as a source of cash flow.

Prohibiting commissions on lump sum investments will mean that standards in relation to advice fees and the requirement for product suppliers to facilitate advice fees (Proposals JJ, KK and LL) will also need to be implemented in Phase 2, in relation to lump sum investment products – recognising that lead times will be required for product suppliers to effect any necessary system changes¹⁴.

In addition, consideration will be given to reducing the maximum causal event charges for new recurring contribution policies sold during this phase, pending further reduction once commissions on such policies are fully prohibited in Phase 3. This is to ensure that the decision to defer the prohibition of recurring contribution policy commissions to Phase 3 does not unduly perpetuate the sales of new policies at current causal event charge levels.

(c) Phase 3

Extension of the prohibition of product supplier remuneration to recurring contribution investment products, will take place in Phase 3. Implementation will be aligned with implementation of the proposed special remuneration dispensation for the low income market. Further reduction in causal event charges will also need to coincide with the finalisation of the remuneration model for recurring contribution products.

¹³ Further consideration will however be given as to whether the low income market dispensation discussed in Theme 6 below should specifically accommodate small lump sum investments. The commission dispensation for lump sum tax free savings products will also require discussion.

¹⁴ We are however of the view that systems changes required to facilitate advice fees on lump sum investment products are likely to be less complex than for recurring contribution products.