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Business Cost of Annual Fee Review for Financial Advice

Background

We have been engaged by Industry Super Network to provide our views on the impact of adopting an 'Opt In' rule for financial advice under the Government's Future of Financial Advice ('FOFA') changes.

In this letter we:

- Compare the different types of advice typically provided in the Australian market;
- Discuss the processes that would need to be adopted by financial advisers to comply with a regular 'opt in' requirement;
- Identify the key process and system changes that would be required, within both dealer groups and product providers; and
- Provide an estimate of the additional costs of establishing and administering an annual 'opt in' regime, over and above those that would be incurred under an 'opt out' regime on the assumption that advisers are already in regular (at least annual) contact with their clients.

Given the 'grandfathering' provisions within the FOFA proposals, the focus of our comments is on advice provided and business written after the FOFA changes. However, the impact on existing client relationships is discussed briefly under 'Remuneration for Past Advice' below.

Under the *Future of Financial Advice* ('FOFA') reforms, it will not be possible for advisers to receive commission from product manufacturers for their advice services to clients. The reforms also require advisers to negotiate their fee with each client annually in advance. The purpose of this requirement is to prevent advisers charging asset-based fees at the same level of trail commissions without any specific regular review of fees with clients.

In addition to providing a formal mechanism for clients to confirm that they wish to continue receiving advice, the "Opt-In" rule would:

- Ensure that adviser remuneration is aligned with personal exertion like other professionals; and
- Avoid fees creeping up in line with market performance, particularly in superannuation which is growing by about 6% p.a. in real terms.

The Financial Planning Association and other industry commentators have argued that the cost of requiring an annual fee negotiation is excessive and will add significantly to the costs of providing financial advice. At the extreme, it will lead to lower numbers of Australians receiving financial advice, possibly to the detriment of their financial position.

Forms of Financial Advice

Before discussing the processes and costs of renewing advisory relationships, it is worthwhile considering the forms of advice that will be provided which fall into the following broad categories:

Holistic Advice Under Retainer

This is the form of advice most usually highlighted in the debate on this subject. The process would involve a comprehensive review of a client's financial circumstances and arrangements. The advice provided would cover a range of needs including some or all of, life insurance, retirement funding, superannuation, investments, tax planning and debt management. The advice would include recommendations for implementation - ie product and asset selection - and would extend to assistance with the actual implementation of the recommendations.

The agreement with the client would include the ongoing monitoring of their financial affairs, regular reviews (at least annually, but frequently semi-annually or even quarterly) and the adjustment of the product and asset selection in response to changing circumstances.

The usual basis of remuneration for the adviser is an up front fee and an ongoing instalment fee. Some advisers charge the instalment fee explicitly at an agreed frequency while others rely on instalment (trail) commissions paid from the implemented products.

Holistic Advice Without Retainer

For a number of clients, the relationship does not extend to an ongoing review. They require a comprehensive review of their financial affairs and broad advice on their proper management at a critical point of time in their life. For example, clients nearing or at retirement could seek comprehensive advice on their financial arrangements in retirement with the aim of meeting their income requirements. The implementation of the advice could be carried out independently of the advice.

The usual basis for remuneration is a fee at the time of delivery of the advice. However, many advisers will assist with implementation of appropriate products and they will receive a trail commission without any requirement to provide a further regular service.

Limited Advice Without Retainer

Clients frequently seek advice for only one or a limited range of financial matters. For instance:

- Investment allocations for an SMSF or superannuation holding;
- Life insurance coverage;

- Debt consolidation; or
- The deployment of superannuation, other assets and the pension in retirement.

Within superannuation funds, members could seek advice on simple single issues such as:

- Appropriate contribution strategies (accessing the government co-contribution or sacrificing salary into concessional contributions);
- Determining an appropriate investment strategy to meet the member's aspirations and risk profile;
- Setting appropriate levels of life insurance including income protection; and
- Assessing likely benefits (including Age Pension entitlements) at different retirement ages.

Superannuation funds provide the above intra-fund advice¹ on matters related to their products and services and are seeking to expand the range of advice given.

