HM TREASURY

Assessing the likely market impacts of charge caps on the child trust fund

December 2003

Deloitte.

ASSESSING THE LIKELY MARKET IMPACTS OF CHARGE CAPS ON THE CHILD TRUST FUND

Prepared for HM Treasury by Deloitte

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1. Executive Summary

1.1 Terms of Reference

This report contains details of the analysis and findings of research on the Child Trust Fund (CTF) conducted for the Government by Deloitte. The research and analysis was conducted in response to an Invitation to Tender issued by the Government in July 2003. In the main, work was conducted during a ten-week period ending in early October 2003.

The stated objectives of the Government at the outset of this project were:

"The research will consider the implications of a price cap on the CTF for consumers and providers, and the impact on distribution. More specifically, the following areas would be considered:

- *The impact on consumers of different price caps, in particular the difference between those making no additional contributions and those making the maximum permitted additional contributions;*
- *The potential market size given assumptions and sensitivities regarding propensity to make additional contributions*
- *The impact on different types of providers and distributors under different price caps, specifically the return on capital, payback periods and willingness to participate in the market; and*
- *The implications for market reach, specifically to low-income families*

1.2 Project approach and reporting

The key stages to the project were:

- An initial, intensive round of meetings with key industry figures including a variety of providers, distributors and other stakeholders. Details of the meetings held are outlined in Appendix One of this report. The objectives of these meetings were to explore industry enthusiasm for the proposals and to facilitate industry input to the modelling and analysis. We are grateful to the many companies that participated in this phase of the project and who provided valuable insights and, in many cases, data and models of their own to inform our own model building;
- An analysis of possible demand and estimated market size drawn from publicly available research and data provided by industry participants in the study;
- The central modelling phase that focused on understanding the fixed and variable costs of manufacture and distribution and describes the rate of return and payback period for various volumes of business, expenses and price cap structures and levels;

- The final phase of the project took the outputs from all previous stages to describe the possible market outcomes of different charging structures and levels.

1.3 Policy and Regulatory Context

In the Budget of 2003, the Government announced its plans for the introduction of a new Child Trust Fund (CTF), providing children born from September 2002 with an endowment at birth.[1] This project also flows from the proposals put forward by Ron Sandler to the Government in July 2002 for a series of price capped products[2].

The work for this report has been carried out in the context of ongoing work on various aspects of the Stakeholder project, in particular Discussion Paper 19 Options for regulating the sale of "simplified investment products" from the Financial Services Authority (FSA). The analysis in this report, concentrating as requested on the likely implications of a charge cap, has therefore had to be carried out with some aspects (such as product features and detailed sales regulation) yet to be finalised.

Other significant changes in the regulation of the distribution of financial services are also in motion. In addition the financial services industry is experiencing a period of both reduced available capital and significant changes in the financial reporting of profits and capital required.

1.4 The Consumer – Market Shape and Size

All research points to strong support among parents and grandparents for saving for a child's future. Many also support the idea of children themselves saving and learning about money matters including schools playing a more active role in financial education. The need for savings in general is widely recognised with the majority of the population endorsing prudence. Saving for children is a widespread activity but often takes the form of informal savings and is often in the adult's name rather than that of the child, making it difficult to assess the true size of the children's savings market and to provide a benchmark for the impact of the Child Trust Fund.

Research among children reveals that 50% (6.3 million) currently has some form of formal / designated savings in the form of cash deposits, shares, unit trusts etc. (Family Resources Survey). Holdings increase with the age of the child with 40% of those under three having some form of savings increasing to 60% among those aged 16-18.

The average value of these savings (approximately £1100 among those who are saving) rises with the age of the child from circa £580 among children aged below three to close to £2400 among children aged 16-18. The Family Resources Survey data on children's savings indicates that a total of between £6n and £8bn is invested in identifiable children's accounts / investments.

[1] Press notice at http://www.hm-treasury.gov.uk/budget/bud_bud03/press_notices/bud_bud03_press03.cfm
[2] http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

Unlike many other markets, some parameters for the size of this new CTF market can be estimated with some degree of certainty. These ‘certainties’ include:

- In the first year of operation, the number of new plans is likely to number approximately 1.76 million plans in month one (children born between September 2002 and April 2005) plus 675,000 further new plans spread over the first year.
- Barring a significant shift (in either direction) of fertility or migration, the size of the market is unlikely to exceed approximately 680,000 new plans per year.
- Minimum contribution levels will be determined by the level of Government endowment of £250 or £500 on day one of the plan (the latter for children in families who qualify for Child Tax Credit income threshold, currently £13,230) and any subsequent endowments at later ages. In addition, it is expected that providers will be required to accept voluntary contributions above a certain level, perhaps £20.
- Maximum voluntary contribution levels are expected to be set at £1,200 per annum.

The main uncertainties in sizing the potential market, particularly given the equity-based content of the default product, are:

- The proportion of CTF plans that will attract additional contributions,
- The pattern, distribution and average values of those contributions, and
- The number of Revenue allocated accounts that will exist. In this section and the subsequent financial modelling, we have made no estimate of the number of such accounts but have worked on the hypothesis that they will be relatively small in number. Should there be considerable apathy among parents for selecting a provider for the CTF endowment, this could in turn have a significant impact on the assumptions for additional contributions and the allocation of marketing costs.
- In addition, it is unclear how much of current savings activity will be diverted from existing products that serve this market.

Although not directly affecting the overall size of the market, there is also considerable uncertainty over what type of CTF will be actively marketed by providers and desired by customers (ie Stakeholder or non-stakeholder versions, and what type of underlying fund).

Using assumptions tested in the market through research and discussions with providers and distributors, three scenarios of a single year’s contributions have been modelled (excluding the initial uplift in 2005). These scenarios suggest:

- Base case scenario: £379 million new contributions consisting of £229 million of initial government endowment and voluntary contributions of £150 million.
- Optimistic scenario: £476 million new contributions with voluntary contributions rising to £246 million.
- Pessimistic scenario: £307 million new contributions with voluntary contributions falling to £77 million.

1.5 Opportunities and Constraints for Providers and Distributors

Issues of concern to providers and distributors that have been expressed to us during this project include:

- A general lack of capital within the industry, resulting in reduced willingness to subsidize new initiatives or accept long pay-back periods;
- A level of uncertainty as to how long-lasting current government proposals, such as the CTF, will be in practice;
- A fear of future regulatory action penalising behaviour that is today deemed acceptable, for example as a result of a simplified sales process or relaxation of the money-laundering requirements;
- The relatively small size of the market. Providers acknowledge the clear need to attract significant additional contributions. The government endowment by itself will not create an attractive market for manufacturers and distributors.
- Details of the working of CTF including the administration of the voucher system, details of lifestyling, the requirement to track children of revenue allocated accounts, the nature and frequency of reporting;
- The relative complexity of administration of children's accounts with money flowing from more than one contributor and a variety of payment methods being accommodated;
- Clarity on regulatory developments such as depolarisation and the outcome from DP19
- The impact on competing / existing children's savings plans;; and of course
- The structure and level of the price cap and the detail of the deductions that will be included and excluded from the price cap.

1.6 Financial Model

Financial results are calculated both for a single year's worth of new business and for 10 years' worth of new business. Internal rates of return on the capital utilised are shown, together with the period over which the capital is repaid. The sensitivity of the results to alternative assumptions is shown.

1.7 Market Impacts

The table below summarises the possible market impacts of the different price cap structures and levels modelled as part of this project. The observations made are relative just to these charge caps and do not draw comparison with current levels of charging in the market or with other potential structures. [3]

[3] * Denotes poorest value to consumers in top two lines and smallest market size in volume of sales , ***** Denotes best value to consumers and largest market size.

2. Terms Of Reference

This report contains details of some of the analysis and findings of research on the Child Trust Fund (CTF) conducted for the Government by Deloitte. The research and analysis was conducted in response to an Invitation to Tender issued by the Government in July 2003. In the main, work was conducted during a ten-week period ending in early October 2003. [4]

This report follows a similar exercise conducted by Deloitte for HM Treasury and the Department for Work and Pensions concerning the proposals for Stakeholder products arising from the Sandler Report[5]. However it was recognised that the CTF differs from the proposed stakeholder products in a number of respects, such as the target market, provision of Government endowments, maximum contribution limits, length of contract time and different cost structures in production and distribution. These differences affect both the revenue and cost of manufacturing and distributing CTF and therefore may imply a different price cap is needed in order to achieve the Government's objectives.

The stated objectives of the Government at the outset of this project were:

"The research will consider the implications of a price cap on the CTF for consumers and providers, and the impact on distribution. More specifically, the following areas would be considered:

- *The impact on consumers of different price caps, in particular the difference between those making no additional contributions and those making the maximum permitted additional contributions;*
- *The potential market size given assumptions and sensitivities regarding propensity to make additional contributions*
- *The impact on different types of providers and distributors under different price caps, specifically the return on capital, payback periods and willingness to participate in the market; and*

The implications for market reach, specifically to low-income families

[4] The Government remains solely responsible for its independent judgement to evaluate any observations, comments, advice or recommendations contained in this report. The Government will be responsible for deciding whether our observations, comments, advice or recommendations make sense in the context of its decision, and whether it wishes to rely on, implement or act on them, including the actions necessary to realise any expected benefits.

This report and any other advice provided to the Government is provided for their exclusive use. No other party may rely on the information set out in this report and/or information derived from this report and we accept no responsibility to any other person to whom this report is shown or into whose hands it may come.

[5] http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

3. Project Approach And Reporting

This section of the report sets out the approach to meeting the objectives set down in the brief, the methodologies applied, the defined stages of the project, the structure of this report and some of the key project limitations.

3.1 Methodology

The approach taken by the project team was to undertake as detailed an assessment as possible of the costs of distribution and manufacture of the Child Trust Fund against a number of different price cap options in order to understand:

- The implications for consumers in terms of value for money;
- The potential market size;
- The implications for distribution;
- The impact on efficient providers and distributors in terms of return on investment and timeframe for achieving that return.

In assessing the last of these we have calculated financial results for a hypothetical company using an aggregate approach, i.e. the financial analysis was based on a "project" methodology rather than considering the profitability of individual cases.

The key stages to the project were:

- An initial, intensive round of meetings with key industry figures including a variety of providers, distributors and other stakeholders. Details of the meetings held are outlined in Appendix One of this report. The objectives of these meetings were to explore industry enthusiasm for the proposals and to facilitate industry input to the modelling and analysis. We are grateful to the many companies that participated in this phase of the project and who provided valuable insights and, in many cases, data and models of their own to inform our own model building;
- An analysis of possible demand and estimated market size drawn from publicly available research and data provided by industry participants in the study;
- The central modelling phase that focused on understanding the fixed and variable costs of manufacture and distribution and describes the rate of return and payback period for various volumes of business, distribution channels and price cap structures and levels;
- The final phase of the project took the outputs from all previous stages to describe the possible market outcomes of different charging structures and levels.

3.2 Report Structure

This report is structured in the following way:

Section 4 describes the policy and regulatory context for this project, examining in particular some of the uncertain elements that will affect the way in which the market emerges;

Section 5 explores savings behaviour as it relates to saving for children and provides a view on the possible size and value of the market;

Section 6 summarises current provider and distributor views on the market and their views on opportunities and constraints;

Section 7 contains the results of the central analysis of costs and profitability for providers and distributors;

Section 8 assesses the potential market impacts of the results for the consumer, distribution, providers and the government objectives.

3.3 Project Limitations

As ever, time constraints have led to a significant number of assumptions being made that with more time could have been modelled in more detail. We have relied heavily upon input from providers who at this stage are themselves unsure of some aspects of the product design and the response of parents and other family to contributing to the Child Trust Fund. In addition, it is worth noting that the Deloitte project team did not specifically assess the following issues:

- Aspects of product design beyond the price cap;
- Consumer response to either the product proposition or the sales process through any original consumer research, although desk research and interviews with providers did reveal research conducted by others into the broad area of consumer response;
- Whether current market players would enter the market at different pricing levels, but rather assessed the point at which efficient manufacturers and distributors would be able to compete. No attempt has been made to identify the individual financial or other organisations that may or may not wish to operate in the potential market.
- The detailed impact of permitting both price capped and non-price capped products to co-exist in the market. Some high level observations are included in section 8 of this report.
- The detailed impact of permitting deposit based vehicles to be marketed actively alongside equity-based vehicles. Some high level observations are included in section 8 of this report.

4. Policy And Regulatory Context

This section of the report summarises government and associated regulatory developments that will impact on the market outcomes for the Child Trust Fund, not least of all the finalised proposals for the product itself.

4.1 Child Trust Fund Proposals

In the Budget of 2003, the Government announced its plans for the introduction of a new Child Trust Fund (CTF), providing children born from September 2002 with an endowment at birth.[6] The Child Trust Fund will be available to each child born on or after 1st September 2002. At the time of writing, details of the product have not been made public. However, the main characteristics of the product are expected to include:

- The Child Trust Fund is scheduled to be launched in April 2005.
- An initial contribution from Government of £250 or £500 will be made to a CTF plan for each child. The endowment of £250 will be available to all children who become eligible for Child Benefit. A further endowment of £250 will be available to children in low-income families who qualify for full Child Tax Credit and have a household income of less than the threshold, currently £13,230pa.
- The potential for further government endowments as the child ages has been discussed although specific amounts or the timing of such amounts have not been agreed. For the purposes of the Deloitte modelling only, an assumption has been made in the Deloitte work that each child will receive a further endowment of £100 or £200 according to the value of the initial endowment made at the age of seven.
- Parents will be sent a voucher shortly after registering for child benefit. Upon choosing a provider, the parent will pass the voucher to their chosen provider to collect the initial endowment from the Government. Providers are expected to receive the initial Government endowment of £250 shortly after notification to the Inland Revenue of receipt of a voucher.
- Where parents fail to make a choice of provider within one year of issue of the voucher, a CTF plan will be set up for the child by the Inland Revenue with one of the providers in the market (Revenue allocated accounts). Accounts will be opened on a rotation basis with one of the approved providers.
- Where the child qualifies for the second tranche of £250, the payment of this will occur once confirmation of the family's qualification for full Child Tax Credit has been made by the Inland Revenue. This may delay payment of the second tranche by up to one full year according to the date of the child's birth in relation to the tax year. Payment of the £250 will occur automatically to the child's plan once confirmation has been achieved.
- Children born between 1st September and 6th April 2005 are expected to start receiving their vouchers from 1st January 2005, thus enabling accounts to be set up in advance of the launch date and allowing providers to spread the effort required to set up these accounts.

