

*Review of Medium  
and Long-term  
Retail Savings*

*A Consultation  
Document*

*July 2001*

# Foreword

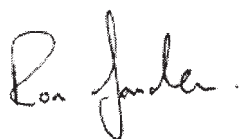
The long-term savings industry is of crucial importance to the UK economy. It provides the means whereby millions of people are able to provide securely for their future financial needs. It also manages a substantial pool of assets that have a significant impact on the allocation of capital in the economy.

There can be no doubting the success of the industry. It has made a major contribution to the economy as a source of employment and growth, and ordinary savers have benefited from access to professionally managed investments in financial markets.

But there are also concerns over the effectiveness of the competitive processes in this industry. This is hardly surprising given the inherent complexities of long-term savings products and the consequent difficulties facing consumers in making informed purchase decisions and exerting influence over product providers. These concerns fall into two broad categories: first, is the consumer being well served with products that are low cost and offer attractive returns in relation to the risks involved; and second, do the incentives for investment performance that operate in the industry lead to an effective allocation of capital? The answers to these questions are far from straightforward, and that is why I have been asked by the Chancellor to conduct this review. I will be seeking to understand how the forces of competition operate in the industry and to identify where policy responses may be necessary.

Many of these concerns are not new. A great deal of work is already underway on possible reform and improvement, both from within the industry itself, and by Government and regulators. I intend to work closely with these various initiatives to ensure that our efforts are complementary rather than duplicative or contradictory.

This consultation paper sets out the key issues that I believe this review needs to address. I welcome responses from all interested parties on both these issues and any other related topics, and look forward to the dialogue and further consultation that will follow.



Ron Sandler

The deadline for responses is **Friday 28 September 2001**.

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Further copies of this paper can be obtained from

<http://www.hm-treasury.gov.uk> (see 'consultation documents')

# 1 Terms of Reference

1. The Myners review of institutional investment reported at the time of the 2001 Budget. Its remit was to investigate possible distortions in investment decision-making by institutional investors. It considered the role of life insurance companies and unit trusts as institutional investors as part of its work.

2. It concluded that:

“...competition to offer retail customers superior investment performance should be the primary driver of investment decision-making. In principle, however, several factors work against this.”

and recommended that a further review be set up to examine these markets.

3. This review was announced in the Government’s statement “Enterprise for all – the challenge for the next Parliament” on 18 June 2001. Its terms of reference, for the markets for long-term retail savings, were:

*“to identify the competitive forces and incentives that drive the industries concerned, in particular in relation to their approaches to investment, and, where necessary, to suggest policy responses to ensure that consumers are well served”.*



# 2 Scope of the Review

4. The review will cover:
  - life insurance savings products;
  - pensions sold either direct to retail investors or to retail customers via their employers (including personal pensions, insured occupational pension schemes, Group Personal Pension and stakeholder schemes); and
  - collective investment vehicles.
5. The review will not cover bank deposit accounts or other forms of cash savings, nor will it look specifically at products and services aimed solely at high net worth individuals.
6. The review will examine all elements of the value chain, from product design through distribution to the final customer.
7. This review will look at whether the UK market as currently structured, with its products and government and regulatory infrastructure, leads to efficient investment decision-making and to optimal outcomes for consumer interests more broadly. It is not, as such, a review of the adequacy or effectiveness of current regulation, but will examine the effects of regulation on competition in the industry, as well as the impact of such matters as governance structures.
8. This consultation document sets out the main issues to be investigated at all levels in the value chain: consumers; intermediaries; and product providers. Its purpose at this early stage of the review is to gather information and ideas in order to understand the functioning of the industry and how it serves its consumers.



# 3 Introduction

**9.** The long-term retail savings industry is of considerable public policy importance. Not only do the participating companies manage the savings of millions of people but, in doing so, they control a pool of over £1 trillion and as such have a significant impact on the allocation of capital within the economy.

**10.** This industry has been extremely successful in encouraging a wide range of retail customers to save for the long-term and to benefit from stock market returns in recent decades. It has also made a major contribution to the UK economy as a source of employment and growth.

