Financial Services

DISTRIBUTION DISRUPTION

IMPACTS OF THE DEPARTMENT OF LABOR FIDUCIARY STANDARD FOR US LIFE INSURERS

AUTHORS

Mick Moloney, Partner
Insurance Practice, Americas

Ramy Tadros, Partner
Head of Insurance Practice, Americas

David Clarkson, Partner
Wealth & Asset Management Practice, EMEA

Anthony Bice, Partner
Insurance Practice, Australia

The Department Of Labor's (DOL's) latest proposal to expand the definition of a fiduciary under the Employee Retirement Income Security Act (ERISA), if adopted substantially in its current form, will cause significant disruption to the advice landscape surrounding 401K rollovers and IRAs and will have substantial knock-on effects for retail insurance distribution channels generally.

From a new business perspective, more than half of the new money flows to the Variable Annuity and Fixed Index Annuity market and about a quarter of Fixed Annuity sales are from qualified pools of retirement assets. This is "ground zero" for the DOL's campaign. The stakes are high with an estimated 5-year flow from IRA rollovers of $2.5 TN which represents a huge share of addressable asset flows for insurers, wealth, and asset managers.

More broadly, however, the changes will have a range of strategic impacts on life insurers beyond annuity manufacturing including retention strategies for DC assets in retirement businesses, effects on mutual fund complexes and the economics of owning distribution in the form of broker/dealer platforms or tied agents.

Since the publication of the notice, industry participants have been examining the potential implications for their business models. Reactions range from believing that the fiduciary standard will profoundly impair sales of products used within IRAs, such as annuities, with knock-on implications on non-qualified assets, to more nuanced views of the changes to compensation models and distribution structures that will be required by the Best Interest Contract exemption.

Our view is that the proposal will have very significant effects – based on our knowledge of the requirements of fiduciary standards within institutional retirement plan settings, and an analysis of similar though more extreme changes which have already occurred in the UK and Australia. These UK and Australian regulatory changes were prompted by issues similar to those identified by the DOL although reforms in both places went significantly further by implementing an outright ban on commissions for advisors. The landscape in both countries has been deeply impacted with changes continuing to play out today; we have identified some of the key trends evident in both places as a result of reforms.

While commission structures will still exist in the US, we believe that the trajectory of change is close enough to that in the UK and Australia that similar impacts will occur here. These changes will significantly affect competitive dynamics in a manner that could have profound impacts on market participants.

Generally, we believe that the proposals will cause a redistribution of economics across the value chain value thereby accelerating the emergence of new business models.

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WHAT'S HAPPENING?

The DOL has long had a concern that people choosing to rollover assets from an employer sponsored pension plan to an IRA are not being well advised and, as a result, are investing in products which are not the most appropriate for their needs and/or are unnecessarily expensive. Central to their concern is what they perceive as a lack of transparency around the standard under which an advisor is providing advice and how he/she is being compensated. This is not surprising since advisors operate under multiple standards with a majority of asset flows falling under a "suitability" rather than fiduciary standard[1].

The DOL's proposed solution is to expand the definition of a fiduciary under ERISA and the Internal Revenue Code to impose fiduciary status on anyone providing advice regarding assets of an ERISA plan or IRA – specifically including advice on rollover of assets to an IRA. Becoming a fiduciary would impose duties of loyalty, prudence, disclosure and monitoring but would also have a very fundamental impact on advisor compensation. Specifically, "ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, **including using their authority to affect or increase their own compensation, in connection with transactions involving a plan or IRA.**" This covers "fees and compensation common in the retail market, such as **brokerage or insurance commissions, 12b–1 fees and revenue sharing payments,** (which) fall within these prohibitions when received by fiduciaries as a result of transactions involving advice to the plan participants and beneficiaries"[2].

Becoming a fiduciary would, therefore, prohibit many of today's common compensation arrangements. To facilitate continuation of certain commission payment practices, the DOL has proposed a set of changes to the so called Prohibited Transaction Exemptions under ERISA and the Code. The principal of these changes is the introduction of a new "Best Interest Contract Exemption". In order to qualify for the Exemption, the advisor and financial institution must contractually acknowledge fiduciary status and commit to certain conditions – thus providing a basis on which rights can be directly enforced by the advisee. Exhibit 1 captures what we consider to be principal requirements of the Exemption that will drive substantial change.

