

The context

1. The Government announced this Review on 18 June 2001, with a remit 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. The retail savings industry is of considerable public policy interest for two principal reasons:
 - the welfare and living standards of millions of consumers are affected by the products that it develops and how it distributes them; and
 - it exerts a significant influence on the functioning of the UK capital markets.
3. There is much that is positive about the industry. It has over the years enabled millions of people to save for their retirement. In terms of productivity, it fares reasonably well in international comparisons. But the industry also has some features that are cause for concern.
4. The UK retail savings market is characterised by a high degree of complexity:
 - there are a considerable number of product types, and a huge range of products – for example, there are some 1,600 unit trusts/oeics on offer;
 - charging structures are complex;
 - complicated tax treatments compound the difficulties; and
 - wide use is made of technical terms which are largely incomprehensible to the layman and, in many cases, may not even mean the same thing when used by different providers.
5. There is considerable opacity as well. Price and performance are generally hard to compare and are often not even identifiable at all. There are also wide ranges in the prices of similar or even identical products. For example:
 - although unit trusts and unit-linked life policies are effectively the same product, their investment returns cannot readily be compared because of their entirely different tax treatments;
 - most providers of with-profits products do not disclose their underlying investment performance at all; and
 - the charges of UK unit trust tracker funds, which have only minimal differences between them, vary from as low as 0.3 per cent per year to as high as 2 per cent per year.

6. Commission-driven selling of these products remains the norm, leading to persistent concerns about consumer detriment and to consequent regulatory intervention. Recent research by the FSA found statistically significant evidence of advisers recommending one provider's offering over another because it paid a higher commission.
7. Moreover, investment decision-making does not appear to function effectively. For instance:
 - recent research showed that the average UK unit trust underperformed the market by 2.5 per cent per year due to a combination of charges and unsuccessful active management;
 - correlation between higher charges for unit trusts and superior investment performance is at best weak. Consumers who pay more usually receive no additional benefit; and
 - a greater percentage of products are actively managed than in the institutional market, despite the fact that institutional investors generally are better equipped to identify superior investment managers.
8. At the same time, it also became clear to the Review that complexity and opacity are contributing to the wider problem of consumer reluctance to save, particularly in lower-income segments. Although the precise figure is open to debate, there is a wide consensus that the UK population is not saving enough for retirement. One recent study has estimated that savings levels are 20 per cent or more below what they should be. The problem appears to be particularly acute amongst the less affluent, where insufficient levels of saving are likely to have more serious impact.
9. This shortfall is in part a rational (or at least understandable) response by consumers to the length of the timescales concerned and the uncertainty involved. But insufficient saving is also clearly affected by other features of the industry, such as complexity. The Review has therefore sought in its work to identify the barriers that may be inhibiting consumers, particularly the less well-off, from accessing retail savings products, and to develop proposals to overcome these.
10. The work of the Review has focused on the drivers of complexity and opacity in the long-term retail savings industry, and the consequential impact of these upon the competitive process. This has led to the development of recommendations directed towards two separate, albeit related, objectives:
 - to increase competitive intensity in the industry, creating greater pressures for price and quality improvements; and
 - in doing so, to make retail savings products more accessible, particularly to those on lower and middle incomes.

11. Insofar as the regulatory regime bears upon the competitive processes in the industry, the work of the Review has overlapped with that of the Financial Services Authority (FSA). However, it has not been for the Review to seek to duplicate the work of the FSA. Rather, the Review has had a different remit. While the FSA must have regard to the impact of its activities on competition, it is not an economic regulator responsible for such issues as industry efficiency, value for money for the consumer, or the effectiveness of investment decision-making. These issues have been the principal focus of this Review.
12. More broadly, the Review has been alert to the considerable number of reviews currently being carried out in the industry. It has recognised the industry's concerns about the workload which these generate and the danger that their mere existence inhibits work which the industry itself is carrying out to rectify problems. In response, it has sought to avoid, wherever possible, duplication of the work of other reviews, and to concentrate on its unique focus: namely, on issues of industry economics, competition and efficiency.
13. The first part of this summary sets out the Review's analysis of the market. The second part contains the Review's recommendations.

PART 1: ANALYSIS OF THE INDUSTRY

Consumer weakness

14. Many of the concerns identified above have been driven by the unusual position and nature of consumers in this market.
15. Retail savings products are inherently more complex than almost all other consumer goods. Even to make basic choices between one kind of savings and another requires the consumer to have some grasp of investment issues: the differences between cash, equity and bonds, for example. These are far from straightforward. Unlike other complex high value-added goods such as cars or computers, it is not only the means of delivering the benefit that is complicated. The benefit itself – the potential for higher income in future through the forgoing of consumption now plus the taking on of risk – is complex. This complexity leads to consumer confusion.
16. A number of practices in the UK retail savings industry have served to compound this confusion:
 - the industry has historically used opaque and inconsistent terminology;
 - the reporting of product charges is typically neither clear nor consistent; and
 - there are very large numbers of products on offer.
17. A further feature of retail savings products is the fact that they deliver their costs and benefits over the long term; additionally, they tend to be purchased infrequently. With regular repeat purchasing, if customers are dissatisfied with product quality or value for money, they can quickly switch to another product or provider. This is very difficult for individual consumers to do in the case of retail savings products.
18. Furthermore, partly because the benefits of savings products are deferred for so long, consumers are often reluctant to purchase them, even when confronted with information which suggests that they should. If consumers are inherently reluctant to engage in the saving process, they are less likely to exert pressure on providers after they have bought the product, by monitoring its performance and switching if dissatisfied. The response is more likely to be to forego further savings altogether, in favour of consumption.
19. Finally, the concepts of price and quality, as applicable to a retail savings product, are inherently difficult to understand and to assess. Even those consumers who are aware that savings products have a price often find it difficult to determine what this price is. Establishing quality is equally problematical. It involves analysing issues such as investment performance over long periods of time, and understanding different tax treatments.
20. It is true that the industry and the FSA are working to improve the way in which information is presented to consumers. But most of these initiatives

have only recently been launched, and as such it is too early to judge their impact. The FSA also carries out work to educate consumers in financial literacy, and to provide consumer information and generic advice. However, the level of resources committed to these activities is low.

21. Taking all of these considerations together, the result is a market in which consumers, in general, are weak.
22. This weakness is an extremely important feature of the industry. It drives many of its special features. The structure of the industry, and the way competitive forces operate, both derive from the inability of consumers to exert meaningful influence. In addition, the regulatory regime, which has a considerable impact upon industry behaviour, is fundamentally a response to consumer weakness.