**11.** At the same time, there are grounds for concern as to whether the competitive process in the industry is necessarily producing efficient investment and an appropriate range of products that deliver to the consumer an efficient risk-return trade-off at the lowest possible cost. There are various reasons for this concern:

- many consumers lack the time for or expertise in investment and savings issues, and there is limited shopping around;
- as a result products are usually distributed through intermediaries, who are subject to their own commercial incentives;
- costs and charges are poorly understood by consumers and exhibit very wide variations across the various product markets;
- high distribution costs generally create substantial disincentives for the consumer to switch products or providers even where it might be in their best long-term interests to do so; and
- in certain products, such as with-profits policies, competition is based on proxies that are only indirectly related to the underlying investment performance.

**12.** It cannot therefore be assumed that capital will be allocated efficiently as a result of the underlying competitive process, nor that consumers are being adequately served.

**13.** The review seeks to understand the competitive dynamics of the industry and the implications for both capital allocation and the end consumer.



# 4 The Value Chain: Consumers

## Extent of Consumer Influence

**14.** In efficient markets, the preferences of the end-consumer will ultimately drive behaviour and market structure. However, where consumer influence is weak, these preferences may be dissipated by intervening structures and incentives as these are transmitted through the system.

**15.** While consumers are not a homogeneous mass, the general picture emerging from published consumer research into the long-term savings market is one of weak consumer influence. The population as a whole has a relatively poor understanding of investment and savings issues. Even basic matters, such as the distinction between independent and non-independent advice, and how charging structures operate, are not well understood. Consumers do not generally research widely prior to making a purchase decision, nor do they monitor effectively the results of a decision after it has been made. They are aware that buying long-term financial products involves risk, but they have a poor understanding of the risks involved and only a rudimentary grasp of risk-return trade-offs.

### ***To what extent is this an accurate description of consumer behaviour?***

**16.** This weakness of consumer influence plays a fundamental part in shaping the way in which the market functions and how firms compete.

**17.** It becomes difficult for competitive forces to work effectively to reward those companies providing high quality, cost-effective products that meet consumers' needs. If consumers do not understand what they are buying and at what price, then they may continue to purchase products which offer poor value or are unsuitable.

**18.** Greater weight is therefore placed on the need for advice and the role of financial advisers. To the extent that advisers' incentives are not aligned with those of their clients, competition within the industry may not lead to optimal outcomes for consumers. And even where incentives are properly aligned, an agency relationship itself should ideally be monitored and subject to competitive pressures. This is unlikely to be the case where consumer understanding and influence are weak.

**19.** The relative lack of consumer understanding and influence also affects significantly the distribution economics in the industry. It is time-consuming and expensive to sell to consumers who do not understand long-term investment issues and have difficulty in dealing with the inherent complexities of the products. This has produced a tendency towards front-loaded cost structures. These structures may not be transparent to consumers and may create barriers which discourage product switching.

## 4 *the value chain: consumers*

**20.** Consumer behaviour also ultimately affects investment decision-making. Many consumers will pay inadequate attention to investigating investment performance, or will assess it in simplistic or inappropriate ways, for example, selecting products on the basis of short-term performance in peer group league tables.

**21.** The reality of weak consumer influence has led to the FSA's statutory objective of promoting public understanding of the financial system. It is also one of the drivers behind the FSA's work on disclosure and comparative information, where this review and the FSA will be working closely together.

***Is weak consumer influence inevitable? Can action be taken to mitigate it? If so by whom? To what extent can regulation compensate for it?***

***To what extent can consumer education compensate for it?***

***To what extent can improvements in the quality of information provided to consumers by the industry help to improve consumer influence?***

***Does new technology offer opportunities to increase consumer power by making information, particularly comparative information, more accessible?***

### The Corporate Purchaser

**22.** The above analysis assumes that consumers are always individuals. This is, of course, not necessarily the case. For a number of products, the purchasing decision is taken, for all practical purposes, by the employer of the end-consumer:

- insured occupational pension schemes;
- other employer sponsored pension arrangements, such as Group Personal Pension (GPP) schemes. Stakeholder pensions have also led to increased employer involvement; and
- Save As You Earn (SAYE) schemes. Whilst the decision to save is an individual one, the choice of provider is typically made by the company.

