OPEN DOOR POLICY

BUILDING PROPOSITIONS

FG 12/16 : Assessing Suitability Replacement Business and Centralised Investment Propositions.

July 2012.

Analysis Series

INTRODUCTION

FG12/16 isn't new, it was published in 2012 and gives great guidance on switching and the construction or Centralised Investment Propositions (CIP). Time has moved on, with further development and the introduction of the CRP concept, similar but dealing with retirement. At the time the regulator was the FSA, rather the FCA so you will see reference to that in this summary.

As you read through this summary you will no doubt see future echoes of the Consumer Duty, here in FG12/16 the Regulator is continually referencing client outcomes, mitigating risk that could cause client harm as well as introducing controls and MI.

The outcome is that this Finalised Guidance is still very relevant today and should be the basis of the design of a firm's CIP, CRP or even development into a dual Centralised Investment and Retirement Proposition (CIRP).

This is an Open Door Policy Summary and Analysis document, and it offers a summarised version of the Regulator's published document. It is designed to keep all the salient points but in a more compact, and easier to read form. Open Door Policy recommend that you also take time to read the full version from the (then) FSA.

FG12/16 is an important document and part of a collection of publications which inform the development of several key areas within the advice process. These are the consultancy areas that Open Door Policy can provide to advisory firms and support services.

- Value and Charging Proposition (VCP)
- Centralised Investment and Retirement Proposition (CIRP)
- Consumer Duty Proposition (CDP)

If you would like to explore the consultancy service we offer to firms, visit our website and email.

Website

www.opendoorpolicy.co.uk

Email

info@opendoorpolicy.co.uk

KEY TAKEAWAYS

Systems and controls

- Robust processes and controls should be in place.
- Systems and controls should be fit for purpose and effectively mitigate risk of unsuitable outcomes.
- Conflicts of interest should be managed fairly, and any potential conflicts identified. Where a potential conflict arises, appropriate steps to mitigate the risk should be undertaken.
- Firms should have a robust and challenging file review process.
- Management information (MI) should be in place.

Centralised Investment Proposition (CIP)

- CIPs should:
  - consider the needs and objectives of its target clients
  - ensure that it is not shoe-horning
  - establish a robust risk identification and control system
- When offering a CIP, consider the requirements of target clients.
  - knowledge and experience
  - financial situation
  - investment objectives
  - the type, level and cost of the service
- Firms may create different portfolios of assets to cater for different client risk profiles.
- A firm must ensure that its advisers are competent and understand the CIP.

Know your client

- Firms are required to obtain the necessary information about the client’s investment objectives.
- With existing investments, firms should collect necessary information to assess whether a replacement investment is suitable and meets client needs and objectives.
- Fact-finding should never be approached with a preconceived agenda to switch.

Recommendations

- When recommending based on improved performance, the Regulator expects justification specifically on why the new investment is likely to out-perform the existing investment.
- Regard should be given to potential tax implications.
- Firms should not systematically transfer all existing investments into the CIP without considering client needs and objectives.
- Firms should consider whether a recommendation to a client to sell their existing investments is suitable.

Costs

- When switching to a more expensive investment because of the prospect of improved performance, additional costs to be accounted for.
- Consider whether it is possible to recommend the adjustment of existing investments to meet risk profiling in a more cost effective manner. If it results in an additional cost firms should judge on whether the additional cost is in the client's best interest.
- Consideration should be given to whether additional costs are likely to make a recommendation unsuitable, including the magnitude and the potential benefits associated with that cost.
- A firm may offer different service levels and features to suit clients with different requirements and should inform clients of the services and costs in a way that is fair, clear and not misleading.

Risk management

- Firms are responsible for risk management and ensuring systems and controls are fit for purpose.
- Where a firm creates or uses risk-rated portfolios as part of its CIP, it must ensure the portfolios align accurately with the risk descriptions and outputs from any risk profiling tool it employs. Where there is a mis-alignment there is a risk of systemic mis-selling.
- The firm should explain these risks to its clients in a way that they are likely to understand.

Segmentation

- Segmenting involves offering a range of CIP solutions to meet the needs and objectives of different client segments. This is in firms' interests as it is likely to increase the number of clients for whom a CIP solution is suitable.

1. SUMMARY

Following the RDR, the Regulator carried out a thematic review to assess how a move to CIPs has affected consumers. FG12/16 outlines their findings and concerns which, if not mitigated, could result in poor customer outcomes. It also identified suitability failings relating to replacement business.

