Robert Powell's Retirement Portfolio

This new conflict-of-interest rule will push 'bad eggs' out of the financial industry

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After the Dept. of Labor's fiduciary ruling, the sky will not really fall. Shutterstock.com

Now that the Labor Department has announced its conflict-of-interest regulations, critics will charge — as they have been doing since the revised version of the so-called fiduciary rule was proposed a year ago — that all heck is going to break loose here in the U.S.

Read: New fiduciary rules set to protect retirement savers.

The critics will say that what happened in the U.K. when that region implemented similar rules (the retail distribution review, or RDR) in 2013 will happen here in the U.S.; that investors would pay more for advice, that fewer investors would be able to access advice, that there would be fewer advisers, and so on.

Read Chuck Jaffe's column, Fiduciary standard leaves more questions than answers.

By way of background, the RDR rules, according to the U.K's Financial Conduct Authority, were aimed at making the retail investment market work better for consumers, which we should note is quite similar in tone and tenor to the Labor Department's goal with its conflict-of-interest rule: that being, to make sure that retirement advisers put their clients' best interests before their own profits.

The Financial Conduct Authority, or FCA, is a financial regulatory body in the U.K. but operates independently of the U.K. government, and is supported by fees paid by members of the financial services industry.

Here in the U.S., the Labor Department's conflict-of-interest rule treats persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under the Employee Retirement Security Act of 1974, or ERISA, in a wider array of advice relationships than the existing ERISA regulations.

The new rule, and related exemptions, would increase consumer protection for plan sponsors, fiduciaries, participants, beneficiaries and IRA owners.

What's more, the Labor Department also announced new exemptions and amendments to existing exemptions from the prohibited transaction rules applicable to fiduciaries under ERISA that would allow certain broker-dealers, insurance agents and others that act as investment advice fiduciaries *to continue* (emphasis mine) to receive a variety of common forms of compensation that otherwise would be prohibited as conflicts of interest. In other words, the Labor Department is not banning commissions as the U.K. did. Rather, advisers would have to make the case that a commission product is in the best interest of their client.

In the case of the U.K., the RDR rules raised the minimum level of adviser qualifications, improved the transparency of charges and services and removed commission payments to advisers and platforms from product providers. The RDR, in effect, raised the standards of professionalism across the financial advice market.

And what has happened in the U.K. since RDR went into effect, since the U.K. banned commissions on the sale of investment products?

Are investors paying more for advice in the wake of retail brokerage commissions being abolished? Are there are fewer advisers? Are there fewer investors seeking out advice?

Well, having just returned from London a few weeks ago, having interviewed government officials and other experts, and having read a number of reports about the advice industry/profession in England, including one just published on March 14, I think it's safe to say that investors (and the good advisers) here in the U.S. have something to look forward to when the Labor Department's fiduciary rule becomes the rule of the land, likely sometime in January 2017 before President Obama leaves office.

There are slightly more advisers in the U.K. now than when RDR went into effect. Investors are paying slightly more for advice, but the cost is now transparent. Plus, some costs have declined.

And, in the wake of RDR, the U.K. is also addressing what it calls the advice gap. The FCA released this month a report showing that some 16 million people in the U.K. need professional advice but cannot afford it. And given that, the FCA is recommending ways to make advice more affordable and accessible.

Among other things, the FCA is encouraging firms to deliver robo advice. And that is exactly what's happening here in the U.S. Robo-advisers are sprouting up and making advice affordable and accessible to those who need it most as well as those who are not being served well or at all by the advice industry as it exists now in the U.S. Read Financial Advice Market Review (FAMR).

That's the big picture. Here are the details and what it all means for investors in the U.S. as well as those in the advice industry/profession.

Number of financial advisers rising

The number of advisers dropped 11% in the run up to RDR, from 35,073 in mid-2012 to 31,132 at year-end 2012, according to Chris Hannant, the director general at Association of Professional Financial Advisers, based in London.

But the numbers stabilized in 2014, and have slightly recovered since. In fact, there's been a 6% increase in the number of advisers and small rise in the number of advice firms, according to Hannant.

Of note, the drop in the number of advisers in the months before RDR being implemented, according to Hannant, was caused by the new professional standards that required advisers to do extra exams. "Some near retirement chose to not take the exams and go early," he said.

So what can we expect here in the U.S. given that? My guess is that advisers who earn a living by charging commissions on the sale of investment and insurance products and who might not to act in the best interest of their clients (or put another way: those who tend to do merely what's suitable for their clients) will leave the industry. And that's a good thing. The bad eggs ought to leave. Consumers and investors ought not pay a commission to advisers for products that aren't in their best interest.

Firms focus on profitable clients

In the post -RDR world, Hannant said, advice firms are focused more on those clients who are profitable. "The need to charge and justify fees brought greater scrutiny of their own costs and so identified a portion of clients that wasn't worth looking after," he said.

That may or may not happen here in the U.S. Providers here may ask their less profitable clients to find other advice options. But that doesn't mean that's a bad outcome. Why so? First, less profitable clients are hardly ever the focus of any adviser's business. If you're a C client, your calls are always the last to be returned.

And second, there are plenty of firms and advisers, including robo advisers and human advisers who charge a fee or charge by the hour, that can serve the so-called less-profitable clients. (Truth be told, there isn't a sufficient supply of good fee-only and hourly advisers to meet the current and potential demand for advice. But, there are enough robo-advice options that will do just fine for those who can't find or afford human advice.)

Profits rising

Not surprisingly, profits at advice firms are rising. In fact, profits before tax were up 5.3% according to a recent APFA report, The Financial Adviser Market: In Numbers. And the FCA noted in a 2014 report that firms overall appear slightly better placed to deliver on their long-term commitments, with both average revenues and profitability of advisory firms having increased. Read the APFA's report, The Advice Market Post RDR.