***Do corporate purchasers exert greater competitive pressures on providers and intermediaries?***

***What role, if any, might employers have to play in improving the functioning of the market?***

## Information to Consumers: the Regulatory Framework

23. Retail financial services are highly regulated. The industry has specific features that make regulation inherently necessary:

- the products are complex, and more importantly, long-term; consumers may not realise the consequences of a poor decision until it is too late; and
- consumers are not able to judge the financial health of the firms from which they are buying the products, even though this can be crucially important.

24. The need for regulatory intervention also appears to have been driven by the weakness of the end-consumer. However, until now regulation in the UK has been designed to protect consumers from detriment; “economic regulation”, or the promotion of industry efficiency, is not a primary consideration.

25. Regulation has tended to focus on two main areas:

- prudential regulation of the providers of retail savings products, to ensure that they are financially sound; and
- conduct of business regulation of both providers and distributors, effectively seeking to regulate not the products themselves, but the process of selling them and specifically, the flow of information between the industry and consumers.

The FSA has also recently taken major initiatives to promote financial education and provide high quality information to consumers directly about financial products and choices.

26. Direct product regulation has not generally been used as a tool of policy, with a few notable exceptions: unit trusts and stakeholder pensions are both the subject of detailed product regulation on charges, investment strategy and the like. CAT marks, though voluntary, affect product design directly for CAT-marked products and indirectly through the impact that these products have on the dynamics of the rest of the market.

***How effective has this regime been in tackling the issue of the consumers' weak influence? What other consequences has it had?***

## Personal Finance Media and Other Information Providers

27. The retail savings and investment market receives unusually wide coverage in the media, both newspapers and broadcast. Supplements or programmes dealing with personal finance are perhaps more widespread than for any other product. This is interesting, given the research suggesting that, in general, consumers are not interested in examining the detail of these products, except perhaps at very specific moments

## 4 *the value chain: consumers*

in their lives, for example, upon receiving an inheritance. More significantly, the personal finance media potentially offer a source of information for consumers without any economic incentives related to the sale of one product rather than another.

***What has been the role and focus of the personal finance media?***

***What has been their impact?***

**28.** There are also commercial entities providing information to the consumer about retail savings products, particularly over the internet. At the moment, their coverage appears to be largely restricted to a small group of well-educated and active consumers.

***Can these information providers play a more significant role?***

# 5 The Value Chain: Distribution

## Choice of Channel

**29.** As identified above, the relative lack of consumer understanding means that distribution issues are central in defining how the retail savings market functions. The general experience to date has been that a face-to-face meeting with a salesperson or adviser is usually necessary. Direct sales (i.e. sales made without advice from an independent adviser or company representative) to consumers through direct marketing and advertising is difficult. The picture varies from product to product; for example, it appears that collective investment schemes are somewhat easier to sell directly than most life products but even then, direct sales of unit trusts and open-ended investment companies (oeics) account for only 15% of total sales. It appears to be difficult to establish brands in retail savings of comparable strength to other consumer brands. Historically, salesforces were the preferred channel, but this is now in decline relative to Independent Financial Advisers (IFAs).

***Why has direct selling on a large scale not occurred?***

***Would a greater role for direct selling be desirable? How might this happen?***

***What role could branding play in this process?***

**30.** A key aspect of the market is the “polarisation” regime which has shaped the distribution arrangements for life assurance and collective investment schemes for more than a decade. Earlier this year the FSA announced its decisions on the first stage of its review of polarisation, as a result of which direct offers of products were removed entirely from the regime, and companies were also allowed to import stakeholder pensions from other providers.

**31.** The FSA is now engaged on the second, wide-ranging stage of its review of polarisation. This review is looking at all areas of potential market failure in the distribution of products in the market. The FSA has made clear that it has not ruled out any option for change, including the possible introduction of multi-tied arrangements.

**32.** The FSA review of the polarisation restrictions is addressing key market structure questions alongside consumer detriment considerations. The FSA plans to publish for consultation, in Autumn 2001, proposed options for change, based on economic and consumer research now under way and taking account of the benefits that sharpened competition can bring to consumers. The retail savings review will build on this work under way, including the FSA’s emerging proposals. Meanwhile, those who have observations to make on the key issues also relevant to the retail savings review – as outlined in paragraph 33 to 40 below – are encouraged to copy to the FSA any

## 5 *the value chain: distribution*

relevant points they put to this review which bear on those issues. Written correspondence should be marked for the attention of Patricia Worthington. E-mail correspondence should be addressed to [cp80@fsa.gov.uk](mailto:cp80@fsa.gov.uk).