1 The Financial Industry Regulatory Authority's (FINRA) Rule 2111 requires that an advisor must have "a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors" whereas the requirement under ERISA as described by the DOL would be that "…the Adviser and Financial Institution act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor, when providing investment advice to them. Further, under the best interest standard, the Adviser and Financial Institution must act without regard to the financial or other interests of the Adviser, Financial Institution or then Affiliates or any other party."

2 Federal Register/Vol. 80, No. 75/Monday, April 20, 2015/Proposed Rules – Proposed Best Interest Contract Exemption – Executive Summary, Purpose of Regulatory Action

Exhibit 1: Best Interest Contract Exemption Summary

PROPOSAL REQUIREMENTS	LIKELY IMPACTS
• **Advice must be in the "best interest" of the investor** • Best interest is defined to mean that the Advisor and Financial Institution act with "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor"	• Likely to require a more comprehensive advice framework than currently used i.e. advisors will need to comprehensively capture financial circumstances and consider a broad product set including e.g. use of passive/ETF alternatives, retention of assets in 401K plan etc. • Will make use of proprietary products more challenging and may require broadening of advice to cover non-product related actions (e.g., debt reduction) • May increase the scrutiny on the credit worthiness/rating of the insurers where an advisor is recommending products with long-dated guarantees
• Proposal requires **both public and individual disclosure of advisor compensation with exhaustive detail** • Must show compensation for full product suite available and products used • DOL provided model form disclosure for website showing examples for proprietary and no-load mutual funds, annuities (Fixed and Variable) and Equities, ETFs, Fixed Income • For VAs, would require disclosure of upfront charge on investment, breakdown of upfront and ongoing commission paid by insurer to advisor and firm, charges to investor, payments to any affiliates and any special rules such as surrender charges	• Will make fee structures and advisor compensation levels very transparent to investors • More expensive structures likely to come under significant scrutiny as a result • Will facilitate comparison across all available investment options likely resulting in downward pressure through time on fees • Could cause an increase in allocations to low cost passive and ETF based strategies as advisors look to demonstrate value for an all in fee level
• Financial institutions using the Exemption **must warrant that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest** • Must state that quotas, bonuses, contests, special awards, differentiated compensation or any other incentives are used which would encourage advisors not to act in best interests of investors	• Will require redesign of many incentive arrangements • Will require establishment/review of suitable policies and procedures and monitoring processes to ensure best interest behavior
• **"Reasonable compensation"** must contractually commit to receiving no more than reasonable compensation	• Will need to define "reasonable" which will presumably entail both an absolute and relative assessment i.e. are fees reasonable vs. costs and are fees reasonable vs. others

Overall, the DOL's proposals will impose a fundamentally different duty of care on many advisors, will make the cost of advice very transparent, and will facilitate much greater investor scrutiny of fees across product manufacturing and distribution.

Products most impacted will be those with the highest embedded commission levels. We would expect that the natural reaction by advisors will be to pivot away from more complex products toward those which are simpler, easier to explain and lower cost – thus facilitating more scalable advice delivery. Variable and indexed annuity sales could be significantly impacted as a result.

We do expect that some product opportunities will result from the new standard. Several insurers have significant retirement businesses serving defined contribution (DC) and defined benefit (DB) plans where the changes may enable both increased retention of assets in these plans and also the opportunity to perhaps develop a fiduciary advisory model to increase retention of IRA flows. In addition, the standard might require advisors to give more robust consideration to the use of immediate and deferred immediate annuities or simpler longevity protection products which have had very little traction heretofore. Finally, the standard is likely to provide a significant tailwind to advisory models which benefit from scale be they the emerging "robo-advisors" or technology based advisory platforms.

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WHAT LESSONS CAN WE LEARN FROM ELSEWHERE?

Similar issues to those identified by the DOL have prompted regulatory changes internationally. The UK and Australia in particular have implemented reforms that, while more far-reaching, offer harbingers as to what the DOL proposal might mean. We have provided a brief summary of each reform below.

