

Advantage

RETAIL DISTRIBUTION REVIEW UPDATE
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 NAVIGANT

Welcome

Hola! and Welcome to the Autumn Edition of Navigant's Advantage Newsletter for those interested in the latest RDR discussion points.

This edition has the Wild West as its theme; firstly, we enter the realms of the Mexican Standoff; Jason Whyte reviews the best way to manage your own impending standoff between distributors, platforms and asset managers. Who will blink first?

The Good, the Bad and the Ugly are explored in Mark Lester's piece on Unit Rebates; why is the FSA keen on such rebates, while remaining averse to cash rebates?

Orphan Clients are big news as the Retail Distribution Review kicks in, with over 40 million accounts expected to be orphaned and offering opportunities for innovative Direct to Customer offerings.

We hope you enjoy this edition of Advantage. Please contact Kenn Taylor or Karen Bond for additional information related to this newsletter.



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The Mexican Standoff: the Future of Fund Pricing



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The Retail Distribution Review was meant to be like the cavalry in an old-school Western, riding over the hill to rescue customers from the evils of high fees and lack of transparency. But PSI 1/09 seems likely to usher in a scenario straight out of Sergio Leone: a Mexican Standoff between distributors, platforms and asset managers, a stalemate where it's in no-one's interest to act.

A Fistful of Dollars

There's no denying that the current model is opaque. Consumers typically pay the headline Annual Management Charge (AMC) for their funds, and the fund manager feeds some of this back to the adviser, the platform and (more rarely) the customer.

The FSA's proposals would ban cash rebates and make platform and advisor charges explicit; unit rebates directly into the customers' funds could continue. The idea is to increase transparency and incentivise funds and platforms to compete on price.

The increased transparency is a positive move. But price competition is much less likely.

For a Few Dollars More

The big advantage of the rebate model is that it makes it easier for fund managers to manage costs. Each headline AMC requires a different share class, and each share class adds fixed cost to a business model where revenue is wildly variable. Cash rebates allow fund managers to limit the number of share classes they need to run.

It's also rumoured to cover wide variations in rebates between platforms. However, the only surprise in Fidelity FundsNetwork's recently disclosed rebates was that they were disclosed at all, so it may be that rebates are much more ho-hum than everyone suspected.

Either way, fund managers have a disincentive to offer too many different prices. But there's worse to come.

Il Buono, Il Brutto & Il Cattivo

The FSA's proposals also place a big emphasis on best execution: advisers need to find the best price for their customers. And not just for new business: TCF is leading advisers to review existing holdings and rebroke if better terms are available.

Given that, consider the repercussions of a fund manager deciding to offer a lower AMC share class to a favoured platform. Advisers should be looking to push all their new business

that way, and rebroke existing holdings where the cost is justified. Other platforms would see business churning away, and would have little to lose by threatening to delist the fund unless they also get the best price. The fund manager itself is losing income from the back book churn. Even the adviser is having to do a lot more work for, at best, the same money.

It's a classic Mexican standoff. The market will quickly settle on a price it thinks it can bear, but there's little chance of genuine price competition in the post-RDR world.

If you want to learn more about how to best manage your own Mexican standoff, please contact at jason.whyte@navigant.com or on 0207 015 8750

Unit Rebates: Good, Bad or Just Plain Ugly?



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Among all the debates on transparency of charges following the Platform paper there remains one oddity in the direction set and that is the merits of unit rebates. We suspect investors are not interested in how the mechanics of charges work, merely that they are getting a fair deal but within the industry the practicalities of the post RDR solution are likely to be critical in achieving operational efficiency.

So why the aversion to cash rebates from the regulators and acceptance of unit rebates? Let's consider some of the arguments.

The Good

We suspect there is a mixing of the 'transparency' and 'mechanics' debates here. On the face of it if each part of the value chain is priced and disclosed separately with no cross subsidy surely each method would be equally effective?

In the past rebates were not always transparent so the Platform had the opportunity in a bundled charging structure to 'hide' the level of rebates it negotiated with Fund Managers – the insinuation being that Platforms were acting against the interest of customers in pocketing the proceeds of their skilled negotiations. You could equally argue that with so many Platforms in the market competitive pressure would force any over pricing to be counterproductive.

Mechanically, either method will 'work'. Cash rebates work on the assumption that the overall charge deducted by the Fund Manager is sufficient to cover the platform fee, the adviser charge (pre-RDR) and any 'discount' to be passed back to the customer. If it isn't then the Platform or adviser needs to make a separate charge, either billed directly to the customer or by selling unit holdings.

Unit rebates work by calculating the equivalent cash fees to be passed back and converting this into units. If the platform, adviser or customer wants the cash equivalent, they sell the units. So, rebates in unit form assume that buying and selling transactions can take place quickly and efficiently, and importantly, for small amounts. We will comment more on this later.

Adopting a unit rebate method could allow existing platform customers to continue to trade into the same share class pre and post RDR giving them consistency of unit records and making platform administration slightly easier. Platforms would still have to administer a combination of cash and unit rebates, potentially for the same customer, so it is not clear there is a huge saving here.

What we do accept is that in our post RDR transparent world if every platform ends up trading into the same 'clean' share class there is an issue of how Platforms leverage their buying scale to the customers' advantage – unit rebates could certainly play a role here.

The Bad

The obvious issue with unit rebates is that this method creates a second and third cascade of trades for each investment. This could potentially be confusing for the customer, unit statements will become lengthy and there must be additional costs with small amounts of units being constantly created and subsequently cancelled. Given the objective of the exercise is to get cash back to the platform or customer forcing the 'currency' of these trades to be units seems counterintuitive.