[6] Press notice at http://www.hm-treasury.gov.uk/budget/bud_bud03/press_notices/bud_bud03_press03.cfm

- In addition to Government endowments, each child will be able to receive contributions into its plan of a maximum of £1200 in each year from birth up to age 18. Contributions can be made by parents, grandparents, family and friends and by children themselves.
- No withdrawals will be permitted until the child reaches age 18 when the fund will be paid to the child. Until that age, the CTF will be held for the beneficial interest of the child and administered by the parents or those with parental responsibility.
- It is expected that a number of private sector financial services providers of Child Trust Fund products will market products to parents[7] (and eventually to children). The Inland Revenue will approve each CTF provider.
- Approved providers will not be able to refuse an account.
- One of the criteria for approval will be the availability of a 'standard' or 'stakeholder' fund. The stakeholder fund will be a lifestyle fund with savings in the early years invested in equity-based funds, gradually moving to cash during the final years of the plan. , although other funds will be permitted. The stakeholder fund choice for CTF, in common with the proposals for stakeholder pensions, will be required to incorporate a form of lifestyling. Whilst not prescriptive, it is expected that providers will be required, unless instructed otherwise by parents, to move the child's funds gradually from equity to cash during the final few years of their account.
- It is expected that the underlying product wrapper will be either a life assurance contract or a collective investment contract (unit trusts, open-ended investment companies (OEICs)) or investment trusts.
- It is expected that providers will be required to accept voluntary minimum contributions of £20, as with stakeholder pensions. Providers will be responsible for monitoring the maximum cap for contributions of £1200pa per child.
- It will be possible for parents to transfer CTF holdings between providers without restriction.
- Providers will be required to issue a minimum of an annual statement outlining the value of the fund and contributions received.
- The CTF is expected to qualify for the same tax advantages as ISAs, in that the investment income and gains will not be subject to tax and the fund will be tax-free in the hands of the child at age 18.
- At the time of writing, it is not clear whether the price cap for CTF will be applied only to the stakeholder fund or to all funds available for investment.

4.2 Sandler Review and Stakeholder Products

In June 2001, the Government commissioned Ron Sandler to "identify the competitive forces that drive the retail financial services industry, in particular in relation to their approaches to investment, and where necessary to suggest policy responses to ensure that consumers are well served". The Sandler review was commissioned by the Government in response to a recommendation of the earlier Myners review of institutional investment and against a backdrop of industry and consumer body concerns about the savings gap in the UK. Among other recommendations, Sandler proposed that a suite of simplified products allied to a simplified sales process could be employed to help overcome the general lack of power and engagement among consumers in this market.

[7] Or those with parental responsibility

On 5th February 2003, the Government launched its consultation document "Proposed product specifications for Sandler "stakeholder" products"[8], followed in July 2003 by a further paper setting out in detail the Government's proposals for these products[9]. In this latter paper, the Government concluded that the Child Trust Fund should be made available in the suite of Stakeholder Products, thereby including CTF in the debate concerning the changes to the sales process that have been put forward by the FSA and discussed below.

4.3 FSA Developments

The case for provider and distributor engagement in this new market will in part be influenced by the degree and manner in which the regulation of advice is adapted by the FSA. Some providers and distributors are taking the view that a considerable proportion of sales will flow from direct marketing activity with no advice. For them, the current rules on financial promotion and direct offers will apply. For others, the outcome of the debate on the 'simplified sales process' outlined in DP19 will have a more significant impact on the cost of sale and concerns about potential 'misselling'.

A core aspect of the original proposals in the Sandler Review was the concept of reducing in some manner the full array of Conduct of Business Standards (COBS) for Stakeholder products whilst continuing to protect the consumer through product regulation. In essence, although the product may not be the absolute best available solution for an individual's particular circumstance, the nature of the product should be such that it would generally be suitable, and there would be limited downside if the individual bought a Sandler product rather than another financial services offering (or taking another course of action). The FSA issued Discussion Paper 19 ("DP19") in January 2003 to set out some options to achieve this reduction in COB requirements. In summary the three options described in DP19 were:

- ***Self help and plain English warnings (Option 1)***
- ***Guided self-help (Option 2):***
- ***Focused advice (Option 3):***

The consultation period on DP19 ended on 15 April 2003. At the time of writing, the FSA has published its response to initial consultation on the simplified sales process and is engaged in market testing of option two, guided self-help. The outcome of the research and further proposals are expected from the FSA towards the end of 2003.

Some uncertainty also exists concerning the impact of depolarisation on this market. At present, the manufacturers of Friendly Society tax exempt savings plans are restricted in their ability to distribute their products through some tied channels. In future, depolarisation may remove this restriction and provide manufacturers of Child Trust Fund with more access channels. However, until distributors' strategies become more certain, it is difficult to predict the availability of today's tied channels to manufacturers.

[8] http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_sandler_products/consult_sandlers_index.cfm
[9] http://www.hm-treasury.gov.uk/consultations and legislation/consult

5. The Consumer – Market Shape And Size

This section of the report describes:

- Consumer attitudes and behaviour in relation to saving for children;
- The profile of potential contributors to CTF plans and estimates of the possible market size and value;
- Potential distribution channels.

In addition to information obtained as a result of interviews conducted with potential providers and distributors, a number of research papers described in appendix one to this report contributed to the following summary.

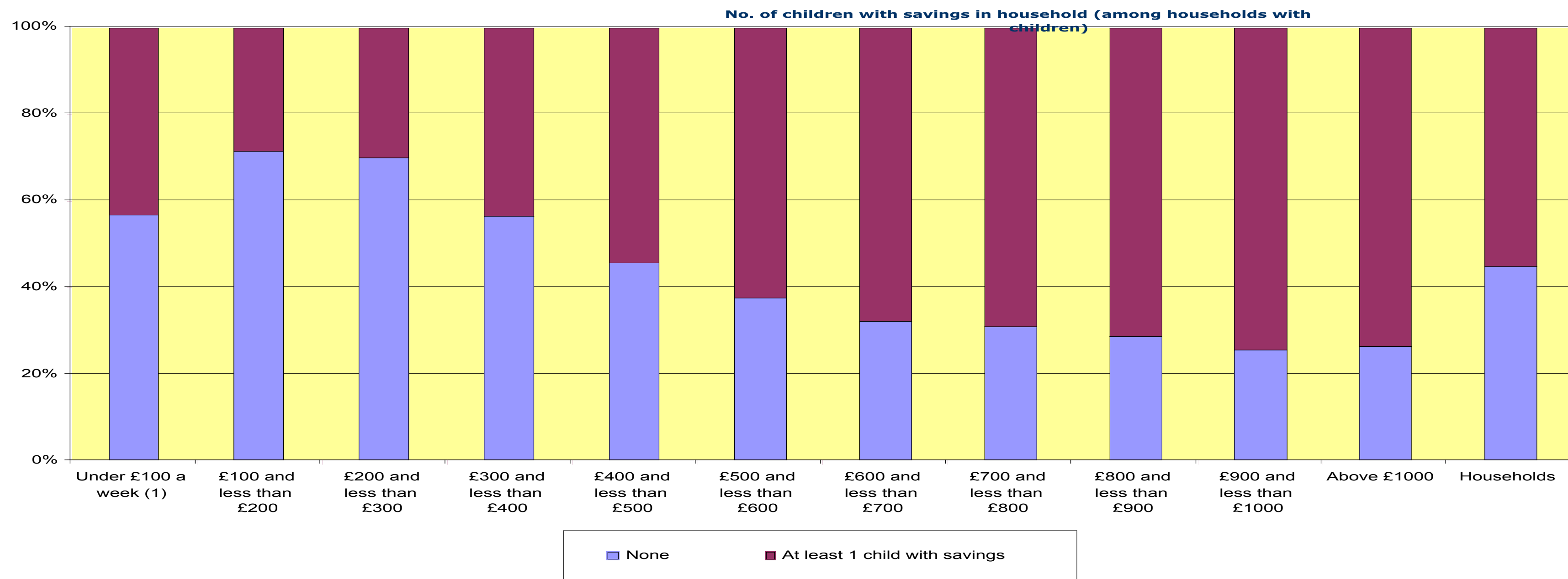
5.1 Current Attitudes and Behaviour

All research points to strong support among parents and grandparents for saving for a child's future. Many also support the idea of children themselves saving and learning about money matters including schools playing a more active role in financial education. The need for savings in general is widely recognised with the majority of the population endorsing prudence. Saving for children is a widespread activity but often takes the form of informal savings and is often in the adults name rather than that of the child, making it difficult to assess the true size of the children's savings market and to provide a benchmark for the impact of the Child Trust Fund.

Research among families indicates that between 50% and 70% of parents claims to save for their children. A significant proportion of the remainder recognise that they should be saving for their children. Grandparents are slightly less likely than parents to save formally for their grandchildren. Current savings activity includes a mixture of casual and regular saving with an unknown proportion not formally designated for child. Saving activity often does not start at the birth of the child when financial pressures are greatest but at a later point during the first five years of a child's life.

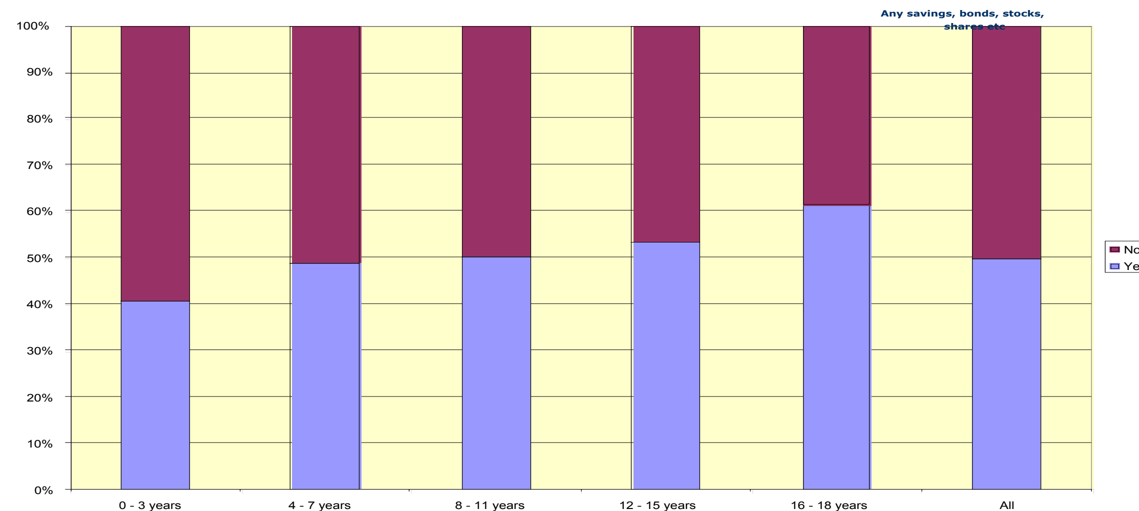
Saving activity for children increases with income as shown in the chart below with the proportion of households with children being able to identify at least one child savings account / plan peaking at 74% among those households with incomes in excess of £1000 per week. The existence of children's savings also varies significantly by region with the highest ownership levels in the South West (74%) and the lowest in the North East and North West (48%).

Chart 1 - % households with children with at least one children's account / savings by weekly household income



Research among children reveals that 50% (6.3 million) has some form of formal / designated savings in the form of cash deposits, shares, unit trusts etc. (Family Resources Survey). Holdings increase with the age of the child with 40% of those under three having some form of savings increasing to 60% among those aged 16-18.

Chart 2 - % of children with identifiable savings (cash deposits, shares, unit trusts, bonds etc.) by age.



The average value of these savings (approximately £1100 among those who are saving) rises with the age of the child from circa £580 among children aged below three who save to close to £2400 among children aged 16-18. The Family Resources Survey data on children's savings indicates that a total of between £6n and £8bn is invested in identifiable children's accounts / investments.

Less information is available on the amounts saved and the nature and frequency of saving making it difficult to estimate with any confidence the amount of money flowing. Research published by Baillie Gifford among parents suggests that the average amount saved regularly for children is £30pm with the majority (60%) saving £20pm or less. One of the distinctive features of the children's savings market is the desire on the part of parents and grandparents to treat each child in family as equally as possible. Particularly in large families, this can lead to average contributions to each child's accounts being relatively small sums of money even where the total amount saved may be significant.

All research on the subject of children's savings reports that cash-based savings and national savings are the most popular form of savings with unit trusts, insurance savings plans and investment trusts of lesser popularity. By far most popular mechanism for saving among children is the Piggy Bank with bank or building society savings / deposit accounts being the most popular formal mechanism (68% of parents who save). Older children may also have a current account. Long term or equity-based savings for children are a minority activity. 18% of parents who save claims to do so via a life assurance / Friendly Society plans whilst only 4% claims to save through ISA s, Unit Trusts or Investment Trusts.

5.2 Market Size and Profile

Unlike many other markets, some parameters for the size of this market can be estimated with some degree of certainty. These ‘certainties’ include:

- In the first year of operation, the number of new plans is likely to number approximately 1.76 million plans in month one (children born between September 2002 and April 2005) plus 675,000 further new plans spread over the first year.
- Barring a significant shift (in either direction) of fertility or migration, the size of the market is unlikely to exceed approximately 680,000 new plans per year.
- Minimum contribution levels will be determined by the level of Government endowment of £250 or £500 on day one of the plan (the latter for children in families who qualify for Child Tax Credit income threshold, currently £13,230) and any subsequent endowments at later ages. In addition, it is expected that providers will be required to accept voluntary contributions above a certain level, perhaps £20.
- Maximum voluntary contribution levels are expected to be set at £1,200 per annum.

