THE ADVICE GAIN:
The impact of generic financial advice on the financial services industry

Summary

This report summarises the predicted impacts on the financial services industry of improved financial decision making, driven by increased access to financial advice, by low to median earners. It is based on economic modelling carried out for the Resolution Foundation by Deloitte.

The findings show how the financial services industry will benefit from consumers having increased access to financial advice. Although the impact will vary by product, the overall effect on the industry will be positive. The results are based on 10 per cent of the Resolution Foundation's target group acting on advice. Within four years of this being the case:

- New contributions to medium term savings plans would increase by £1.5 billion net.
- Pensions premiums would increase by £560 million.
- Annuity premiums would increase by £58 million (but would increase by £300 million by 2060 as more people retire with larger pensions pots).
- Life assurance premiums would increase by £225 million.
- Young lower earners would have credit card balances averaging £800 – but this figure would be £1900 without advice.
- Credit card debt would fall from £2.5 billion to £830 million.
- Unsecured debts would fall by £2.2 billion.
- Mortgages and secured debt would remain relatively stable

These changes result from individuals achieving:

- A better balance between consumption and saving;
- More efficient management of debt (for example, high interest rate debts are paid off first);
- Improved interest rates on savings and debts;
- A better balance between short and long term saving (moving more from the former and into the latter); and
- Improved annuity rates at retirement

The overall effect will be beneficial for the majority of the industry – particularly when wider benefits of more financially capable consumers are taken into account. These include:

- Better access to advice might reduce the industry's distribution costs as consumers are more confident in buying products;
- Increased demand for some products might create new markets among lower income groups and opportunities for new product development;
- Levels of bad debt should decrease, reducing the amount the industry has to write off each year;
- There might be a regulatory dividend for the industry, as more capable consumers would require less regulatory protection; and
- The wider economy will benefit as consumers become personally wealthier, increase their consumption, and become more resilient to financial risk.

The Resolution Foundation has suggested that both the Government and the financial services industry should contribute to the funding of a national generic financial advice resource. We have argued this on the basis that the industry would benefit not just directly from better financial decision making, but also that more financially capable consumers would lead to a healthier, more sustainable financial services market. This report provides some valuable evidence to support both of these arguments.

Introduction

For the past 18 months, the Resolution Foundation has been exploring how to develop a national advice resource to provide free, impartial, generic financial advice to those on low to median incomes.

During this time, the issues of financial capability and the provision of generic financial advice have featured more and more in policy debate. This culminated in the publication of the Treasury's strategy paper *Financial Capability: the Government's long term approach*, which announced the Government's intention to establish a feasibility study, led by Otto Thoresen, the Chief Executive of AEGON UK, to research and design a national approach to the provision of generic financial advice.

In March 2006, the Foundation published its proposals for a national generic financial advice resource, with associated costs, and suggested that these be met through a partnership between the Government and the financial services industry.[1] To support the case for such investment, we published *A National Dividend* in September 2006. Based on economic modelling carried out by Deloitte, this report summarised the potential benefits of improved financial decision making, driven by greater access to financial advice, for the consumer and the Government.

The findings from the modelling demonstrated that both the consumer and the state have much to gain from an increase in the supply of generic financial advice. However, this research did not assess the impact on the financial service industry.

The Foundation conducted a widespread consultation on our proposals last summer. The lack of evidence on the benefits to the industry was highlighted in the responses. As a result, whilst many sectors of the industry welcomed the prospect of a generic advice service, there were mixed feelings regarding the potential benefits, and consequently, the level of investment that should be expected from the sector. With this in mind, the Foundation decided to commission Deloitte to model the potential impact of increased access to financial advice on the financial services industry.

This report summarises Deloitte's findings and presents these alongside the wider benefits that could result from more financially capable consumers.[2]

The wider policy debate

The increased focus on generic financial advice, and consumers' financial capability in general, comes as the financial services market has reached a crossroads in its development, brought about by two corresponding trends.

Firstly, consumer debt has grown apace – more than doubling since 2000 to £1,291 billion in December 2006.[3] This has been coupled with changes to insolvency law, which reduces the penalties associated with personal insolvency and making it a more viable option for those in debt. Between 2005 and 2006, the number of personal insolvencies increased by 55 per cent.[5] As a result, the number of debts being written off by lenders is also increasing year on year – Barclays alone saw the cost of its bad debts jump 45 per cent.

These record levels of consumer debt, combined with other trends illustrating low levels of financial capability, emphasise the weak position of many lower income consumers in a complex financial services market.[6]

Secondly, and and perhaps partly as a result of growing awareness of this weak position, the financial services industry is coming under increasing scrutiny. For example, unauthorised overdraft and other such bank charges are now the subject of a review by the Office of Fair Trading after it emerged that the top six high street banks in the UK made an estimated £4.5bn from penalty charges in 2005. A test case in 2006, where a consumer successfully challenged the legality of the charges his bank had made,[7] has led to greater media interest and more people being urged to seek refunds from their banks. In February 2007, the Financial Ombudsman Service (FAS) stated that 5,000 customers a day were registering for their service to help reclaim bank charges.[8]

However, it is not just the banking industry that is under closer scrutiny. The FSA's Retail Distribution Review, launched in June 2006, is reviewing consumer access and levels of professionalism in the retail investment market (which includes banks, life insurers, financial advisers, building societies and fund managers).

This illustrates increasing recognition that the current unbalanced relationship between the consumer and the industry is not sustainable over the long term. There are many ways in which the relationship between consumer and industry could be rebalanced, thereby achieving a healthier and more sustainable market. One way is to render the consumers' position stronger relative to the industry, by improving financial capability. A national generic advice service is one tool that can help achieve this aim.

[1] Following a series of focus groups attended by low to median earners, for example, we found that 80% of such consumers would trust and use an advice service that was funded by the government and the financial services industry combined.
[2] The Resolution Foundation commissioned Deloitte to model the potential impact of advice on the financial services industry. The views expressed in this document are those of Resolution Foundation, except where expressly otherwise stated.
[3] December 2006 figure from Credit Action http://www.creditaction.org.uk/debtstats.htm
[4] http://news.bbc.co.uk/1/hi/business/6321903.stm
[5] IBID
[6] The trends include a lack of savings and pensions provision (recently the focus of the Government's pensions reforms) and concerns about competition in the home credit market.
[7] Stephen Hone Vs Abbey National Bank
[8] http://www.telegraph.co.uk/news/main.jhtml;jsessionid=RXQOIGEZ1KCGLQFIQMFSFFWAVCBQ0IV0?xml=/news/2007/02/23/ncharges23.xml

The Research

Research methodology

In 2006, the Foundation commissioned Deloitte to model the potential impact of providing advice to people on low to moderate incomes. They constructed an economic model to estimate the impact of people behaving in different ways throughout their lives, either making financial decisions as they do now, or in a more capable way.