- » The method does throw up some additional challenges:
- » CGT loss and complications of significant additional work in doing the calculations (one per distribution)
- » Additional transaction charges payable by the client either by cashing each rebate or potentially pro-rata against all holdings, unless specific instructions were held as to which investments should be sold first. This could lead to client disadvantage if those investments were the best performing
- » VAT issues for platforms providing greater administration

The Ugly

We believe there are two additional issues with unit rebates worthy of consideration.

1. Most units are forward priced and many have trading spreads. As a consequence calculating the exact amount of units needed to realise the charge required is either a process of initial trades and then small rebalancing items or each party accepts that the amounts can only be calculated once the final balances are known thus causing a delay in the process.
2. Until the units are sold they are still Client Assets (CASS regulations) meaning additional record keeping and reconciliation for the platforms. It is unlikely that platforms will want two processes, one for clients to keep the units and another for those who want or are forced to sell them.

So, there will be differences; either shortfalls in overall numbers which cannot be made up or units left over which cannot be allocated to investors without selling and treating them as

cash fractions, or allocating them to The Man With No Name. It remains to be seen what attitude the regulators will take to the treatment of these differences, but it is clear that even if a pragmatic solution is found, there are likely to be investors who lose out from these proposals.

Conclusion

The direction set in the Platform Paper is clear; at some point rebates to Platforms from Fund Managers will be banned to add to the ban on commission to advisers. The end game seems fairly obvious, Fund Managers issue 'clean' share classes and Platforms charge separately for their services which customers pay directly or by cancelling unit holdings. Without a set implementation date for this all providers and platforms have a dilemma; do we move to the end state as soon as possible or amend our fees and charges in two stages, firstly to take out adviser commission whilst keeping our platform rebate and secondly to remove all cash rebates?

We suspect Platforms will only want to do this once and we have already seen some early moves to 'un-bundled' charging structures. If this transparency prevails what is the issue with discounts negotiated by Platforms from Fund Managers being rebated back to clients, in cash? It feels a whole lot easier than the alternatives of unit rebate trade proliferation or multiple share classes.

If you'd like to discuss your approach to Rebates, please contact mark.lester@navigant.com or on 0207 015 8750

The Apple Dumpling Gang – Orphan Clients

With up to 40 million customer accounts expected to be "orphans" post Retail Distribution Review, more firms are considering adoption. What are the options?

A group of orphans needing protection across the Apple Dumpling desert link up with some unusual partners, but strike gold at the end. Does this have any hopeful messages for clients and providers post RDR? In this article we look at some of the opportunities for orphan clients thrown up by these developments.

The RDR is creating an interesting market dynamic...

On the one hand distribution influence is expected to concentrate into fewer and larger firms as smaller IFA firms leave or merge, and winning platforms and fund managers emerge. Therefore, distributors, product manufacturers and platforms are carefully prospecting for the right post-RDR partners.

On the other hand, the possibility of lacklustre consumer appetite for adviser charging, particularly for ongoing service, and a strong interest in unlocking the potential in the mass market segment is leading many product manufacturers and platforms to consider developing or enhancing their direct to consumer (D2C) propositions.

Successful post-RDR D2C offerings will need some key ingredients: scale to leverage competitive execution only pricing, cost effective client acquisition and strategies to retain and maximise the value from existing clients.

And this is why some firms are gambling on orphan clients. Orphan clients are customers that either decide to discontinue using an existing advisory relationship or no longer have an active advisory relationship – for example if their IFA goes out of business. Some firms have broadened their definitions to include a lack of contact between the client and the adviser for set periods of time.

So what are firms specifically interested in?

First, there are significant numbers of orphan clients and their numbers are expected to grow. Our research in the Life industry has estimated that approximately 25%-30% of policyholder accounts currently have orphan status (c. 30 million accounts in total) and evidence submitted to the Treasury Select Committee who are investigating the impact of RDR has suggested that up to 10 million customers are likely to become orphan clients as a result of RDR.

Second, orphan clients already have a history of buying financial products. There is a threat to existing holdings, which might come under pressure from another provider offering a post-



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RDR charging structure, but also an opportunity. Clients who already have financial products generally have a high propensity to purchase additional products and are more likely to have available assets to invest.

There are a number of dependencies that make developing a D2C proposition not as simple as it sounds:

- » You have to be confident that there is value in the client base for a D2C proposition. This may require detailed analysis and segmentation.
- » You have to be able to offer a compelling proposition, including competitive pricing and a nimble, technology enabled delivery capability. Competition will be fierce.
- » You have to be able to identify orphan clients. Choosing who you contact and how is a sensitive matter as getting it wrong is likely to frustrate both your clients and your distribution partners.

To date the market response has been mixed

There have already been a number of launches of new or enhanced D2C propositions targeted at orphan clients such as Aviva and Friends Life. Most of these have been 'soft' launches with little advertising to avoid raising concerns from distribution partners and other existing clients. Others are opting to do nothing and monitor market developments, which might be the right choice if you don't think that D2C suits your product set, your clients or your delivery capability. However, you risk leaving yourself open to an eroding client base and missing the opportunity to gain sufficient market share.

There are also some innovative challenger options emerging such as Paymemy.com/mission which is looking to benefit from greater awareness of investors and increasing numbers of orphan clients.

Some firms are investigating the possibility of paying off the trail commission paid to distributors and looking at how they might be able to 'switch off' trail commission payments in certain circumstances. While these customers would not be classified as orphans today, ending the stream of trail might clear the way for a later D2C approach.

What is clear is that is that firms need to give careful consideration to the commercial opportunities and threats associated with orphan clients. Like the Apple Dumpling Gang, with large numbers of orphans looking for services, there are opportunities for much gold to be discovered and shared!

If you have questions about orphan clients opportunities, please contact karen.bond@navigant.com or call 020 7398 3842





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