Distribution and commission

23. Providers wishing to sell retail savings products are confronted with the challenge of consumers who:
 - lack understanding of the products; and
 - are reluctant to save.
24. Consumers face their own challenges. Some may be so daunted by the overall complexity of the market that, to do anything at all, they feel the need to obtain advice. Others may be more confident, but may conclude that they still require additional specialist resource to research the market, or to give advice on issues such as tax. Even those who are fully capable of doing all the relevant research themselves may be time-constrained and would rather pay an intermediary to research, execute and manage their investments on their behalf.
25. A face-to-face sales process meets the needs of both product providers and consumers. The adviser/salesperson is able both to persuade consumers of the need to save, and to assist them in overcoming the challenges of product selection and purchase.
26. The predominance of such “advised sales” has two important implications for the functioning of the market.
27. First, it transforms the basis of competition among product providers. Consumer weakness means that the majority of consumers rely heavily on their advisers. As a consequence, the real customer for the product provider tends to be the adviser, rather than the consumer.
28. Second, it has a fundamental impact on the economics of distribution. Advice inevitably has a significant fixed cost element. However modest consumers’ incomes and however simple their financial affairs, a certain minimum amount of time has to be spent gathering relevant information about them and informing them of all the options. While it will generally take longer to advise

more affluent individuals with more complex needs, the increase in time is not normally proportional to the increase in wealth.

29. Advisers are not a uniform group. The so-called “polarisation regime” makes a basic division of advisers into two groups: tied advisers, who may advise on and sell the investment products of just one specified company; and independent advisers (IFAs), who can recommend the products of any company, and do not represent any particular product provider. Both these terms embrace a range of different business models. But irrespective of whether tied or independent, in the overwhelming majority of transactions, advisers are remunerated on the basis of commission paid by the product provider.
30. A commission system allows advisers to offer initial advice and consultation which appears entirely free. This is highly effective in attracting otherwise reluctant consumers. It also creates sharp sales-related incentives for advisers, which is attractive to providers.
31. Commission leads to:
 - the potential for adviser bias;
 - complexity;
 - a poorly functioning market in advice; and
 - to some extent, incentives to focus on higher-income consumers.
32. Prima facie, the fact that advisers are remunerated at different rates by different providers for selling different products creates the concern that this will lead to consumer detriment through the sale. Research carried out for the FSA as part of the depolarisation review confirmed the existence of both product and provider bias in certain areas.
33. Commission also adds significantly to the complexity of the retail savings market. Its structures are complex, with extensive use of confusing terminology, and this serves to:
 - fuel consumer confusion generally;
 - make it extremely difficult for consumers to understand how much the adviser with whom they are dealing is being paid; and
 - impact significantly on product provider costs and efficiency, particularly because of requirements placed upon IT systems.
34. Commission also contributes to a widespread confusion about the nature of market interactions. Consumers do not set the price for advice, are broadly unaware of what it is costing, and may not even be aware that it is being purchased. Therefore, consumers are not in a position to judge whether or not they are receiving an appropriate service. Cost-effective, good quality advice is therefore not directly rewarded.

35. Finally, commission, because it is *ad valorem*, encourages advisers to concentrate their efforts on the more affluent consumers.
36. The impact of commission was one of the issues considered by the FSA in its review of the polarisation regime, and set out in its Consultation Paper (CP) 121, “Reforming Polarisation: Making the Market Work for Consumers”. The Review welcomes the thrust of CP121’s proposals. It believes that they will help improve the range of products available to consumers and should also contribute towards efficiency by enabling greater investment in distributors. At the same time, the Review has some recommendations for modification of the proposals, in order to create a more transparent and better functioning market for advice. These are set out in Part 2 of this summary.
37. There has been a series of changes in the structure of the distribution market in the last decade, including:
 - growth of IFAs at the expense of direct sales forces (DSFs), in part due to increased regulatory pressure;
 - the emergence of networks of IFA firms, seeking economies of scale; and
 - the appearance of funds supermarkets and growth in execution-only business.
38. These developments show that there are forces driving greater efficiency and customer focus present within the distribution market. But this does not eliminate concerns raised by the commission system, nor change the fact that the dominance of advised sales means that the focus of competition for providers is on winning distribution rather than on providing simple, good value products to the end consumer.
39. These concerns about the nature of distribution have also been one of the major drivers of the very significant regulatory interventions in the long-term retail savings industry.

Regulation

40. Assessing the effectiveness of the regulatory regime is not within the remit of this Review. The Review is concerned with regulation to the extent that it impacts upon the competitive dynamics of the industry: in particular, with regulation of the sales process, carried out by the FSA; and product regulation (or quasi-regulation) by the Government through the creation of CAT standards and stakeholder pensions.
41. The retail savings industry has argued strongly, both to the Review and more widely, that regulatory activity has led to higher compliance costs and complexity, which in turn make it more expensive to serve low/middle income customers.

42. The Review accepts the basic contention that costs associated with regulatory compliance have risen. But this rise is not necessarily undesirable or inappropriate. The introduction of the Conduct of Business (COB) regime was specifically intended to improve substantially the quality of advice and information provided by the industry, in the face of major concerns raised by pensions mis-selling and analysis of the industry more broadly. Raising quality should have a positive impact on sales through an increase in consumer confidence.
43. It is also true that such quality improvements will inevitably increase costs, absent counterbalancing improvements in efficiency. The question then is why such improvements have not been made. This is considered subsequently.
44. From the Review's perspective, the issue is whether the operation of the regulatory system somehow creates unnecessary costs. The Review is also interested in whether ways can be found to ensure that consumers below the rising minimum breakeven point can continue to access savings products, without undermining the quality improvements created by the new regime.
45. The COBs regime essentially embodies two major principles: "know your customer", and a duty to give "suitable advice". Much of the detail of regulation simply clarifies the application of these principles in particular circumstances.
46. Judgment is required from adviser firms as to what information should be obtained about customers and, crucially, to what level of detail, in order to meet these requirements. Not surprisingly, the Review found a wide range of approaches to this issue in the industry. As a general observation, however, the competitive dynamics of the industry are such as to make the process of gathering information more rather than less elaborate. The rewards for seeking to minimise this process are limited.
47. Conversely, the sanctions for not gathering copious information are perceived to be potentially very serious. The Pensions Review has played a key role in shaping industry perceptions, with the burden of proof clearly placed on advisers to show full documentation of the sales process. This has led to a strong focus in compliance departments on collecting and recording of information. The general supervisory approach of the Personal Investment Authority tended to reinforce this.
48. The result is a situation in which there is no written regulatory requirement for a lengthy and heavily documented sales process; but on the basis of past experience the industry believes this to be necessary, if future regulatory sanctions are to be avoided.
49. This is not a desirable state of affairs. However, the FSA has already made clear that it wishes to change the way in which supervision is conducted. It is moving to a risk-based approach, under which firms complying quickly and effectively with regulations will be rewarded with less regulatory attention, and resources will be allocated on the basis of regulatory priorities. Supervisors

are now expected to deal with issues by focusing on “outcomes”, in contrast to the Personal Investment Authority’s focus on documentation. The Review is strongly supportive of these measures and their focus on more serious risks. It is important that they are seen to be effective if understandable industry scepticism about the degree of change is to be tackled.