### Intermediaries: Commercial Incentives

**33.** The use of intermediaries means that a separate group with its own set of incentives also influences the decisions made in the market place. Remuneration structures are clearly the key source of incentives for tied agents, direct salesforces and IFA's, as they would be in any market.

**34.** IFA's, as businesses in their own right, also face the issue of cost management. However, the requirement to spend time with clients, with the associated cost consequences, may limit the potential for substantial further cost efficiencies in this channel.

***Is increasing revenue the key business issue for IFA's rather than reducing costs?***

**35.** For both tied agents/direct salesforces and IFA's, remuneration arrangements are clearly critical. Once again, consumer behaviour appears to have had an important impact on the way in which market structures develop. Ultimately consumers pay for advice, either directly or through commission. Consumer research to date has tended to conclude that consumers are unwilling to pay for advice directly through fees. Commission arrangements have therefore been the norm in the industry – more specifically, commission arrangements that are sales-related, creating an important element of front-loaded costs. This in turn has important consequences for investment returns to consumers and for switching or redemption penalties.

***Why are consumers reluctant to pay directly for advice? Why is advice bundled with selling? Why is there no market for advice? Could a market for advice be developed and how?***

**36.** To some extent, sales-related commission payments reflect the nature of the sales process: making the initial sale can often involve a heavy investment of time upfront to educate the consumers about even such basic issues as the need for saving. At the same time, such remuneration arrangements also have the effect of rewarding advisers for maximising sales volume rather than necessarily for providing the best advice for clients. Their front-loaded nature also makes switching difficult for customers once the product has been bought.

***Are there alternative methods of remuneration for IFA's and direct sales forces?***

***Why are they not more widespread?***

37. The situation is further complicated by the fact that providers pay different levels of commission for different products and also for different channels. It is hard to see a clear relationship, across products, between commissions paid and costs incurred by the channel.

38. The regulatory regime relies heavily on disclosure to consumers of intermediaries' commissions as the basis for safeguarding consumer interests. However, the complexities of commission structures and indirect benefits with which product providers can reward the distribution channel may mitigate the effectiveness of this regime. In practice, most consumers do not understand that they may end up paying the commission cost – through the front-end charge.

***What factors drive commission levels?***

***What are the consequences of different products having distinctly different levels of profitability for their distributors?***

***Is there a case for regulatory intervention in the setting of fees and commission levels?***

39. It would appear that relationships between consumers and their advisers tend to be long-standing. This may reflect a generally high level of satisfaction on the part of consumers; alternatively, it may simply be a consequence of inertia or reflect the fact that the consumer is not easily able to make informed choices about switching, or is daunted by the process. This issue is central to understanding the extent to which consumers drive intermediary behaviour, or the reverse.

40. In law, the relationship between the IFA and the consumer is that of agent to principal, with all that entails in terms of duties and responsibilities, particularly where conflicts of interest exist. In practice, it is not clear that this is widely understood.

***What causes the relationships between consumers and their advisers to be long-standing? Are consumers aware of the duties owed to them by their IFA's?***

### Intermediaries: Regulation and Scope of Advice

**41.** Given the characteristics of retail consumers of savings products, advice has an extremely important impact on behaviour. The existing regulators have adviser training and competence regimes and the FSA's successor regime will come into force on 30 November 2001. The competence of individuals is an important part of the FSMA regime. Nonetheless, it has been suggested that advisers tend to concentrate on issues of product design, such as tax treatment, and that they do not have a comparable level of expertise in investment issues.

**42.** In particular, it is argued that both advice and the regulation of advice tend to focus on the issue of which provider and which product to choose, rather than on the underlying investment strategy.

***Is the current standard of advisers' knowledge about investment issues sufficient?***

***How much attention is paid to investment strategy as opposed to selection of product and provider?***

**43.** As set out above, government and regulators have sought to compensate for consumers' lack of understanding of retail savings products by regulating the way in which they are advised. The regulatory system in this area is based on two broad key principles: to "know your customer" and to provide suitable advice. The aim is to ensure that regardless of the commercial incentives acting on them, advisers are under a clear requirement to provide high-quality and appropriate advice. However, except in extreme circumstances, the quality of advice is inherently difficult to measure and assess.