The main uncertainties in sizing the potential market, particularly given the equity-based content of the default product, are:

- The proportion of CTF plans that will attract additional contributions,
- The pattern, distribution and average values of those contributions, and
- The number of Revenue allocated accounts that will exist. In this section and the subsequent financial modelling, we have made no estimate of the number of such accounts but have worked on the hypothesis that they will be relatively small in number. Should there be considerable apathy among parents for selecting a provider for the CTF endowment, this could in turn have a significant impact on the assumptions for additional contributions and the allocation of marketing costs.
- In addition, it is unclear how much of current savings activity will be diverted from existing products that serve this market.

Market research conducted by a number of organisations suggests that CTF will be met with a strong degree of support from parents (suggesting that the number of Revenue allocated accounts could be minimal) . Research conducted by Homeowners Friendly Society indicates that 85% parents and grandparents when shown details of CTF believe that the concept is a good idea with 72% believing that the level of savings for their children would increase as a result. Research conducted by Virgin showed similarly high levels of support for CTF (92% believing it to be a good idea) with expected average contributions of £38pm.

Once launched, some of this enthusiasm for CTF may be dampened by a combination of the locked in nature of funds – parents/grandparents will not be able to access any savings they make for the child and the child will not be able to access any of the funds themselves until age 18. In addition, the equity-based nature of the product may deter some from making additional contributions. Research suggests that deposit accounts, government bonds or property are most commonly quoted as the preference of parents for CTF savings, in spite of the long-term nature of the product, although much of this research was conducted at a time of poor stock market performance. In periods of higher growth or stability in equity prices, more may be attracted to equity-based products. The need for clear information and education regarding risk/return trade-offs is evident.

In many respects these accounts will resemble CAT-marked equity ISAs. Equity ISAs as a whole are held by approximately 16% of the adult population[10] compared to approximately one in three who has a Cash ISA, further suggesting that the nature of the product may act as an inhibitor on take-up of additional contributions. Life assurance endowments or friendly society savings plans might also be held up as comparable products. Ownership of these products is waning from its peak but currently stands at 26% of the adult population.

It is not expected that the tax status of the CTF will, by itself, have a material impact on its appeal to the mass market. However, it could appeal to those parents who are currently affected by the annual limit imposed (£100) before investment income on their child's savings arising from parental contributions is taxable.

Little research has been conducted into the pattern of likely contributions. At present, different types of children's accounts and investments attract very different types of contributions. Cash based accounts typically attract regular monthly as well as ad-hoc contributions. Life assurance and Friendly Society savings plans typically attract either regular contributions or one-off lump sums but rarely both (due largely to the technical constraints of such contracts). Unit and investment trusts typically attract one-off lump sums with some regular monthly contribution plans. It is expected that over the course of 18 years, CTF plans may attract regular savings for some years, ad hoc contributions and a small proportion maximum contribution lump sums. A very small proportion of accounts is expected to experience the last of these behaviours. The majority of accounts is expected to receive ad-hoc contributions from parents / grandparents and/or children themselves.

In order to reduce this complexity and to generate estimates of the potential size and profile of the market, three scenarios have been produced. The assumptions used are derived from the research above but adjusted to reflect discussions with companies currently active in the children's savings market. The first of the scenarios is described below as the base case. Both a more optimistic and pessimistic case has been built in order to show the sensitivity of market size to the two key drivers (% contributing and average contributions). Some of the data from this exercise has been used in the later modelling section of this report as an input to the profile of customer types and contribution levels. The market size model seeks to measure only the first year's worth of contributions for the CTF market in a typical year (i.e. excluding the 1.76 million deferred plans that will be put into place at the launch).

Base Case Assumptions

- 680,000 new plans
- 65% children receive £250, 35% children receive £500
- 42% of £250 endowment and 64% of £500 endowments accounts receive no further contributions (ie 50% of children's accounts attract no additional savings);
- Regular contributions deemed to start at birth and continue – 35% of £250 endowments and 20% of £500 endowments attract regular monthly contributions of £50 per month and £30 per month on average respectively.
- Ad hoc contributions have been averaged across the life of account – 20% of £250 endowments and 15% of £500 endowments attract ad-hoc contributions averaged at £200per annum and £100 per annum respectively
- A small proportion of accounts (3% of £250 and 1% of £500) receive the maximum annual contribution of £1200 per annum by way of lump sum.

[10] Deloitte: Wealth & Portfolio Choice 2002.

Optimistic Case Assumptions

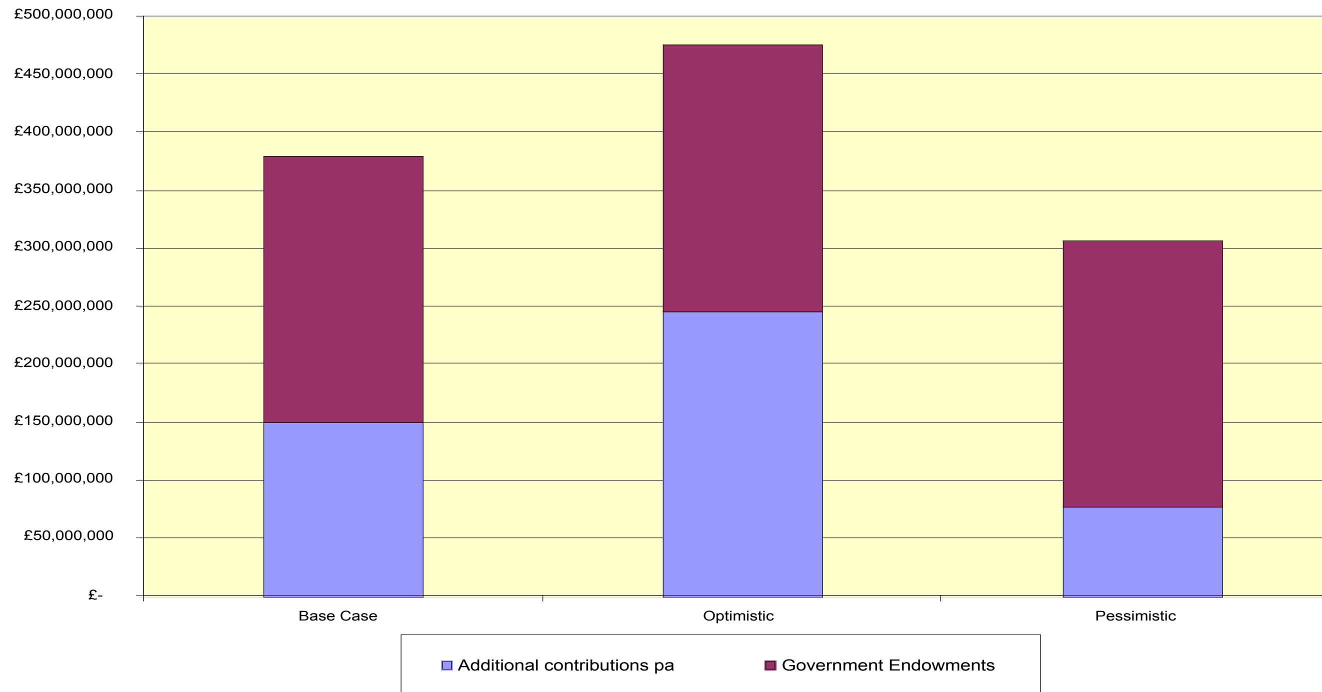
- Base case with 30% uplift in % saving something and in average saved (except for 'tax max' where limited to £1200)
- Results in 65% accounts receiving additional contributions

Pessimistic Case Assumptions

- Base case but with 30% reduction in % saving something and in average saved (except for 'tax max' where £1200 limit maintained)
- Results in 35% accounts receiving additional contributions

The results of these assumptions are shown in the chart below. In all scenarios, government endowments generate £229.5 million. In the base case, this is supplemented by a further £150 million of voluntary contributions rising to £246 million in the optimistic scenario and falling to £77 million in the pessimistic.

Chart 3 – Amount of one year's contributions for one cohort of children under different scenarios



The pessimistic case described above implies very little market growth and a failure to attract new savings into the Child Trust Fund. Any or all of the following could result in this scenario occurring:

- Limited marketing activity on the part of Government and industry resulting in low levels of awareness and confidence among parents / grandparents
- A price cap that limits marketing and sales activity, particularly to low and middle income consumers
- Few providers and distributors with access to parents / grandparents enter the market
- The processes for lodging the initial voucher and for making additional contributions are difficult and time consuming for consumers
- Significant numbers of parent / grandparents lacking confidence in the equity-based nature of the lifestyle stakeholder version and other funds marketed by providers
- Early allegations of misselling leading to a lack of market confidence
- Media discourages parents from investing
- The Stakeholder brand lacks punch with consumers
- The economy becomes more uncertain

By contrast the optimistic case results implies an increase in children's savings activity in terms of both the percentage of children holding assets and the amount saved. For this to be realised, all or most of the following will be necessary:

- Significant on-going marketing activity and education of both adults and children;
- A price cap that both stimulates provider and distributor activity and provides good value to consumers;
- Significant numbers and variety of providers and distributors able to reach parents / grandparents;
- Ease of making contributions such as gift vouchers, payments at the counter;
- Consumers are attracted by the simplicity and transparency of the contracts and encouraged to increase their level of saving
- Media support for CTF;
- Economic stability and an improvement in stock market returns

5.3 Reaching the market

The question of the distribution of Child Trust Fund products is not easy to predict due to the lack of a truly comparable market and some uncertainty about the impact of changes to FSA sales regulation[11].

The closest products available in the market today are Friendly Society tax exempt savings plans, often packaged as "Baby Bonds". These products are purchased both with and without advice and predominantly through direct marketing and the IFA channel. The limitations imposed by polarisation have

[11] See section 4.3 above.

led to these products being largely unavailable through other channels. Although the limitations of polarisation do not apply to direct offer sales, in practice few 'tied' channels have taken up the opportunity to market other companies' Baby Bonds. Other products marketed as long-term children savings plans (e.g. unit trust or investment savings plans or endowments) are similarly marketed in the main through direct marketing and IFAs.

We have not tested the willingness of consumers to purchase CTF with or without advice. Neither have we tested the responsiveness of consumers to face-to-face channels versus remote channels such as direct mailing or advertising. The role of different channels will depend in part upon:

- The simplicity of products available in the market. Consumers will find it easier to respond directly or without advice to simple product designs than to more complex arrangements;
- The degree of willingness of today's and potential new intermediaries to distribute these products, with or without advice. High street retailers or financial services distributors have the potential to provide reach across the income range of the population if sufficient diversity of brands is attracted to the market;
- The price cap structure and level that will define whether or not sufficient margin is available for advice or the simplified sales process;
- The outcome of the current testing of the simplified sales process by the FSA.

The following section of this report describes the views of current and future distributors of CTF on the mechanisms they expect to employ in this market.

6. Opportunities And Constraints For Providers And Distributors

6.1 Overview

The comments in this section are drawn principally from the results of industry interviews carried out in August and September 2003. Interviews were carried out with a wide range of current manufacturers and distributors of financial products, in particular those known to have current expertise, or interest in, products specifically designed for child savings. The full list of organisations with whom discussions were held is set out in Appendix 1.

The particular focus of the interviews was to seek practical input as to the special characteristics of distributing and administering child savings products, so as to inform the building of the model described in the following section. Some of these characteristics are not experienced in the general retail financial savings market - for example having a number of different contributors placing funds into a single child's contract, or having a single contributor wishing to divide new funds amongst different beneficiaries. Hence it is expected that the distribution and administration dynamics for the CTF could differ significantly from those for other retail financial services products.

A previous report to the Treasury on the possible market impacts of alternative price-caps for the Stakeholder suite of products outlined the general market environment in which these government initiatives need to be considered. The following issues, discussed in that report, are equally important when considering the CTF proposals:

- A general lack of capital within the industry, resulting in reduced willingness to subsidize new initiatives or accept long pay-back periods,
- A level of uncertainty as to how long lasting current government proposals, such as the CTF, will be in practice, and
- A fear of future regulatory action penalising behaviour that is today deemed acceptable, for example as a result of a simplified sales process or relaxation of the money-laundering requirements.

The following paragraphs describe these and other more specific issues facing the retail financial services industry as a result of the CTF proposals, and how they can impact on the attitude of potential providers and distributors to the CTF initiative.

6.2 Size of market

In section five the potential size of the market was discussed. A key issue arising from this is the clear need for manufacturers and distributors to attract significant additional contributions. The government endowment by itself will not create an attractive market for manufacturers and distributors. This is likely to influence the attitude of the industry towards the project since material marketing and administration costs would need to be spent to enter the market for Child Trust Funds, yet such expenditure could be reallocated to other products that have a greater potential size with greater levels of potential return on capital.

This makes the market of interest to a relatively small number of distributors and manufacturers – in particular those who can either efficiently reach the recipients of the government endowment, or those who have existing systems that do not require significant investment to be able to cope with the

particular features of the CTF. Further, those who are already significantly involved with child savings will be concerned with the CTF market regardless of its potential size since it is likely to affect their core business.

The market size could in theory be increased if the cap on annual contributions was increased from £1200pa, However this would in practice only affect a small section of the market – and one that is not central to the objectives of the government in establishing the CTF. Of more potential value would be government encouragement to save more than the endowment. Marketing activity is likely to be needed not just at the time of birth but at frequent intervals during childhood.

The industry recognises the potential to use the CTF as a method of accessing consumers who could then be offered a wider range of financial products. However the low level of capital readily available in the market makes it difficult for firms to follow such a strategy if it involved carrying out the CTF business at a loss. This is particularly important for providers with shareholders or where each operating division or initiative is assessed on a stand-alone basis. In the past, providers have sometimes been prepared to subsidise younger savers in the hope that these customers will continue to stay with them into adulthood when there is greater opportunity for providers to make a profit on their business. However brand loyalty has dropped in recent times and providers are no longer prepared to take this risk. In addition, providers feel that child trust funds are likely to be cashed in at maturity and not recycled. Hence it is unlikely that there will be a material amount of explicit cross-subsidy by providers when the CTF market commences.

