Financial Services Authority

Investment Quality of Advice Processes II

August 2008

Contents

1 Background

- Between September and December 2007, the Financial Services Authority (FSA) visited a sample of 50 advisory firms, and mystery shopped a further 50 to review the quality of their advice processes and the extent to which these processes supported the delivery of the right outcomes for consumers. This review was part of the FSA's wider 'thematic' work on improving the quality of advice.
- The review was a follow-up to similar work carried out in 2006, where we identified a number of areas in which the majority of firms needed to improve their processes, in particular in respect of management information and overall systems and controls, the assessment of customer needs, and communications with customers. Each of these three areas were the subject of further communication to the industry after the first review, and these communications included the introduction of a number of specific tools to help firms which had been developed with the assistance of the industry.
- Therefore the second review was to establish whether firms had considered our communications and used the help provided to make the necessary improvements to their advice processes.
- Our overall findings and key messages for the industry, as set out in this report, are based mainly on the visits findings, which were compiled from the review of a number of recommendations to customers and the advice processes in place at each firm at the time. The mystery shopping findings are based on one recommendation by each firm and therefore they do not allow us to draw conclusions about individual firms, but do give us a direct view of how firms interact with customers. Key messages from the findings of the mystery shops have been specifically stated where relevant.
- We published the preliminary results of our findings in March 2008.

2 Executive summary

Visits

- Most firms in the visit sample (36 out of 50) were assessed as making progress towards having appropriate advice processes in place, but the vast majority of these (30) still have more to do to in order to improve the quality of their advice processes.
- The remaining 14 firms were assessed as having made limited progress, and these firms showed failings throughout a significant part of their advice processes.
- The vast majority of firms (45) gathered relevant management information about their businesses, but just under a third of these firms (16 of the 45) were not actively analysing and using that information to review their processes.
- A disappointingly high number of firms (36) failed overall to demonstrate adequate systems and controls to monitor their advice process, with many of them not adequately considering findings from their review of customer files as part of their management information.
- Just over half of the firms (29) demonstrated that they gathered sufficient Know Your Customer information when assessing customer needs.
- A majority of firms (35) failed to consistently produce clear, fair and not misleading suitability letters.
- Most firms that provided focused advice (40 of the 50) failed to consistently make their customers adequately aware of the implications and consequences of receiving such advice.
- The vast majority of firms (42) offered and conducted regular reviews of their customers.

Mystery shopping

- In a majority of the mystery shops (31 out of 50), concerns were identified about the advice processes employed.
- A significant number of firms (28) did not offer customers a genuine option to pay by fee or did not offer a fee option at all.

– In 16 firms, customers were dissuaded from paying by fee.

3 Visits methodology

- The visits were designed to measure the quality of the advice process within the firms and identify the key elements that make up the difference in practices between firms that have good processes compared to those firms with poorer processes.
- In general, the visits were conducted on a principle based approach as opposed to identifying individual rule breaches, although specific rules were referred to where appropriate.
- The visits included interviews with senior management and at least two advisers at each firm. To get to the root of how firms operated, we reviewed and followed those advisers' recent transactions to identify any particular trends in their methods and approach to dealing with customers. If any concerns were identified in relation to the review of the customer files and the advice provided, this was then followed up through discussion with the advisers concerned to obtain further clarification. If any trends were identified we pursued how these were (or were not) dealt with through the firm's systems and controls. We did not focus on the sale of specific products.
- The interviews with the senior management provided us with evidence of the level of TCF within the firms' culture and systems and controls. These also provided us with an understanding of how advisers were trained and monitored on an ongoing basis and allowed us to determine whether the approach in these areas had an impact on the advice provided by the advisers.
- The interviews with the advisers provided us with an understanding of the way in which they followed through the advisory process with customers. Information from the interviews was then contrasted to the findings from the customer file reviews.
- The exact methodology used varied between individual firms to take account of the different way the businesses were organised. In reviewing the advice process we are looking at a number of areas as follows:
  - Quality of advisers
  - Impartiality of advisers
  - Assessment of customer needs