UK RETAIL DISTRIBUTION REVIEW

In 2006, the UK Financial Services Authority (FSA) instigated a review of the retail advice landscape under the banner of the Retail Distribution Review (RDR). The review was a reaction on the FSA's part to perceived widespread failures in the retail investment landscape. These failures were colorfully outlined in a speech at Gleneagles by then Chairman of the FSA, Callum McCarthy, where he drew parallels between the positive behaviors resulting from changing incentives for 18th century prison ships exporting criminals from the UK to Australia[3] and the negative consequences of incentive structures surrounding retail investors. The FSA suggested that the status quo was causing:

- A focus on business volume rather than quality leading to low persistency and churn
- Advice biased toward product sales rather than actions consistent with consumers' priority needs (e.g., selling someone an investment product when they might be better off paying down debt)

Following a lengthy period of formulation and consultation, the RDR provisions came into effect at the beginning of 2013 instigating an immediate **ban on commissions to advisors** for sale of new products while providing some grandfathering (which will end in 2015) for prior product sales. "Pure protection" policies, such as pure life and health insurance, can still be sold on a commission basis.

AUSTRALIAN FOFA

The Australian government launched an inquiry in 2009 in reaction to issues associated with the collapse of several financial product and service providers. The review focused on the role of financial advisors, the role of commission arrangements and potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisors. Following the review, a series of regulatory changes were introduced through the Future Of Financial Advice (FOFA) reforms, the first of which became mandatory in July 2013 with a number of changes made to the reforms in July 2014 (Streamlining Future of Financial Advice). The main features of the FOFA changes were:

- A prospective **ban on conflicted remuneration and Asset-Based Fees** for all new retail financial products sold after July 1, 2013 with grandfathering for trail commissions on prior product sales
- A statutory **Best Interests Duty** for financial advisors with a "safe harbor" provision defining a set of activities which would ensure compliance with this duty

3 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0916_cm.shtml

Both sets of UK and Australian regulations focused on issues similar to those identified by the DOL. RDR and FOFA have gone significantly further than the DOL proposal in banning outright commissions for advisors. Clearly the UK and Australian financial services landscapes have significant differences to that in the US so any parallels need to be drawn with care. That said, certain common reactions to the commission ban can be observed in both markets. While commission structures will still exist in the US, we believe that the trajectory of change is close enough that similar impacts may occur here in that the ability to operate certain commission and remuneration structures will go away and downward pressure will be placed on other structures as a result of transparency and disclosure.

Our examination of the UK and Australian effects yields five key trends summarized below.

1. Evolution in advisory models	The RDR implementation has seen the traditional UK advisor gravitate toward one of three distinct models: • **Outsourcers** focusing purely on financial planning and pensions advice while outsourcing investment strategy formulation and investment management to 3rd party discretionary wealth managers or multi-manager funds • **In house investment strategy** approaches providing financial planning and investment management services but where strategies make more limited use of 3rd party active funds with greater use of passive funds and ETFs • **Vertically Integrated Firms** providing financial planning, investment strategy and investment management. In these cases, incentives are often provided to use in house funds by way of reduced fees Similar trends are observable in Australia where some independent advisors have looked to capture more of the value chain by establishing model investment portfolios and others are shifting their value proposition away from "fund selection" towards "asset allocation" and making much more use of low-cost/passive investments to keep the overall cost to the customer the same.
2. Emergence of "advice gaps" and under-served segments as advisors retrench from serving segments no longer profitable under the new regime	As is expected in the US, the implementation of both regimes saw the emergence of "advice gaps" in the mass affluent segments where ability to profitably serve smaller investors was impacted. These advice gaps have begun to be addressed by D2C models and scaled advice platforms.
3. Evolution of the self-investor segment and potential shift towards robo-advisors	Nor surprisingly perhaps the shift to transparency on advisors fees saw accelerated growth in the UK of the already emerging self-investment segment as individuals decided to take more of a DIY approach with obvious benefits for providers supporting that model. In Australia, the rise of "Self-Managed Superannuation Funds" has been significant. These are individual trusts managed by the individual with just administrative support provided by an accountant. This segment now accounts for >30% of the superannuation market. Separately there has been a lot of talk about "scaled" advice and robo-advice but successful models have yet to emerge. Some companies are blaming an unfriendly regulatory environment, but the regulators themselves (Australian Securities and Investments Commission) have said they will not stand in the way of any sensible approaches.
4. Continued shift of assets onto platforms and growth of platform providers' service proposition beyond the advisor segment	In UK, the cost pressure caused by fee disclosure drove the emergence of platforms designed to provide economies of scale to advisors. Several of these platforms are owned by insurers e.g., Standard Life's platform and Aviva's Elevate. Platforms have been the main visible "product" in Australia for over 10 years. The main direct impact of FOFA was consolidation of financial advice practices, in particular many of them joining the large vertically integrated firms (The "Big-4" banks and AMP) who were willing to pay significant premiums and incentives to get planners to align to their advice networks. While there has been some emergence recently of independent distributors getting enough scale to make an attractive counter-offer to the big platforms, the trend overall has been towards fewer, larger advice networks.
5. Shifting attitudes at retail banks regarding their offering to the retail mass affluent segment	The UK has seen significant fallout of bank channel advisors following the commission bans where the economics of a fee based model proved challenging for retail mass affluent customers. Australia, by contrast, has seen banks work actively to bring more advisors into their networks which we believe is largely to increase distribution reach in order to protect their significant investments in wealth (Super) manufacturing.