The individuals included in this model were those identified by the Foundation as earning below median incomes and receiving no more than 20 per cent of their income from welfare benefits, and elderly people on below median incomes and not receiving means-tested benefits. This covers around 15 million people in total.

How the model works

The model takes a representative individual for each age cluster[9] of the Resolution Foundation target group and projects forward their personal profit and loss and balance sheet for each year of their remaining life. The life path taken by the individual is determined stochastically (based upon the probability of events such as marriage, having children, losing one's job).

- Using the Monte Carlo technique, 1,000 iterations were run for each of five different age clusters within the group to account for the probability of different life stage events. This gave rise to different income and expenditure patterns for 1,000 'typical' consumers in each of the clusters.
- These profit and loss and balance sheet figures are first calculated based on current financial behaviours of those who are not currently exposed to ongoing advice. A second calculation is then carried out by imposing different outcomes in the event of individuals acting on financial advice. For example, with the receipt of advice, people are assumed to achieve:
  - A better balance between consumption and saving;
  - More efficient management of debt (for example, high interest rate debts are paid off first);
  - Improved interest rates on savings and debts;
  - A better balance between short and long term saving; and
  - Improved annuity rates at retirement

This model has now been used to estimate the impact of improved access to financial advice among this income group on the financial services industry. This has been achieved using the same assumptions regarding people's behaviour following the receipt of financial advice, and estimating the impact this would have on purchasing and repayment behaviour of individuals in respect of the following products:

- Short term savings: current account/savings account savings
- Medium term savings: equity, ISAs and so on
- Long term savings: pension accumulation
- Annuity purchase
- Life assurance cover
- Credit card debt
- Unsecured debt
- Mortgage debt

The model also estimates the changes in funds moving in and out of the following products when people act on advice:

- Life assurance premiums paid
- Payment to pensions funds
- Payment to investment portfolio
- Payment to cash savings
- Repayments of debt and additions to debt
- Interest yield on savings
- Interest payments on different types of debt
- Premiums used to purchase an annuity at retirement

[9] The five clusters are: young people, families, middle-aged people, those on the eve of retirement and elderly people

Key principles:

- The Resolution Foundation's previous research has established its target group of people on low to median incomes as consisting of 12 million low earners and 3 million elderly people.
- The model assumes that 10 per cent of the target group access and act on advice.
- Two scenarios were modelled – "partial" advice, where a person would act on some of the advice they were given, and "full" advice, where a person would act on all of the advice they were given. Unless otherwise stated, the figures set out in this report presume "full" advice.
- It is assumed that once someone receives advice, they will continue to act on it through their remaining lifetime.
- The model gives results based on people acting on advice for the next four years, and then projects results forward in deciles to 2060.
- Changes in behaviour having received advice have been designed as "realistic" rather than perfectly rational. The model does not assume a sea-change in people's behaviour. So, for example, the model does not assume that people will significantly reduce their consumption, or pay off all of their debt before they start saving.
- The type of advice used in this model is assumed to be generic – for example, advice on budgeting, how to shop around for products, how to manage debt and so on, but may of course lead to further regulated advice linked to product sales.

The original model was created during the period in which the Government's pension reforms were still being developed. As such, whilst the new State Pension Age and the link between the Basic State Pension and earnings were both included in the model, it was not possible to account for the new system of personal accounts. However, the assumption of the model is that people will contribute to a pension if they act on advice – if they act on "partial" advice, they would contribute 3 per cent of their salary – a scenario which is similar to auto-enrolment (though not taking into account employer or Government contributions).

Research findings – the overall picture

By acting on financial advice, people are likely to be better at managing their money. This means making the most of their savings by placing them in higher interest investments, and using savings to pay off expensive debt. It also means seeking cheaper ways of borrowing money and paying off expensive debts more quickly.

The findings support this theory. They indicate that if low to median earners act on financial advice, they are likely to save more overall, but shift more of their savings from short term to medium and long term investments. They are also likely to invest more heavily in protection products, and build up larger pensions pots with which to purchase an annuity at retirement. Although their consumption is likely to rise on the whole due to greater personal wealth[10], they reduce their credit card and other forms of unsecured debt considerably.

Assuming 10 per cent of people on low to median incomes were to act on financial advice for the next four years, the impact on key financial products would be:

- A transfer of £90 million from short term savings deposits into debt repayment, ISAs or other longer term savings products.
- A £1.5 billion net increase in investments in ISAs and other medium term savings products.
- An increase of £225 million in life assurance premiums paid.
- A reduction in credit card debt from £2.5 billion to £830 million.
- A reduction in other unsecured debts of £2.2 billion.
- A reduction in total mortgage interest payments being made from £1 billion to £750 million.

Summary of findings – product by product

Savings

Acting on advice is likely to result in people having more savings overall – not by making large cuts in consumption, but rather thanks to better household budgeting, managing debt more effectively (e.g. paying off the more expensive credit first) and shopping around for better interest rates.

What people do with their savings is also likely to change. Keeping large amounts of savings in cash deposits means people miss out on the higher interest rates available on other types of investment. Acting on advice would encourage people to move more of their money out of short term savings accounts and into medium and longer term investment products, such as ISAs, bonds, and equity investments. If people acted on advice, we assume that they would only keep a maximum of 40 per cent of their salaries in short term savings as an emergency fund and gradually use the rest to pay off debts or invest in higher interest savings products.

[10] The increase in personal wealth comes about from improved savings behaviour and securing better deals on financial products. For more details on how much a person would be better off over his or her lifetime if acting on advice, see *A National Dividend*, Resolution Foundation, London 2006

What people do with their savings is also likely to change. Keeping large amounts of savings in cash deposits means people miss out on the higher interest rates available on other types of investment. Acting on advice would encourage people to move more of their money out of short term savings accounts and into medium and longer term investment products, such as ISAs, bonds, and equity investments. If people acted on advice, we assume that they would only keep a maximum of 40 per cent of their salaries in short term savings as an emergency fund and gradually use the rest to pay off debts or invest in higher interest savings products.