- Recommendations (including research)
- Communication
- Post sale
- Corporate Culture/Systems and Controls

4 Mystery shopping methodology

4.1 FSA methodology

- The mystery shops were primarily designed to identify the practices of firms in a 'live' environment when interacting with customers. The findings were based on one recommendation by each firm, and although no definite conclusions can be drawn about individual firms, the findings do give an indication of the quality of their processes.
- By posing as genuine investors, each mystery customer contacted an adviser and arranged for both a preliminary interview and advice appointment. The premise of each shop was that each customer was either seeking advice due to a "life changing" event requiring a financial review or they were allocated one of three specific scenarios.
- The life changing events used were:
  - New employment or promotion – increase in salary
  - Divorce – asset sharing or income payments
  - Redundancy – lump sum pay off
  - Retirement – lump sum received
  - Inheritance – lump sum received
- The scenarios used were:
  - Shopper had a surplus lump sum or a regular premium to invest for growth for a specific goal and time length.
  - Shopper had a lump sum or a regular monthly surplus sum and an outstanding mortgage or other debt/liability.
  - Shopper is post-retirement age with a lump sum/regular amounts to invest for additional income.

- The shoppers attended their appointments and subsequently completed a detailed questionnaire based on their experiences of the appointment and the adviser. Each shopper was encouraged to ask the adviser for documentation to support their recommendation, including customer specific illustrations and suitability letters.
- The results from each mystery shop were analysed by FSA staff and assessed under the following categories:
  - Impartiality of Advisers
  - Assessing customer needs
  - Recommendations
  - Communication
- The analysis was designed to capture:
  - Qualitative data by way of examples of good and bad practice to determine indications that the advice process treated customers fairly.
  - Quantitative data on each of the assessment criteria mentioned above to measure the quality of advice.
- The quantitative data was captured by using the recordings together with any documentation supplied by the adviser, whilst the shopper questionnaires were used as a guide to potential issues as part of the assessment.

4.2 GfK methodology

- GfK was the agency commissioned to conduct the study using trained mystery shoppers. Shoppers were asked by GfK to opt in to take part in the shops and were given a list of the scenarios and were each asked to choose one which closely matched their real situation. This was monitored by GfK to ensure a good spread of scenarios. Each shopper was then allocated a number of firms in their postcode area to contact. Shoppers were given a detailed briefing on the requirements of the task and the overall project objectives by the field manager. Each shopper was also provided with a set of detailed guidelines created by GfK in conjunction with the FSA project team.
- The sample mix consisted of medium and small retail investment firms and incorporated a geographic spread of the UK. GfK then distributed these based on the proximity to the shoppers employed in the study. To minimise delays in fieldwork each shopper was provided with a number of potential firms to visit.
- An agreed budget for fees was agreed at outset to accommodate firms where a fee would be applicable.

The visits

- Shoppers called their assigned firm(s) and requested a face to face meeting with the adviser. Generally the first meeting with the adviser consisted of a discussion of the shopper's needs; therefore the majority of shoppers were required to attend two appointments with the firm in order to receive full advice. Shoppers only took the sales process to the point of advice and were advised not to sign application forms or be cautious when signing any documents to ensure that they did not become tied in to any product or contract.

5 Findings and key messages

Overall assessment

- Just over a tenth of the firms (6 out of 50) visited were assessed as making significant progress towards having appropriate advice processes in place.
- Three-fifths of the firms (30 out of 50) visited were identified as making some progress but needed to up the pace of their progress. We believe that it would not require much work by senior management at these firms to raise their standards and make the necessary improvements.
- Just under three tenths of firms (14 out of 50) were assessed as making limited progress and where there were failings throughout a significant part of their advice processes. The worst of these firms will be referred for significant supervisory intervention and may face enforcement action.

Key messages

- Having appropriate advice processes in place is an important element in supporting delivery of the right outcomes for consumers, and in helping firms to demonstrate they are treating their customers fairly.
- Whilst we found that most firms in the sample are making progress towards having appropriate advice processes in place, a significant number still have more to do in some key areas.