Robust processes and controls should be in place when recommending replacing an existing investment. In particular:

- costs are in the client's interest
- presented in a way that the client can understand
- when improved performance is a driving factor it is clear why the new investment is likely to out-perform
- the recommendation is suitable given:
    - tax implications
    - client specific objectives
- collation of information on existing investments demonstrates why these no longer meet needs and objectives.

Firms conducting replacement business should consider reviewing

- its replacement business sales process
- the controls in place to mitigate the risk of unsuitable recommendations
- the quality of management information and whether issues are identified and acted on
- the quality of the file review function

A firm engaging with CIPs should:

- consider the needs and objectives of its target clients
- ensure that it is not shoe-horning
- establish a robust risk identification and control system

2. OVERVIEW

Firms offering a CIP which may be driven by creating additional value for clients and to justify ongoing adviser charging.

The FSA used the term CIP to reflect a standardised approach to providing investment advice such as:

- Portfolio advice services
- Discretionary investment management, in-house or referred to a third party
- Distributor-influenced funds (DIFs).

The FCS recognise there can be benefits to offering a CIP for both clients and firms, however they had concerns that a CIP may be unsuitable. For example:

- Shoehorning: recommending a 'one size fits all' solution
- Churning: advising a switch without adequate consideration
- Additional costs: higher and potentially less transparent charges with few additional benefits

TR12/16 focused on the:

- CIP, designed to meet the needs and objectives of target clients
- the sales process, designed to ensure it is only recommended to clients when suitable
- firm's adviser competency
- CIP promotion and recommendation in a way that is fair, clear and not misleading
- adequate oversight MI to mitigate the risk of unsuitable advice

Key findings

Replacement business

- Identification of firms failing to consider the impact and suitability of additional charges in replacement business
- Failing to consider the costs and features of the existing investment
- Inability to quantify the additional charges associated with a new investment
- Failing to provide comparison costs in a way the client was likely to understand
- Recommending switches based on improved performance, but providing no supporting evidence
- Failing to collect adequate information on the existing investment
- Failing to consider the features and funds available within the existing solution
- Indications that file review functions failed to identify or challenge advisers

The Regulator consider that these factors create a significant risk that clients are receiving unsuitable advice.

Centralised investment propositions

- Good practice, such as
    - conducting detailed research on the typical needs and objectives of target clients
    - segmenting client banks to offer a range of CIP solutions for different segments
- Operating a CIP as the automatic investment solution for all clients
- Not always ensuring advisers were competent to identify when the CIP was not suitable
- Receiving additional financial gains, incentivising the firm and its advisers to recommend the CIP rather than an alternative solution
- Conflict of interest not managed

3. REPLACEMENT BUSINESS

Key issues firms should consider

Poor outcomes can occur if firms fail to:

- consider objectively their clients' needs and objectives
- collect information on existing investments and the recommended new investments
- implement a robust risk-management system

Factors that influence a recommendation to switch investment

Firms are required to obtain the necessary information about the client's investment objectives. The main factors that usually dictate a client's investment return include:

- charges
- performance
- tax treatment

The Regulator expects firms to consider these factors and demonstrate the benefits of a new investment proposition before recommending a switch. Even in a case where making a return is not the client's primary objective (e.g. ethical investment) so that any disadvantages of the switch can be clearly explained.

Considering cost

Expectations

- Consider costs for all recommendations to replace existing investment
- Where a more expensive solution is recommended, there needs to be a good reason with justification
- When switching or transferring, conducting a cost comparison
- Consideration all the costs, such as trading charges
- Where additional costs apply, judging whether they are suitable considering the needs and objectives of the client
- Additional costs may be justifiable where they are associated with a specific benefit valued by the client
- Any difference in the cost disclosed in a way that is fair, clear and not misleading

Good practice

- Using reduction in yield (RIY) figures in cost comparisons
- Using comparative projections to demonstrate the impact of cost differences

Poor practice

- Providing cost comparison in a suitability report when recommending replacement business.
    - The annual cost of the recommended investment was based on the annual management charge.
    - The provider's illustration highlighted additional charges which were omitted from the cost comparison.
    - This increased the annual charge by up to 1% which was not considered

- Offering a CIP via a discretionary service, but a cost comparison not assessing the impact of all charges. The senior management team and compliance were unaware of the impact that a large volume of trades may have.