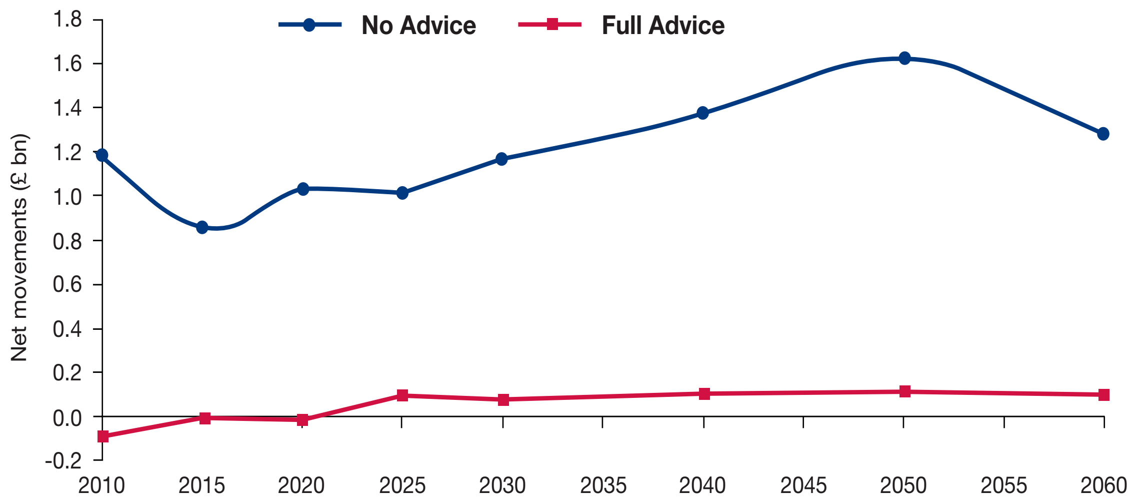
This change in behaviour would see an increase of investment not only in medium term savings, but also in pensions. People are more likely to increase their pensions contributions if acting on advice, because they have more money available to do so (thanks to them managing their debt more effectively, and so on), and will also see the value in topping up their longer term savings, especially if they have reached a certain amount of investment in their medium term savings.

Short term savings – cash deposit accounts
Investing more in longer term savings would mean today's young low to median earners would have much lower amounts of cash savings – around £3k by the time they reached 60.

Assuming 10 per cent of those on low to median incomes were to act on advice:

- £90 million would be moved out of short term savings and be used to pay off debt or moved in to medium or long term investments four years after advice was delivered.
- The financial services industry might pay more interest on savings accounts in the short term as people learn to shop around for better interest rates. However, in the long term, the amount of interest paid by the industry will fall, as deposit levels decrease. With advice, by 2060, the industry would pay £200 million less in interest.

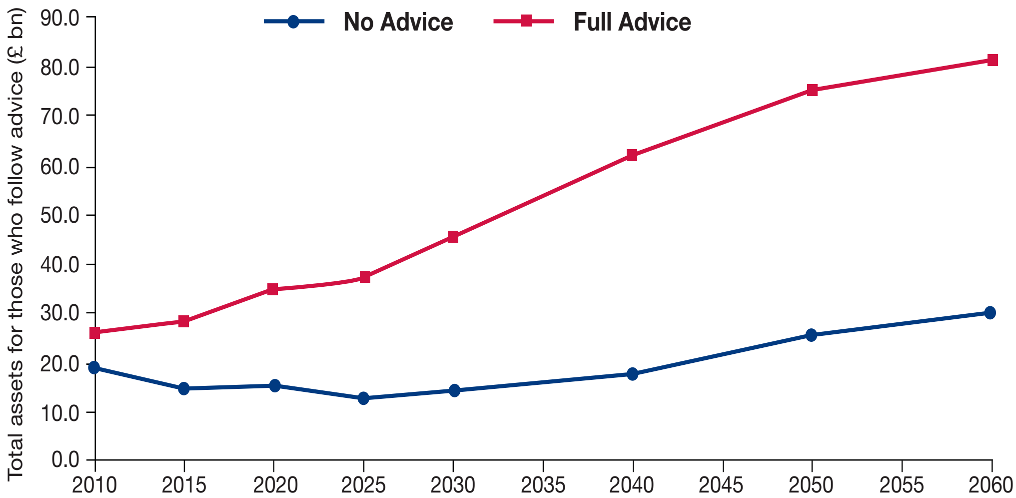
Change in contributions to short term savings made by 10 per cent of low to median earners



Medium term savings
This reduction in short term savings has a direct impact on the levels of medium term savings – such as equity based savings, ISAs, and so on – being held by those acting on financial advice. For today's lower income young people, their average investment fund at age 60 would increase from £17k to £50k if they acted on advice throughout their lifetime.

- Under current conditions, without advice, 10 per cent of low to median earners will probably have ISAs and other investments worth a total of £20bn in 2010 and £30bn by 2060.
- But if this group acted on advice throughout their lifetimes, their funds could be worth £26bn in 2010 and £81bn in 2060.
- Assuming that the industry charges 1.5 per cent to manage these funds, the gross revenue to the investment industry would grow by an extra £106m in 2010 and £774m by 2060 if this group acted on advice.