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WHAT DO WE THINK INSURERS SHOULD BE DOING NOW TO PREPARE?

Given the scale of the potential impacts to insurance business models, it's not surprising that we see a long-list of activities that we think insurers should be considering with a view to ensuring that impacts are understood and opportunities are being pursued as early as possible.

1. **Portfolio strategy:** at the top of the house, insurers need to assess the implications of the standard across their portfolio of businesses appreciating that impacts will differ significantly for retail annuity businesses, DC businesses, asset management complexes and "owned" distribution. There are immediate threats and opportunities to be considered, the most obvious being the consequences of potential reduction in annuity sales. More fundamentally, however, we think it will be beneficial to develop alternative future scenarios which anticipate different trajectories for market participants' behaviors under the new standard. These scenarios can then facilitate development of consensus views across the organization and can allow plans to be developed to triage risks and begin to drive towards opportunities.
2. **Distribution strategy:** insurers must have a clear articulation as to how the various types of distribution partners will react to the fiduciary standard. An analysis of the distribution economics by product and channel will help inform where disruption and opportunities will be greatest which may then open up the possibility of more strategic portfolio plays.
3. **Product strategy:** insurance products in general, and annuity products in particular, have long suffered from a "vicious cycle" of escalating complexity in features, coupled with a need for higher commission payment to compensate an advisor. This trend could be reversed with a need for radical product simplification – potentially with richer product features and reduced advisor compensation.
4. **Legal and compliance:** the imposition of a fiduciary standard and the disclosure and compliance requirements of the Best Interests Contract exemption obviously have very significant legal and compliance implications with an early need for documentation and process review and development of an plan for execution against the new standard.

CONCLUSION

As we mentioned above, we have seen a range of reactions to the new standard in our conversations with insurers, distributors and advisors. Our own view is that it is very difficult *ex ante* to precisely determine the full range of impacts the new standard will cause. What is clear is that effects will be material and there will be a period of disruption before a new equilibrium emerges. In the most benign scenario, that "new equilibrium" might look reasonably similar to today's landscape but with advisors operating under a more transparent fee model and flows to product types being reasonably similar to today (though with different embedded commission structures). However, it is more likely, we think, that the new equilibrium will be some distance from today's and, in more extreme scenarios, could see the disappearance of significant portions of the current distribution and product landscape with displaced flows diverting through re-engineered advice models and platforms to simpler, lower cost product types.

We believe that organizations should be preparing themselves by going through a cross-organizational process of building scenarios (e.g., Benign, Expected, Adverse, Severely Adverse) for the evolution of the environment post-standard. These scenarios should include an impact assessment and relatively detailed state-contingent strategy covering economic and product consequences and likely opportunities to capitalize on disruption. This will ensure that management teams build consensus views ahead of time around risk and opportunities and will allow scenarios to be refined and strategies firmed up as events emerge.

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For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS
+1 212 541 8100

EMEA
+44 20 7333 8333

ASIA PACIFIC
+65 6510 9700

www.oliverwyman.com

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