Attitudes of distributors will be affected by the terms of remuneration available from the providers, and the “opportunity cost” involved in distributing CTF products. For example some distributors may be able to add a CTF offering without disturbing their existing business or a CTF could be the only financial services product that they could realistically offer. In such cases there is likely to be enthusiasm for the CTF initiative. Other distributors however may already be distributing a range of products and including a CTF product would have to “dislodge” other offerings that could have higher levels of margin.

6.3 Proposed features of CTF

The scope of this report does not include specific comments on the various proposed features of the CTF. However during our consultation with providers and distributors various comments were made that indicate the industry’s unease with some expected features of the CTF. In order to understand the current concerns of the industry, and hence the possible approach taken to entering the CTF market, some of these items are set out in this section (excluding specific concerns with the potential structure and level of the price cap).

Uncertainty over longevity of proposals

There will need to be some investment in new distribution and administration systems for the CTF. Hence, as shown in section eight, the attractiveness of the CTF to the industry depends to a large extent on having significant funds being built up so that the charges levied can repay these costs. Achieving these large funds depends in turn on being able to encourage regular savings over the full 18 year period, and for many years’ worth of new children to receive a CTF. This will only happen if the CTF is a long-lasting feature of the financial services and welfare environment.

Administrative requirements

The Treasury is following an open process with the industry to try and ensure a smooth introduction of an efficient system. This process has included, for example, regular workshops to discuss significant proposals for the administration of the products. Nonetheless there are still aspects of the proposed CTF environment that cause concern to some providers and distributors. The principle issues that have been raised include:

- The need to deal with the paper-based voucher system that adds to the complexity of setting up an account;
- The administration costs of dealing with “allocated business” on which no further contributions are likely to be received, in particular keeping track of the child;
- Although there are attractions in the “look-back” of the CTF to all births since September 2002 there are likely to be administrative difficulties in dealing with this initial large influx of new business;
- The nature and frequency of the required regular reports to the Revenue;
- The detailed procedures for collecting the endowments from the Revenue using voucher identification numbers. In particular it will be important to prevent any “mis-match” between creating a new CTF and the receipt and investment of money. This is particularly important with unitised structures.

Product features

There is also, at the time of preparation of this report, some concern over particular features of the CTF including:

- How the detailed rules for the “Lifestyling” requirement for the stakeholder fund will be drawn up. In particular some types of potential provider, such as Investment Trusts, may find this difficult to run in practice because of the nature of their establishment.
- Making the £1,200 pa limit applicable to a child’s year between birthdays is likely to be attractive and understandable to contributors. However it is likely to require changes to current systems since these are usually set up to monitor maximum contributions over a tax year. There are also likely to be special difficulties arising from the “multi-contributor” feature of CTFs – for example many relatives making contributions at a birthday leading to a breach of the limit. Although the use of a Feeder Account could cope with over-contributions it is unclear how the settlements legislation will apply to such Accounts.
- What underlying structures (life insurance contracts, Unit Trust holdings, etc) can be included within the CTF wrapper, and whether any distortions or competitive anomalies will be introduced into the process? For example would the CTF tax treatment over-ride the normal life insurance rules, including those applicable for contracts written on children’s lives?
- Whether any “non-stakeholder” investment options offered alongside the stakeholder fund would be subject to the same price cap and simplified sales regime as the stakeholder fund.
- The ability to impose a minimum contribution level.
- Items of expenditure that are to be met from the price capped charges, and items that can be deducted directly from the fund. In particular, investment trusts have expressed concern over the ability to fund stamp duty at point of purchase.

6.4 The need for specialisation in manufacturing and distribution

At present there are relatively few providers and distributors of financial products aimed specifically at the child savings market. There are various reasons for this, including both the settlements legislation that limits the benefits for parents of contributing large amounts into products for their children and the particular customer dynamics around savings for children.

Although the CTF will disapply the settlements legislation for parental contributions (up to the £1,200 pa limit per child) the other reasons will remain in place - such as the ability to access parents and other potential contributors. Indeed the special features of the CTF mentioned in 6.3 and the size of the market described in section 5 and paragraph 6.2 make it likely that the need for specialists in this area will continue.

This is expected to lead to arrangements under which organisations such as the smaller building societies or specialist retailers that wish to offer a CTF to their customers distribute a product from a third-party manufacturer (provided the proposed changes to the polarisation regime allow such structures).

Hence different potential providers and distributors have exhibited differing levels of enthusiasm for the CTF depending on what role the organisation expects to play in the market, and how important this is to their overall business.

6.5 Regulatory aspects

There are two main regulatory issues that affect the attitude of providers and distributors towards the CTF market: namely depolarisation and the introduction of "simplified advice". The former is regarded as critical since it will affect the ability to construct distribution deals between distributors that have existing financial products but where the provider of those products does not wish to enter the specialist child savings market and CTF providers. The latter is regarded as important since it will enable CTFs to be distributed through appropriate salesforces – although many providers expect a significant proportion of business to be sold through the direct offer process without advice.

The precise requirements over money-laundering will also need to be clarified so as to ensure that there is minimal expense associated with the CTF. It would appear that there should be minimal obligations because of the lock-in period to age 18, the existence of the Voucher and the low annual contribution limits. Nonetheless some providers remain nervous about potential compliance costs, and potential fines if their procedures are not deemed adequate..

6.6 Replacement of other existing child savings vehicles

At present many Friendly Societies offer financial products that would have similar tax treatment as a CTF, but with annual contributions limited to £270 pa rather than £1,200. For various reasons, including the relative small size of the contracts, the reduction in yields on these contracts tends to be in excess of 1% pa. Subject to the details of the nature of CTF outlined in 6.3 it is likely that the CTF will attract funds that were in the past invested in these "tax-exempt" Friendly Society contracts. Such Societies are therefore likely to need to offer CTFs in order to be able to continue to attract new business.

Other financial institutions, such as several banks, building societies and Investment Trusts also offer child savings contracts. The former usually offer simple deposit accounts (subject to the settlements legislation) while the latter offer equity-based schemes. Both are therefore also likely to experience the impact of the introduction of CTFs.

6.7 Implications for possible alternative charging structures

The special nature of the CTF, including the “lock-in” until age 18, the limit on annual contributions, the differing distribution channels, as well as the other aspects of child savings, suggest that there is little theoretical reason why the price cap for a CTF should automatically be the same as for other “stakeholder” products – other than the general approach of having a simple system.

Within the CTF it would be feasible to consider differential charges on that part of the CTF arising from the government endowment and that from additional contributions. However this would add a significant level of complexity as well as being hard to explain to consumers.

It would also be possible to have differing charges on contributions to “stakeholder” funds and those on other funds – particularly if investment to the latter would be subject to the full regulation on sales.

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7. Financial Model

7.1 Objectives and Overview

The purpose of the core model is to investigate the potential financial results for companies supplying CTF under a variety of different charging structures. These potential results can then be used to inform the comments made in Section eight about the potential market impacts of different price cap structures and levels. The financial dynamics that are modelled are those of a single hypothetical company.

The assumptions have come largely from consultation with the industry. This has helped build a bottom-up model of the expenses a company is likely to encounter in providing CTF. The industry has been very helpful in supplying recent experience for similar products as well as their views on how these will be affected by the introduction of CTF.

However a wide range of these figures has been supplied and as a result it is difficult to attain a high degree of comfort in some of the assumptions used. In particular, companies vary in their approach to analysing their fixed and variable cost base. Where possible we have attempted to base our assumptions with an emphasis on the more apparently efficient producers. Many assumptions have a significant impact on the results and sensitivities are therefore shown where appropriate.

The financial modelling contained within this section of the report assumes that CTF products are written as life assurance, collective investments or investment trust style contracts (subject to the comments on prudential reserving and capital requirements set out in 7.3.11). No consideration has been given to the implications of writing CTF products as deposit account contracts.

All the CTF business included in the model has been treated as being subject to the same level of charges, taken as the charge cap on the Stakeholder version.

After setting out some global considerations about methodology (7.2) we describe the assumptions used in the model and how it works (7.3–7.5). We then show some results, gradually building up the complexity of the business shown (7.6). We investigate these under different possible charging structures as well as looking at the effect that each of these has on the investor (using reduction in yields 7.7). Finally we have a section on sensitivities in order to show the effect of variations in the assumptions used (7.8).

7.2 Methodology

There are various methods used by providers of financial services to assess the financial attractiveness of supplying products. These different methods are a result of the nature of financial products, where margins emerge year on year that are used to support not only the pure marginal costs of selling and administering that particular contract, but also to support the infrastructure of the business. In addition losses are usually made in the early years of a contract, with profits only emerging later. The following paragraphs outline the resultant issues over treatment of expenses and of calculation of payback periods and return on capital.

7.2.1 *Allocation of expenses*

Firms vary in the degree of sophistication used to allocate expenses across various criteria such as:

- between fixed and marginal,
- across product lines and
- across different individual contracts of the same product type.

This variety in approach to allocation of expenses leads to different methods for assessing the profitability of a line of business, or of particular types of policy of the same line. Indeed, differing conclusions can be made about the attractiveness of a policy depending on how expenses are allocated. To illustrate this point, consider two alternative approaches, one that could be described as "fully-allocated" and the other as "pure marginal". Under the former approach the entire firm's acquisition and administration costs (including those regarded as fixed or overhead in nature) are allocated across existing business and expected future new business. The allocation is such that if the company sells the expected level of new business then the total of the allowances included in the cohort of new business equals the company's actual acquisition expenses. Hence any profit that emerges does not need to cover any further expenses. Under the second approach only the estimated incremental costs of selling and administering that policy are included, with fixed expenses excluded from the analysis. With such an approach the calculated profits are needed to support the fixed expenses that were excluded from the analysis.

Under both illustrative approaches to expense allocation it is likely that larger sized contributions are assigned a higher level of profitability than smaller cases, but the degree of importance of this varies with the allocation method. In an extreme case of a pure marginal approach all costs could be treated as fixed, with no expenses included at the contract level. Such an approach would make all case sizes "profitable", although it would be necessary to ensure that the total of these "profits" was sufficient to cover the fixed costs. The greater the amount of expenses allocated on a flat per policy basis, the greater the likelihood that smaller case sizes are seen to be un-profitable.

Nonetheless, despite the variation in approach seen within the financial services industry the experience of most providers is that not only do different products (for example term assurance or an ISA savings plan) have differing levels of profitability, but different individual contracts of the same product type also have different expected profitability (for example changing the contribution size, policy duration or age can change the expected profitability of a contract). Hence some implicit "cross-subsidy" between contracts is a recognised feature of the current market. The degree to which companies are prepared to work with such cross-subsidy depends on the culture of the organisation, the sophistication of their internal financial and expense management, the level of competition in the market, and the ability of the distribution method to actually target the more profitable types of contract.

7.2.2 *Payback periods and return on capital*

With most financial products a loss is made in the first year of a contract as a result of the sum of the expenses incurred and any required statutory provision for the contract being greater than the charges received. This loss is gradually recouped in the future. As a consequence it is possible for an analysis of a single contract to calculate the time taken to recoup this loss – this is generally termed the payback period. In addition the internal rate of return can be calculated, being that rate of interest at which the discounted value of future profits equals the value of initial losses. It is important to not only carry out these analyses at the level of a single product or a single year's production of new business, but also to consider the effect of continuing to write new business for several years in the future. This enables appreciation of whether the emerging profits on earlier years' business are sufficient to not only repay earlier losses, but also to finance the strains of continuing to write new business. If this were a life product, there would be additional

sterling reserves that would make the product less capital efficient or profitable than is shown in the projections. We have assumed that even if a life assurer were minded to enter this market, they would do so by means of one of the other wrappers.

Providers of financial services naturally seek to minimise the payback period and maximise the internal rate of return.

7.3 *Data structure and inputs*

7.3.1 Setup Costs

These represent the one-off cost of setting up the business to be able to write CTF. They are incurred once in year 1 irrespective of the volume sold. They represent items such as:

a) systems expenditure;

b) initial training of staff;

c) initial marketing spend that might not get repeated.

After feedback from the industry, a figure of £350,000 has been assumed as being the typical amount that an existing provider would have to spend to add CTF to his range.

7.3.2 Variable Initial Expenses

These are the marginal expenses that are incurred for each new contract at its inception by both the manufacturer and distributor combined. The first component, distribution, has been assumed to be £50 per policy based on all business being written in response direct offer. Were regulated advice or the simplified sales process applied, the cost could be expected to be higher. This is an average figure across all new business, including that allocated by the Inland Revenue. In practice some marketing effort would be spent on these customers even though they do not respond to the marketing. If these customers were excluded from the analysis of distribution expenses, then those allocated to the customers that selected their own provider would have to be increased.

The second component is the variable costs of manufacture to cover the processing of the application, post sale disclosure and compliance activity, collection and investment of the first contribution, issue of contract and other documentation. These have been taken as £20 per contract.

Expenses are all incurred immediately in the model – there has been no amortisation.

7.3.3 Fixed Initial Expenses

These are the annual expenses that are incurred on top of the variable expenses in each year that new business is sold and are independent of the volume of business sold. They include items such as the costs of a share of senior management, channel management and corporate infrastructure.

Fixed initial expenses (including those in respect of distribution and manufacture), which are incurred each year in order to support that year's new business acquisition activity for this type of product, have been assumed to be £400,000 in total. This includes the cost of regulating against money laundering. However the maximum annual premium of £1200 is below the cash threshold specified in the EU/EC 2nd Money Laundering Directive, and as such the product will not be subject to the Directives stipulation of enhanced due diligence and customer identification for cash transactions above the threshold.

7.3.4 Variable Renewal Expenses

These are the annual marginal costs of administering each additional contract. They include the costs of collecting and investing contributions subsequent to the first, contract accounting, contract, client, and account servicing (including statements), updates, switches, and surrender quotes. Many industry players were able to give us consistent numbers for these expenses and it is these on which the assumption of £10 per contract has been based.

7.3.5 Fixed Renewal Expenses

These are the annual costs experienced by the manufacturer of running the ongoing administration of contracts irrespective of the number of contracts in force. They occur each year and have been set in the same way, at a level of £200,000pa, as the fixed initial expenses in section 7.3.3.