50. The second form of regulation is a form of product regulation through voluntary benchmarking: CAT marks and stakeholder pensions. These were introduced in recent years by the Government to address concerns about value for money in retail savings products.
51. The aim of the CAT regime is to define straightforward, easy to understand and fair products that offer good value. Penetration of CAT marking has been varied. The vision behind the CAT marks is a highly desirable one: a market characterised by a small number of simple products available at modest cost, enabling consumers to be more confident and effective in exerting pressure on price and quality. However, the industry has limited incentives to introduce such products in the current regulatory environment, since advised sales of CAT products are effectively subject to two sets of regulation: both product and sales regulation.
52. Stakeholder pensions were introduced by the Government in April 2001. Their purpose was to encourage those with no existing pension provision to take out a pension by making available a simple, cheap and easy to understand product. The most significant impact of stakeholder pensions, from the Review’s perspective, has been the creation of considerable downward price pressure across the whole pensions market. It has become increasingly difficult for providers to justify charges for non-stakeholder pensions that are significantly higher than the 1 per cent per annum stakeholder regime. Sales of stakeholder pensions are hampered by wider features of the market that are outside the scope of any stakeholder-specific regulations:
 - although stakeholder pensions may themselves be relatively simple, they continue to operate in a particularly complex environment, because of the pensions tax regime and the interaction between occupational and personal pensions; and
 - charge-capped products are unattractive to commission-remunerated advisers.

With-profits products

53. With-profits policies raise a specific set of concerns because of their particular structure and their importance in the market. The work of the Review on with-profits has coincided with the FSA’s investigations into these products, although from a different perspective. The Review has concentrated on issues of competitive intensity and investment efficiency, whereas the FSA has concerned itself with consumer protection, principally through enhanced transparency and greater disclosure. The Review is strongly supportive of the FSA’s work and believes that both activities are complementary.

54. With-profits policies take a variety of forms, but typically have four main features:
- the contractual form of a life insurance policy;
 - smoothing of investment returns. This is the key characteristic of with-profits products. While the exact rules and methods used vary between insurers, smoothing will principally be effected by holding back some of the returns when markets are buoyant and using these to boost contract values when returns are poor;
 - a minimum payout level for the policy, provided the contract is not broken; and
 - a complex interrelationship with the provider's business.
55. There are interconnections at several points between the with-profits fund and the provider's business:
- many with-profits policies still share in business profits and losses of other activities of the provider, most notably in mutual companies;
 - many funds are run under the so-called "90/10" model, under which shareholders receive typically 10 per cent of bonus distributions, with the remainder going to policyholders; and
 - historical practice has been for the provider to charge costs directly to the with-profits fund. This exposes policyholders rather than shareholders to the benefits of cost efficiencies and the risks of cost overruns.
56. The industry maintains strongly that with-profits products deliver considerable benefits to consumers, citing figures showing that with-profits products have delivered good historic returns.
57. The Review readily acknowledges that:
- there is a real aggregate benefit from using pooling between different generations of policyholders to reduce risk; and
 - with-profits products have allowed investors of even relatively small sums to get access to professional asset allocation and invest in a diversified way across a broad range of asset classes.
58. But the Review does not find the data on with-profits performance conclusive. A number of studies have been produced attempting to assess how the performance of with-profits products has compared with alternative investment vehicles. The results have been mixed. This inconclusive outcome highlights the opacity of with-profits products and the difficulties of establishing their true comparative performance. For example:
- with-profits providers have been able to boost payouts to policyholders who hold to maturity at the expense of those who surrender early. Maturity returns therefore only give a partial picture of performance;

- the period selected for the comparison will influence the results – one would expect with-profits to show a better comparative performance in times of bear markets;
 - use of the inherited estate can mask underlying performance;
 - more generally, with-profits performance is made up of many different elements and the lack of disclosure makes it impossible to assess the magnitude of these individually; and
 - it is not easy to define suitable comparator investment vehicles.
59. The Review's concerns about the structure of with-profits products arise from four areas:
- the general opacity of the product;
 - the conflicts of interest which it raises in its current form;
 - the 90/10 structure; and
 - inherited estates.
60. The most significant concern of the Review is that the extreme opacity of the product, as it currently exists, serves to inhibit effective competition. In particular:
- the return on with-profits products is composed of four distinct elements: the underlying investment return, smoothing of this return either up or down, the contribution from participation in the provider's other business, and the charging of costs. Even once the policy has matured, although customers can see what the overall return on their money has been, they do not know how these four components have contributed to it;
 - during the life of the policy, consumers usually cannot even establish if the policy is performing well, since the final payout on the policy may well form a significant part of the total return. So assessing the quality of the product or its investment strategy is impossible; and
 - focus on price and costs is equally weak. Charges are also not routinely reported to customers as they are for unit-linked funds or unit trusts, and there is no clear notion of one with-profits product being cheaper than another.
61. With-profits products also create inherent conflicts of interest in proprietary companies, particularly over the selection of investment opportunities. The policyholder's rather vague contractual rights contrast with the unambiguous duties of the provider's directors to its shareholders. Consumers also have very little information about how funds are invested and how expenses are charged to them. This situation creates a danger that the provider's decisions will benefit shareholders at the expense of policyholders.
62. The principal governance structure to counterbalance these sorts of concerns is the appointed actuary, whose role is to protect policyholder interests. But he is appointed by the board and his legal power depends on the articles of

association of the company, and can in some cases be fairly limited. More generally, there will continue to be concerns about conflicts of interest as long as the opacity of the product means that customers or their advisers cannot exercise proper scrutiny over the use of the assets.

63. The 90/10 structure, explained above, also raises concerns, in two ways. First, since costs are charged directly to the fund and disclosure of costs is limited, incentives toward efficiency are weak. Second, the 90/10 structure increases opacity. The justification for shareholders receiving 10 per cent of payouts of the fund is that shareholders stand ready to provide capital for the fund should it be required, and part of their share of the bonus payouts is in return for this. It is true that with-profits funds need to have capital underpinning them, and the provision of this capital should be properly remunerated. However, this should be related to the quantum of capital and the level of risk involved. An arbitrary figure of 10 per cent of bonus declarations is clearly not the result of such a pricing process. The result of this structure is that the financial performance of the fund is further obscured.
64. The existence of inherited estates also raises concerns. Providers may use these, subject to regulatory constraints, to subsidise activities in a variety of ways, or to provide capital for investments that have wider benefits for the shareholder's business. This distorts competition and increases opacity still further.
65. These concerns about the structure of with-profits products in turn prompt concerns about the competitive environment for with-profits providers.
66. Ideally competition should focus on the actual investment returns of the with-profits fund and the cost efficiency of the provider (reflected in the level of charges). But in practice, it is impossible to determine what these are. Instead, competition in with-profits has concentrated upon historic payout performance and financial strength.
67. As a basis for competition, neither measure is satisfactory. For various reasons, including the ability to use the inherited estate, a focus on payout to maturity gives at best only a partial picture of the performance of policies. Financial strength, whilst clearly relevant, is also problematic as a primary focus of competition. Measuring it involves a degree of imprecision and subjectivity, and its linkage with payout values is tenuous.
68. In other words, competition in with-profits focuses on issues which are poor indicators of the value for money or quality of the product. The Review believes that a new model of with-profits products can be devised to address these concerns. The key features of such a model are set out in Part 2.

