Retrocessions
A thing of the past?

Andrew Power
Partner
Consulting
Deloitte

Andreas Timpert
Partner
Consulting
Deloitte

Erika Merizzi
Consultant
Consulting
Deloitte

Ever since the global financial crisis and the European debt crisis, regulators have been scrutinising the financial services sector and implementing legislation to make the industry more transparent and accountable. The latest wave of regulations that address the asset management business model is no different.

With MiFID II on the way and similar regulations in non-EU jurisdictions, the asset management industry is being forced to undergo a major transformation. One widely-debated topic has been the fee structure of advisors, particularly the ban on inducements. Regulators across Europe see these fees as non-transparent and are taking measures to either ban retrocessions outright or drastically reduce them through stringent controls.

The 27 EU member states will likely be allowed their own inducement approach, but either way the directive is calling for radical change. The Netherlands, Denmark and United Kingdom, for example, have decided to implement a complete ban on inducements. Such regulations are resulting in fundamental changes to the way in which financial advisors and asset managers operate, forcing them to re-evaluate their entire business models.

EU and the Markets in Financial Instruments Directive (MiFID) II

The aim of MiFID II is to help move the EU towards a more unified, competitive and transparent financial services industry. The 'trialogue' between the European Union's Council, Parliament and Commission is shortly expected to reach a conclusion on a final directive, which could require transposition by EU member states by 2015. MiFID II broadens and refines MiFID I (in place since 2007) and will have a fundamental impact across the European securities markets. More specifically, MiFID II focuses on thirteen key strategic topics, one of which relates solely to the use of inducements, or retrocessions. Historically, fund managers have offered financial advisors hefty commissions or retrocessions, which are fees charged to the fund and therefore an indirect cost to the investor.

Under the current revision of MiFID II, advisors will no longer be allowed to accept any monetary or non-monetary benefits paid by any third party, except for minor non-monetary benefits—but only if they improve the quality of service and do not prevent the firm from acting in the best interest of the client[1]. In addition, advisors will have to disclose all management fees and upfront fees.

Furthermore, MiFID II's revised definition of independent investment advice states that financial service providers will only be able to claim independence if they do not receive any form of remuneration from third-party providers.

1 European Council, June 2013, Article 24

Impact of MiFID II

1. **New business models**
   Under this new legislation, banks will need to start charging an explicit advisory fee to clients and/or increase the brokerage fee to replace the lost revenue from retrocessions. Changing the fee structure could impact the business model in different ways. First, the new fee structure will likely lead to fewer advisors, as clients may be unwilling to pay these advisory fees. In this scenario, clients may decide to bypass the advisor entirely and go directly to the asset manager via online platforms. Second, the client may still seek traditional types of advice from an advisor but that client base is likely to be far smaller and primarily affluent or high net worth. Third, new lower cost advice models will need to be developed whereby less affluent customers obtain guidance on their investments rather than a full advice service.

2. **High margin products likely to suffer**
   We believe that these changes are also likely to impact the more sophisticated investment products where banks benefit from the highest margins. More complex products logically call for higher fees due to higher costs, uniqueness and complexity. Since the new legislation mandates that these fees be explicit, client demand for these products is likely to decrease unless true value is being delivered to the client. The industry has already suffered a substantial decrease in demand for complex products subsequent to the financial crisis, when preferences shifted towards more transparent and simpler products. Overall, a further reduction or elimination of fees from high margin products is likely to worsen the profitability problems of many asset managers.

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UK and the Retail Distribution Review (RDR)

The United Kingdom is one of the three European jurisdictions to prohibit inducements and implemented this change through RDR, a new legislation which came into effect just over a year ago (31 December 2012). The UK's Financial Conduct Authority (FCA) introduced this mandate to a) end conflicts of interest in the financial advisor payment structure, b) increase transparency in respect of how investors pay for their financial advice and c) strengthen the professional qualifications of advisors and clarify the type of advice they provide[2]. Under the new regulation, financial advisors (and platform operators as from 6 April 2014) are no longer allowed to receive commissions from fund managers on new business. Instead, all retail investment advisors must develop an upfront fee structure and disclose it to investors. Deloitte research has predicted that as a direct result of this new fee structure, up to 5.5 million people in the United Kingdom would either become unable or unwilling to pay for financial advice (also called the advice gap)[3].

Before RDR even came into effect, some of the UK's largest financial institutions had already announced their plans to withdraw advisor services from the mass market segment, including Lloyds Banking Group, HSBC and Barclays[4].

Shortly after RDR came into effect, Aviva and Axa also announced they would discontinue advice as well, further impacting other players. In the year leading up to the implementation of RDR, the total number of bank and non-bank advisors dropped by 44% and 20%, respectively[5].