The same comments for specialist providers apply as were set out in section 6.4

7.3.6 Termination Expenses

This is the cost of terminating each contract. It includes receipt and processing of instructions, legal and other processes to confirm the liability, realisation of funds to cover payment, payment of the claim, updating of records, and storage. We have received estimates from the industry that centred around £12.

7.3.7 Fund Management Costs

In addition to the fixed and per contract costs described above, companies incur investment expenses. These are expressed as a percentage of funds under management. 10 basis points has been assumed, this being largely the consensus of the information received from the industry reflecting the likely nature of the allowable investments within a CTF. The additional work involved with running a "lifestyling" profile has been assumed to be covered by the renewal expenses, as part of the general administration of the contract.

7.3.8 Expense Inflation

The above expense levels apply at the current date. Future renewal expenses incurred are inflated by 2.5% per annum throughout the projection, this being roughly in line with expected future RPI. Since the expense assumptions above have been based on those achievable following current projects underway to improve efficiencies (and hence are in general below current actual levels), it was not felt appropriate to build in additional efficiency gains going forward. The exception is for variable initial expenses where efficiency gains are assumed to offset inflation.

7.3.9 *Persistency*

Persistency is a key factor in the profitability of the contract. The paid up assumptions have been based on the industry's experience from similar products. Since the assumption is for net rates, no allowance for any restarting of contributions has been made on contracts that become paid-up.

A higher rate has been assumed in the first year of a contract's life than thereafter. The assumption of 10% of regular contributors ceasing these regular contributions in the first year has been made on evidence that parents who can not afford the regular contributions they initially intend, tend to discover this early on. From year 2 onwards the assumption stabilises at 2.5%.

7.3.9.1 *Investment Return*

An overall return of 8.1% has been assumed on equities and 4.5% on bonds (these being consistent with the assumptions in our other stakeholder research) and an Equity Backing Ratio ("EBR" in this report) of 60%, giving an overall investment return assumption of 6.7%. No allowance for tax has been made (see section 7.3.10 below).

7.3.9.2 *Discount rate for future profits*

The rate of return required by companies on their capital varies significantly, depending on their corporate structure and general internal financial disciplines. In order to gauge whether companies are likely to met their own specific requirements, two parameters are calculated. Firstly the present value of future after-tax profits (PVFP) is calculated on a discount rate of 11%. A positive value indicates that a return of 11% or greater will be achieved. The second is the actual internal rate of return (IRR). The latter gives the return that is in fact projected. In both cases profits over the lifetime of the contract (18 years) have been used.

7.3.9.3 *Case size and volume inflation*

New contracts taken out in successive years increase in contribution size by 4.5% pa; the exception being those contracts that are already benefiting from maximum contributions. This is based on the expected future rate of earnings growth. However regular contributions into a given CTF are assumed to stay constant over the lifetime of the contract. Unlike pensions, there is little evidence that people do regularly increase their contributions once these are in place.

The base assumption for the model is that a given provider will capture 10% of the total market. This represents 68,000 contracts pa. However there will also be an initial surge of demand at launch when the provider's share of children born between September 2002 and April 2005 will be 176,000 (again representing 10% of the total demand).

7.3.10 *Tax*

It has been assumed that all companies will be taxed on profits at a rate of 30%, regardless of whether the products are written within a life insurer or other statutory entity. Where the CTF business is showing a loss, tax credits are earned. There is therefore an implicit assumption the company is making profits in other areas to offset these losses. In addition initial expenses have been relieved in the year they are incurred.

It has been assumed that there would be no tax on the roll-up of the customer's fund other than irrecoverable tax on dividends.

7.3.11 Reserves

Life insurance companies currently operate under a statutory reserving regime that requires companies to provide for any expected future losses, calculated on a prudent basis. For unit-linked business sold under the CTF structure this would be expected to result in the need for ”sterling reserves” to be held in addition to the value of the units allocated to contracts. It is our understanding that unit trusts and other non-insurance structures do not need to consider such reserves to the same extent. Since institutions are likely to be able to sell CTF under a variety of legal structures the model has not included any allowance for sterling reserves.

However a solvency margin is held equal to 1% of the funds under management. This is a simplification of the need for some “risk-based capital” that will be required under the forthcoming integrated Prudential Sourcebook, regardless of legal entity providing the CTF

It is possible that companies (either because of developing regulatory requirements or because of internal disciplines) would need to hold higher amounts of reserves and capital than has been included in the projections. This would naturally lengthen the pay-back period and the amount of capital needed to finance the business.

7.3.12 Customer Profile

In practice, the flexibility of the CTF will lead to a wide diversity in consumer behaviour with CTF plans receiving a combination of regular and ad-hoc contributions and changes occurring throughout the lifetime of the contract. In order to simplify the analysis, a number of customer archetypes have been modelled. The split assumed between customer groups has been taken to be consistent with the consumer analysis (see section 5.2) and is as shown in table 7.1

Table 7.1 Customer Mix and average contributions

	Government Contributions at start of year		Regular Monthly	Regular Annual	
Customer Segment	1	8	Contributions	Contribution	Proportion of Total (%)
Basic Endowment Only	250	100	0	0	27.3%
Enhanced Endowment Only	500	200	0	0	22.4%
Regular Savers £250	250	100	50	0	22.8%
Regular Savers £500	500	200	30	0	7.0%
Ad hoc savers £250	250	100	0	200	13.0%
Ad hoc savers £500	500	200	0	100	5.3%
Max investors £250	250	100	0	1200	2.0%
Max investors £500	500	200	0	1200	0.4%

Each customer group has different assumptions with regard to average contribution sizes. They have each been run through the model separately and the results aggregated in order to simulate the distribution of different types of customer in the market place.

The initial Government contributions are all assumed to be received at the start of the first year. In practice, those children that qualify for £500 will experience a delay (of 6 months on average) in receiving the second half of this. The small effect of this timing difference has been ignored in the model.

7.3.13 Projection period

The cashflows resulting from the sale of products are projected 18 years and therefore include profit from future years at a time when the fund has grown to a significant size and more significant charges are being levied. 18 years has been taken as the average term. In practice some of the initial sweep-up business will have a term of less than this since they will be up to 2.5 years old when the contracts are taken out. Other contracts will stay on the books for longer than 18 years as some children may not withdraw their funds immediately on their 18th birthday.

7.4 Charge cap structures and levels

The alternative structures for charge caps for which results are shown are discussed in more detail in section 7.6. The following characteristics were considered when deciding which structures to investigate:

- Value to the consumer: Structures that would automatically produce a high reduction in yield (see section 0) were not considered.
- Simplicity and transparency: Any structure with many different types of charges was rejected. Too many different charges could allow many different non-comparable models to emerge in the market, which could add to complexity.
- Implications for market reach: Structures were considered that would be likely to encourage the market to reach lower income consumers, i.e. those that allow for marginal profitability at lower average contributions. In addition, structures were considered that better mirrored the expense profile than a single fund charge, i.e. structures with increased initial charges.
- Equality amongst consumers: Charge caps should not automatically result in differentiation between low and high income consumers but allow for competition to deliver any potential for reduced charges for larger investments.
- Existing expectations / research – the original Sandler Review proposed a 1% annual management charge (AMC) only. Other structures such as 1% AMC combined with an up front charge of 5% of contribution are, we understand, current in other jurisdictions.

7.5 Model structure

Model point files were set up representing the customer segments described above with the associated assumptions behind each model point. For each charging structure or set of per contract assumptions, these were run through Prophet, B&W Deloitte's actuarial software package. This projected the average expected per contract cashflows on a monthly basis over the lifetime of the contract.

These results were accumulated according to the scenario being investigated and fixed expenses and overheads were included.

Calculations were made on the present value of future profits (PVFP) available from entering the market, the calculated payback period, the capital required, and the return on capital achievable. The shape of the profit signature was also investigated. It is these results that are shown in sections 7.6 and 7.8 below.

Several companies interviewed felt that 11% was indicative of the return investors required on their capital and that they look for payback periods in the region of ten years. The implication is that they would not allocate capital to projects that offered less than this. Comments and conclusions on the financial results and possible market impacts are set out in section 0.

7.6 Model results

7.6.1 Explanation of Results

The results of the model are best explained by building up the picture gradually. We therefore start by looking at the cashflows resulting from just a single contract for a charging structure of 1% AMC only. As we are just looking at a single contract, we have excluded any required contribution to overheads, i.e. all fixed expenses have been ignored. Since there is such a marked difference between different customer segments, we consider both the two extremes below.

Basic Endowment (£250) only, marginally costed

Chart 7.1a

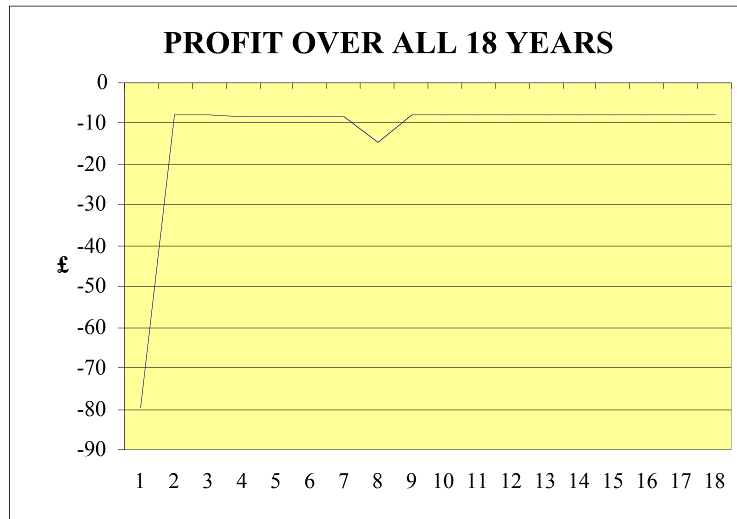


Chart 7.1b

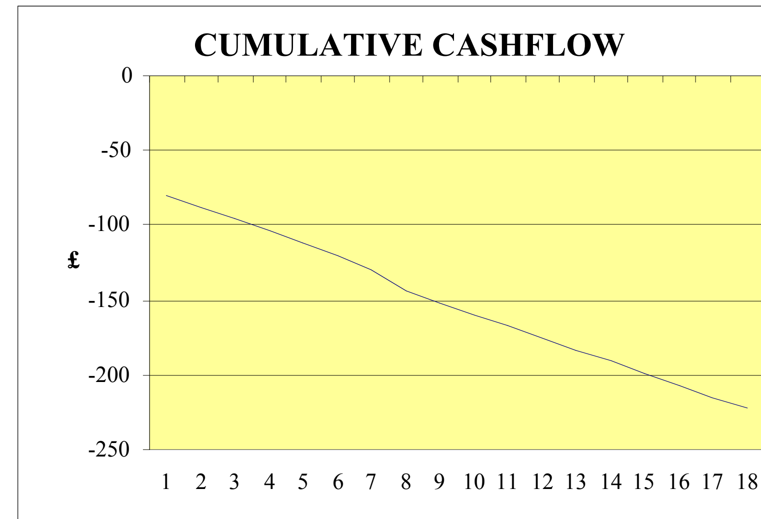
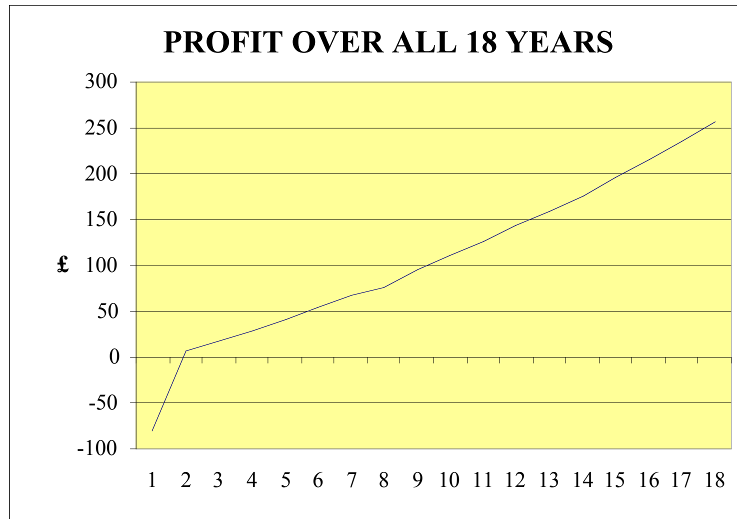
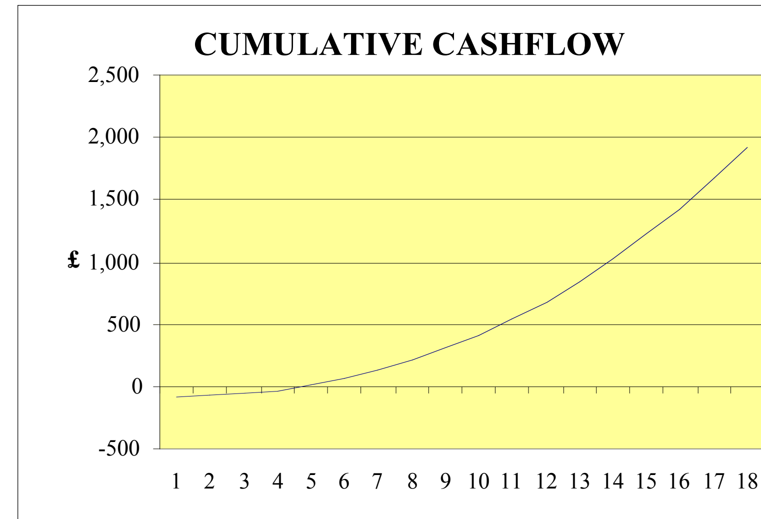


Chart 7.1 shows that for customers who do not make their own contributions, these contracts are not profitable under a charging structure of 1%. Roughly speaking, the provider receives 1% of £250, or £2.50 each year, which does not even cover the marginal renewal expenses of £10. In fact, on the assumptions used, this basic endowment only contract would make a negative contribution of £131 to the profits and overheads of the provider offering it. The provider would need to achieve £223 in order to be able to write this business.