***How effective is the requirement to provide suitable advice? What other effects has it had?***

**44.** When advisers look at the issue of investment performance, it appears that an important factor in their considerations is performance by the product concerned in historic peer group investment performance league tables.

***How important are such tables in determining advisers' recommendations?***

***What impact does their use have on product providers' investment strategies?***

## Intermediaries: Impact of Other Market Forces

**45.** High street banks have an important role to play in the market for long-term savings and investment. It is argued that their broad product mix and strong brands should enable them to become dominant players in distribution of retail savings products; however, this has not happened to date. At the same time, other branded distributors, such as Virgin and Marks & Spencer have entered the market, as have “fund supermarkets”.

***What is the likely future impact of high street banks and other branded distributors on trends in distribution channels?***

***What is the likely future impact of e-commerce on trends in distribution channels?***



# 6 The Value Chain: Product Providers

## Trends in Industry Structure

**46.** Recent years have seen a clear trend towards consolidation, both within the life insurance and unit trust industries themselves, and within financial services more broadly. This has been fuelled by such developments as globalisation, greater reliance on information technology and the rise of bancassurance. It is not clear, however, whether this will lead to a fundamentally different approach to creating and distributing retail savings products, or whether it simply leads to cost savings at the margin for the firms involved.

***Will consolidation within financial services fundamentally affect the other issues highlighted in this document (for example, distribution methods, consumer choice)?***

## Investment Decision-Making in Product Providers

**47.** In principle, since retail savings products are being sold in a competitive market, product providers should be motivated by competitive pressure to obtain the best risk-adjusted investment returns. As the discussion above suggests, the way in which the market functions means that competitive interaction is governed by factors other than investment performance. For example, it has been suggested that marketing expertise and effectiveness of channel strategy are far more significant determinants of competitive success.

**48.** The organisational structure of product providers creates a further complication. At the level of the investment management function, funds will typically be divided up by market (UK equities, US equities, fixed-income and the like), rather than by product. Though different products may well be accounted for separately and be legally distinct, they are not generally managed separately.

**49.** This prompts the question of how investment objectives are set and measured, and by whom, and what is the interaction between the marketing function and the investment management function. Given the rather indirect relationship between the funds under management and the products that are sold to retail investors, it is not clear how, if at all, competition for retail custom determines these objectives.

***How are investment objectives set for individual markets or funds managers within a product provider? What benchmarks are used, and over what timescale?***

**50.** Where a consumer has bought a product invested solely in a single market, there are often no further asset allocation decisions to be taken. But for managed linked funds, or with-profits funds, an asset allocation decision certainly needs to be

## 6 *the value chain: product providers*

taken to aggregate the various market funds together to construct products. The decision will differ depending on the nature of the product and, in particular for with-profits funds, the need for actuarial involvement.

**51.** Again, the issue of investment objective is relevant here. For managed linked funds, it may be assumed that the relevant benchmark is likely to be some sort of peer group measure. This would be likely to lead to highly similar asset allocation strategies for managed funds. For with-profits funds, the situation is more complex, since the underlying investment performance of with-profits funds is typically not disclosed.

***How are asset allocation decisions taken? Against what targets?***

***In the case of with-profit funds, are these decisions taken in the same way as for managed linked funds or unit trusts?***

### Myners Principles

**52.** The Myners review put forward a set of investment principles. This review has been asked to assess their applicability to life insurance companies and collective investment schemes. Whilst the structure and governance of these entities differs from those of pension funds, many of the Myners principles could readily be adapted to fit. This may not be appropriate, however, if the existing competitive process already ensures that companies operate in this way – for example, giving an adequate emphasis to asset allocation, and setting explicit mandates with clear timescales for fund managers. This question is particularly relevant for defined contribution occupational schemes run by insurance companies. The Government has said that it will issue revised principles following consultation, but a copy of the current version of the principles is attached in the annex as background.