Funds under management among 10 per cent of low to median earners



Pensions

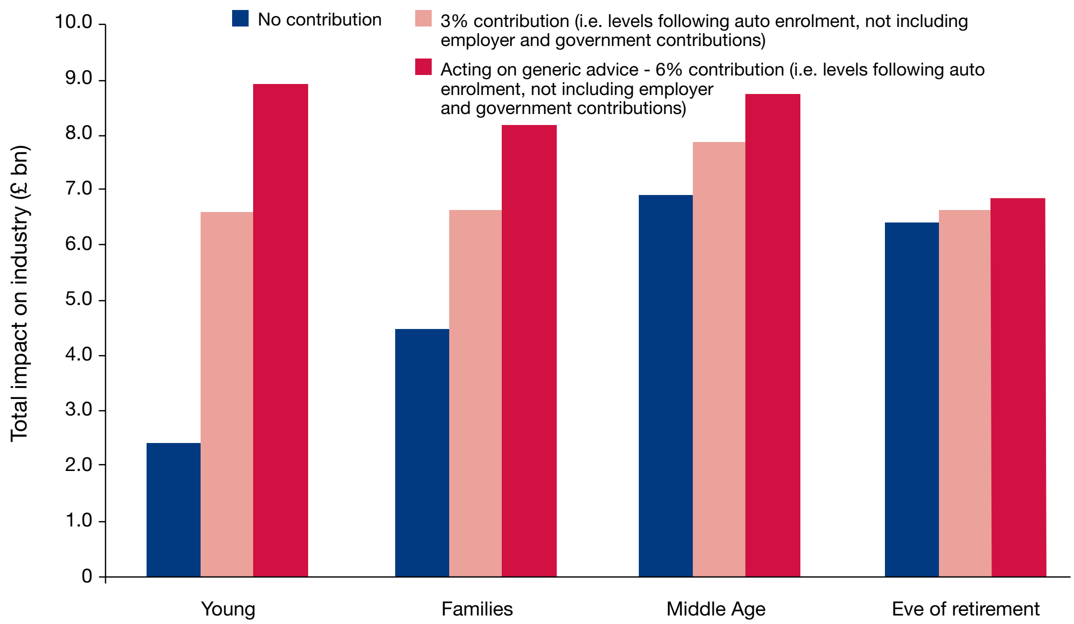
If acting on advice, once people reached a sensible level of medium term savings, they might decide to top up their longer term savings – in the form of a pension.
As discussed earlier, the model has not taken into account auto-enrolment into personal accounts. However, accessing advice is likely to enhance the impact of auto-enrolment by, for example, improving people's ability to contribute higher amounts to their personal accounts through better debt management and budgeting.

As such, people acting on advice are likely to have larger pensions pots than those who do not. As a result of larger pensions pots (and being able to shop around for the best rates), people acting on advice are also likely to have larger pensions annuities.

Pension accumulation
If acting on advice throughout their lifetime, people are likely to contribute 6 per cent of their salaries to their pensions. Therefore, even after auto-enrolment becomes a part of the pensions framework in 2012, acting on advice could help people significantly increase their pensions savings by enabling them (through better budgeting and better interest rates on their short and medium-term savings) to put more into their pensions pots – from 3 per cent required by auto-enrolment to 6 per cent.

- If today's young low to median earners contributed 6 per cent of their salaries to their pensions, they would hold a total pensions pot worth £9 billion (not including the additional contributions from employers and Government available after 2012).
- In four years, the 10 per cent of those on low to median incomes will have a total pensions pot of £15 million. If they acted on advice, this would increase to £18 million.

Total size of pensions funds for 10 per cent of low-median earners on reaching 60 years of age



Pension annuitisation

Pensions annuities should increase if people act on advice, as they will build larger pensions funds to buy annuities on retirement, and might also shop around for a better deal on their annuity product.

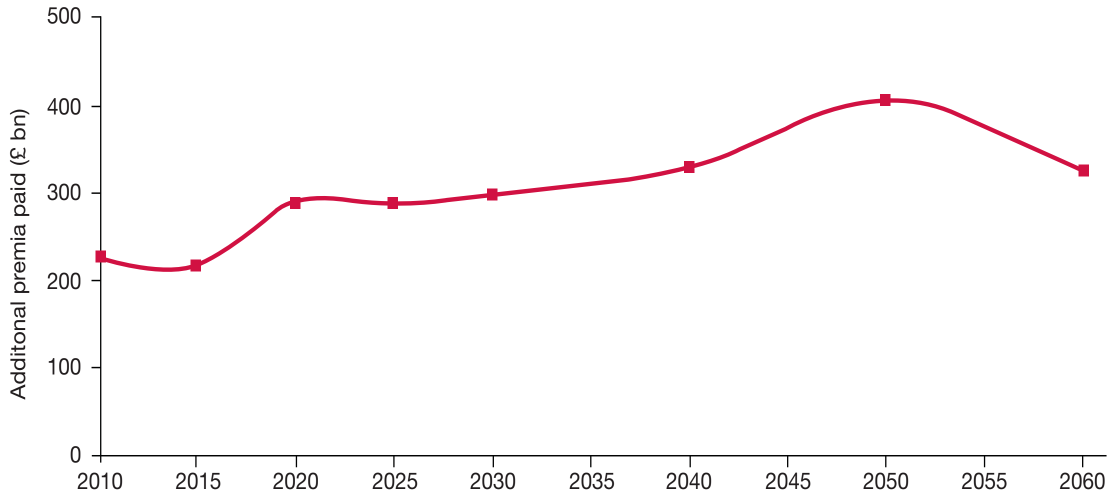
- In the short term, the increase in pensions on the annuity market is limited. Those low to median earners who reach retirement in four years' time should have increased their pensions pots slightly if they acted on advice. As such, they would pay an extra £60 million in annuity premiums on retirement.
- However, by 2060 an extra £500 million in annuity premiums would be generated if 10 per cent of low to median earners acted on advice. This figure might be even higher as it does not take into account the extra amount generated by employer and Government contributions to people's pensions pots after 2012.

Life assurance

Better financial decision making, driven by financial advice, will increase the likelihood that people will purchase life assurance. Currently, 40 per cent of low to median earners have life assurance compared to 58 per cent of higher earners. Similarly, this income group tend not to buy other types of protection product – they are only half as likely as higher earners to have critical illness or income protection insurance. Giving people advice will help them recognise the importance of these products and give them more confidence to purchase them. As such, if low to median earners acted on advice, we might predict that they will purchase insurance worth four times their salary on the birth of their first child.

Even if just 10 per cent of low to median earners purchased life cover, the returns to the life insurance industry could be sizeable – with extra premiums worth £225 million in 2010 and peaking at £401 million in 2050.

Additional premiums paid to the insurance industry if 10 per cent of more low to median earners bought life cover



Debt and credit

Credit card and other unsecured debt should decrease significantly if people acted on advice. Consequently, this will have an impact on the financial services industry, as the amount paid to the industry in interest will also decrease.

This reduction in debt is not driven by an unrealistic reduction in consumption.[11] As we explain above, the model used in this report assumes a realistic change in people's current behaviour – so acting on advice would not mean people would significantly cut their spending. Instead, debts could be reduced by securing better interest rates, managing debt more effectively and building up savings to help pay off debt more quickly.

On the other hand, mortgage and other secured debt will only fall slightly. This is in part because acting on advice does not stop people buying houses, or needing mortgages, and so overall demand for mortgage products should not fall if people acted on advice (unlike some other forms of credit). In fact, acting on advice might help people save enough to buy a house, therefore increasing the demand for mortgages. The small reduction in mortgage debts is driven by people shopping around for the best deals and repaying their mortgages more quickly.