"Max Investor" contract, marginally costed

Chart 7.2a	Chart 7.2b





The situation looks a lot better for a contract that receives the maximum allowable contributions throughout its lifetime. Even at a discount rate of 11%, this contract contributes £522 to the profits and overheads of the provider winning this business. The actual return that a provider will get on an initial investment of £81 is 43% over the lifetime of the contract and he will get his initial outlay, ignoring fixed costs, back after only 5 years.

On the assumptions used, the model shows that for a contract attracting regular voluntary contributions, these would have to be at a level of £320pa in order for the contract to just give the provider a return of 11% on a marginal basis. The cashflows associated with such a contract are shown in chart 7.3. The same contract would need to attract annual contributions of £420 in order to meet the payback period requirement of 10 years.

Regular contributor (£320pa), marginally costed

Chart 7.3a

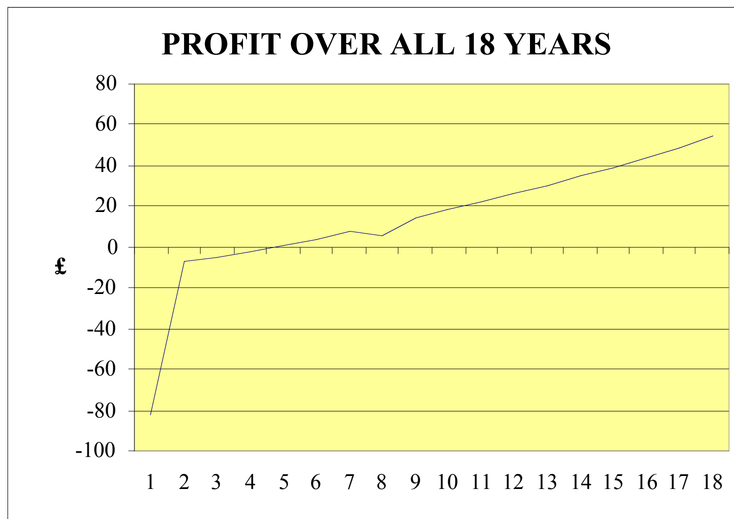
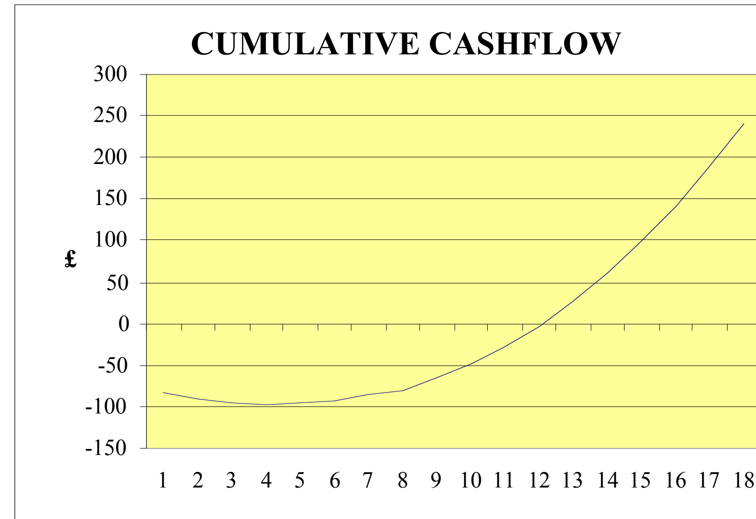


Chart 7.3b



In reality, business won by a provider will represent a mixture of customers, all contributing different amounts, and therefore representing different attractiveness to the provider. Using the distribution assumptions outlined in section 7.3.12, the cashflows resulting from a full year's worth (a cohort) of new business is shown in chart 7.4. This cohort consists of 68,000 contracts or one tenth share of the total market available.

One cohort of business, marginally costed

Chart 7.4a

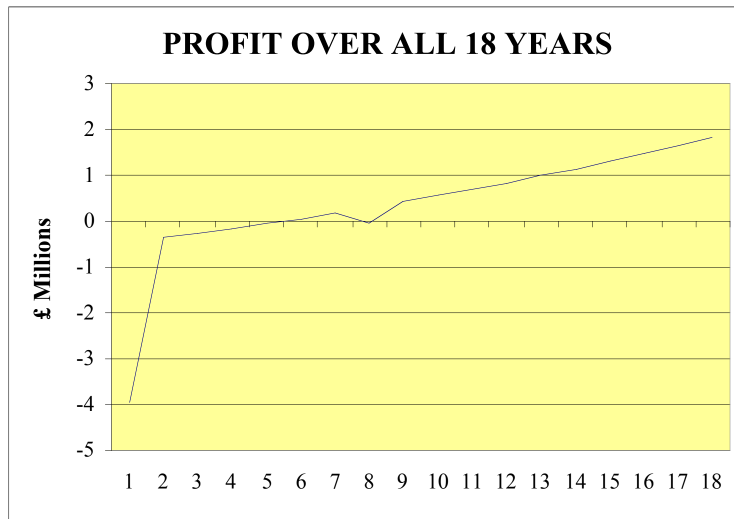
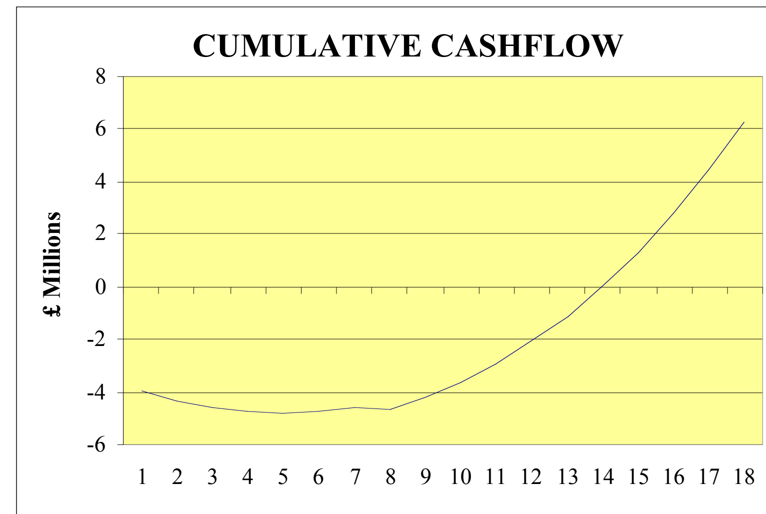


Chart 7.4b



These show that a provider needs to invest £4.8m, ignoring fixed costs, in order to write this cohort of business and, even ignoring these overheads, will get a return of only 8% on this investment. It will take him 14 years to recoup his initial outlay, ignoring fixed costs. The large negative cashflow in year one reflects the costs of marketing the business, paying commission to the distributors, and the administration costs of getting the contract onto the provider's system. The dip in year 8 reflects the cost of administering the additional government contribution that will be received then. Otherwise the cashflows become increasingly positive from one year to the next. This is due to the growth of the funds (from further contributions and investment returns) and hence the annual management charge that is levied on these.

Next we look at a whole portfolio of business that a provider entering this market might expect to write. This effectively represents the cashflows from many cohorts superimposed on each other but also includes the overheads and set-up costs associated with putting the systems and infrastructure in place in the first place. We consider 10 years worth of new business / cohorts (providers do not know what the future will hold and can therefore assume that they will be writing this business indefinitely), as well as an initial surge due to eligible children born prior to April 2005 (see section 7.3.12). In each year after this initial surge, the cohort size remains at 68,000 contracts. The cashflows that result are shown in chart 7.5.

In practice new business would continue to be sold if the CTF remained in place, but it is likely that the fixed expenses associated with the sales would be materially different from those assumed, and would be expected to be much lower – so that the loss associated with marketing and selling the fund would have diminished significantly.

Whole portfolio, fully costed

Chart 7.5a

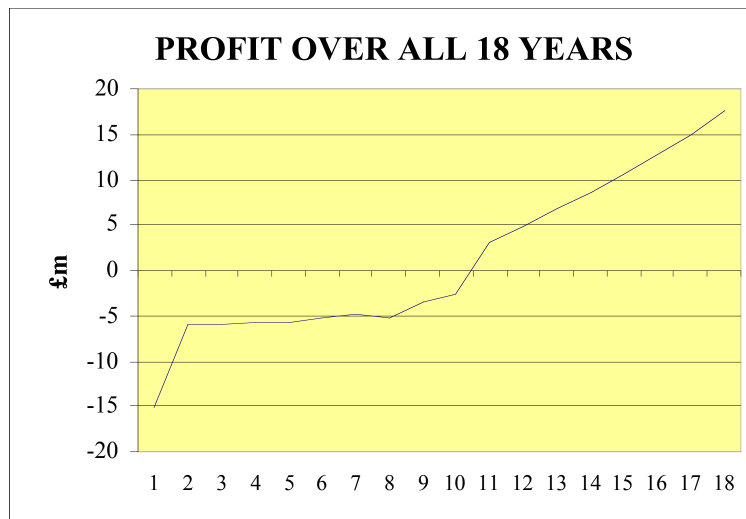
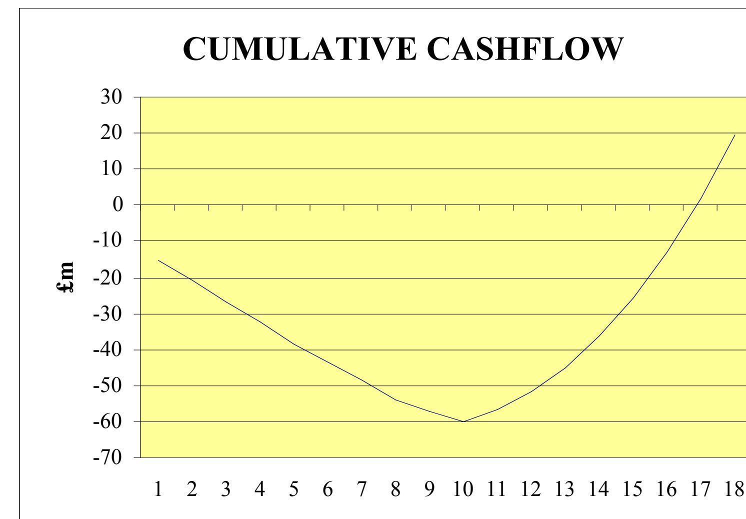


Chart 7.5b



In the first year of operation the initial fixed costs of setting up the business are incurred. In addition, a large amount of business is won (due to the backlog of children born between September 2002 and April 2005), that incurs the cost of sale and entry onto the system. This accounts for the large negative figure in year one. Cashflows over the next ten years continue to be negative due to the initial costs of new business won in these years as these are not yet offset by the AMC received from the (still immature) funds under management from existing business. Thereafter these initial costs

cease and the business already on the books has grown to a size where the AMC recovered from them is more than enough to offset the cost of maintaining these contracts and the provider finally starts to show a profit.

On 1% AMC, the total cashflow over the projection period is positive but discounting at 11% means that the positive cashflows in later years are worth less than the negative cashflows in the early years so the overall present value of future profits is -£11m. The return achieved is 8.7%. It takes 17 years for the provider to recoup the initial investment of £60m. The profitability results are very close to those of the cohort analysis. The overheads become negligible in comparison to the scale of cashflows from writing the business and the remaining differences are due to the different inflation rates of premiums and expenses.

7.6.2 Economies of Scale

The results of section 7.6.1 assume that each provider entering the market gets 10% of the total business available. Should they achieve more than this, economies of scale can be leveraged and the profitability increased. This is shown by tables 7.2 and 7.3 which have been based on a fully costed basis. Results for 2% AMC are shown as well as for 1% in order to be able to show the effect on a positive profitability.

Table 7.2 Effect of scale under 1% AMC

Market Share	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1%	-6	1.7%	0	12
10%	**-11**	**8.7%**	**17**	**60**
50%	-33	9.5%	17	271
100%	-60	9.6%	17	535

Table 7.3 Effect of scale under 2% AMC

Market Share	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1%	1	12.9%	0	7
10%	**59**	**22.1%**	**11**	**28**
50%	315	23.3%	11	123
100%	635	23.5%	11	242

7.6.3 Analysis of different charging structures

Up to this point, the results shown are for a charging structure of 1% AMC only. In this section we look at the results of different charging structures and levels, still assuming that the provider modelled achieves a 10% market share. Clearly the higher the charge, the more profitable the business to a prospective provider. What is less obvious is the effects of different types of structure. A charging structure with an up front charge will benefit the provider whenever contributions are paid in but will not compensate them for administering the contract on an ongoing basis. The AMC will do this and provide a greater income over the long term. Table 7.4 compares the profitability under a discount rate of 11%, the actual return, the capital that needs to be invested by the provider and the period it takes for this to be repaid. All the results are shown on a fully costed portfolio basis consistent with chart 7.5.

Table 7.4 Comparison of different charging structures, fully costed portfolio approach, base case assumptions for Market size and profile

Structure	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1% AMC	-11	8.7%	17	60
1.25% AMC	8	12.6%	15	47
1.5% AMC	25	16.0%	13	38
1.75% AMC	42	19.2%	12	32
2% AMC	59	22.1%	11	28
1% AMC + 3% up front	12	14.2%	14	32
1% AMC + 5% up front	27	19.1%	12	20
0.5% AMC + 5% up front	-9	7.8%	19	36
1.5% AMC + 3% up front	47	22.1%	11	22
1% AMC + 5% up front for 3 years	5	12.6%	15	33
2.5% AMC for 5 years then 1%	9	13.7%	14	28

For comparison, table 7.5 shows the equivalent results on a marginally costed cohort basis (only one year's worth of sales at 68,000 contracts and ignoring fixed expenses), consistent with chart 7.3

Table 7.5 Comparison of different charging structures, marginally costed cohort approach

Structure	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1% AMC	-1	8.4%	14	5
1.25% AMC	1	12.5%	12	4
1.5% AMC	2	16.1%	10	4
1.75% AMC	4	19.4%	9	4
2% AMC	6	22.5%	8	4
1% AMC + 3% up front	1	14.1%	11	3
1% AMC + 5% up front	3	19.5%	9	3
0.5% AMC + 5% up front	-1	7.1%	16	3
1.5% AMC + 3% up front	5	22.6%	8	3
1% AMC + 5% up front for 3 years	0	12.5%	13	3
2.5% AMC for 5 years then 1%	1	13.7%	11	4

In view of the uncertainty over the size and profile of the market, tables 7.6 and 7.7 show how the fully costed portfolio approach figures would vary under the optimistic and pessimistic assumptions of the market outlined in section 5.