In addition to the ban on inducements, in October of last year, the FCA decided to further investigate fund charges, particularly the cost of third-party research and other fees. Currently, asset managers pass these fees onto the investors via management fees. The head of the FCA, Martin Wheatley, told the Financial Times that asset managers have 'stretched the definition' of what they can use commissions to pay for[6]. If the UK goes forward with legislation to unbundle management fees, it would be the only country in the world to do so, and it would likely lead to a decrease in asset managers buying research.

One implication could be that active portfolio managers, who have a tendency to depend on research to be successful, will be negatively impacted, whereas passive managers could benefit.

2 *Financial Services Authority (FSA), 'FSA details the enhanced standards people can expect from all investment advisers,' (2009) <http://www.fsa.gov.uk/pages/library/communication/pr/2009/082.shtml>*

3 *S Cohen, P Evans and A Power, 'Bridging the advice gap: Delivering investment products in a post-RDR world' (2012) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-bridging-the-advice-gap.pdf>*

4 *A Power, 'Recognising RDR Reality: The need to challenge planning assumptions' (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>*

5 *N Holt, 'First official RDR stats: adviser numbers down 20%, bank advisers fall 44%' (2013) < http://www.moneymarketing.co.uk/first-official-rdr-stats-adviser-numbers-down-20-bank-advisers-fall-44/1068505.article>*

6 *S Fleming and D Oakley, 'Shake-up on charges for UK asset managers' (2013) < http://www.ft.com/intl/cms/s/0/59b33776-40ca-11e3-ae19-00144feabdc0.html#axzz2keldHPB8>*

Impact of RDR

In our view, the ban has led to the following five key changes:

1. **New fee structure**
   As a result of RDR, the advisory industry has been forced to re-evaluate its fee structure and find a cost-effective solution. Different schools of thought have emerged as banks and advisors try to find the right formula. Some of the new fee structures include: hourly rates, percentage of funds invested and annual flat fees[7]. This fee-for-service structure is also shifting advisor behaviour. Rather than trying to beat the market or aggressively sell a product, advisors are amending their propositions to something they can better control and that is aimed more at financial planning[8].

2. **More clients going direct**
   Alternatively, many retail clients are choosing not to pay for financial advice, instead opting to either use online platforms or go direct. According to Deloitte Research, this growing segment currently represents approximately 20% of the wealth market, a total of around £450 billion in Assets under Management (AuM), which is likely to grow by another £125 billion as a result of the advice gap[9]. This growing trend to go direct is causing concern among the regulators. In fact, in September 2013, Wheatley expressed concern over the advice gap: 'It is a concern that people with portfolios below £50,000 to £100,000 are not getting the same service they were getting'[10]. To take advantage of this opportunity, players in the non-advised market will need to differentiate themselves by targeting specific client segments and implementing a pricing strategy that is both competitive and profitable, despite the ban on rebates[11].Those that can implement new, innovative solutions to target the mass market will win.

3. **Tailored approach for mass market**
   Banks and asset managers need to focus on improving their operational efficiency. At the current rates, the client base for advisors is quickly shrinking. In order for advisors to hold onto a larger portion of their affluent customer segment, they need to further tailor their approach and offer services with lower fees that are most closely aligned with the sophistication of client needs and the willingness to pay. Getting client segmentation right is more important than ever.

4. **Passively managed products are benefiting**
   Passively managed investment products are receiving more attention owing to the increase in transparency. Previously, the low charges on these products meant they could not afford to pay retrocessions so were rarely recommended by advisors. In the new environment, advisors no longer have this distinction and can use lower cost, passively managed products to appeal to customers who might object to paying advisor fees.

5. **Development of clean share classes**
   Investment managers have had to develop clean share classes that strip out commission and platform fees. A significant debate is under way regarding whether all clients should be switched into these lower cost share classes automatically or if they can be kept in traditional share classes as the commission reflects advisory services provided in the past. Tax plays a key role in whether such a switch is beneficial to a customer.

Switzerland: lawsuits, FINMA publications and the Financial Services Act (FSA)

A number of factors, both at home and abroad have created a heated debate in Switzerland about the use of retrocessions. In Switzerland, two civil lawsuits have triggered widespread debate. The most recent was a civil lawsuit that took place in October 2012 against UBS, whereby a client made a claim for the retrocessions his advisor received. In this landmark ruling, the Swiss Federal Supreme Court ruled in favour of the claimant and ordered UBS to reimburse the fees with retroactive effect. The judgment makes it clear that investors are entitled to all commissions and/or retrocessions that banks receive from funds. If the bank fully discloses all fees, clients still have the choice of whether or not to waive their right to make any such claims.

In line with these court rulings, and in light of developments across the EU, Switzerland’s watchdog, the Financial Market Supervisory Authority (FINMA), published a Position Paper in February 2012 on distribution rules, which stipulates that banks must inform clients of any remuneration received from third parties or from within the company. This implies that in certain cases, banks could be required to disaggregate bulk rebates the bank may have received from funds in order to determine how much is owed to a specific individual. In a similar way to MiFID II, the Position Paper also states that advisors may only claim independence if they do not receive any third-party incentives. In addition to the Position Paper, FINMA published a revised Circular on the ‘Guidelines on asset management’ (which took effect on 1 July 2013) that sets forth specific guidelines for asset managers to follow as a minimum standard for rules of conduct.