**53.** If the adoption of some version of the principles would be helpful, then some degree of customisation for different products is likely to be required. For example, it is hard to imagine that identical principles should apply to both unit trusts and with-profits policies.

***How do life insurance companies and collective investment schemes currently measure up against the Myners principles?***

***To what extent and in what way should the principles, if relevant, be modified to make them applicable to the various products?***

## Governance Issues

**54.** The governance requirements of providers of long-term retail savings products are unusual in a number of respects.

**55.** It has been argued that, for life companies, the legal duties of the board to shareholders operate inappropriately against the interests of policyholders. The recent debate about the correct attribution of orphan assets is cited as one example of this. Concern has also been expressed about the role of the independent actuary, and in practice, how the responsibilities of this function are discharged. This concern is particularly acute in the context of with-profits management and disclosure.

### ***How effective are existing governance structures for life companies?***

**56.** Mutuality is still an important form of corporate governance among life insurance companies. It remains more widespread here than among the former building societies, and even allowing for the effect of “carpet-bagging”, this difference is noteworthy. The issue of weak consumer influence in the market is also relevant here. Mutuality might be thought of as a means of compensating for consumer weakness by ensuring that what is lost as a consumer is gained as a shareholder. Alternatively, it could be argued that from a corporate governance perspective, the insulation of the board from institutional shareholder pressure is not ideal.

### ***Why does mutuality remain an important form of corporate structure among life companies?***

### ***Does mutuality help to compensate for the relatively weak position of the consumer?***

**57.** The financial reporting of life insurance companies is also unusual, reflecting the inherent complexities of life insurance accounting. Life companies are generally valued using the concept of embedded value, which is also used to generate senior management performance targets. However, embedded value has been criticised as being subjective and capable of manipulation.

### ***What incentives does the use of embedded value create for the management of life companies?***

**58.** In the case of unit trusts and open-ended investment companies (oeics), a trust or company is established separately from the manager of the scheme, with a board of trustees or board of directors respectively. Management of the funds will generally be with the fund management function of the product provider.

### ***What, in practice, is the role of the board of trustees of a unit trust or the directors of an oeic in investment decision-making?***



# 7 Product Design

## Trends in Product Mix

59. In the last five years, a number of trends are visible in product design:

- single premium savings business has grown very rapidly, particularly with-profits bonds; and
- at the same time, pensions business as a whole has grown more rapidly than savings business, and within pensions business, linked business is increasingly significant.

***What is driving these changes in product mix?***

***What is their impact on industry costs and profitability?***

## Impact of Government on Product Mix and Design

60. In a regulated market such as this one, the actions of government clearly have an extremely important influence on product design. For example, the distinction between pensions and other forms of savings is itself fundamentally the creation of government policy.

61. Government may be said to impact on product design in two ways. The first is directly, through product regulation of varying degrees. There are essentially two examples of this: unit trusts and stakeholder pensions, although stakeholder might better be described as product control through selective regulation. CAT marks are a further government initiative with a significant impact on product design.

62. Product regulation, as a consumer protection measure, may be necessary to prevent the extremes of unsuitability of product design. But the impact of regulation on product design for most products and most providers is unclear. In the case of unit trust regulations, for example, it seems likely that most unit trusts would in any case invest in a broad range of assets, even if they were not required to by regulation. (That said, it is noteworthy that hedge funds have been a strong growth area in offshore jurisdictions where investment powers of collective investment schemes are much less regulated, although this may partly be a tax-driven phenomenon).

***Have collective investment scheme regulations in practice had a significant impact on product design?***

***To what extent has the product regulation regime prompted or restricted innovation?***

***To what extent has it been necessary to protect consumers from unsuitable products?***

## 7 *product design*

**63.** The picture is likely to be different with CAT marks and stakeholder pensions. Although different, in that CAT marks are voluntary and stakeholder pensions are regulated, both CAT marks and stakeholder put a strong emphasis on a low cost approach and a degree of standardisation between products to aid comparison. The evidence suggests that CAT marks have changed the design of products through putting downward pressure on costs and requiring a certain degree of standardisation between different providers. However, the precise meaning of a CAT mark may be open to misinterpretation by the consumer, and that in itself could distort competition.

**64.** The impact of the stakeholder model is not fully visible yet, but there is some early evidence to suggest that it may be having an impact on charging structures more broadly.