Considering performance

Expectations

Not to automatically assume that the CIP will provide better performance prospects. When recommending replacing business based on improved performance prospects, the Regulator expects justification specifically on why the new investment is likely to out-perform the existing investment.

When switching to a more expensive investment because of the prospect of improved performance, the Regulator expects the additional costs to be accounted for.

Poor practice

- Stating in suitability reports that factors affecting the choice of investment partner included investment options and performance but with no evidence that these were considered.
- Explaining improved performance by highlighting that the client would benefit from active management, implying that the existing investment was not actively managed. However existing investments were already actively managed.

Considering the tax position

Expectations

Before recommendation, due regard should be given to potential tax implications as tax acts as an additional cost by reducing the client's return on their investment. Firms should consider whether the investment is the most tax efficient option.

Poor practice

- Not considering the impact of taxation by making recommendations which triggered CGT but giving no consideration to mitigating the level of tax payable.

Considering the client's specific needs and objectives

With existing investments, firms should collect necessary information to assess whether a replacement investment is suitable and meets client needs and objectives.

Collecting and assessing appropriate know your client information

Expectations

Once objectives and financial priorities are established, they should help in client understanding and prioritising. It should be approached in a fair and balanced way, in accordance with the client's best interests. Fact-finding should never be approached with a preconceived agenda to switch as this may not be the most suitable option.

Recommendations should be presented in a personalised suitability report, reflecting specific client needs and why replacing existing investments meets those needs.

Good practice

- Client files with detailed fact finding including specific investment objectives and underlying motives behind objectives. This level of detail helped demonstrate that replacement business met client needs and objectives.

Considering the client's risk profile

Expectations

If recommending switching to allow assets to be managed in line with risk profiling, it should be suitable considering the client's objectives and their existing investments.

Firms should consider whether it is possible to recommend the adjustment of existing investments to meet risk profiling in a more cost effective manner. If it results in an additional cost firms should judge on whether the additional cost is suitable and in the client's best interest.

Collating and assessing information on existing investments.

Expectations

To collate necessary information on existing investments to assess whether a switch meets client needs and objectives. Firms should consider several factors:

- Investment flexibility. Where an existing investment solution is flexible enough, consider whether it is in best interest to switch. The FSA would question whether the need for a 'wider investment choice' is adequate justification to incur additional costs if the existing product already has a wide enough investment choice.
- Guarantees. If guarantees are no longer suitable, a switch may be appropriate. If the guarantees have value, consider whether the switch is suitable in light of the loss of the guarantees.

Good practice

- Details of each existing investments presented in a suitability report, including features & benefits and performance. Clearly documented recommendations for each investment, including specific rationale and recommending retaining existing investments that already meet client needs and objectives.

Controls and oversight

Expectations

Firms are responsible for risk management and ensuring systems and controls are fit for purpose and effective in mitigating the risk of unsuitable outcomes. Controls include:

- using documents to record specific information around the rationale for the switch
- rating replacement business as ‘high risk’ resulting in a higher number of checks requiring pre-approval
- using MI to monitor advisers’ business levels and advice

Different controls are likely to be effective for different firms depending on their size, structure, their advisers and the services they provide.

A firm will need to adopt a consistent approach across the different parts of the business, including:

- senior management team
- compliance
- file checkers
- advisers
- paraplanners
- support staff
- any other individual involved in the advisory process

Consideration should be given to whether additional costs are likely to make a recommendation unsuitable, including the magnitude and the potential benefits associated with that cost.

Good practice

- Placing a limit on the additional acceptable cost at 0.5% per annum, exceeding this limit only in exceptional circumstances after management approval.
- A range of cost levels on a traffic light scale (red/amber/green ratings) with different requirements for each.

Poor practice

- Not clearly defining acceptable additional costs. As a result, file reviewers were not consistent on whether additional costs were justified.

4. CENTRALISED INVESTMENT PROPOSITIONS

This section considers:
- steps to take when designing or adopting a CIP
- expectations to ensure recommendations into a CIP are suitable
- expectations of firms to act honestly, fairly and professionally, in the best interests of clients

Key issues firms should consider

When designing a CIP, poor outcomes can occur if firms fail to:

- consider the needs and objectives of their target clients
- consider whether the CIP is suitable for each individual client
- establish a robust control system to mitigate risks

CIP design and due diligence

Client needs and objectives should be at the heart of the decision to offer a CIP. A firm should consider whether a CIP is appropriate and the type of CIP that should be offered.

