The future of distribution

Perspectives on the life, pensions and investments' markets in the UK
**Contents**

1. Introduction ........................................................................................................ 01
2. Distribution and manufacturing: why vertical integration is back on the agenda.................. 02
3. Balancing shareholder demands against regulatory objectives.......................................... 04
4. What are the options for intermediaries ................................................................. 05
5. Regulatory due diligence ...................................................................................... 06
6. Contacts ............................................................................................................... 08
Investment in distribution seems to be the order of the day. Insurance companies and asset managers are investing into intermediaries and platforms; Private Equity (PE) players are looking to invest in platforms and intermediaries; platforms are investing in intermediaries, and it goes on – this time with intermediaries in on the act.

Intermediaries are consolidating and building their own investment propositions and platforms – and so competing directly with the institutions that used to be their suppliers. And across the industry players are looking to engage with consumers via non-advised web-based propositions.

The historic long-term savings and investment value chain is breaking up; offering huge opportunities for current players and new entrants. In this publication we provide some context for these changes and also some thoughts about the potential impacts on all the constituencies involved.

We also describe some of the threats – in particular how institutions might avoid the strategic and tactical mistakes that characterised some previous attempts to move up the value chain and take direct control of customer engagement. In that case, what capabilities are required? How does one ensure the best possible outcomes for clients whilst looking to scale up one’s own platform or investment solution? And, can conduct risk be managed and mitigated to a level acceptable to an institutional board?

Finally, we look at the due diligence that must take place before an acquisition or sizeable investment. Our very significant experience in this space reveals that paying insufficient attention to this area, or under-investing in the resources necessary for the task, can be very costly indeed – but a systematic approach can mitigate these risks.

I hope you find the publication of interest and value. As always, the writers and I would be delighted to meet and discuss.

Trevor Hatton
UK Partner and Life & Pensions Leader
The future of distribution

About 55 million years ago the Indian continental plate collided with the Asian plate and began the thrusting and folding of the Tibetan plateau that became the Himalayas. The changes taking place in the UK Life & Pensions value chain look set to be just as seismic and potentially as risky for those who want to explore them. And while they have started slowly, the pace of change is accelerating.

Until recently, it looked as if the gap between advice and manufacturing was growing rather than shrinking. The raising of qualifications and banning of subsidies for distribution under the Retail Distribution Review (RDR) seemed to have discouraged providers from playing a broader role in the value chain. And yet in the last 12 months we have seen two major acquisitions of advice businesses by providers. It seems likely that others will follow. Major investments in direct-to-customer propositions have also been announced. We’ve been here before, several times, with tied distribution through estate agencies and building societies and providers taking stakes or outright ownership of networks, and in each case the providers have ultimately withdrawn – unbowed, perhaps, but usually bloodied by the experience. Observers might be justified in asking ‘what has changed?’ twice over – why the providers’ change of heart? And why do they think it will be different this time?

The answer to the first stems from a combination of classic forces for change: technology, regulation and competition. A combination of platform technology and regulation has driven down the cost of simply administering investments and fostered competition that is now driving down margins. Transparent pricing and super-clean share classes have driven down the retail price of many investment funds. Value has been taken out of the value chain and given back to the customer.

At the same time, RDR has forced distributors to look at their business models and most have realised that long term value lies in advising on a client’s collected assets over a long period of time. But they have also realised that an asset-advisory business model is more differentiated, more efficient and more lucrative if it captures more of the value chain and manages the investments within your group as well. This model is not new – one leading player has followed it successfully for 20 years – but an increasingly diverse range of advisers see their future in both advising on and managing investments. Smaller players, who lack the scale to create their own Authorised Corporate Director (ACD), can achieve a similar result through Discretionary Fund Management (DFM). The changes in the Chancellor’s Budget have accentuated this further, with the possibility of maintaining a relationship with a customer and their money that stretches not only through retirement, but to their children and beyond.

The Financial Conduct Authority (FCA) is watching closely to ensure that advice and suitability standards are followed and that there is no cross-subsidy between the advice and manufacturing arms of the business. But the trend is now too well-established to stop.

Providers are also watching closely: if advisers are managing investments for themselves, then those assets are largely lost to the providers. And not only are these new model advisers capturing assets from providers, some of them are also actively acquiring other distributors – threatening to drive up a mountain range isolating the providers from much of the value in the value chain. They are only foothills today, but how soon could they become Himalayas?

Providers and distributors are in competition in a way they have never been before. For a provider, establishing an advance base camp in advice territory starts to seem less like an expedition into the unknown than a necessary defensive move.