A significant proportion of advice provided by financial advisers is limited in nature. Consequently, there is also a desire by advisers for 'intra fund advice' mechanisms to apply to limited advice delivered on topics outside superannuation

The usual basis for remuneration is a fee at the time of delivery of the advice. Financial advisers often receive commissions rather than charging fees but this practice will, of course, cease after the implementation of FOFA.

Limited Advice will be the major growth area of the future and will expand advice to an increasing number of Australians.

Limited Advice Under Retainer

It is common, especially with respect to the management of account-based pensions and other retirement funding arrangements, for clients to require ongoing support and monitoring and a regular review of their arrangements.

Clients may prefer to negotiate an ongoing advice fee for the provision of these services.

Costs of Providing Advice

A number of protagonists in the debate have indicated correctly that there are costs associated with the provision of advice that extend beyond the cost of the time spent in preparing and delivering the actual advice.

Financial advisers are not unusual in this regard and in common with lawyers, accountants and actuaries would incur costs including:

- Research and information services;
- Continuing professional development;
- Administration;
- Compliance costs, including insurance; and
- Marketing.

¹ In this context, the term 'intra-fund advice' is used generically and is not restricted to advice under the RG200 relief.

The challenge financial advisers face in recovering these costs is also not dissimilar to that faced by the other professions. The fees set by these professionals include a margin to cover the extra expenses and it would not be unusual for charge out rates to be double or an even larger multiple of the remuneration earned by the adviser.

However, historically, the majority of financial advisers providing holistic advice have received most of the remuneration for delivering the advice. Their overheads have been funded by their licensee ('dealer group') from 'platform fees' or contributions from product manufacturers. The ban on commission will require a change in the remuneration structure of these advisers.

There would appear to be nothing peculiar to financial advisers that would suggest they require some special form of remuneration to fund their overhead expenses any differently to other professionals.

Liability

It has also been stated that there is a liability risk for the adviser should a client not seek regular ongoing advice. The argument appears to be based on the need for an adviser to continue to monitor and change products as a client's circumstances change.

You might choose to seek formal legal advice to confirm our view, but the concerns expressed regarding the liability of advisers should a client not renew an advice agreement appear misplaced.

Advisers are required to provide advice that is appropriate to the circumstances of their clients and can and will be held liable should that advice prove not to be appropriate. This currently applies where a client has an ongoing relationship with an adviser, but also applies where a client does not have an ongoing relationship having simply obtained advice at a point in time for a one off fee.

Advisers who offer or provide an ongoing service clearly have a need to ensure that the plans they are managing remain current and would generally have an ongoing liability to ensure the ongoing appropriateness of the plan.

The changes proposed would appear to limit rather than expand the liability of advisers for this ongoing advice. As contemplated by the various reviews, advice agreements would be for one year and require explicit renewal by the client at the end of that period. It would also be reasonable to assume that any dealings with the client in relation to the renewal of the advice contract would emphasise its impending termination. It would therefore seem extremely unlikely, should a client fail to renew the contract, that an adviser would be held liable for the impact of changing circumstances following the termination of the contract.

Commentary

Holistic Advice Under Retainer

Under the proposed changes, the client and the adviser would enter into a contract for the provision of advice services. This may involve an initial advice fee and ongoing advice fees.

It should be possible for a client seeking ongoing holistic advice to arrange payment of the initial advice fee in instalments over a period longer than one year. This arrangement would be sensible where:

- A relatively extensive - and therefore expensive - financial plan has been prepared;
- The client has insufficient cash flow to pay for the advisory services upfront; and

- Providers of risk insurance agree to collect fee instalments on the adviser's behalf, as part of the normal premium payment process.

However, the client's ability to negotiate payment instalments longer than one year would not alter or dilute the requirement that advisers ask their clients to renew contracts annually. Any fees spread over two or more years must relate to services provided within the year of contract, which the client and adviser agree to at inception.

By the same token, if the client does not renew the contract for services at the end of the year, then he or she would have no further right to advisory services and the adviser no obligation to provide them. The client would, of course, be obliged to pay fee instalments beyond this period, as stipulated in the contract for payment.

Further, the amount and frequency of fees must be disclosed clearly in dollar terms, and the basis of any increase from year to year clearly set out. It is usual for increases to be based on changes in the rate of the consumer price index (CPI) or average weekly ordinary time earnings (AWOTE).