Table 7.6 Comparison of different charging structures, fully costed portfolio approach, optimistic assumptions for Market size and profile

Structure	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1% AMC	14	13.5%	15	51
1.25% AMC	39	17.7%	13	40
1.5% AMC	64	21.4%	12	33
1.75% AMC	88	24.8%	11	28
2% AMC	111	28.0%	10	25
1% AMC + 3% up front	46	21.1%	11	24
1% AMC + 5% up front	68	28.5%	9	15
0.5% AMC + 5% up front	17	16.3%	13	22
1.5% AMC + 3% up front	95	29.8%	9	18
1% AMC + 5% up front for 3 years	35	20.0%	12	21
2.5% AMC for 5 years then 1%	40	20.5%	11	20

Table 7.7 Comparison of different charging structures, fully costed portfolio approach, pessimistic assumptions for Market size and profile

Structure	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
1% AMC	-34	1.0%	25	71
1.25% AMC	-22	4.8%	19	61
1.5% AMC	-11	8.0%	17	53
1.75% AMC	-1	10.8%	15	44
2% AMC	10	13.4%	14	38
1% AMC + 3% up front	-20	4.3%	20	52
1% AMC + 5% up front	-11	7.0%	18	40
0.5% AMC + 5% up front	-34	No positive IRR	No Payback	63
1.5% AMC + 3% up front	2	11.5%	15	35
1% AMC + 5% up front for 3 years	-23	2.6%	22	52
2.5% AMC for 5 years then 1%	-20	3.7%	21	47

7.7 Reduction in Yield

In order to show the effect on consumers of the various charging structures discussed in section 7.6, an investigation into the effective reduction in yield (RiY) to the consumer of each has been carried out. To be consistent with the rest of the report, an investment return of 6.7% has been assumed (This is different to the returns required by the FSA to be used for projections). A reduction in yield of 2% means that should net investment returns follow this

assumption of 6.7%, the consumer would see an actual return of 4.7% on his contributions, the difference being as a result of the charges levied by the provider (ignoring any expenses that are outside the charge cap and that are charged directly to the fund's investment performance).

The results are set out in the table below. For the simple charging structures of a flat % AMC only, it can be seen that the reduction in yield is shown as slightly more than the AMC. This is due to the timing of the cashflows. The assumption is that charges are taken at the start of each time period whereas investment returns are earned uniformly over the time period.

RiYs are calculated over the entire lifetime of a contract up to the point where the customer surrenders their policy. In most cases this will be when the child comes at age at 18. Only the RiY figures at term 18 are relevant for these contracts. Other terms might be important if a customer decided to switch providers. For example if this happens half way through the 18 years, and the contract is held with two different providers for 9 years each, then it is the RiY for a term of 9 years that will apply. For those charging structures that include an up-front charge, RiYs for shorter terms would be more penal than those for a term of 18 years. In order to illustrate this point, two terms are shown in Table 7.8, 10 years is shown as well as 18.

For charging structures that include a charge on contributions, the exact RiY varies according to the pattern of contributions over the lifetime of the contract. For a contract that receives no personal contributions on top of the initial Government endowment, the average period that the funds will have been invested is close to 18 years and the initial charge will have a proportionately smaller effect than it would on a contract that receives a lot of contributions near maturity. For this reason, three different types of investor are considered in Table 7.8 where appropriate:

- The case where no contributions are made other than those made by Government
- The case where the maximum contributions are made throughout the life of the contract
- The case where a parent puts in the maximum amount in the first year but nothing thereafter

Table 7.8 RiY experienced by customers under the charging structures considered

	Term (years)	
	10	18
1% AMC	1.06%	1.06%
1.5% AMC	1.58%	1.58%
2% AMC	2.10%	2.10%
1% AMC + 3% up front, non-contributor	1.44%	1.25%
1% AMC + 3% up front, max-contributor	1.63%	1.36%
1% AMC + 3% up front, first year only max contributor	1.39%	1.24%
1% AMC + 5% up front, non-contributor	1.69%	1.39%
1% AMC + 5% up front, max-contributor	2.03%	1.57%
1% AMC + 5% up front, first year only max contributor	1.62%	1.36%
0.5% AMC + 5% up front, non-contributor	1.17%	0.86%
1.5% AMC + 3% up front, non-contributor	1.96%	1.77%
1% AMC + 5% up front for 3 years, non-contributor	1.56%	1.31%
2.5% AMC for 5 years then 1%	1.77%	1.43%

7.8 Sensitivity Analysis

The accuracy of the results we have shown so far are very dependent on the underlying assumptions. Some of these are uncertain or depend on events that can not be foreseen. This section aims to understand which assumptions the model is most sensitive to, and the impacts of varying the assumptions. These need to be taken into account when looking at the results on the central assumptions that represent just one possible outcome. In each case, sensitivities are shown for the basic 1% AMC structure proposed in the Sandler Review and the base volume from the previous section has been used. Similar results would be obtained for other possible charge caps.

Table 7.9 Sensitivity results

Scenario	PVFP (£m)	IRR	Payback Period	Capital Required (£m)
Base	-11	8.7%	17	60
Market size one third of base	-7	6.8%	18	25
Market size two thirds of base	-9	8.2%	18	42
Persistency worse	-18	6.7%	19	62
Persistency better	-6	9.6%	17	59
Case size halved	-37	No positive IRR	No Payback	73
Case size doubled	26	15.5%	14	45
Pessimistic market profile	-34	1.0%	25	71
Optimistic market profile	14	13.5%	15	51
40% get £500 endowment	-12	8.3%	18	60
Fixed Costs doubled	-16	7.7%	18	67
Fixed Costs halved	-8	9.2%	17	56
Variable Costs doubled	-92	No positive IRR	No Payback	170
Variable Costs halved	28	19.4%	12	20
Investment Returns of 4.7%	-19	6.4%	19	62
Investment Returns of 8.7%	-1	10.8%	16	57
Discount rate of 12%	-14	8.7%	17	60
Discount rate of 10%	-7	8.7%	17	60
Solvency margin 2%	-17	7.8%	19	75
Solvency margin 0%	-4	9.9%	16	45

The extent to which the assumptions have been varied under each of the sensitivities shown in table 7.9 is explained below:

- Market size: The two sensitivities shown assume that the total market size is reduced to one third and two thirds respectively of the number of children born each year but that each provider still gets 10% of this reduced market. The introduction of deposit based accounts as an alternative to collective investment schemes is an example of an event that could have this type of impact.
- Persistency: The number of customers ceasing to pay regular premiums each year has been doubled and halved.
- Case sizes: The average contributions paid by each customer segment have been doubled (subject to the maximum £1,200 pa contribution limit) and halved. The government contributions remain unchanged from the base scenario.
- Market profile: The optimistic and pessimistic scenarios are outlined in section 5. The scenario under which 40% of the population are assumed to qualify for the £500 endowment gives worse results than the base scenario as these people are also assumed to give lower contributions of their own.
- Fixed Costs: Double and half of the base assumptions respectively are shown. This applies to set-up costs, fixed initial costs and fixed renewal costs.
- Variable Costs: Double and half of the base assumptions respectively are shown.
- Investment returns: These have been increased and decreased by 2% respectively from the base assumption of 6.7%. The numbers ignore second order effects such as customers blaming the provider for the poor returns and switching their business to another provider.
- Discount rate: Future profits have been discounted at 12% and 10% respectively instead of the 11% used under the base scenario. This sensitivity only affects the present vale of future profits.
- Solvency Margin: Under the base set of assumptions, it is assumed that companies hold a solvency margin of 1% of the funds under management. In practice companies are likely to hold more than this. These sensitivities assume that they instead hold 2% and 0% respectively. This illustrates the relative importance of possible regulatory capital requirements. Other than this sensitivity, there has been no other investigation into sterling reserves or other regulatory capital requirements.

8. Market Impacts

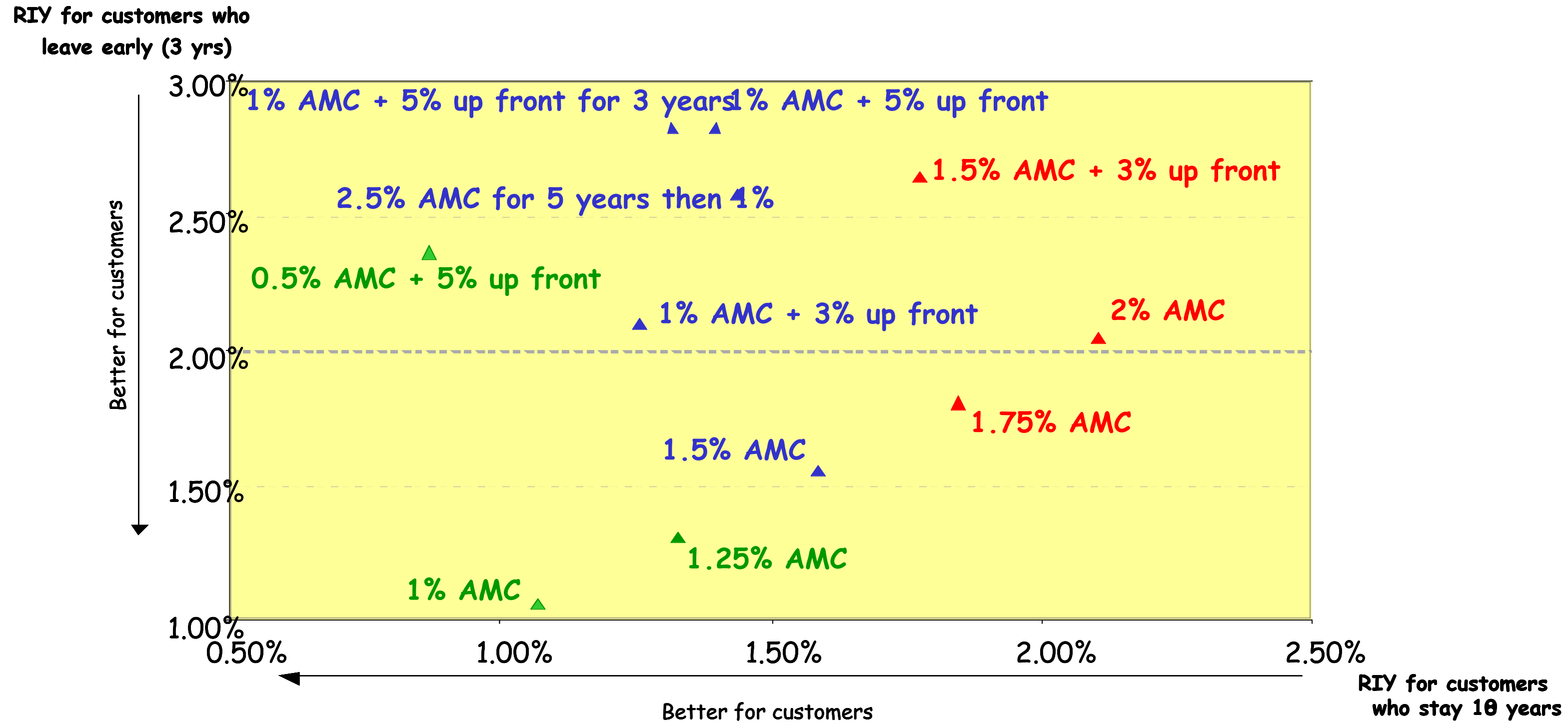
8.1 Consumer Impact

Given the low levels of consumer understanding of charges identified by Sandler, differences between charging structures and levels for the Child Trust Fund are unlikely to influence significantly consumer demand for children's savings plans. The degree and type of education, information and marketing activity on the part of Government and providers as well as the accessibility of information and, where required, advice is expected to be more influential in increasing contributions to CTF.

However, the structure and level of the charge cap as well as competition below the cap will affect the outcome for the child. Given the inaccessibility of the CTF funds until the child reaches 18, the outcome for different customers is affected by the structure of the cap and by their own behaviour.

- A charge cap that permits only a level annual management charge throughout the contract will, barring competition below the cap, yield the same results for all customers irrespective of their behaviour. Whether or not the child's fund attracts additional contributions, whether contributions are increased, decreased or stopped altogether, whether funds are transferred several times from provider to provider during the 18 years, the reduction in yield throughout the contract will be close to the level of charge permitted.
- A charge cap that permits both an annual management charge and a deduction from contributions or one which allows for higher AMCs in the early years of a contract will penalise some customers more than others. In the case of both structures and where providers are permitted to treat transfers in the same way as other contributions (ie to deduct a contribution charge or treat transfers as the start of a new contract), customers who move their money from one provider to another frequently will suffer the highest RIY. Customers who stop contributions but who leave the existing funds with the same provider suffer less and will over the longer term achieve an RIY of close to that incurred by customers who maintain contributions or do not make any.

This is most easily illustrated by the reduction in yield suffered by the fund under different charging structures and summarised in the table below. Those charging structures shown in green yield the best results (with greater weight given to the longer term RIY) and a long term RIY of close to 1%, those in red the worst with long-term RIY of closer to 2%, with those in blue with a long term RIY of close to 1.5%. The figures for RIY suffered in year 18 relate only to those who do not move their funds.



RIY for Endowment Only Customers – Similar picture for contributors
3 year RIY suffered only by those who move funds to new provider
RIY for customers who leave early (3 yrs)
Better for customers
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
1.00%
1.50%
2.00%
2.50%
1% AMC + 5% up front for 3 years
1% AMC + 5% up front
1.5% AMC + 3% up front
2.5% AMC for 5 years then 1%
0.5% AMC + 5% up front
1% AMC + 3% up front
2% AMC
1.75% AMC
1.5% AMC
1.25% AMC
1% AMC
Better for customers
RIY for customers who stay 10 years

The table below summarises the effect of different charging structures on consumers.