Investment

69. Investment decisions in the retail savings industry have a considerable impact on the UK economy. Approximately £800 billion is held in the products covered by this Review. This is a substantial pool of capital, the allocation of

which clearly has important implications for the UK capital markets and the functioning of the broader economy.

70. The quality of investment decisions also determines whether individual savers obtain satisfactory financial outcomes given their specific circumstances.
71. Investment decisions can be broadly divided into a hierarchy of:
 - asset allocation: between the broad asset classes of equities, bonds, cash, property and alternative assets, and between geographical markets or particular equity sectors; and
 - security selection: the choice of individual securities.
72. A widespread consensus exists among investment theorists that, in most circumstances, the asset allocation choice is far more important in determining overall investment performance than is the set of security selection decisions.
73. Investment decisions are made at the stage when products are chosen. The nature of the investment decisions, and the involvement of the various parties, depends on the type of product. In general:
 - for with-profits products and “managed funds” (unit trusts or unit-linked), consumers (and/or their advisers) are responsible only for the primary asset allocation decision: to invest in a diversified portfolio of assets. Thereafter, the precise basis of asset allocation and the subsequent security selection are left to the provider; and
 - for other unit trusts or unit-linked life funds (other than managed funds), consumers are effectively taking the asset allocation decision, although they may not understand it in these terms. Thereafter, security selection is the province of the provider.
74. There are three distinct groups involved in investment decision-making – consumers, advisers and product providers.
75. Consumers’ investment decision-making is typically characterised by:
 - an excessive focus on past performance at the expense of attention paid to charges;
 - insufficient attention to asset allocation;
 - a preference for active management which is hard to justify; and
 - a tendency to use inappropriate timescales over which to assess performance.
76. Research demonstrates that consumers tend to rely on past performance in selecting investment products. Yet the strong academic consensus is that past performance alone is no guide to future performance. More important, a focus on past performance can be positively unhelpful, to the extent that it leads consumers to disregard variations in charges between providers. The impact of charges is much smaller than that of investment performance – but it is also much more predictable.

77. The result is that consumers are likely to pay premium prices for funds with good past performance records which are not in fact justified by subsequent performance achieved. More broadly, this sort of behaviour leads to insufficient competitive pressure on price as evidenced by the persistence of wide variations in fund charges. This is most striking for passively managed funds, where annual charges vary from 0.3 per cent to more than 2 per cent across providers of broadly similar products. Variations in quality between passive funds are not such as to justify such wide variations in price.
78. Consumers are in any case hampered in assessing product quality by the difficulty of comparing both price and historical performance across products because of disclosure practices in the industry. Certain categories of expenses, such as trustees' fees, registrars' costs and dealing costs, are not generally included in the explicit charges reported to consumers. Moreover, measures of cost are themselves complex.
79. Retail consumers also display a preference for active management that seems hard to justify. One would expect to find that institutional investors as a group made somewhat greater use of active management than retail consumers, since they are typically better equipped to identify outperforming fund managers. In fact the reverse is the case. Retail investors are incurring the additional costs of active management when there is little chance of their achieving higher returns to compensate for this.
80. The evidence also suggests that consumers tend to use inappropriately short timescales (typically a year or less) over which to assess investment performance when choosing products and reviewing their portfolio returns. There will be cases when it may be justifiable for consumers to assess investment performance over this sort of period. But in most instances it is misguided. Switching on the basis of short-term performance is likely to increase the likelihood of underperformance by wrongly identifying managers as failing, and by increasing dealing costs.
81. It is not possible to disaggregate precisely which aspects of consumers' behaviour reflect their own preferences and which reflect those of their advisers. But it is clear that, given the lack of investment expertise of the bulk of consumers, advisers do play a very significant role. In this regard, a number of aspects of adviser behaviour are cause for concern.
82. Minimum adviser standards of knowledge on investment are currently low. There is a clear lack of material on investment fundamentals in the FPC, the dominant qualification for advisers. The FSA is in the process of reviewing the current adviser qualifications regime. The Review welcomes the work of the FSA in this area.
83. Furthermore, the syllabus of the FPC and the advice process more generally have a strong focus on product categories (such as investment bonds, unit trusts, and with-profits) rather than on the underlying assets. This is unlikely to lead to a sound approach to asset allocation. The advice process tends

not to “look through” the product choice to the underlying assets; it is likely to ignore the effects of portfolio diversification, and generally deals inadequately with issues of risk, equating a particular risk preference with a particular product class.

84. The analysis above noted consumers’ proclivity for active management. Data from a mystery shopping exercise analysed by the Review suggested that consumers’ preference for active funds is shared by their advisers.
85. The final group of decision-makers is product providers. Clearly, providers have to respond to the consumer and adviser preferences identified above, though to some degree, providers are responsible for shaping these through their marketing strategies. There are, however, two additional concerns about investment decision-making which relate specifically to providers.
86. Interview evidence suggests that tracking errors for actively managed retail funds have typically shrunk considerably over the last ten years, from perhaps 3-4 per cent for an average risk or “balanced” fund, to as little as 1 per cent. Fund managers argue that this is in response to consumer demand. This may well be true, but the result is likely to be that undiscerning retail investors will pay charges appropriate for active management in return for management which is quasi-passive. Where consumers are knowledgeable and information is readily available, market mechanisms could be expected to redress this inefficiency. However, as the Review has noted, this is not the case with retail savings.
87. The widespread aim of top quartile performance in league tables for measurement periods of 1-3 years contrasts with the commonsense observation that different customers will have different timescales. In an efficient marketplace one would expect some fund managers to compete on the basis of longer-term performance strategies, whereas others would concentrate on trading on the basis of short-term trends, according to their comparative advantage. However, such differentiation of investment timescales is not generally observed.
88. One aspect of with-profits funds’ investment strategies is also noteworthy. The bulk of with-profits money is managed actively. But both investment theory and studies of historical data show that the probability of a single manager outperforming the market over the timescale of most with-profits products is negligible. It is not clear that such extensive use of active management is justifiable.

Taxation

89. The tax regime for retail savings products is complex in three principal ways. First, different categories of savings product have fundamentally different tax treatments. Second, even within a given category of savings products, there are sub-categories with different tax rules applied to them. Third, the detail of the tax treatment for a given product is often complicated.