We would expect most advisers to develop a schedule of fees. If these change during the contract term, then the client would not be subject to any increase unless they agree to it (as with any similar retainer for professional services). This agreement could be obtained by a simple email acknowledgement of the new fees, or by a signed agreement made at the time of annual renewal of the advice contract.

The extent of the service and the frequency of review would determine the level of the fee. Quarterly reviews would justify a higher fee than annual reviews. Whatever the agreement, there are two elements that are critical when considering the cost of renewal:

- The service will include regular engagement with the client; and
- The cost of this engagement will be included in the fee agreed.

The adviser will not need to arrange separate dealings with the client for the purpose of renewing the advice agreement. The renewal can and is probably best carried out as part of the review process. There does not appear to be a need for a separate renewal activity. The cost of the adviser's time and communication with the client would already be covered by the negotiated fee.

Holistic Advice Without Retainer

The advice provided is a one off service for which a fee will be charged. There is no ongoing relationship to renew and there cannot therefore be any cost for renewal.

It is possible, if a significant body of advice has been provided, that the fee could be large and therefore difficult for the client to pay as a single sum. It should therefore be possible for the adviser and client to agree a payment schedule which might extend over a year or two. It is unlikely that either party would wish to see the schedule extend over too long a period.

Advisers, in common with the other professionals, may well seek further business from such a client. The cost of this activity is more properly considered as a marketing expense and costed into the charge out rates for the advisers.

Limited Advice Without Retainer

The advice provided is a one off service for which a fee will be charged. There is no ongoing advice relationship to renew and there cannot therefore be any cost for renewal.

By its nature this advice is limited to one or a small number of issues. It is not generally complex and so the fees will be moderate. A single up front payment is therefore appropriate, although payment by instalments should be permitted in a similar way to that described under 'Holistic Advice Without Retainer' above.

Limited Advice With Retainer

Some limited advice, for instance retirement incomes and pensions advice, could sensibly require an ongoing advice relationship. Whilst they will be more limited in nature than ongoing holistic advice they will also have the same two elements:

- The service will include regular engagement with the client; and
- The cost of this engagement will be included in the fee agreed.

The adviser will not need to arrange separate dealings with the client for the purpose of renewing the advice agreement. The renewal can and is probably best carried out as part of the review process. There does not appear to be a need for a separate renewal activity. The cost of the adviser's time and communication with the client would already be covered by the negotiated fee.

It should also be possible for clients and advisers to agree contract periods longer than one year subject to the conditions indicated for *Holistic Advice Under Retainer*.

Remuneration for Past Advice

The discussion above focuses on advice provided after the introduction of the proposed FOFA changes.

We have assumed that existing business would be subject to 'grandfathering' provisions which would mean that the removal of commission and the requirement for regular renewal of the advice contract with the client would not apply in respect of existing business and advice provided before the date of change.

Advocates of grandfathering argue that existing adviser trail commission arrangements are a form of deferred remuneration for advice provided in the past.

For business written historically on commission terms where the adviser has not maintained ongoing communications with the client, a requirement for regular opt-in for advice would clearly involve significant cost to the adviser. However, the proposed grandfathering provisions do not envisage such a requirement.

Nevertheless, if the adviser were to sell their book of business it is assumed that the grandfathering provisions would no longer apply. This would obviously be taken into account by the potential acquirer when valuing the business.

Costs of Compliance

There will be some extra costs associated with compliance:

- The development of the new system will require amendments to disclosure documents, Financial Services Guides and client agreements. The proposals see this process staggered over an extended period so much of this development can be incorporated into normal review and replacement processes without significant additional cost;

- Client agreement to ongoing advice contracts will need to be recorded. There will be no new or extra costs associated with the initial agreement. There will be some new costs associated with recording the renewal agreements. These will be incurred at two levels:
 - Licensees: Licensees will need to amend their systems to include the contract renewal communication in the review processes and record the next renewal date. They will also need to ensure the return and recording of the client agreement and the lodgement of that agreement with the product and product platform providers who debit fees. They already account for and reconcile the fees earned and charged to clients, but the audit requirements will probably be greater in the proposed regime. We note that existing adviser systems should record future client renewal dates and provide appropriate communication triggers;
 - Product and Product Platform providers will need to amend their systems to provide for time limited fee deductions from client accounts on behalf of advisers. They will also need to administer the recording of renewals. There is unlikely to be extra cost for accounting reconciliation and audit as these functions are already carried out.