7 *Financial Conduct Authority (FCA), ‘Supervising retail investment advice: how firms are implementing the RDR’ (2013) <http://www.fca.org.uk/static/documents/thematic-reviews/tr13-05.pdf>*

8 *N Blake, ‘Why it's too early to call a result to RDR’ (2013) <http://www.ifaonline.co.uk/ifaonline/feature/2296781/why-its-too-early-to-call-a-result-to-rdr>*

9 *A Power, ‘Recognizing RDR Reality: The need to challenge planning assumptions’ (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>*

10 *S Dale, ‘Wheatley admits 'concern' over post-RDR advice gap and hints at action’ (2013) <http://www.moneymarketing.co.uk/wheatley-admits-concern-over-post-rdr-advice-gap-and-hints-at-action/1077089.article>*

11 *A Power, ‘Recognizing RDR Reality: The need to challenge planning assumptions’ (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>*

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More specifically, it establishes additional requirements for asset managers to inform clients of the 'calculation parameters and spread of inducements they receive or might receive', as well as to disclose the amount of any inducements already received at the request of the client.

Despite FINMA's publications, many issues remain unaddressed by the law. New legislation is therefore under way under the Financial Services Act (FSA), which will ultimately determine the use of retrocessions. Implementation is not expected before 2015. Market expectations are that a compromise with strict conditions is more likely than an outright ban.

Impact of the lawsuits and the FSA

The reimbursement of retrocession fees on a retroactive basis will vary from bank to bank but the impact will be sizeable. According to Reuters, independent asset managers in Switzerland have earned approximately CHF 7 billion in retrocessions over the last five years, of which a large portion is at risk of being owed to the client[12]. In fact, the exposure could prove to be even greater, as the retroactive effect is still being debated (it will be either five or ten years). Although the highly integrated financial services companies will likely face the biggest bills, smaller asset management firms may find it hard to fund the rebates.

As a result of these events, UBS became one of the first Swiss banks to eliminate retrocession fees associated with products sold to discretionary private clients, and will phase them out by the end of 2013[13]. Credit Suisse and AKB have also decided to phase out retrocessions, by 1 July 2014[14] and 1 January 2014[15], respectively. In addition, many asset managers are also reacting to the new landscape. For example, Swisscanto, the Berne-based asset manager owned by Switzerland's cantonal banks, has created commission-free share classes for both qualified and discretionary investors[16].

Conclusion

Regardless of your jurisdiction, there is a clear regulatory trend sweeping across Europe to move away from retrocessions and towards a more transparent, upfront fee structure. The following are three ways for asset managers to respond:

- If you have advisors in-house: sell your products and earn advisory fees on asset management products
- If you do not have retail distribution: brand, performance, price or meeting investor requirements are the few remaining ways to raise your profile with retail investors not using advisors
- If your products are not performing, you will be exposed—more rationalisation and a stronger emphasis on passive products might be the only way

12 *M de Sa'Pinto, 'Swiss asset managers sweat over UBS fee ruling' (2012) <http://uk.reuters.com/article/2012/11/12/swiss-investment-fees-idUKL5E8M97RB20121112>*

13 *NUBS Press Release, 'Revised pricing structure for discretionary mandates' (2013) <http://www.ubs.com/global/en/about_ubs/about_us/news/news.html/en/2013/03/13/20130313a.html>*

14 *'Credit Suisse verzichtet auf Retrozessionen' (2013) <http://www.nzz.ch/aktuell/wirtschaft/wirtschaftsnachrichten/credit-suisse-verzichtet-auf-retrozessionen-1.18177022>*

15 *'Auch AKB leitet Retrozessionen weiter' (2013) <http://www.handelszeitung.ch/unternehmen/auch-akb-leitet-retrozessionen-weiter-522253>*

16 *D Ricketts, 'Switzerland plans crackdown on rebates' (2013) <http://www.igniteseurope.com/c/578394/65254/switzerland_plans_crackdown_rebates?referrer_module=emailMorningNews&module_order=0&code=WVdKaGRXTm9ZWFJBWkdWc2IybDBkR1V1YkhVc0lERXdNekV4T0RRc0lERXdPVEUyT1RNM09UWT0>*

To the **point**:

- Across Europe, retrocessions are likely to be either banned or highly restricted in the next one to three years
- The traditional advisory business model is at risk, but careful segmentation and new, innovative propositions can help distributors retain their client base
- In countries with inducement bans already in place (e.g. the UK), we have seen a significant shift in consumers preferring to go direct
- In countries without retrocession legislation already in place (e.g., Switzerland), we have seen banks and asset managers take pre-emptive action to reposition themselves ahead of the changes—deciding how to prepare for this shift should be a key priority for each asset manager

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