Considering the needs and objectives of your target clients

Expectations
When offering a CIP, the FSA expect consideration of the requirements of target clients. For example:

- knowledge and experience
- financial situation
- investment objectives
- the type, level and cost of the service

Good practice
- Using client feedback to identify if clients only required a simple, low cost CIP. The feedback used to design and implement a CIP that provided a simple ongoing review service at a lower than average cost.
- Engaging client-facing staff to provide guidance on client needs and objectives when considering whether to offer a CIP.

Poor practice
- Inheriting CIP solutions following mergers or acquisitions, and subsequently failing to establish whether the CIP was suitable for the needs and objectives of a new, larger client bank.

Client segmentation

Expectations
Segmenting involves offering a range of CIP solutions to meet the needs and objectives of different client segments. This is in firms' interests as it is likely to increase the number of clients for whom a CIP solution is suitable.

A firm may offer different service levels and features to suit clients with different requirements and should inform clients of the services and costs in a way that is fair, clear and not misleading.

Good practice
- Segmenting a client bank effectively and designed appropriate solutions to cater for each segment, including
    - a preferred fund panel for transactional clients
    - a suite of low-cost managed funds for clients with modest asset levels who required a low-cost ongoing service
    - a model portfolio service for clients with a higher level of assets and investment experience, where the additional costs were appropriate
    - discretionary fund management for clients who required bespoke investment management solutions

Designing or adopting a CIP

Our expectations
Firms must decide whether to design a CIP themselves or adopt a CIP created by a third party. Whichever option, it must still ensure the CIP is suitable for its target clients and meets their needs and objectives.

When adopting a CIP by a third party, adequate due diligence should be conducted to ensure it meets the needs and objectives of target clients. Firms cannot assure themselves that the CIP is likely to be suitable for their clients without due diligence and therefore should not adopt the CIP. Consider:

- terms and conditions
- charges
- the provider's reputation and financial standing
- range of tax wrappers
- type of underlying assets
- flexibility and adaption to meet individual client's needs and objectives
- the provider's approach to due diligence on the underlying investments.

A firm may decide to refer investment selection to a third party. When referring to a discretionary manager, both the introducer and the discretionary manager have obligations to ensure client suitability. The obligations on each party will depend upon the nature and extent of the service.

Both parties should be clear on their service and meet the corresponding suitability obligations. If either or both parties are not clear, there is a risk that clients may receive unsuitable advice and/or have their portfolios managed inappropriately.

When the discretionary manager treats the advisory firm as its client the advisory firm should explain the position clearly to its clients. It should emphasise that it is not carrying out the investment management itself and that the discretionary manager in not treating the end investor as its client.

Good practice

- Carrying out a review of their client needs and formulated a list of key requirements before tendering for a third-party CIP provider.

Poor Practice

- Adopting a CIP provided by a third party with an existing relationship but failing to undertake any due diligence.
- Acting as an agent for its client referred to a discretionary fund manager but not adequately explain to the client that it was not responsible for the investment management and that the discretionary fund manager was not treating the client as its customer.

Constructing portfolios that are suitable for the risk profile of distinct client segments

Expectations

When designing a CIP, firms may create different portfolios of assets to cater for different client risk profiles. Where a firm creates or uses risk-rated portfolios as part of its CIP, it must ensure the portfolios align accurately with the risk descriptions and outputs from any risk profiling tool it employs. It is the responsibility of the firm to ensure this alignment. Where there is a mis-alignment there is a risk of systemic mis-selling.

When using an asset-allocation approach to portfolio construction, firms should ensure robust processes are in place to mitigate portfolio drift. Firms should clearly explain to clients the importance and reason for ongoing reviews.

Poor practice

- A CIP using model portfolios managed on a discretionary basis, which contained significant exposure to non-traditional and equity-based investments than were appropriate for clients, particularly at the lower end of the risk scale. Not providing evidence that needs, objectives and knowledge & experience of its clients were considered, some of whom were not financially aware and were unlikely to understand the risks.
- Offering an asset allocation process but neither offering an annual review to rebalance nor explaining the importance of rebalancing to its clients.