Ultimately, this should be good news for consumers. Arguably, many of the worst failings of the long term savings market have come up from commission-led advice and sales or from the abdication of responsibility for customer outcomes that can arise when providers can outsource advice risk to third-party distributors; in both cases there was limited incentive to provide ongoing advice and course-correction. When advice and investment management are under the same brand, there’s more of an incentive to invest in the customer’s financial plan, and less opportunity for churning, favouring sales over advice or putting the blame for poor performance on someone else.
However, the FCA – mindful of the distortions created by owned distribution in the past – are likely to look for more tangible measures of consumer benefit and safeguards against consumer detriment. An example of the former might be showing how the benefits of value chain integration are passed back to the customer through a reduced total cost of ownership for the investment. As for the latter, vertically integrated models can expect close scrutiny of suitability and awkward questions if a small number of in-house investment options seem to be ‘suitable’ for the vast majority of customers. At a corporate level, there will be a need to demonstrate that the advice business is commercially sustainable in its own right, and that there are no cross-subsidies or other financial links that might create undue influence between the advisory arm, the investment solution and the ultimate corporate parent. That’s likely to mean that the governance of the investment solution includes the right to fire the parent if its performance or propositions aren’t up to scratch.

What about advisers? What’s in it for them? Some commentators have been quick to question whether quality advisers would want to be part of a restricted, provider-owned setup with their echoes of the old tied salesforces. But this may be less of an issue in a market where advisers actively want their own investment propositions, where older principals are looking for a way to cash out and where younger ones are looking for the capital to buy them out. For many, becoming part of a larger business is a way to address all of these points – and to become part of something backed by a long-established and trusted provider may be more appealing than joining an aggressively growing new entrant.

Providers, for their part, have not chosen this option lightly. They know the history, and they are wary of the advice risk. They know that to succeed they will rapidly need to acquire new and alien skills and ways of thinking, and find a financial model that incentivises advisers to build a sustainable business while giving them an eventual exit.

Right now, only one thing seems certain: the direction of travel is clear and reversing it would be as hard as reversing continental drift.

The re-emergence of the vertically integrated firm

The life, pensions and investment value chain is undergoing major change. Some clear trends have emerged in the past 12–18 months, and we are seeing a definite re-emergence of the vertically integrated firm, albeit in a diverse range of shapes and sizes.
In this article, we look at some of the underlying commercial drivers that drive the benefit case for consolidation and controlled distribution strategies. It is these drivers that will create the most regulatory interest – in particular, ensuring that there is no customer detriment and that investment solutions are appropriate to customers’ needs.

Business case drivers
The vast majority of new controlled distribution and consolidator models are emerging in the wealth market and comprise one or more of the following components:

► Consolidation of funds onto a single platform
► Consolidation of front and back office functions onto a common technology platform
► Restricted advice model, aiming to increase investment flow to in-house funds or services
► In-house ACD or DFM proposition

All of the above-mentioned business case drivers make good commercial sense as they increase revenue share from the value chain – on which the benefit case of the acquisition will be at least partially dependent. They should also ensure improved consistency of the advice process and customer outcomes – ultimately improving the firm’s exposure to conduct risk.

Demonstrating customer benefit
As these businesses scale up, one of the major benefits should come through significant efficiency gains – from client handling, lower cost of acquisition, and low cost, automated processes. It is not readily apparent how these benefits will translate into better client propositions, but there should be potential for lower cost of advice and improved fund pricing.

It is these “hard” benefits to customers that the regulator would like to see emerge alongside the “soft” benefits associated with a more consistent advice process.

Ultimately, what flows through to customers may well depend on the business case for any given acquisition but EY believes the interests of shareholders need to be balanced against the upside for customers if these models are to thrive and not be subject to ongoing regulatory scrutiny.

Investment or subsidiary?
As the quote above states, most consolidators are looking to sell their businesses at some stage, in anticipation of a future demand for ready-made controlled distribution and funds under management. Their businesses are often backed by PE and sufficiently managed for investment return.

It is not yet clear how provider-backed consolidation will play out but there is some merit in trying to emulate the PE approach, if for no other reason than they will (by their very nature) run relatively ‘tight ships’. Layering in management overhead (and, in some cases, group overhead) can significantly compromise the business case, but, perhaps even more importantly, it can over-complicate a business as it tries to grow and innovate. Measuring controlled distribution as an arms length investment might well prove to be a better way of allowing the business to thrive until such time as it becomes an obvious part of the wider business.