Quality of advisers

- Over half of the firms visited (27 out of 50) did not have appropriate Training & Competence procedures implemented and maintained.
- Only half of the firms visited (25 out of 50) identified gaps in training needs of their advisers as part of their Training & Competence monitoring.

Key messages

- Firms need to ensure that they have adequate Training & Competence schemes in place to support and develop advisers so that any training needs are identified and addressed on a timely basis to ensure that advisers are and remain competent in these areas.

Impartiality of advisers

- There was a significant number of firms giving impartial advice in that they:
  - recommended repayment of debt (8 out of 50), and
  - recommended non-commission earning products (32 out of 50) before recommending an investment, or
  - refunded commission where the commissions paid to them was not proportionate to the work carried out (37 out of 50).

Mystery shopping

- The findings from the mystery shopping sample were mixed; whilst many firms recommended non-commission earning products (27 out of 50) and advised the customer to repay their debt (18 out of 50), the number of firms offering customers a genuine fee option was disappointing.
- Less than half of the mystery shopped firms (22 out of 50) offered customers a genuine option to pay by fee; the significant majority (28) did not offer customers a genuine fee option or did not offer a fee option at all.
- Just under a third of firms (16 out of 50) dissuaded customers from paying a fee and/or suggested that commission was an easier option.

Key messages

- Firms holding themselves out to be independent must offer customers a genuine option of paying a fee for advice.
- Dissuading customers from paying by fee or trying to influence them by suggesting that commission is an easier option is not acceptable. However where a firm truly believes that paying by commission would be more cost effective than a fee (i.e. after having made an appropriate assessment), a firm can and should advise the customer of the better option, presenting them with appropriate information for them to decide.

Assessment of customer needs

- Just over half of the firms visited (29 out of 50) could demonstrate that they consistently gathered sufficient Know Your Customer information (KYC). There were a number of reasons for poor KYC identified in firms, where the most common weaknesses were:

- Identifying and recording the customers' needs and objectives – less than half of the reviewed customer files that demonstrated inadequate KYC failed to provide adequate evidence of identifying and recording the customers' needs and objectives.
- Establishing and recording customers' attitude to risk – less than two-fifths of the reviewed files with inadequate KYC failed to provide evidence of this.
- Exploring all areas of financial needs when giving full advice – just over two-fifths of the files where full advice was given did not adequately explore all relevant areas.

Key messages

- Before giving advice, advisers must be clear about the customer's needs and objectives, their attitude to risk across different objectives, whether they can afford to address these at once, and that they understand and accept the risks involved.
- Where full advice is offered, advisers should explore all areas of the customer's financial needs, and not just those in relation to the customer's stated objectives, before making a recommendation.

Recommendations to customers

- Less than half of firms visited (22 out of 50) could consistently demonstrate a fair and adequate recommendation process. There were a number of reasons for unclear recommendations identified in firms, with the most common weaknesses being:
  - Insufficient KYC – customers' relevant needs and objectives and attitude to risk were not adequately recorded.
  - Poor research – insufficient evidence of research was kept on file to support the choice of provider/funds.
  - Suitability letters – lack of explanation as to how the recommendation would meet the customer's needs & objectives.

Key Messages

- Firms need to gather and record sufficient information on file to be able to demonstrate adequate consideration of KYC information, research to support why a particular provider and product has been recommended, and a balanced reflection of how the recommendation addresses a customer's needs and objectives in the suitability letter.

Communication

- Over two-thirds of the firms visited (35 out 50) failed to consistently produce adequate suitability letters; the main reason for suitability letters being deemed inadequate was due to them not being clear, fair and not misleading, in particular:
  - there was no explanation of the reasons for switching products/funds;

- the letters were insufficiently personalised and often contained jargon; and
- the risks and charges associated with the recommendation were not specified.

- Just under a third of the customer files reviewed (136 out of 456) were on a "full advice" basis; over two-thirds (315 out of 456) were on "focused advice" basis, where nearly four-fifths of the firms (40 out of 49) that provided "focused advice" to customers failed to make their customers adequately aware of the implications and consequences of receiving such advice.