90. This compounds consumer confusion and increases the cost of saving, by adding to the requirement for advice and the attendant need for regulatory supervision. Tax complexity can also weaken competitive forces by distracting attention away from the real economic costs and benefits of different products – charges and performance – and by making comparisons between different products more difficult.
91. Many tax changes have been influenced by the hope that savings propensity can be enhanced through tax-based incentives because consumers will wish to benefit from what is effectively a gift from the government. There has been considerable academic work to test this proposition. There is little evidence that tax incentives can significantly increase the overall level of saving. But taxation can materially affect the composition of household saving – for instance, tax incentives appear to have significantly affected pension savings in many countries – though the research as is available suggests that these incentives are likely to have limited impact on lower/middle income consumers.
92. This evidence therefore suggests that, in future, governments should avoid introducing new tax incentives if their aim is to increase aggregate savings levels. The overriding policy goal in this area, instead, should be one of reducing complexity and distortions in the taxation of savings products.
93. There are a number of areas where there is potential for tax simplification.
94. Pensions taxation is particularly complicated. There are eight basic Inland Revenue regimes for pensions and over twenty different sets of taxation rules that may apply to an individual's pension. In addition, in order to attain approved status (and thus qualify for tax-advantaged treatment) a pension scheme must meet a number of fairly complicated conditions on contribution and benefit levels which depend on the type of pension. The pensions tax regime has also distorted competition by creating some artificial barriers to the provision of pensions by companies that are not life insurers.
95. Life insurance taxation is also complex and distorting in its effects. In particular, concerns are raised by:
 - the “qualifying life policy” regime, under which certain products – essentially long-term regular premium policies with at least a nominal protection element – are tax-advantaged for higher-rate taxpayers; and
 - the 5 per cent withdrawal rule. This was originally introduced for reasons of administrative simplicity. But it now enables high-income earners near retirement to move income into their retirement years, when their tax liabilities are likely to be reduced.

96. The 5 per cent rule and the qualifying regime are unsatisfactory for a number of reasons:
- they increase complexity and introduce additional product distinctions (between qualifying and non-qualifying policies);
 - the actions which they encourage serve no obvious public policy objective, whilst advantaging a particular type of provider: life insurance companies;
 - both regimes are regressive, in that their benefits are focused on higher-rate taxpayers; and
 - they weaken competition by distracting adviser, and ultimately consumer, attention onto the tax features of the product, and away from the more fundamental features of investment performance and charges.
97. The tax system also creates unnecessary differences between investment trusts and unit trusts/oeics. It is true that there are some important differences between these two types of product, but it is not obvious why these distinctions should lead to the differences in tax treatment.
98. Despite the Review's belief in the inappropriateness of tax incentives to stimulate aggregate savings, it does not believe that there should be large-scale tampering with the ISA regime. ISAs are now an established feature of the savings landscape: the term is well recognised and the concept is widely understood. But it would make sense to revisit the maxi-mini ISA distinction. This largely exists because of the polarisation rules. In the event that polarisation were to be abolished, the case for mini-ISAs would be considerably weaker.

The competitive process in the long-term retail savings industry

99. As discussed above, consumers find it extremely difficult to assess both investment performance and price. The rewards to the adviser for providing superior advice in these areas are therefore limited. Advisers tend to focus on product-based advice, finding products which either offer some sort of tax planning advantage or which add apparently differentiable features such as additional protection. These are easier to explain to consumers and fit better with advisers' product-focused training. Advice on matters such as tax and protection is needed, but not to the extent that it replaces an emphasis on product price and quality.
100. Partly as a result, the focus of competition between providers of long-term savings products is not principally directed towards either administrative efficiency or product simplicity.
101. Advisers are better placed than consumers to assess the price-performance tradeoff, but they have only weak incentives to seek out keenly priced products, since their clients will tend not to value the fact that they are doing so. So there is generally little incentive for providers to compete fiercely on

price. In its place, brand has a considerably greater influence on the behaviour of the consumer.

102. In particular, providers have limited incentive to minimise regulatory compliance activity. The regulatory system requires authorised companies to make judgments about the appropriate level of compliance necessary to meet standards that are only broadly defined. The sanctions both in financial and reputational terms for failing to meet regulatory standards can be considerable. The penalties for excessive compliance activity – increased costs – are much smaller.
103. In theory, an ability to produce sustainably superior long-term investment performance should be the principal basis of competition in the industry. In practice, this is extremely difficult to deliver. Moreover, for life companies, investment performance is generally too opaque for this to be a meaningful competitive variable. And for unit trusts/oeics, where investment returns are considerably more transparent, a short-term focus predominates.
104. Critically, incentives towards product simplification are also limited for providers. A simple product, competing in a universe of complex ones and sold in a regulated environment, offers little advantage. The duty of providing suitable advice means that advisers cannot simply point consumers in the direction of the simplest product, but have to show that they have considered the (complex) alternatives properly. Indeed, if the focus of advisers is on additional features and tax planning, a simpler product may have limited appeal.
105. The above observations about provider incentives are particularly relevant when, as has been generally the case for the last two decades, financial markets are growing strongly. In such an environment, providers can earn rising income without having to improve efficiency or increase market share, because their charges are related to the value of assets under management.
106. Clearly the incentives described above do not apply uniformly to all types of product providers; for example, the different charging regimes that apply to unit trusts and life companies mean that the former have a sharper motivation to engineer cost efficiencies. Nevertheless, to a greater or lesser extent, the Review observed these incentives in operation across the full range of providers.
107. There are also forces acting in the life industry, in particular, which inhibit the proper functioning of pressures to deliver superior shareholder value. It is extremely difficult to determine how well a life company is performing or how it compares to competitors, including those based in other countries:
 - international comparisons are difficult because most other countries do not yet use the achieved profits methodology used in the UK;
 - within the UK, mutual life companies do not use achieved profits; and

- even where it is used, assumptions on issues such as persistency and costs play a key role in determining the results. This means that for a proper assessment of company performance, it is essential to have clear and consistent reporting of the original assumptions used, and how these change, from one year to the next, on the basis of actual experience. This is currently not the case. Companies adopt different assumptions, and disclose these with varying levels of clarity.
108. Taken together, the primary competitive pressures acting on providers serve to create an industry characterised by:
- limited resistance to upward pressure on commission payments, because of the need to capture distribution;
 - a tendency to add extra features to products and to proliferate products, principally to meet the sales needs of advisers;
 - a focus on getting these new products as quickly as possible to market, as they can easily be copied;
 - an emphasis on achieving and promoting short-term past investment performance, as this is what consumers focus on; and
 - significant attention paid to branding.
109. In this context, it is noteworthy that the unit costs of the life industry have risen sharply in recent years. Over 1986-2000, administration expenses per contract rose by 5.7 per cent per annum in real terms and acquisition expenses per contract grew by 10.8 per cent per annum in real terms.
110. A number of factors lie behind the rise in unit costs of the life industry over this period:
- the business mix has shifted over time from life products to pensions, which are fundamentally more complex;
 - distribution has shifted increasingly from DSFs to IFAs. The IFA channel is highly fragmented with many small firms and diverse commission structures. The proliferation of commission structures accompanying the shift in distribution is a further driver of complexity;
 - the complications of the tax system for retail savings products have increased over the period;
 - the level of customer contact with the industry has risen; and
 - there has been a move to linked business, which is more administratively demanding.
111. In addition to the forces adding to product complexity there are also structural factors that impede efficiency improvements in the life industry:

- administration costs tend to be additive as a new product is introduced, typically with a new set of customer processes supported by a bespoke system; and
 - transferring products off legacy systems is a lengthy, complex and costly exercise, which few industry participants are willing to undertake.
112. Perhaps most significantly of all, there has been substantial regulatory intervention over the last decade, requiring an upgrade in the quality of advice and customer service more generally. This has driven increases in the cost of interacting with consumers.
113. The continuing fragmentation of both the mutual fund industry and the life industry has hampered progress towards greater efficiency through economies of scale, and has inhibited the development of industry-wide technology initiatives. This fragmentation appears to have a number of causes, including:
- the persistence of mutuality among life companies has enabled many smaller and less efficient firms to survive for much longer than they would otherwise have done;
 - the factors inhibiting the exercise of shareholder pressure make it more difficult for the market in corporate control to function effectively;
 - benefits to consolidation are counter-balanced by the difficulty and costs associated with rationalising legacy systems; and
 - acquirers are inhibited by concerns that they may be assuming hidden liabilities created by past mis-selling.
114. These structural and environmental factors go some way to explaining the rise in industry costs. But that is not a sufficient explanation. There are measures which would have helped to counter these factors:
- product simplification;
 - rationalisation of product portfolios;
 - rationalisation of legacy IT systems; and
 - standardisation of commission arrangements.
115. Yet these measures have, in general, not been determinedly pursued by the industry. Rather, producers have benefited from introducing further product complexity and by innovating around product features, with new product variants generally supported by dedicated systems.
116. An interesting comparison can be drawn with the automotive industry, which shows many of the same features as the long-term savings industry: market pressure towards product proliferation and competition on the basis of product features; the requirement to service over many years a stock of

vehicles no longer in current production; and increasingly stringent regulatory and environmental demands. Yet the automotive industry has achieved substantial efficiency gains through adopting such measures as:

- standardising components across multiple vehicle platforms;
- engineering products to ensure that feature addition does not significantly affect cost; and
- designing products to be manufactured flexibly with infrastructure and systems that are common to the entire range.

117. Analogous processes are available to the life industry, but the lack of effective competitive pressure has blunted the incentives to adopt them. The Review believes that steps can and should be taken:

- to tackle the structural factors tending to increase costs; and
- to improve the underlying incentives through measures designed to make competition work more effectively.

118. The Review has therefore sought to make recommendations to improve these incentive structures, by creating an environment in which there are greater competitive rewards for efficiency and quality. These are set out in Part 2 of this summary.

PART 2: RECOMMENDATIONS OF THE REVIEW

Overall objective

119. The Review has set out how the interactions of a series of participants – consumers, product providers, distributors, Government and regulators – have led to an industry in which competitive intensity is muted. This in turn leads to concerns about:
- inefficient allocation of capital; and
 - the delivery of value for money for consumers.
120. As the analysis has also made clear, these interactions have multiple interconnections and are in many cases mutually reinforcing. It is often not possible to tackle a single issue – for example, insufficient focus on asset allocation – in isolation, with a recommendation targeted specifically at that problem. Moreover, many of the problems of the industry are never likely to be soluble through government or regulatory intervention.
121. The Review’s approach has therefore been to identify what a well-functioning market might look like, and then to develop a series of recommendations which, taken together, can move some way towards that ideal.
122. A well-functioning market for retail savings would be one in which:
- consumers have a reasonable understanding of retail savings products;
 - there is a properly functioning market for advice, with clear pressures on price and quality;
 - the incentives of advisers are aligned with those of consumers;
 - products are simple and straightforward, with differentiation occurring only when it adds value to consumers;
 - there is a strong focus on asset allocation;
 - investment performance is assessed over appropriately lengthy timescales;
 - there is strong downward pressure on price and upward pressure on quality, with more expensive products delivering demonstrable additional benefits;
 - specifically, the prices of the elements of investment, protection and advice are clearly and separately identifiable; and
 - consumers, particularly those from low/middle income groups, can reasonably easily access the markets for products or advice.
123. This is not a fully attainable ideal. It is not possible to turn this into an industry which functions in the way that most consumer goods industries operate, because of a number of intrinsic characteristics of the product.

124. But there is much that can be done to move towards this ideal. This will most often be achieved through an explicit aim of simplification, whether of products, processes or structures. Simplification is a strong theme of many of the Review's proposals.
125. The recommendations are set out in full in Chapter 10 of the report. The following is a summary of the key recommendations.

“Stakeholder” products

126. The Review has sought to demonstrate that at present, competitive forces in the long-term savings industry actually drive towards greater complexity, not simplicity, of products. This leads to distribution economics which make it difficult for low/middle income consumers to access products.
127. The heart of the solution lies in product regulation. A system based on potentially highly complex products, sold with often equally complex advice, will inevitably exclude consumers below a certain level of income because of the fixed costs of the advice process, even if this process is unregulated. Product regulation provides an embedded means of protection that does not rely on advice and so minimises the fixed cost element of interacting with the consumer.
128. **The Review therefore recommends the introduction of a suite of simple and comprehensible products, the features of which would be sufficiently tightly regulated to ensure that, with certain additional safeguards, these could be purchased safely without regulated advice.**
129. The Review recommends that three products should be available within this suite:
- a mutual fund or unit-linked life fund.
 - a pension; and
 - a with-profits product.

Consideration should be given to the issue of whether a protection product should be included in the suite of products.

130. These would need to be promoted as a specific and separate set of products with an overall brand identity. The Review has used the term “stakeholder” as a working title.
131. The Review recommends that “stakeholder” products should be subject to product regulation, as follows.
132. **There should be strict limits on “stakeholder” product features, to ensure simplicity.**
133. **The “stakeholder with-profits” product should be required to have all of the following features, as described more fully in the section dealing with with-profits:**

- an explicit “smoothing account” with smoothing designed to be neutral over the long run;
 - a “100/0” management arrangement, with an explicit management charge to a separate management company and no shareholder participation in with-profits payouts;
 - disclosure of the underlying smoothed and unsmoothed asset values; and
 - standard rules for the calculation of charges for the product to ensure consistency and comparability.
134. **There should be no initial charge, and annual charges for “stakeholder” products should be regulated.** The Review is aware that this is a controversial matter. The Review believes that a pragmatic and flexible approach to the issue of the price cap is required. The Review recommends that, given the existence of CAT ISAs and the existing stakeholder pension, a 1 per cent ceiling would be a suitable starting point but that this should be reviewed at regular intervals to ensure that it remains appropriate.
135. **There should be strictly regulated surrender charges – ideally none at all.** If consumers wished to exit the product, they should be able to do so with a limited and defined financial penalty from the provider.
136. **Through regulation, there should be limits on the investment risk of the “stakeholder” product.**
137. This system of product regulation would provide an embedded means of protection that does not rely on advice and so would minimise the fixed cost element of interacting with the consumer. At the same time, the protection afforded by product regulation has limits. There are consumers whose specific circumstances are such that they need specific and tailored advice. For them, even heavily regulated products could be unsuitable. **The Review recommends that the sales process should begin with the person selling the product giving a number of “plain English” warnings to the consumer, who would then certify that he had received and understood each of these.** At a minimum they would include:
- that the consumer was being offered the opportunity to buy a restricted number of simple products, and that the salesman was not in a position to provide expert advice on the appropriateness of other products owned by the consumer;
 - that, of the suite of regulated products, the pension would be unlikely to be suitable for:
 - people on low incomes who were above a certain age; and
 - people who had access to an occupational scheme.
- If the purchaser were in either category, he should restrict his choice to one of the non-pension “stakeholder” products, and seek advice on his pension arrangements;