***What impact are CAT marks having on product design and on competition in the industry?***

***What is the likely impact of stakeholder pensions?***

**65.** The second form of government influence on product design is indirectly, through other forms of regulation and through the taxation system. In particular, where government provides tax advantages for certain types of products, its impact can be extremely powerful.

**66.** Regulation can also have important second-order effects, often not directly intended. For example, where increasing product range adds significantly to the cost of regulatory compliance, then the existence of regulation designed to benefit consumers has the potential to actually do the reverse, either by making products more expensive or by causing providers to restrict their product range.

***What other impacts, particularly of an unintended nature, has regulation and taxation treatment had on product design and the costs of products?***

### Costs and Charging Structures

**67.** Most products in this market are characterised by a two-part charging structure, consisting of an initial fee and subsequent annual fees. Stakeholder pensions are a notable exception to this, with no initial or transfer charges. It appears that this charging structure is driven largely by the need to recoup initial sales incentives. As a by-product, consumers who attempt to switch providers or liquidate a savings policy in the early years typically achieve very poor returns. This has been to some extent mitigated by the development of a secondary market in certain products, but remains a problem. The concern is heightened by the fact that persistency rates are low.

**68.** This clearly has important impacts on the nature of competition. The focus of competition is on the initial decision to buy, rather than on subsequent customer retention.

**69.** At the same time, it also appears that the degree of front-end loading varies considerably between products. For example, unit trusts and oecis often have lower initial charges than many life products. It is not clear why this is the case.

***Are there better alternatives to this charging structure? If so, what are they and why are they not more common?***

***What could be the impact of greater ease of switching for both consumers and the industry?***

## Specific Issue: With-Profits Policies

**70.** The FSA is currently conducting a review of with-profits policies with a view to improving their transparency and fairness, and has asked a number of important questions about this type of product. At the same time, the broader remit of this review means that there are certain issues that it wishes to raise specifically.

**71.** With-profits policies have been widely criticised for their lack of transparency, poor surrender values and the high level of discretion available to product providers. Yet with-profits policies continue to be sold in considerable volumes, particularly in the form of single-premium with-profits bonds, on which reportedly high levels of commission are currently being paid.

***What factors drive the demand for with-profits products? In particular, why has there been such a substantial increase in sales of with-profits bonds?***

**72.** With-profits products, which were developed in an environment where mutuality was the dominant corporate form, raise particular issues when applied to a shareholder model. It appears that the existence of inherited estates may have impact on competitive dynamics by giving older-established players an inbuilt advantage. The impact of the requirement to balance the interests of shareholders and policyholders on competition between providers is also unclear and needs to be better understood. As part of its With-Profits Review, the FSA is developing a Discussion Paper on these issues for publication in December. Meanwhile, the retail savings review would welcome any views, which respondents are encouraged to copy to the FSA.

***What are the corporate governance issues arising from the existence of with-profits policies?***

**73.** It is widely argued that consumers value with-profits policies because the smoothing of investment returns reduces volatility for them. But it is not clear why the other aspects of with-profits policies are an inevitable corollary of a product the principal design feature of which is reduced volatility. Nor is it entirely clear whether consumers' wish for reduced volatility through investment in with-profits policies is economically sound. It can be argued that the benefits of smoothing short-term volatility are most relevant to those consumers with a high likelihood of early encashment, which in turn would call into question the suitability of such a purchase in the first instance.

***What does research suggest about the reasons consumers buy with-profits policies?***

***Is the with-profits vehicle a superior way of reducing volatility for consumers, or could other, more conventional investment products provide this equally effectively?***

***How attractive are with-profits products to providers and intermediaries? Why are surrender values so poor?***

***How do with-profits returns compare to (for example) comparable managed unit trust performance over the long term?***

***On what basis do with-profits providers compete with each other, given that investment performance is not normally disclosed?***

# 8 Other Issues

## Overseas Comparisons

**74.** In seeking to understand why the UK market has developed as it has and how competition operates, examining the experience of other countries may provide helpful insights.

**75.** There are two areas of particular interest. The first is the observation that high market penetration of with-profits products appears to be largely a peculiarly UK phenomenon. To the extent that the justification for these products rests largely on the benefits of smoothing to the consumer, it would be interesting to learn whether and how similar benefits are delivered in other countries.