Key messages

- The findings above and those in 2006 suggest that the production of a suitability letter (now known as 'suitability report') in particular remains an area which requires significant improvement. In confirming their recommendations to customers, advisers must ensure that their suitability letter is adequately personalised to the customer's needs, explains the reasons for the recommendation and highlights the risks and charges involved, whilst giving a balanced view.
- It was disappointing to see the vast majority of firms giving focused advice failed to highlight the consequences to their customers, given that we had made comment on this after the 2006 findings. Whilst focused advice is perfectly acceptable as long as it addresses the customer's needs and objectives and the customer is made aware of its limitations, firms should consider on a case-by-case basis whether or not a focused advice approach is appropriate. We found a number of cases where focused advice had been assumed without customers having been offered a full review of their circumstances. Where focused advice is given, firms should ensure that their customers are made adequately aware of the implications and risks of receiving such advice.

Management Information and Systems and controls

- The vast majority of the firms visited (45 out of 50) gathered relevant Management Information (MI) about their businesses, but just over a third of these firms (16 out of 45) were not actively analysing and using that information to review their processes and to demonstrate whether they were treating their customers fairly.
- Just under three-quarters of the firms visited (36 out of 50) failed overall to demonstrate adequate systems and controls to monitor their advice process.
- Over a third of firms (19 out of 50) were not giving consideration to findings from their review of customer files as part of their MI.
- In some cases, the monitoring of customer files appeared to only concentrate on the completeness of the files rather than reviewing the quality of the information gathered from, and provided to, customers as recorded in the files. In other cases, where issues were picked up, they were not followed up by remedial actions or learning and development requirements being put in place.

Key Messages

- Firms must ensure that they collect and use appropriate information about their businesses to review their advice processes and monitor their advisers on an ongoing basis. This is to ensure that firms are able to make necessary improvements to their processes and regularly review their progress in order to deliver the right outcomes for their customers.
- The quality of information firms gather about their customers is key to the delivery of the right outcomes, and firms should satisfy themselves as part of their monitoring that they are able to demonstrate that sufficient information has been gathered and recorded on file.

Post-sale

- The vast majority of firms (42 out 50) visited were offering and conducting regular reviews of their customers.
- In almost half of the firms (23 out of 50) there was evidence that customers' needs had been re-assessed due to environmental factors (e.g. changes in benefits allowances, taxation, or legislation) or new product launches.

Key messages

- It was encouraging to see that the vast majority of firms visited were offering and conducting regular reviews of their customers. This is an improvement since the 2006 findings

6 Conclusions

We will be revisiting a number of firms who fell well below the required standards and have asked a number of other firms to undertake significant remedial action and report back to us on this. We have referred four of the firms visited to Enforcement where significant failings were identified.

We have worked with the industry to develop a number of tools to help firms in the areas we have highlighted for improvement as a result of the findings of the 2006 work (management information, assessing customer needs, communicating with customers). These tools can be found on our small firms website and we encourage all financial advisory firms to make use of them.

http://www.fsa.gov.uk/pages/Doing/small_firms/advisers/tool/index.shtml

We intend to publish a series of monthly factsheets, which will include case studies and examples of good and poor practice, from both the visits and mystery shopping findings, to further help firms. We expect firms to consider and use our communications and help made available to make the necessary improvements, in particular in the areas of;

- The use of MI and systems and controls for monitoring the advice process,
- assessment of customer needs,
- communication with customers including producing suitability letters and highlighting the risks and limitations of focused advice,
- clarity on type of advice offered and
- genuine fee option on paying for advice.

Having appropriate advice processes in place is an important element in supporting delivery of the right outcomes for consumers when giving advice. We launched our enhanced strategy in March 2008 to help small firms meet their TCF obligations. All financial advisers and mortgage intermediaries will be assessed as part of the strategy, as will general insurance firms selling high risk products. The aim is to provide firms with the assistance they need to ensure they are treating their customers fairly, and take action against those that aren't.

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