Licensee implementation costs would vary depending on the design of their current business and IT processes. However, for small dealer groups which have more flexibility to make changes, the costs will be relatively small. Larger dealer groups, particularly those that are part of vertically integrated wealth management groups, have a requirement to conform to broader group risk and compliance with protocols around changing IT systems and this may involve higher costs. However, these are no different to any other change in legislation (which happens regularly).

We have discussed the potential additional costs of adopting an annual 'opt in' rule with a number of dealer groups and financial institutions. However, we are not aware of any which have developed estimates for the specific costs of establishing and maintaining 'opt in' arrangements over and above the broader costs associated with implementation of the Future of Financial Advice changes.

As such, the estimated costs set out reflect an empirical analysis of the specific additional functions required and cost estimates for each, based on our experience in implementing process and system changes more broadly within financial services businesses.

On this basis, the overall cost of an 'opt in' regime over and above an 'opt out' regime, when expressed as a percentage of funds under advice, are estimated to be in the range **0.003% per annum to 0.009% per annum (or 0.3 basis points to 0.9 basis points)**. In the long term, once one-off establishment costs no longer have an impact, costs are estimated to reduce to between **0.002% per annum and 0.007% per annum (or 0.2 basis points to 0.7 basis points)**.

These figures include costs incurred by dealer groups and by product providers.

Further details of the approach to determining these cost estimates and sensitivities of the results to changes in key assumptions are set out in the Attachment to this letter.

Conclusions

Advice is a process that requires customer contact whether it be face to face, on the phone or, increasingly, via the internet. If advice is being delivered, contact will be occurring and this contact can be used as the vehicle for advice contract renewal. This will generally eliminate extra costs associated with dealing with clients.

Systems redevelopment across the market will require a significant investment, but most participants are already committed to this as part of the process for removing commissions. Once the systems have been redeveloped, the extra compliance costs should be modest.

This report constitutes a Statement of Advice as defined under the Financial Services Reform Act. It is provided by Rice Warner Actuaries Pty Ltd. which holds Australian Financial Services Licence number 239 191.

Attachment A Cost of 'Opt In' for Financial Advice

Background

We have discussed the potential additional costs of adopting an annual 'opt in' rule with a number of dealer groups and financial institutions. However, we are not aware of any which have developed estimates for the specific costs of establishing and maintaining 'opt in' arrangements over and above the broader costs associated with implementation of the Future of Financial Advice changes.

As such, the estimated costs set out reflect an empirical analysis of the specific additional functions required and cost estimates for each, based on our experience in implementing process and system changes more broadly within financial services businesses. Because the results are based on estimates, we have shown below their sensitivity to changing the underlying assumptions.

Advisers assumed to contact their clients at least annually

Where the adviser is in regular (at least annual) contact with their client, the additional costs of obtaining annual confirmation from the client that they wish to 'opt in' for continuing advice will be small. They will include the cost of recording the client's 'opt in' confirmation each year and the date of expiry of the current advice period.

Costs of change reflect synergies with other FOFA changes

Some initial costs will be incurred in establishing appropriate systems and processes and others will be ongoing. We have considered these separately.

Where IT systems and processes require change we have assumed that these will be carried out as part of the broader change program resulting from FOFA. Thus, the assumed additional costs for 'opt in' represent the 'marginal additional costs' over and above those that will necessarily be incurred as part of the broader FOFA initiative.

Overall additional costs of an 'opt in' regime over an opt out regime

If establishment costs are amortised over a period of 7 years, then the overall cost of an 'opt in' regime over and above an 'opt out' regime, when expressed as a percentage of funds under advice, are estimated to be in the range 0.003% per annum to 0.009% per annum (or 0.3 basis points to 0.9 basis points). In the long term, once one-off establishment costs no longer have an impact, costs are estimated to reduce to between 0.002% per annum and 0.007% per annum (or 0.2 basis points to 0.7 basis points).

These figures include costs incurred by dealer groups and by product providers.