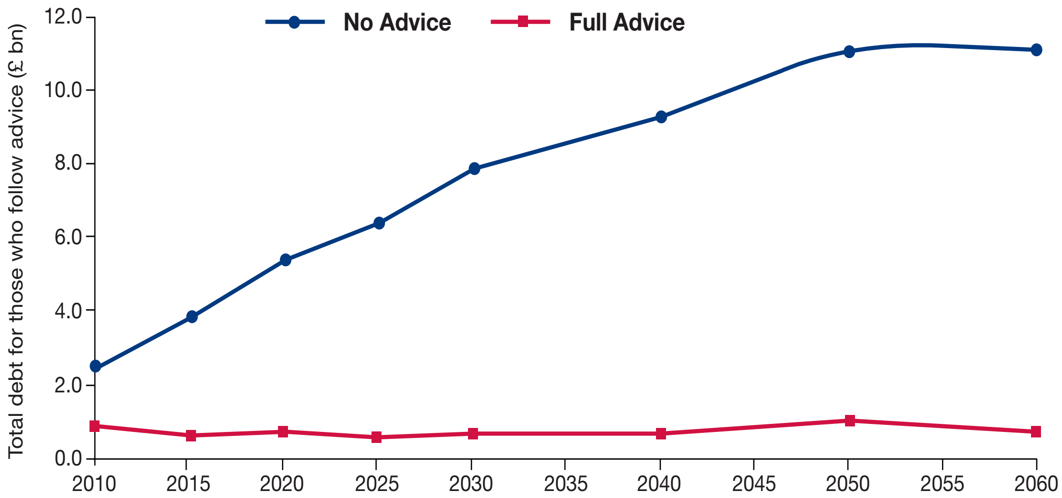
Credit card debt

Under current trends, credit card debt among low to median income groups will increase significantly over the next 50 years, as will the amount paid to the industry in interest. If people acted on generic advice, however, the debts owed on credit cards and the interest paid would both fall.

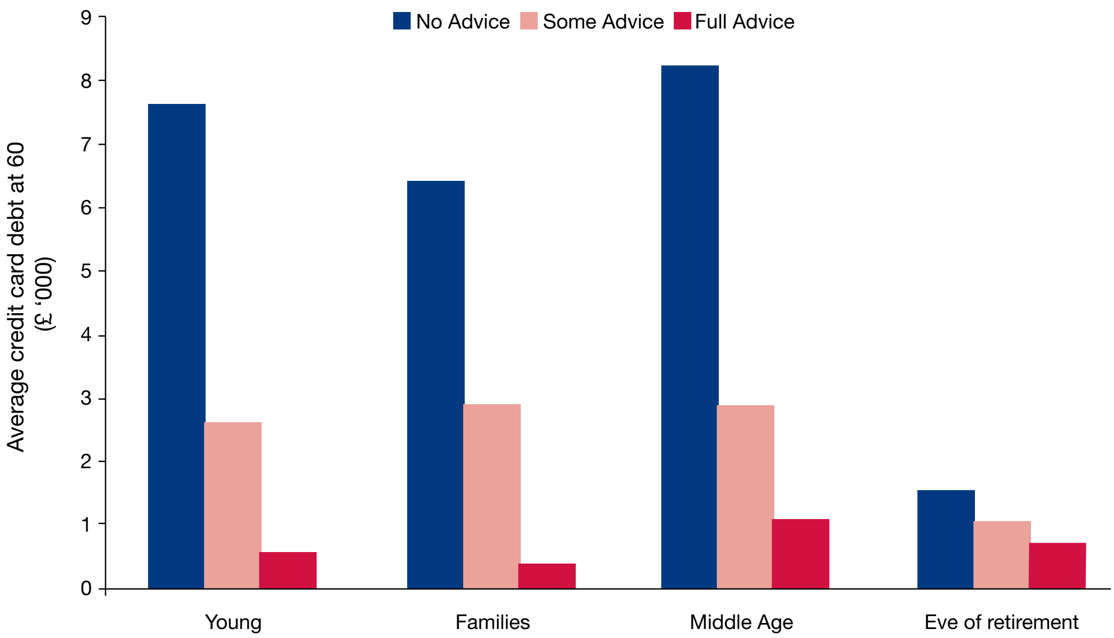
- If advice were delivered from now on, in four years the average credit card balance of young low to median earners would be £800 if they acted on advice, and £1900 if they did not.
- In four years' time, lower income young people will be adding to their credit card debt at a rate of over £200pa. But if they acted on advice they would be repaying their debt at a rate of £38pa.
- By age 60, today's lower income young people will have a credit card debt of nearly £8k without advice. However, if they acted on advice, their credit card debt should average £500 at age 60.
- In four years' time, the amount of low to median earners paying more than £750 pa in credit card interest would fall by 300,000 if 10 per cent of the group acted on advice.
- Low to median earners in the UK will have a total estimated credit card debt of £25bn in 2010, and pay interest in the region of £7.3bn. If just 10 per cent of this group acted on advice, this debt would fall by over £1.5 billion.

[11] Although we assume that if acting on advice, some people might sensibly cut back if they find themselves with very large debts.

Total credit card debt of 10 per cent of lower earners



Levels of credit card debt at age 60 among low to median earners

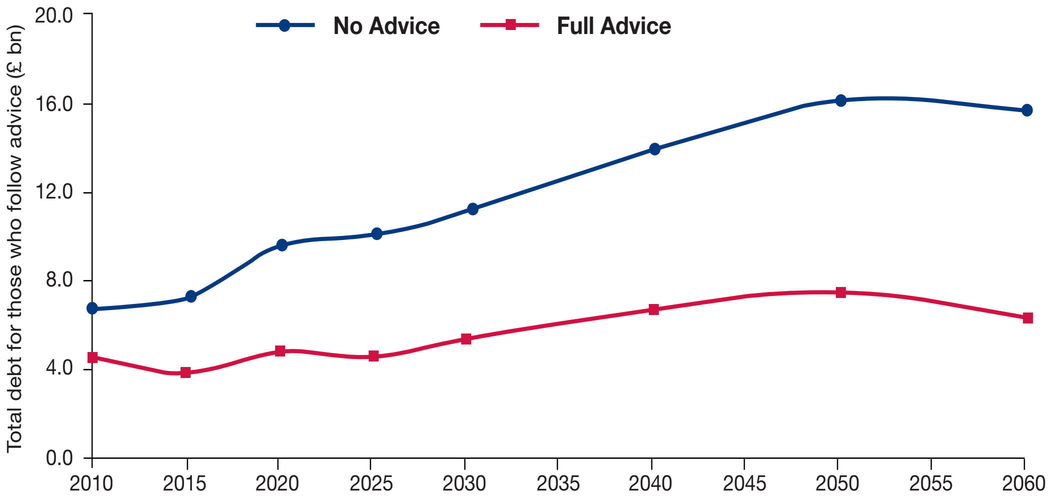


Other unsecured debts

As with credit card debt, the amount owed in loans among low to median earners is likely to increase significantly over the coming years. The amount paid to the lending industry in interest will increase in line with this growth. Acting on advice would help reverse this trend.