- that the products being sold had an element of financial markets risk, and that therefore consumers should consider carefully before they put too much of their savings in them;
 - that these products were not appropriate for meeting specific future liabilities, as their future value could not be guaranteed; and
 - that purchase should not be considered if the intended savings horizon was less than, say, five years.
138. The Review is confident that the features above would create a class of product which could be sold without regulated advice as safely as existing products can be sold within the present regulated advice regime. **Provided that the warnings had been delivered and certified as understood, the Review recommends that providers should be free to market “stakeholder” products, without the bulk of the COBs regime being applied, specifically:**
- no requirement for those selling the products to be FPC3 (or equivalent) qualified, as financial advisers are;
 - no COBs requirement to provide “suitable advice”; and
 - no requirement to “know the customer”.
139. This proposal covers areas which are the direct responsibility of the FSA, but also has clear connections to Government initiatives such as CATs. It is for the FSA and the Government to determine between them the appropriate division of responsibilities for taking forward the Review’s recommendations in this area. However responsibility is divided up, it is clear that there would need to be consultation on all aspects of these proposals.

Distribution

140. The Review believes that for independent advisers, remuneration should be the subject of negotiation purely between the adviser and the consumer, with no provider involvement. This would have two important benefits:
- first, it would make it much more difficult for commission bias to operate; and
 - second, this method of payment would enable the development of a properly functioning market in advice. Consumers would be much more aware that they were purchasing advice, distinct from the product, at a cost.
141. This payment could take a number of forms: it could be a conventional hourly or fixed fee, which was paid regardless of whether a sale took place. But it could also be sales-contingent, as commission is today, it could be paid in instalments, and it could be expressed as a percentage of the value of the assets under management. At the start of a relationship, and periodically thereafter, the adviser would present the consumer with a “tariff sheet” setting out his charges.

142. This preferred system of remuneration would require a means of signalling clearly to consumers where advisers had adopted it. In addition, there should be some commercial advantage to advisers who did adopt this method, since it would require, at least initially, a greater effort to persuade consumers to pay separately for advisers – or at a minimum, no commercial disadvantage. The FSA's proposal in CP121 would provide such a signal by its restriction of the term "independent" to those advisers using a defined payment system, but the Review believes that the CP121 definition is too restrictive, as it does not permit payment for advice to be contingent on a sale. It is true that making payment for advice contingent on a sale of some sort tends to bias the adviser against recommending that the consumer do nothing, even if that is the best advice. But by and large, consumers should be saving more, not less. Remuneration systems that create incentives to save are generally to be welcomed.

143. **The Review recommends that:**

- **the proposals in CP121 should be amended so that "independence" is compatible with a sales-contingent fee, including one that is advertised in advance as such. The definition of an "independent adviser" should instead be that he is an adviser who is not paid by a provider; and**
- **the use of the word "adviser" should be restricted to those who meet the "independence" criterion.** While "adviser" covers a wide range of relationships, it principally carries the connotation of "acting solely in the interest of the client". A term such as "financial product distributor" more accurately describes an adviser whose remuneration arrangements are decided with product providers. Restricting the use of "adviser" in this way would enhance the value of "independent" status.

Regulation

144. The Review has a number of recommendations relating to aspects of the FSA's work.

145. **The Review recommends that the FSA's consumer education activities should be given additional resources, with a ring-fenced budget.** The FSA should establish a long-term plan for delivering clearly specified education objectives. The FSA should consider the establishment of a separate governance structure for education, such as a sub-board, accountable to the main FSA board and with suitable external representation, responsible for all aspects of consumer education.

146. **The Key Features Document should be substantially shortened so that it disclosed only a few important features, such as the level of charges for the fund and its investment strategy.** A full set of product information could be prepared in a separate document which would be available on request.

147. Given the importance of the concept of mis-selling, the Review believes it would be helpful if there were greater clarity about what constitutes mis-selling. **The Review therefore recommends that the FSA should issue clarification of this issue.** Whilst this would not provide the industry with total certainty of what is or is not acceptable practice, it would help eliminate costly unnecessary activities.
148. The Review encountered a belief in the industry that the FSA was not always willing to provide guidance on regulatory issues. The Review understands from the FSA that this is not the case. **The Review therefore recommends that the FSA should publicise more widely its willingness to give guidance: in particular, guidance about new industry working practices before these are implemented.**

With-profits

149. The Review has a number of concerns about with-profits products. To address these, a new model of with-profits products is required.
150. In this model, competitive forces would need to act considerably more effectively than at present. The performance of the product needs to be open to much more effective scrutiny and competitive pressure, allowing consumers and advisers to make informed comparisons of with-profits products, both with each other and, even more significantly, with other investment alternatives. These products should compete solely on their cost-effectiveness and on the underlying investment performance they were able to deliver, rather than on payouts which may have been boosted by hidden assets of uncertain origin and which may have masked poor investment performance or operating inefficiencies.
151. This new type of with-profits would have the following principal characteristics:
- **the fund should be 100/0** i.e. shareholders would not share directly in the returns to the fund, and policyholders would not be directly exposed to cost risks;
 - **a separate management company (which could be owned by the parent insurance company) should make clearly identified management charges for running the fund;**
 - **smoothing should aim to be neutral in ‘the long run’**, with smoothing being carried out through a clearly delineated smoothing account, having an average balance in ‘the long run’ of zero. The operation of the smoothing account should be underpinned by supporting capital. Movements of assets between this capital and the smoothing account should be clearly accounted for and, where appropriate, remunerated;
 - **annual statements to customers should disclose four figures: the current redemption value of the policy; the proceeds on death to reflect the value of protection included in the policy; a projection of maturity value of the policy; and the value of the underlying assets, (i.e. the unsmoothed asset share);**

- **there should be strong industry-wide prescription on the treatment of costs**, to ensure consistency across providers and products;
 - **providers should also produce an annual report setting out the financial condition of the fund, asset allocation, investment performance, and costs charged to the fund;**
 - **the language used to describe this product should be simplified and streamlined;**
 - **payout rights should also be more clearly defined and set out.** The policy payout value should be set annually, with the policyholder able to cash in the policy at anytime during the following year at the redemption value. This could only be varied by application of an explicit Market Value Adjustment (MVA), not by an unspecified “change in the payout policy”. Any surrender charges should have been stated at the point of sale and their effect set out in the annual statement. An MVA could only be applied in specific circumstances; and
 - **in proprietary firms, with-profits funds should not be used to finance other parts of the provider’s business, though this may need to be voluntarily applied because of interactions with European law.**
152. **The Review recommends that the best practice model, as set out above, should apply in full to “stakeholder with-profits” products.** With profits products which did not conform with this model in full could not be sold through the “stakeholder” route.
153. **The Review recommends that the FSA should, following appropriate consultation, set a date for implementation of the new model.** Policies sold up to that date would be classified as “existing policies”. Those sold thereafter would be classified as “new policies”.
154. **The Review recommends that the FSA should, following appropriate consultation and sufficient time for preparation, require new policies to adopt the best practice model in full, with the exception of the requirement for a 100/0 structure.**
155. **The Review recommends that the FSA – again following appropriate consultation and sufficient time for preparation – should require existing policies to:**
- **disclose their performance, as set out above; and**
 - **disclose the existence and performance of any investments in businesses or assets in which the provider had an interest.**