“...In one camp are providers and fund managers, who seem motivated by growing and protecting funds under management. In the other are aggregators with a view to selling the consolidated businesses at a later date”

Industry commentator
There are some potentially exciting opportunities in this new and more dynamic market. These include mergers with similar firms to achieve economies of scale; negotiating a deal with an intermediary consolidator to be acquired at some point in the future; actually selling to an intermediary consolidator today, or to an insurance company, investment manager or platform provider. Alternatively, one could just “stick to the knitting” and carry on as an Independent Financial Adviser (IFA).

In theory, merging firms make sense. In practice, far more mergers are discussed than created. It’s hard to find the perfect partner. The problems might include location, strategy, risk appetite, technology and platform options, risk appetite, culture and simple chemistry. Sometimes, the key issue that can’t be resolved is the exit strategy.

Exit strategy can of course be facilitated by consolidators — both large and small. In fact, that is their primary function. And it is particularly powerful when some of a particular firm’s principals wish to cash-out and others want to stay on and build the business. So, all good? Not necessarily.

The larger consolidators are vertically integrated — playing across the value chain and looking for revenues from in-house platforms and investment propositions as well as advice and commissions. This implies that advisers are likely to become restricted. Of course, this doesn’t mean they can’t have access to the whole market, but if the IFA brand is important to them and to their clients then this can present a challenge.

A second challenge can occur if the consolidator’s strategy and business case is dependent upon a significant proportion of new business, and, potentially, existing business being invested into the in-house propositions. Not necessarily a bad thing when appropriate — just something to be borne in mind.

A similar situation may arise if the intermediary firm is purchased by a product provider, investment manager or platform. Of course, these businesses will be looking to ensure the best possible client outcomes, but their business case will depend on retaining or increasing assets under management as well as creating revenues from advice. And their adviser proposition may be tied rather than just restricted.

Having said that; does it mean that joining these larger firms will automatically disadvantage advisers and their clients? No. This doesn’t have to be the case. Scale is important and can help create wonderful client experiences that are quite different to those offered by most IFAs.

What does all this mean to ‘traditional’ IFAs (if there is such a thing) who wish to stay away from these transactions and stick to the knitting. What threat do the vertically integrated consolidators and providers actually pose? Can we learn from other markets?

Clothing represents a good example. Vertically integrated stores have a significant, market share and appeal to a very wide range of consumers, ranging from those who favour Primark through to Next, H&M, Boss, Armani, Joseph and Chanel. And some of these firms also distribute through third party retailers, such as hypermarkets, department stores and boutiques.

Boutiques also have a significant market share — particularly in the more affluent consumer segments; and their relationships with their customers tend to be more intimate. In fact, some boutiques refer to their customers as clients and call them up when new lines are introduced which they think will appeal. Effectively these shops offer a unique experience to the shopper, which in turn makes them unique. In some ways, just like IFAs — albeit their product is very tangible whereas the IFA product is advice. And of course, IFAs are qualified professionals.

There is no reason why the rise in vertically integrated firms poses a threat to well run IFA businesses. And as far as the bigger picture is concerned, their ability to facilitate advisers’ exits and provide continuity of service to clients, is a real benefit to the market.

04 What are the options for intermediaries?
by Malcolm Kerr
Once a provider firm has decided to acquire distribution and a target firm has been identified it needs to consider the due diligence process. This article focuses on the regulatory aspects of that diligence. It also briefly covers some of the key considerations for post-acquisition integration.

Regulatory due diligence is a key part of any intermediary acquisition and should be carried out alongside the other due diligence work streams that assess the financial propriety of the target.

**Regulatory due diligence**

There are a number of key areas that provider firms should ensure are included:

**Correspondence with the regulator** – the acquiring firm should ensure there is a review of the previous two years’ correspondence with the regulator. This will enable the acquiring firm to familiarise itself with notifications that have been made and any firm specific issues raised by the FCA. Firms should also ensure they are aware of any Skilled Persons reviews that have been conducted and that any issues have been resolved to the satisfaction of the regulator.

**Compliance resourcing** – the acquiring firm should satisfy itself that the target firm has had sufficient resources within its compliance department and that those resources are appropriately skilled. This will entail a review of the CVs of key members of compliance and a review of resources against requirements.

**Compliance reporting** – compliance reports made to the Board of the target entity over the previous two years should also be reviewed. The diligence should assess whether the reports appear sufficiently independent of the management of the firm and whether appropriate actions have been taken to address issues raised.