- By 2010, the research predicts that the amount owed in unsecured loans by the UK's low to median earners could reach £67 billion. If just 10 percent of this group acted on advice, the debt would be reduced by £2.2 billion.
- This group would be paying £500 million in interest on their unsecured loans. If they did not act on advice, this figure would be £1.1 billion.
- Across the industry, the impact of changing debt and interest rate levels would reduce the interest received by the industry from this 10 per cent by £670 million.

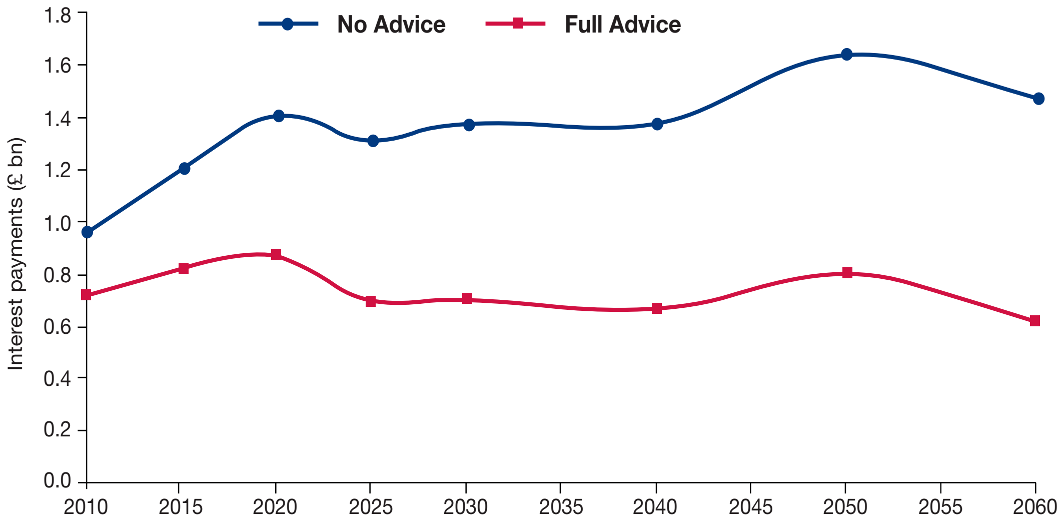
Total unsecured debt levels of 10 per cent of low to median earners



Whilst unsecured debts might be considerably reduced if people acted on advice, the impact of low to median earners acting on advice on mortgages and other secured debts is marginal. As we explain above, this is because whilst some people acting on advice might achieve a better interest rate and pay back their mortgages early, others might also be more likely to purchase a mortgage in the first place (as increased levels of personal wealth may encourage more to buy their own homes).

- 10 per cent of low to median earners will have a total mortgage debt of £14.8bn in four years if current trends continue. If they acted on advice from now, this would fall to £14.5bn.
- The amount of interest being paid to the industry would also fall – without acting on advice this 10 per cent would be paying £1bn in interest on their mortgages in four years. With advice this figure would be just over £750m.
- This would represent a drop of 50,000 in the number of people paying more than £2k pa in interest on their mortgages.
- Acting on advice would also increase the speed of repayment – if today's "eve of retirement" low to median earners acted on advice, their average mortgage repayment would rise from zero to almost £700 pa within four years.

Interest received by the mortgage industry from 10 per cent of lower earners



What does this mean for the financial services industry?

Overall, the financial services industry will benefit from better financial decision making driven by increased access to financial advice. There will be variable impacts on different products and on different providers. For example, a full service bank might see its market for loans growing smaller, but a simultaneous opportunity will arise to meet the increased demand for investment products.

In addition, we must also bear in mind that this research quantifies only some of the direct effects of changes in financial behaviour – there are a range of other benefits implied by this work which makes the overall picture for the industry even more positive. These are explained below.

The wider implications of these findings

The findings outlined above describe changes in demand for and investment in specific products driven by better financial decision making. However, this is but one (albeit more easily quantifiable) category of benefit the industry is likely to enjoy should people act on advice. There are other wider benefits of more financially capable consumers that have not been quantified here, as well as a range of additional considerations that these findings give rise to. We ought to take these into account when we consider the real-life impact of a national advice resource on the consumer, Government and financial services industry.

1. Reduction in distribution costs

The financial services industry invests very large sums of money every year in attracting new customers through advertising and paying commission to brokers and advisers. For example, the life assurance industry has been informally estimated as spending over £5bn per annum on commission to Independent Financial Advisers and 'commission equivalent'[12] to tied sales forces, whilst data from Taylor Nielsen suggests that the financial services industry spends at least £1.5 billion per annum on media advertising and direct mail alone.[13]

These costs are in part driven by poor response rates to marketing efforts (direct mailings only generate response rates of around 1 per cent) and poor conversion rates from enquiries to sales. These trends can be partially attributed to poor understanding among consumers of both their financial needs, and the different products that might meet those needs. This in turn leads to a general lack of trust among consumers and artificially lower demand for products – evidenced in poor take up of protection and savings products among those groups who are in most need of them.

In short, the costs of distribution are high in the financial services sector because products have to be sold to consumers rather than be bought by them. However, with access to advice and improved financial capability, individuals should have a greater understanding of their needs, the products they require to meet those needs, and should feel more confident in buying them – reducing the need for a hard sell by financial services firms and the associated costs.

[12] This is a calculation, required by the FSA, to establish the costs of running a tied sales force operation and expressing it as a commission figure for the purposes of commission disclosure at the point of sale. This is thus a method of expressing the costs of two different distribution models on an equivalent basis.