**76.** The second area of particular interest is the structure of distribution, and specifically the role of the independent adviser.

***What significant lessons can be learned from observation of long-term retail savings markets in other countries, as regards industry structure, regulatory practice, product emphasis or company strategies?***



# Annex Myners Principles

## PROPOSED PRINCIPLES: DEFINED BENEFIT PENSION SCHEMES

### **Effective decision-making**

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise to be able to evaluate critically any advice they take. Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary. It is good practice for trustee boards to have an investment subcommittee to provide appropriate focus.

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward-looking business plan.

### **Clear objectives**

Trustees should set out an overall investment objective for the fund that:

- represents their best judgement of what is necessary to meet the fund's liabilities, given their understanding of the contributions likely to be received from employer(s) and employees; and
- takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.

Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.

### **Focus on asset allocation**

Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.

Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.

### **Expert advice**

Contracts for actuarial services and investment advice should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.

### **Explicit mandates**

Trustees should agree with both internal and external investment managers an explicit written mandate covering agreement between trustees and managers on:

- an objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances;
- the manager's approach in attempting to achieve the objective; and
- clear timescale(s) of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale other than for clear breach of the conditions of the mandate or because of significant change in the ownership or personnel of the investment manager.

The mandate should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.

The mandate should incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager, rather than these being charged to clients.

### **Activism**

The mandate should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Managers should have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

### **Appropriate benchmarks**

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;

- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and
- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving managers the freedom to pursue genuinely active strategies.

### **Performance measurement**

Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

### **Transparency**

A strengthened Statement of Investment Principles 2 should set out:

- who is taking which decisions and why this structure has been selected;
- the fund's investment objective;
- the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at;
- the mandates given to all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

### **Regular reporting**

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers and send them annually to members of the fund. The Statement should explain why a fund has decided to depart from any of these principles.

## PROPOSED PRINCIPLES: DEFINED CONTRIBUTION PENSION SCHEMES

### **Effective decision-making**

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take

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investment decisions, they must have sufficient expertise to be able to evaluate critically any advice they take.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide appropriate focus.

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively.

They should draw up a forward-looking business plan.

### **Clear objectives**

In selecting funds to offer as options to scheme members, trustees should:

- consider the investment objectives, expected returns, risks and other relevant characteristics of each fund, so that they can publish their assessments of these characteristics for each selected fund; and
- satisfy themselves that they have taken their members' preferences into account, and that they are offering a wide enough range of options to satisfy the reasonable return and risk combinations appropriate for most members.

### **Focus on asset allocation**

Strategic asset allocation decisions (for example for default and lifestyle options) should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make to achieving investment objectives. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.

### **Choice of default fund**

Where a fund is offering a default option to members through a customised combination of funds, trustees should make sure that an investment objective is set for the option, including expected returns and risks.

### **Expert advice**

Contracts for investment advice should be open to competition, and fee rather than commission based. The scheme should be prepared to pay sufficient fees to attract a broad range of kinds of potential providers.

### **Explicit mandates**

Trustees should communicate to members, for each fund offered by the scheme:

- the investment objective for the fund, its benchmark(s) and risk parameters; and
- the manager's approach in attempting to achieve the objective.

These should also be discussed with the fund manager concerned, as should a clear timescale(s) of measurement and evaluation, with the understanding that the mandate will not be terminated before the expiry of the evaluation timescale other than for a clear breach of the conditions of the mandate or because of significant change in the ownership or personnel of the investment manager. The management fee should include any external research, information or transaction services acquired or used by the fund manager, rather than these being charged to clients.

### **Activism**

The agreement with fund managers should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Managers should have an explicit strategy, including the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

### **Appropriate benchmarks**

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;
- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and

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- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving managers the freedom to pursue genuinely active strategies.

### **Performance measurement**

Trustees should arrange for measurement of the performance of the funds and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

### **Transparency**

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- each fund option's investment characteristics;
- the default option's investment characteristics, and why it has been selected;
- the agreements with all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

### **Regular reporting**

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers and send them annually to scheme members. The Statement should explain why a fund has decided to depart from any of these principles.