A firm must have a reasonable basis for believing that its clients have the necessary knowledge and experience to understand the nature of the risks of the underlying investments held in the CIP. The firm should explain these risks to its clients in a way that they are likely to understand. This is particularly important where the CIP uses non-traditional investments.

When the CIP solution is not suitable for an individual client, a firm must either recommend an alternative suitable solution or make no recommendation to the client. It is not acceptable to shoe-horn clients into the CIP solution.

Ensuring a recommendation to switch existing investments into the CIP is suitable

Expectations
Firms should not systematically transfer all existing investments into the CIP without considering client needs and objectives. Firms should consider whether a recommendation to a client to sell their existing investments is suitable.

Poor practice

- Presenting recommendation to transfer into a CIP and completing application forms before analysing the features and benefits of the client's existing investment.

Ensuring advisers are competent and can identify when a CIP is and is not suitable

Expectations
A firm must ensure that its advisers are competent and understand the CIP. Firms should ensure that advisers receive training, highlighting

- potential benefits and features
- associated cost
- risks or drawbacks

Advisers should be able to identify when a recommendation for a CIP is not suitable for a client.

Good practice

- Offering a transactional service when a CIP is not suitable. Advisers received training on the CIP and able to identify under what circumstances it would not be suitable.

Poor practice

- Advisers not permitted to research or recommend any investments other than the CIP. No facility to adapt solutions outside of the range of the CIP and no arrangements to turn away clients for whom the CIP was not suitable. As a result, all investment recommendations consisted of a CIP solution, creating a significant risk of unsuitable advice.

Controls and oversight

Maintaining robust systems and controls to mitigate the risk of providing unsuitable advice. Firms are responsible for ensuring that systems and controls are fit for purpose and effectively mitigate the risk of unsuitable client outcomes.

Identifying and managing conflicts of interest

Expectations
Offering a CIP may create a conflict of interest. For example:

- a firm, or its employees, making an additional financial gain by recommending a CIP
- a firm adopting a CIP provided by a third party that retains a financial interest in the sales volumes of the CIP and provides additional, non related services to the advisory firm

Conflicts of interest should be managed fairly, and any potential conflicts identified when offering a CIP. Where a potential conflict arises, appropriate steps to mitigate the risk should be undertaken. Senior management should place emphasis on managing conflict of interest rather than relying on disclosing the conflict to clients.

Poor practice

- Employees personally benefitting from the success of the CIP offering. Senior management did not recognise there was a conflict of interest and were unable to demonstrate that they had effectively managed it.

Poor practice

- Adopting a CIP designed and packaged by a third-party firm in which the firm had a financial interest in the success of the CIP. The firm also used the compliance and file review functions offered by the same third party. This created a potential conflict as the third party was assessing the suitability of recommendations into its own proposition. Senior management of the intermediary firm had not identified this conflict and did not ensure the firm adopted an independent approach to the file review process.

File checking

Expectations
Firms should have a robust file review process. The file review function should challenge advisers on suitability, disclosure and other failings. File checkers should be trained on the CIP and ensure they are competent in identifying when a CIP recommendation is and is not suitable.

Poor practice

- Setting a minimum threshold for investment into a CIP but failing to confirm this threshold to the third party firm that carried out the file checks. The third-party firm was not checking the suitability of advice against this key measure.

Management information

Expectations
Management information (MI) to monitor risks that could lead to poor client outcomes should be in place. The scope and nature of the MI will depend upon several factors, including the size of the firm and its business model. Examples of MI:

- the volume of CIP recommendations versus the volume of non-CIP recommendations
- ongoing competence of advisers
- file reviews

Where risks or failings are identified, appropriate action should be put in place.

Good practice

- Commissioning the development of a bespoke MI package for daily use by the Compliance Director. The MI provided real-time updates for each adviser against a variety of criteria, such as
    - business mix
    - the proportion invested in a CIP
    - provider mix
    - product persistency
    - income levels
    - file review results

  The MI package enabled the Compliance Director to regularly ask each adviser technical questions. Their answers enabled the firm to develop targeted training sessions for the advisers and fed into their ongoing competency assessment.

Good practice

- Using MI to inform senior management of the volume of business that each adviser was recommending into the CIP, establishing a RAG rating to identify advisers who appeared to be recommending relatively high proportions into the CIP.

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Email

info@opendoorpolicy.co.uk

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