[13] See *Closing the Advice Gap:* Resolution Foundation, 2006

2. Reputation and complaints
The financial services industry does not, on the whole, experience high levels of trust among consumers. Some companies are perceived as profiting from the complexity of their products and poor consumer decision-making – the current campaign against bank charges, fuelled by the banks publishing their end of year profits, is an example of such public criticism. If the industry were to support an advice service, this would demonstrate a commitment to better informed consumers and greater transparency – which should have positive reputational benefits.

Better informed consumers are also more likely to understand the limitations and risks of financial products, and will be able to engage more constructively with those selling such products. If consumers feel they understand the process of buying a product, and that the sales process was transparent, this may lead to a reduction in complaints, which in turn will reduce costs to the industry. Of course, the other side of this coin would be that better informed consumers are likely to be in a better position to hold the industry to account, and know when they ought to complain following poor service. Nevertheless, it is likely that, in the event of a better informed customer base, those complaints based on justifiable grounds and poor practice are more likely to come to light, rather than misunderstanding or misplaced expectations on the part of the consumer.

3. A new market for investment and protection products
Low to median earners are particularly vulnerable to financial risks such as drops in income, unexpected expenditure, and so on. This is one of the key reasons why such income groups are not viewed as a target customer base for the financial services industry – as this group are not financially stable, the risks to the industry are relatively high for moderate returns.

However, one of the benefits of increased financial capability is that consumers can become more resilient to financial risks, and are better able to sustain credit payments and contributions to savings and protection products. In short, by acting on advice, this group can become a more stable consumer demographic – meaning they will be more attractive as customers of the financial services industry. This should serve to increase the size of the industry's market.

Two particular opportunities may arise in this new market. Firstly, we have seen that acting on advice encourages people to invest in medium and long term savings products. For the first time, financial advice may demonstrate the benefits of such investments to those lower income groups who currently have low take up in this product field, and who are not considered to be a target audience by most investment providers.

This may present a significant opportunity for the industry to develop new medium term investment products for the previously untapped customer base of low to median income groups. This would involve, for example, developing more products which allowed for small lump sums to be invested or small regular payments.

Secondly, a similar opportunity may arise in the protection product market. Currently, low to median earners are under-buying life assurance, but if they took advice their demand should rise. As such, a niche may open to meet this demand by creating life assurance products more suitable for lower income families.

Although life assurance is the only protection product modelled in this research, it is likely that demand for other protection products currently under-used by low-median groups (such as critical illness or income protection insurance and buildings/contents insurance) will also increase significantly if people are given advice. This may generate a range of new opportunities for the industry.

4. Reduction in bad debt
As we have seen, acting on advice is likely to reduce the amounts flowing into credit products. As people are able to manage their finances more effectively, they are more likely to pay off their debts or not get into debt, and also seek more competitive interest rates.

Although this will, inevitably, reduce the margins of the credit/lending industry, we ought to bear in mind that acting on advice will change not just the quantity, but the quality of consumer debt. If people act on advice, they are more likely to pay off their debts – implying a reduction in the amount of bad debt that banks and other lenders must write off each year.

This is of potentially huge benefit to the lending industry, as the amount of bad debt is growing every year – in part due to the overall rise in consumer debt, but also due to changes to bankruptcy regulations and the advent of IVAs which give consumers an easier method of defaulting on loans. The top five high street banks will write off around £6.5 billion in bad debt this year – a 20 per cent increase from last year and a 50 per cent increase since 2004.[14]

[14] http://www.nortonfinance.co.uk/news/Banks_expected_to_announced_65bn_bad_debt

The amount of bad debts written off by the top high street lenders, in 2005 and 2006[15]

Company	Bad debts 2006 £bn	Bad debts 2005 £bn	Change
HSBC	2.1	1.7	+18%
Royal Bank of Scotland	0.9	0.8	+5%
Barclays	1.1	0.7	+44%
HBOS	0.9	0.7	+15%
Lloyds TSB	0.8	0.6	+20%

By the end of 2006, Lloyds had written off £905 million in bad debts, an increase of 34 per cent from the previous year. This represents a loss of £5 in every £100 of unsecured debt that it has lent.[16] An advice resource could substantially decrease such costs to the industry.

A second benefit to the lending industry is that advice may increase the size of the consumer base. In the past, lenders have been criticized for failing to carry out adequate checks before allowing consumers to take out loans, contributing to the bad debt and insolvency problem. As a response, some lenders are bowing to this pressure and tightening their responsible lending policies – meaning fewer people are being approved for loans due to their credit ratings. Barclays is turning down around half of its Barclaycard applicants, for example, and Alliance and Leicester are now turning away 60 per cent.[17] Those being refused credit are usually having to turn to the alternative (usually more expensive) credit market. Although such activity has started to stabilise bad debt levels, this is not a sustainable approach to the problem – both the industry and consumer lose out from a reduced market. Acting on advice might help people protect their credit ratings and increase their chances of meeting stricter responsible lending criteria – which would in turn increase the size of the customer base for the industry, and increase cash flowing into the market.

An additional benefit related to this point is that when acting on advice, people are more likely to pay their debts off at a faster rate. From a lender's perspective, this means being able to reclaim the amount lent more quickly and lend it out again to a new customer. This generates larger returns in the long term.

5. A case for greater regulation?

As we explain above, the financial services industry is at a cross-roads. The inequality between the consumer and the industry could justify greater regulation of the latter if the former's relative position in the market is not strengthened.

Although the estimates generated from this model are in no way certain predications, what can be emphasised is that poor financial decision making is a driver of consumers' escalating debts and their inability to get a good deal from the market. For some sectors of the industry, this can generate a significant amount of income.

This can very easily be interpreted as a market failure based on information asymmetry and, as such, might become a target for more stringent supply-side regulation by Government as the failure (i.e. the income being made from poorly informed consumers) grows.

Improving the consumers' position relative to the industry by improving their capability and providing advice is a sustainable approach to improving the long term health of the market. As such, this approach may deliver a regulatory dividend – leading to a reduction in existing regulation and decreasing the need for further regulation of the industry.

6. Implications for higher income groups

We ought to bear in mind that the analysis outlined above is based on the behavioural change of a proportion (10 per cent) of a specific income group. This group – the Resolution Foundation's target group of around 15 million low-median earners – are those who are most in need of advice. However, whilst we recommend an advice service targets its provision to low to median earners for just this reason, the service would not be dedicated exclusively to their needs.

Those groups who earn above median incomes, whilst not necessarily the highest earners, are perhaps the most fertile segment of the population for new financial products. These individuals are still poorly served in the current financial services market, and are likely to take advantage of any advice available. The implication is that the figures above are conservative – they are based on a relatively low spending demographic acting in a more financially capable way. Much higher levels of consumer spending in the industry are possible, in the event of a universally accessible advice service.