**Oversight** – alongside the review of compliance and compliance resourcing, the diligence should assess what other oversight arrangements may be in place. It is unlikely that smaller intermediary firms will have a three lines of defence model in place, however some use external consultants to provide independent oversight. The outcomes of these reviews should be analysed and an assessment made of any actions taken as a result.

**Management oversight** – a review of the Management Information (MI) that have been made available to the board of the target should be conducted. A minimum of 12 months MI should be reviewed to ensure that it is sufficiently robust; addresses relevant issues and that actions are addressed in a timely and robust manner.

**Adviser management** – what are the spans of control within the firm and how sufficient is the oversight? Some advisory firms now implement a risk-based approach to supervision; if this is the case, diligence should assess whether the process is sufficiently robust.

**Conflicts of interest** – a review of the conflicts of interest register should be included. This should ensure that any payments received from product providers have been recorded. The assessment should confirm whether conflicts of interest have been handled appropriately and whether any product provider payments are likely to breach the firm’s duty to act appropriately.

**Policies and manuals** – the target’s key policies should be reviewed for completeness and accuracy. These should include compliance, risk, financial crime, anti-corruption and include the compliance manual. The diligence process will need to assess whether there are any significant gaps that could have led to noncompliance or a breakdown in controls.

**Suitability and advice standards** – the diligence process should ensure a review of the advice and suitability standards in place for advisers. This should include a review of the file checking standards that have been in operation and whether there are any issues that could have led to systemic non-compliance by the firm.
File review — any diligence process of an advice firm should include a sample review of advice that has been provided to assess its quality. The samples taken as part of a due diligence process are inevitably limited and so when selecting the files to be reviewed as assessment should be made of the key risk areas.

The importance of reviewing suitability and advice standards, and an appropriate range of files, should not be underestimated. Identifying potential ‘landmines’ early in the process is key to a successful transaction. Perhaps even more important is the culture of the business being acquired. If this appears inappropriate it probably is. And changing the culture of an organisation is at best challenging and at worst impossible.

Interpretation of the outcome
It is unlikely that any due diligence process will result in no issues being found. The key for acquiring firms is to decide whether the issues identified are within its own risk tolerance or whether issues identified can be rectified. This is a matter of judgement for the acquiring firm.

Lastly, and outside of the regulatory due diligence, firms must ensure that the people and culture of the target firm fit in within the new, larger, organisation they may find themselves in. This assessment will not be part of the formal diligence process, but firms should ensure they will be able to work with the individuals that will be joining them and that the culture they perceive is appropriate.

Post-acquisition
Following completion of the acquisition and the change-of-control process, a post-acquisition plan should be instigated. This should address any issues that were discovered within the due diligence process and map out the integration of the firm acquired with its new parent.

The significance of the post-acquisition process should not be underestimated. It is likely that in key areas there will be departments where working practices need to be aligned, such as finance, compliance and risk. And there will be areas where the acquired firm will need to change its working practices to meet the revised risk culture within which it finds itself working.

Certain key decisions also need to be implemented at this stage. For example; how closely different functions should be integrated – will employees in compliance or finance, for example continue reporting to the advisory firm or will they report to a central compliance team. These decisions need careful thought and planning, as provider firms need to ensure they do not inadvertently provide a subsidy to a separately authorised advice entity, in breach of the inducement rules.

The acquisition of an advisory firm by a provider is a decisive step that can have a significant impact on the risks to which the firm is exposed. Both the due-diligence and post-acquisition phases must be planned carefully to ensure the additional risks are known and appropriate mitigating actions are taken.
<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Contact Information</th>
</tr>
</thead>
</table>
| Trevor Hatton         | UK Partner and Life & Pensions Leader | Tel: + 44 20 7951 8418
                     |                                 | Email: thatton@uk.ey.com                                  |
| Robert Wood           | Executive Director              | Tel: + 44 7702 307 462
                     |                                 | Email: rwood1@ukey.com                                    |
| Jason Whyte           | Director                        | Tel: + 44 20 7951 1070
                     |                                 | Email: jwhyte@uk.ey.com                                   |
| Malcolm Kerr          | Senior Adviser                  | Tel: + 44 7775 783560
                     |                                 | Email: mkerr1@uk.ey.com                                   |
| David Nancarrow       | Senior Manager                  | Tel: + 44 20 7951 7377
                     |                                 | Email: dnancarrow@uk.ey.com                               |
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. EG0241
1594122.indd (UK) 03/15. Artwork by Creative Services Group Design.
ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com