Tax

156. The current taxation regime for long-term savings, as it has evolved over decades, exerts a number of unsatisfactory influences on the market. The Review believes there is considerable scope for simplification of these tax treatments.
157. **The Review recommends that, in future, governments should avoid introducing new tax-based savings incentives if their aim is to increase aggregate savings levels.** The core objective of policy in this area should be simplification. There is some evidence that matching schemes are a more effective means of affecting savings behaviour than ordinary tax relief.
158. It was announced last year that the Inland Revenue was initiating an examination of aspects of pensions taxation, which the Review welcomes. The Review believes it would be desirable to:
- reduce the number of different regimes for pensions tax to the fewest possible; and
 - minimise the number of different variables that the tax system sought to control; specifically, it should limit either contributions or benefits, but not both.
159. It was also noted in the analysis that the tax rules create artificial barriers to the provision of pensions by non-life companies. **The Review recommends that the Government should consider:**
- **changing the IPA rules, if changes are necessary, to allow non-life companies to compete in the pensions market; and**
 - **the differences in treatment between pensions provided through life companies and non-life pensions (and in particular the difference between insurers and others for the VAT treatment of pension fund management). The Review recommends that the Government considers making the playing field level wherever possible by, for example, extending the VAT exemption for pension fund management fees to include those levied by non-life companies.**
160. The qualifying life policy regime creates distortions and complexity. **The Review therefore recommends that the concept of the qualifying life savings policy should be abolished for new business.**
161. The 5 per cent withdrawal rule for life policies distorts the market and is regressive. What is more, it is evident that these consequences were unintended. **The Review recommends that the 5 per cent tax-deferred withdrawal rule for life policies should be abolished for new business, and replaced with a rule (modelled on the previous partial disposal rule) that reflected the economic reality of the withdrawal.**
162. The Review also has two recommendations to help remove competitive distortions between different types of mutual funds:

- **the Review recommends that the Government should introduce an SDRT-exemption for investment trust companies within IPAs which replicates, as far as possible, the present exemption for unit trusts/oeics; and**
 - unit trusts/oeics are exempt from VAT on investment management. Investment trusts are not. **The Review recommends that this inconsistency should be removed.**
163. The Review believes that the ISA regime should continue. It is an established feature of the savings landscape, and removing it would cause considerable confusion and cost. However, it is complicated by the maxi/mini structure, the rationale for which lies in polarised distribution, and which is less relevant in a depolarised world. **The Review recommends that once the likely impact of depolarisation on distribution is clear, the Government should revisit the maxi/mini distinction, with a view to its removal.**

Investment

164. The Review believes that the most important contribution to improving investment decision-making is through its wider effort to create a market of simpler products with better alignment of incentives and stronger competitive pressures on price and quality. The creation of such a market will help focus both consumer attention and adviser effort better on investment issues.
165. Nevertheless, the Review does believe that there are some investment-specific proposals that will bring progress over and above the broader impetus for change that will flow from a better-functioning market.
166. The FSA is currently reviewing the qualification regime for financial advisers. **The Review recommends that a new regime should have:**
- **a much greater focus on investment issues: in particular, the importance and process of asset allocation; and**
 - **a syllabus which is organised around investment issues (investment performance, manager selection, regulatory framework and so on) rather than products.**
167. In addition, more could be done to empower consumers in this area. The FSA already produces a “Guide to Financial Advice” which helps consumers to decide whether they need advice, how to go about getting it and how to help ensure they “get the right advice”.
168. **The Review recommends that either the “Guide to Financial Advice” should be amended, or a new product issued to the following specification:**
- **less factual information;**
 - **greater prominence to the questions which consumers should ask of their advisers; and**
 - **a requirement that its provision is a compulsory part of the sales process.**

169. The main topics about which the consumer should be encouraged to ask questions are:
- the level of charges for the product, including surrender charges;
 - the level of commission being paid to the intermediary;
 - the tradeoff between risk and return underlying the adviser's recommendations;
 - the asset allocation recommendations of the adviser;
 - the level of diversification in the portfolio; and
 - the split between active and passive management in the portfolio.
170. The Myners Review of institutional investment put forward a set of principles setting out a best practice model for investment decision-making by institutional investors. The Review was asked to consider the applicability of these principles to retail savings products. Having considered the Myners principles, the Review believes that retail savings product providers should communicate to consumers their:
- overall investment objective;
 - approach to asset allocation strategy;
 - strategy for stock selection;
 - process for minimising transaction costs; and
 - position on shareholder activism.
171. **The Review recommends that:**
- **with-profits providers should voluntarily disclose in line with the principles above as part of the Statement of Principles and Practices proposed by the FSA in its with-profits review;**
 - **providers of other products should voluntarily ensure that their normal communication with their customers includes the relevant information;**
 - **in addition, the ABI should make such disclosure part of the Raising Standards regime; and**
 - **if the industry fails to disclose voluntarily, the Government should consider requiring it to do so.**
172. **The Review further recommends that a separate set of guidance should apply to the trustees of insured pension schemes.**

Conclusion

173. The Review believes that these recommendations, together with the work

being undertaken by the FSA and the industry, will help move the market for retail savings closer to one in which

- consumers have a reasonable understanding of retail savings products;
- there is a properly functioning market for advice, with clear pressures on price and quality;
- the incentives of advisers are aligned with those of consumers;
- products are simple and straightforward, with differentiation occurring only when it adds value to consumers;
- there is a strong focus on asset allocation;
- investment performance is assessed over appropriately lengthy timescales;
- there is strong downward pressure on price and upward pressure on quality, with more expensive products delivering demonstrable additional benefits;
- specifically, the prices of the elements of investment, protection and advice are clearly and separately identifiable; and
- consumers, particularly those from low/middle income groups, can reasonably easily access the markets for products or advice.

174. The Review would not wish to claim that its recommendations would cause the concerns identified in this report to disappear entirely. In particular, while the Review believes that its proposals will make it easier for people to save, they cannot remove the problem of insufficient saving entirely.

175. The traditional policy response to this has been changes to the tax system. An alternative which has been adopted in some other countries – Australia and Singapore being the most notable – is compulsory saving; in particular compulsory saving for retirement. Not surprisingly, the issue has begun to be debated in the UK, and was frequently raised with the Review by the industry.

176. There are good arguments on both sides of this question. Compulsion has an obvious and strong appeal in that it deals directly with the problem of insufficient saving, rather than trying to tackle it at second hand. On the other hand, it raises issues of political acceptability and enforcement costs, as well as a concern that, by giving people greater certainty about their retirement income, it may have the effect of encouraging them to borrow more or reduce other forms of saving.

177. If the savings level is to be raised, it may be necessary to confront difficult issues such as this one. Compulsion is an important question which deserves serious and wide-ranging debate. However, it is not the role of this Review to make recommendations in this area.