Additional Costs of Opt In

Table 1 below lists the key additional functions and business processes that would be required under an 'opt in' regime. It also shows the estimated costs of establishing the various business processes and managing them on an ongoing basis, for a typical dealer group and a typical product provider.

The costs presented are estimated based on our experience in implementing changes in processes and systems more broadly within financial services businesses.

In practice, a 'typical dealer group' and a 'typical product provider' are difficult to define as there are wide variations between each organisation. For example, dealer group and advice practice costs vary significantly depending on whether their IT systems are:

- Proprietary, in house systems;
- Provided by an external dealer group services provider; or
- For a dealer group that is part of one of the large wealth managers, provided by the corporate parent and conforming to corporate IT standards.

However, we believe that the stated estimated additional costs, when assumed to apply across the industry, provide reasonable overall cost estimates.

It should be noted that costs are presented as fixed rather than varying in proportion to business volumes. This is due to the assumption that the costs to be assessed are those in excess of the costs that would already be incurred where the adviser holds discussions or meetings with their client at least annually. As such, the discussion regarding renewal of the advice contract and the client's request for ongoing advice (opting in) can be dealt with at the same time as normal adviser/client communications and no additional costs will be incurred.

Similarly, any communication with the customer regarding the forthcoming expiry of the advice contract or written request for renewal can take place as part of normal adviser/client communication. In this regard, we have assumed that the 'opt in' regime will permit opting in via email or IVR as well as in writing².

For completeness, the table also identifies some of the key functions that would be required under an 'opt out' regime where advisers are in regular (at least annual) contact with their clients. This serves to show a complete picture of the relevant advice processes, including areas where items required under an 'opt out' regime can be leveraged to support an 'opt in' approach. As a result, it demonstrates why the costs of many of the additional business processes required to support 'opt in' are relatively modest.

² We note that the government is considering a standard form to be designed by ASIC and we would expect that this could be completed online for convenience

Table 1. Additional Cost of Opt In for a Typical Dealer Group and Product Provider (\$)

Function / Business Process	One-off	Ongoing p.a.	Comments on impact of Opt in
Typical Dealer Group			
Retaining and managing client advice contracts (similar to SOA maintenance process)	0	0	Would be required for opt out so no additional cost for opt in
Record selected fee basis for each policy/account	0	0	Would be required for opt out so no additional cost for opt in
Record advice contract renewal date	50,000	0	This is unique to opt-in. Once the process is set up, the additional ongoing cost is minimal as the date can be recorded at the same time as other contract details.
Contract renewal communication - trigger and collateral	45,000	100,000	Even though existing systems and processes should alert the adviser to the need for an annual discussion with each client, an additional control would be to set up a formal trigger (e.g. email or 'task' to the adviser) some time in advance of the expiry date of the current advice period and following up any clients who, for some reason, do not confirm opt in at the relevant adviser/client review.
Separate fee / commission reporting and payment to adviser	0	0	Would be required for opt out so no additional cost for opt in
Accounting, audit and compliance	10,000	10,000	
Total Dealer Group	105,000	110,000	
Typical Product Provider			
Receive notification of opt-in and maintain record of receipt:			Notification may be direct from the client or via the adviser
IVR	50,000	100,000	A link will be required between the IVR system and the record of opt-in/out on the administration / adviser remuneration system. However, this is required for opt-out as well as opt-in so no additional cost. Nevertheless, it is assumed that the cost will be greater for opt-in than for opt-out as there needs to be positive assurance.
Email	50,000	100,000	Same rationale as for IVR
Letter (scan)	50,000	200,000	Same rationale as for IVR
Record advice contract renewal date in administration system, fed by client / adviser notification described above	600,000	0	This may be expensive where the change needs to be made across several administration systems. This has been allowed for in the estimated cost but, for some providers, the date could be recorded centrally and used between the administration system and the fee calculation system to ensure the correct fee payments. Note that the ongoing cost is captured in the previous item above.
Amend disclosure in letter to client on buying a product	0	0	Minimal as most of the cost is already required for opt out. Also, once established there is no additional cost over and above the normal cost of producing the initial client letter.
Time limited fee deductions from client accounts on behalf of dealer group, in administration systems	400,000	0	Systems will need to be changed to ensure that a check is made regarding eligibility for fees before the fee calculation is performed. However, once the new process has been established, it will be automatic so there will be no additional ongoing costs. Note that fee calculation systems will have to deal with 'no fee' cases even under an opt-out regime.
Amend disclosure in annual statement	0	0	Minimal as most of the cost is already required for opt out. Also, once established there is no additional cost over and above the normal cost of producing annual statements.
Amend disclosure in online client reporting	200,000	0	This is unlikely to be mandatory but most providers offer online service allowing customers to view their investments and may want to include details of advice contracts and their expiry. Once this service has been established, there is minimal ongoing cost.
Separate fee / commission reporting and payment to dealer group	0	0	Would be required for opt out so no additional cost for opt in
Accounting, audit and compliance	50,000	50,000	
Total Product Provider	1,400,000	450,000	