[15] http://www.fool.co.uk/news/investing/company-comment/2006/08/04/why-banks-are-a-steal.aspx
[16] http://www.moneyexpert.com/News/Loan/15165771/Lloyds-adds-to-big-banks-debt-damage.aspx
[17] http://www.banking-business-review.com/article_feature.asp?guid=F472B306-C09E-4F7A-8123-B883EB36521E

7. Demand for IFAs

The Resolution Foundation's research shows that our target group of low to median earners are overlooked by the regulated financial advice industry – this is because people in this income group are less likely to buy products, or buy lower cost products, therefore generating a lower return for IFAs than higher earning consumers.

However, one of the clearest implications of the analysis outlined above is that improved financial capability increases demand for financial products. This increase in demand has wider implications than simply greater sales for the financial services industry. There may also be an increased demand for regulated independent financial advice, as people could require product and sales related advice before making a purchase. In this sense, advice can be seen as both increasing financial capability more generally, but also as a gateway for people into the regulated advice market.

IFAs could perhaps adapt to meet this demand – like financial service providers, if they could adapt their product/service to meet specific low to median income needs, they might be able to fill the niche which may emerge as more people act on generic advice.

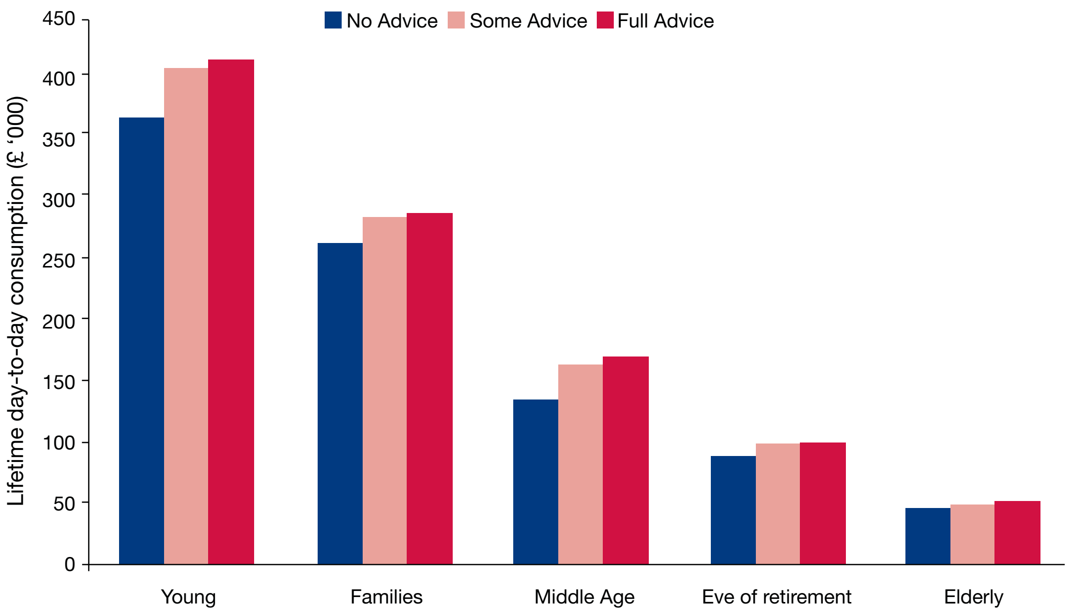
8. The impact on wider economic growth

The findings in this report have wider implications for the economy as a whole. As we have seen in *A National Dividend*, which was also based on the economic model used here, the majority of financially capable consumers are wealthier – their consumption rises over their lifetime as they enjoy greater returns on their investments and more competitive rates of interest.[18]

Increased individual consumption will of course benefit the economy more widely. In addition, these latest findings show that at least part of this increased consumption flows back into the financial services industry, and used to buy investment and protection products.

These products should, in turn, help protect people from financial shocks and unplanned expenditure – again having a wider beneficial impact on the economic growth of the UK as a whole.

Change in contributions to short term savings made by 10 per cent of low to median earners



[18] Resolution Foundation (2006) *A National Dividend*

Conclusion

Following the recent publication of *Financial Capability: the Government's long term approach*, the issue of financial capability – and specifically the need for generic financial advice – has never been more pertinent. The Resolution Foundation has, over the past 18 months, investigated the costs and delivery of a national generic financial advice resource. In *A National Dividend*, we produced a sound financial case for developing a resource by quantifying just some of the benefits this would have for consumers and the Government.

The analysis presented in this report demonstrates improved financial decision making would benefit the financial services industry, although the impact varies by product. Nevertheless, if we review these estimates and the other wider benefits together, the picture is certainly positive. Financially capable consumers increase demand for financial products and have more money to spend and invest.

Furthermore, such consumers also respond to marketing more effectively – which may help the industry as a whole reduce the very large distribution costs it currently bears to promote its products to a generally wary and unenthusiastic customer base. We should also bear in mind that the financial services industry flourishes by finding new products and ways of working to meet demand. This flexibility can be put to good use as more financially capable consumers present a whole range of further product development opportunities for the industry.

Nevertheless, these findings should not be used as a means of assessing the short term gains of the financial services industry thanks to increased access to advice. This research should be used instead to reflect on the longer term outcomes – a more sustainable and healthier financial service market and the creation of wealthier, more financially secure consumers – which are much more valuable to an industry whose current methods of operation cannot be maintained indefinitely. These longer term outcomes can also align the Government's policy aims (of improving the UK's savings culture and encouraging people to plan ahead) with the reality of the financial services market.

Therefore, a provider responding constructively to these findings might in the short term develop a wider range of medium and long term investment or protection products to meet the predicted growth in these markets. They may also devise a strategy to maximise the reputational benefits they are likely to enjoy from supporting a service which promotes better informed consumers and a more transparent relationship between the consumer and the industry. However in the longer term they might also appreciate the benefits of a stronger consumer position as they realise that the status quo – an unreformed demand side characterised by low levels of trust – can only lead to further regulation and associated costs on those seen to be profiting from such an environment of market failure.

Resolution Foundation

Juxon House
100 St Paul's Churchyard
London
EC4M 8BU

Tel: 020 7489 4880
Fax: 020 7489 4860
Email: info@resolutionfoundation.org

www.resolutionfoundation.org

Registered Charity No. 1114839