Others, by the way, see this much the same way. "Most advisers have done well out of RDR — so far, said Danby Bloch, chairman of Helm Godfrey, an investment advisory firm in London. "That's because they mostly focus on higher value clients."

Cost of advice rises slightly

As for the cost of advice, the impact of the RDR on price has been mixed, according to the FCA's Post-implementation review of the Retail Distribution Review. "While product and platform costs have broadly fallen, adviser charges appear not to have decreased," according to the FCA's 2014 report.

Transparency, however, has increased. "The RDR banned commission on investment-related products and required advisers to be transparent about their fees," said Karen Barrett, the chief executive of unbiased.co.uk. "The result is that advisers now charge their clients directly, but all that's really changed from the customer's perspective is that the fees are now in plain sight and not hidden in small print.

In fact, she said the improvement goes further than that — because advice that is influenced by levels of commission is arguably not really advice at all. "The RDR meant that more people could access truly independent advice than ever before," she said.

Bloch agrees. "Clients at the top end can see what they are paying for and have mostly benefited from RDR," he said.

What's more, Barrett said, people in the U.K. are also obtaining better value for money, because products are recommended to them based solely on their suitability. (The word suitability has a different meaning in the U.K than in the U.S.; it's closer to best interest.)

Barrett also noted there was a misconception in some quarters in the U.K., not unlike what might occur in the post-conflict-of-interest rule in the U.S., that advice used to be available “free” but now must be paid for.

“What was actually happening was that the cost of advice was simply spread over the lifespan of the product, and in many cases consumers ended up paying more than they would have in a single upfront fee,” she said. “Now the cost of advice is transparent, and that’s very good thing. When people are made aware of the long-term benefits of advice they start to realize what good value they can obtain from professional advice taken at the right time.”

Read The Cost of Advice.

So, what might happen here in the U.S.? The cost of advice might rise, but those costs will be more transparent than ever before. And that too is a good thing for investors and consumers. Knowing what things costs — be it a car or a refrigerator or financial advice — is worth it for all involved.

Quality of advice improves

RDR also raised the standards required of financial advisers to a minimum QCF 4 level, so consumers are receiving a better quality service, said Barrett. Others agree. “Part of the benefit for clients is derived from the fact that higher compulsory qualifications for advisers also came in with RDR,” Bloch said. “So advisers are generally more clued up.”

The open questions

One open question in the wake of RDR is whether poorer investors are missing out. “I think you could argue that they get a better deal than in the past if they are prepared to pay for advice on a salient and visible basis,” said Bloch. “But most don’t like paying for advice. And they may be right. Quite often there is quite a struggle to get advice with a value that equals or exceeds its cost.”

The good news here? Robo advice is on the way. And less wealthy investors in the U.K., as is the case in the U.S., seemingly don’t mind paying for robo advice.

Another open question for investors here in the U.S. is whether commission-based products, variable annuities and the like, will disappear and be replaced by products that don’t come with commissions. That’s likely to occur. But this too isn’t a bad thing. An investor will pay an adviser a fee for a product that’s right for them instead of a company paying an adviser to sell clients products that may not be right for them.

What the FCA has found

Others have also weighed in on the effect RDR has had on the advice industry and investors. For instance, the FCA wrote in its 2014 report that longer-term effects of the RDR are yet to become clear, but the evidence from the first stage of the review shows a positive picture, with encouraging signs that the RDR is on track to deliver its objectives in many areas.

In particular, the FCA said removal of commission paid by providers to advisers and platforms has reduced product bias from adviser recommendations reflected in a decline in the sale of products which paid higher commissions pre-RDR.

RDR has also made it easier for consumers and advisers to compare platforms, increasing competitive pressure and leading to a significant reduction in direct-to-consumer platform charges, the FCA said. Plus, product prices have fallen by at least the amounts paid in commission pre-RDR, and there is evidence some product prices may have fallen even further.

And, the FCA said the vast majority of advisers are now qualified to the new minimum standards and there has been an increase in the number of advisers going beyond these minimum standards.

What the future holds

So what does the future hold for investors and advisers in the U.K.? First, demand for advice is likely to grow in the wake of pension reforms that went into effect last April. Before last year, workers retiring in the U.K. had to invest their nest egg in an annuity. But that's no longer the case.

Now, U.K. workers retiring are able to do what workers retiring in the U.S. are able to do. Invest in whatever they want. "Pension freedom reform highlighted need for advice at retirement," said Hannant. "People retiring were no longer obliged to buy an annuity and could use the pension pot as they see fit."

That new pensions freedom law also resulted in the need for the FCA to explore the supply and demand sides of the market for financial advice and guidance, the barriers to providing these services and the potential remedies.

In a report published on March 14, the FCA proposed making advice and guidance to the mass market more cost-effective, including the use of robo advisers, and measures aimed at increasing consumer engagement and confidence in dealing with financial advice, including the development of 'rules of thumb' and the use of nudges.

Here in the U.S., we are witnessing a convergence. The U.S. — in the wake of the Labor Department's conflict-of-interest rule — will start to look more like the U.K. in its post-RDR world. And the U.K. — in the wake of the pension freedoms reform — will start to look more like the U.S.

And the clear winner in both countries is certain to be investors and consumers. And the sky — despite claims to the contrary by those in the advice/product industry/profession — will not fall.

Robert Powell is editor of Retirement Weekly, published by MarketWatch. Follow his tweets at RJPIII. Got questions about retirement? Get answers. Send Bob an email here.