In order to estimate the additional industry-wide costs of an 'opt in' regime, we have assumed that the costs set out in Table 1 above are incurred by 100 dealer groups and 25 product providers. In practice, there are many smaller dealer groups and advice firms outside the top 100.

Smaller advice firms tend to use in-house systems that can be enhanced relatively easily or rely on external support service providers who would be likely to provide necessary IT systems and support service enhancements for only a modest additional cost. Furthermore, the majority of the funds under advice across the industry relate to the top 100 dealer groups.

For these reasons, small dealer groups (outside the top 100) have been ignored.

We note that, in many cases, financial advice practices have developed their own business processes and record keeping systems rather than those being provided by their licensee dealer group. It could be argued that practice level costs should be taken into account. However, on the other hand:

- Where practice level business systems are self developed, they are generally easy to amend at little cost; and
- Many of the additional costs set out in Table 1 above relate to IT system changes which, where proprietary financial advice practice software is used, will be provided by software suppliers and this has already been taken into account in the Table 1 estimates.

Given the assumed number of dealer groups and product providers, the overall cost of 'opt in' over and above other Future of Financial Advice changes, is estimated to be \$46 million initially and \$22 million per annum on-going.

We estimate that the funds under advice across the Australian market at 30th June 2010 are as set out in Table 2 below.

Table 2. Funds Under Advice at 30th June 2010

Product Group	Funds Under Advice (\$bn)
Superannuation	237
Managed Investments	231
Total	468

If establishment costs are amortised over a 7 year period, the overall marginal cost of an 'opt in' regime is estimated to be 0.006% per annum of funds under advice, or 0.6 basis points.

This overall rate of additional costs is made up of 0.1 basis points due to amortised one-off costs and 0.5 basis points due to ongoing costs.

It should be noted that, due to the proposed 'grandfathering' of existing advice arrangements at the time of change, the volume of business that is subject to the 'opt in' regime will be small initially. Thus, if the additional costs were to be expressed as a percentage of funds under advice that are subject to the 'opt in' regime, the rate of additional costs would be much higher.

However, the rate of additional costs stated above is an appropriate measure of the overall impact on dealer groups and product providers overall. Furthermore, over time the majority of business will move from being 'grandfathered' to being contemporary, so the additional cost rate will revert to the overall rate stated above irrespective of how it might be measured in the short term.

Sensitivity

Table 3 below shows the impact of adopting different cost assumptions on the overall additional costs associated with an 'opt in' regime.

Table 3. Sensitivities

Assumption	Additional Costs % p.a.	Additional Costs Basis Points p.a.
Base Assumptions	0.006%	0.6
One-off costs doubled	0.008%	0.8
Ongoing costs doubled	0.011%	1.1
All costs doubled	0.012%	1.2

In general, it is likely that costs for a small dealer group with in-house IT systems or using proprietary practice software with enhancements being supplied by the software provider will be significantly lower than those of a large dealer group such as those owned by the large wealth managers.

On the other hand, funds under advice will be lower so, overall, the additional costs as a percentage of funds under advice could be similar.

The same argument applies in relation to product providers, with the large wealth managers being better placed to absorb fixed additional costs but, on the other hand, they often have products on multiple legacy systems which can lead to multiple development and ongoing costs.

As discussed in above, the overall additional costs stated are based on estimates of the costs of each new or enhanced business process. Consequently, the additional costs are subject to a margin for error. In our view, the overall additional costs of the 'opt in' regime would be in the range 0.3 basis points to 0.9 basis points on funds under advice.