	AMC Only					AMC + Deductions from each contribution				Reducing charges over term of contract	
	1%	1.25%	1.50%	1.75%	2%	1% + 5%	1% + 3%	0.5% + 5%	1.5% + 3%	1% (+ 5% over first 3 years)	Higher AMC for 5 years
Impact on Consumer											
Early leaver @ 3 years (regular contributions)	*****	*****	****	****	***	*	***	**	**	*	**
Long term savers to 18 years	*****	****	***	**	*	***	****	*****	**	****	***
Summary	Stayers subsidise early leavers. High contributions subsidise low contributions.	Stayers subsidise early leavers. High contributions subsidise low contributions.	Stayers subsidise early leavers. High contributions subsidise low contributions. Subsidy may not be sustainable in time.	Stayers subsidise early leavers. High contributions subsidise low contributions. Subsidy may not be sustainable in time.	Poor value to stayers likely to lead to competition below 2%. Subsidy unsustainable.	Less cross-subsidy between groups. Poorest value to regular contributors. Better value to "Endowment only" customers	Attractive to most groups of buyers. Regular contributors subsidise "Endowment only" customers to a small extent.	Early leavers get poor deal. Very attractive to "Endowment only" customers who stay the term.	Poor value to most customers	Poor value for early leavers but RiY improves over longer term. 3 year limit insignificant to non-contributors. Those who transfer funds or start saving with new provider risk starting 3 year cycle again.	Reasonable value for both leavers and stayers. Those who transfer funds or start saving with new provider risk starting 5 year cycle again.

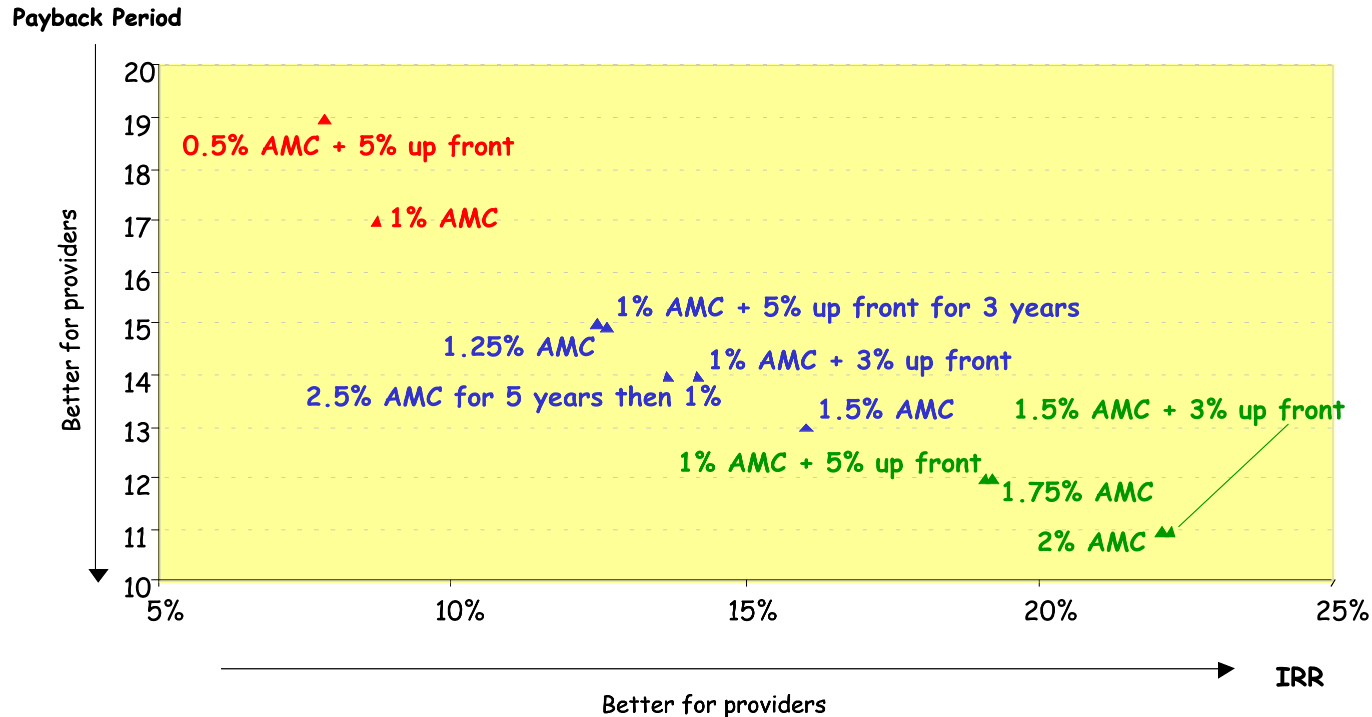
8.2 Manufacturing capacity

The price cap for CTF, although critical to provider profitability, is just one of the drivers of enthusiasm for market entry. Others include:

- ***Current levels of activity in child savings market*** – a small number of providers are heavily engaged in the current market for children's savings and may feel strongly that they want to be in the market, although not at any cost. They will still need to generate an acceptable return on capital to justify the application of capital to this market.
- ***Size and diversity of organisation*** – the research conducted for this report suggests that larger companies with more diverse product ranges tend to exhibit a more cautious approach to this market than smaller niche players.
- ***Current cost structure*** – some smaller organisations have developed very efficient processes for simple savings products and are enthusiastic about the opportunity provided by CTF. However, such providers may find it difficult to scale up or to find the capital to take significant market share.

The research highlights what may prove to be some difficulties for the Government. Those organisations most enthusiastic about the market may be the least able to access the capital needed to sustain a significant market position whilst those organisations who may have more ready access to capital are less likely to enter the market. Smaller companies may be concerned that if they do enter the market and are one of a small number of providers, they face the prospect of attracting more business than they are able to support.

Potential providers of all types will construct their own business case to support the decision to enter the CTF market and will be influenced by their ability to generate adequate returns during a reasonable payback period. The table below summarises these two dimensions based upon the base case scenario modelled and described earlier in this report. Those in green represent the most attractive to producers; those in blue come close to meeting some of the criteria whilst those in red are unlikely to satisfy most potential providers.



On the base assumptions used, most of the charging structures appear to allow for profitable business to be written, although some returns will fall below the thresholds applied by some companies. A major concern for providers making decisions on allocation of capital is the length of time it takes before that profit emerges. In most cases, the payback periods shown in section 7 are longer than providers say they are prepared to accept. Only those structures with high up front charges or high annual management charges address this concern to some extent.

As with the mainstream stakeholder products, uncertainty is a further major deterrent. Providers are uncertain how much marketing effort the Government will itself make. They are uncertain how many families will contribute towards their children's CTF plans, how much they will contribute, what type of customers they are likely to attract and how persistent the contributions being paid are likely to be. Some may also be uncertain about the parameters that are driving the financial conclusions of their own financial and planning models.

The impact of optimistic and pessimistic scenarios is shown in section 7.6 above. In making their decisions on market entry, providers may place greater likelihood on the probability of the pessimistic scenario emerging than that of the optimistic scenario. As shown, under the pessimistic scenario

(in which few consumers make additional contributions and contribution levels in general are lower than in the base case) few of the charging structures show levels of return that might be acceptable and pay-back periods are well beyond fifteen years in many cases. Providers who believe that they are likely to attract business principally from lower income groups may view the pessimistic scenario as more appropriate to their own market entry decisions. Providers at the other end of the income spectrum may take a more optimistic view although if they become one of very few providers in the market they will be faced with results that more closely mirror the base case results.

In addition to the concerns over profitability, the question of availability of capital also arises. On the base case scenario, estimates for the capital required for the industry as a whole to support new business range from £200 million to £600 million. If such capital is unavailable from existing reserves, providers will have to look to the market for additional capital. Moves of this kind may lead to an increase in threshold rates and shorter payback periods in order to satisfy investors. An analysis of capital available within the life assurance sector at the end of 2002 carried out by the FSA suggested that approximately £15bn can be considered 'excess' to current requirements after the new rules for capital are introduced in 2004. This £15bn will be required to support a number of initiatives within the industry and can only be used to support CTF business written in the life assurance sector. Fund managers will need to find their own sources of capital.

The following table summarises the different impacts on manufacturing capacity of the charging structures considered in this report.

	AMC Only					AMC + Deductions from each contribution				Reducing charges over term of contract	
	1%	1.25%	1.50%	1.75%	2%	1% + 5%	1% + 3%	0.5% + 5%	1.5% + 3%	1% (+ 5% over first 3 years)	Higher AMC for 5 years
Manufacture and Distribution											
Capital and return	Extremely capital intensive and unlikely to meet requirements of most providers in terms of return and acceptable pay-back period	Extremely capital intensive. May meet return required but pay-back period remains lengthy	Extremely capital intensive. May meet return required but pay-back period remains lengthy	Moderately capital intensive, reasonable returns and pay-back period but...	Most profitable, lowest payback period and least capital intensive but....	Least capital intensive whilst providing good profitability and low payback periods.	Moderate profitability and pay-back periods. Moderately high capital requirement.	Lowest return and highest payback period	Allows highest return and shortest payback period of all structures.	Moderately capital intensive. Moderate IRR and payback period.	
Summary	Few providers likely to enter market and little support for distribution.	Moderate number of providers likely to enter market but little support for distribution.	Moderate number of providers likely to enter market and support distribution.	... concerns about sustainability of 1.75% for all customers will add to caution and reduce otherwise significant numbers likely to enter market.	... concerns about sustainability of 2% for all customers will add to caution and reduce otherwise significant numbers likely to enter market.	Significant number of providers likely to enter market and support distribution.	Moderate number of providers likely to enter market.	Few, if any, providers likely to enter the market and support distribution.	Significant number of providers likely to enter market and support distribution.	Moderate number of providers likely to enter market.	

8.3 Distribution capacity

Enthusiasm among potential distributors is driven by:

- ***Proximity to children's market***
  - A number of food, clothes or specialist retailers have an affinity with the children's market and access to parents at an early stage of a child's life. Limited research among such distributors suggests some enthusiasm for marketing CTF and would expect CTF to have a presence in store. However, such distributors are less likely to offer any form of regulated advice. If attracted into the market, such distributors will afford the potential for market reach across much of the income range of the population.
  - Distributors who currently distribute savings plans through direct marketing also show some enthusiasm for selling CTF plans.
  - Distributors less closely associated with the children's market or for whom the market is incidental to their involvement in the savings market remain generally ambivalent about the market although some banks and building societies see a role for CTF in their portfolio, albeit that they may choose not to manufacture the product themselves.
- ***Perception of the regulation and cost of distribution*** – enthusiasm is highest among those organisations that see this as a non-advised sale. Those who believe that advice will be required either by the FSA or by their own internal risk controls remain uncertain about the ability to attract sufficient income from the sale of a product to cover the cost of distribution.
- ***Target market*** – distributors who feel able to reach higher income groups are generally more comfortable about the prospects for CTF than those whose business will come in the main from low income groups.

The price cap will affect directly the commission levels and marketing support provided by manufacturers to distributors. From a distributors point of view, a price cap that generates some initial contribution is likely in turn to generate commission rates that require little capital investment from the distributors. Charging structures that spread the payment of commission more evenly over the term of the contract require distributors to take an embedded value perspective on their own revenue flows and will involve the allocation of capital to supporting some of their up-front costs (eg staff training, advertising, store space).

The impact of different price caps for distribution channels is likely to mirror that of providers shown above.

8.4 Non price-capped CTF plans

The analysis undertaken so far in this report assumes that the price cap for Child Trust Fund will be applied to all plans regardless of the underlying fund. Whilst not researched in full during this project, it is possible to draw some conclusions regarding the market impacts were HM Treasury to permit providers to market both price-capped and non price-capped Child Trust Fund products. For the purposes of this analysis, it is assumed that all approved providers will be required to offer the stakeholder fund, but may also market other funds with different charging structures.

The market impacts can be divided into four broad groups: those that advantage and disadvantage the consumer and those that advantage and disadvantage the providers and distributors. These are summarised below:

Consumer Advantages

- Increased choice of providers for all income groups
- Increased choice of funds
- Greater access to information and advice

Consumer Disadvantages

- Higher average charges and, all other things being equal, lower outcomes for the child
- Greater complexity of choice
- Inability to make simple comparisons
- Greater dependency on advisors

Provider / Distributor Advantages

- Ability to cross-subsidise 'stakeholder' sales with non-stakeholder business
- Higher overall returns and faster payback
- Lower capital requirements

Provider / Distributor Disadvantages

- Increased competition leading to lower market share for all
- More complex marketing and systems requirements

8.5 Deposit based CTF Plans

The focus of this research has been on the provision of CTF through collective investment contracts, albeit that a range of funds including cash would be available. As the proposals for CTF have themselves developed, the potential for deposit account plans to be marketed alongside the price capped (and possibly non-price capped) collective investment contracts has emerged more clearly. The modelling described above assumes that all business will flow to price capped collective investment vehicles. We have not considered in this report the issue of price capping for deposit based vehicles.

The impact of deposit accounts on the market size for those organisations offering collective investment contracts could be significant. The impact will vary according to:

- The degree of marketing of deposit based accounts by mainstream banks and building societies, albeit that they also have to offer a stakeholder product. Banks and building societies may be attracted by the simpler regime for marketing and sales that applies to deposit based contracts and the reduced perceived potential for misselling claims.
- The preference for parents to opt for the 'safety' of a deposit account over the potential returns of the stakeholder or other funds.
- The degree of government encouragement to take up the stakeholder fund option.

In the event that many banks and building societies and other distributors choose to promote deposit based vehicles more actively than the stakeholder or other equity-based contracts, the size of the market for life companies and collective investments could be reduced by a very significant proportion and reducing the profitability of that part of the market still further (as shown in the sensitivity analysis above). The relative ranking of the price cap alternatives assessed above will not itself change but a significant shrinkage in the size of the collective investment sector will reduce the profitability at any given level of price cap to that shown in this report.

8.6 Risk Assessment

The proposals for Child Trust Fund are being developed in a period of considerable uncertainty for the financial services industry. The following paragraphs outline some of the areas which could materially impact the successful introduction of the products (beyond the selection of a price cap that will encourage providers and distributors to enter the market).

8.6.1 Capital requirements

The need for capital to support the development, marketing and management of Child Trust Fund products and the general lack of capital available in the market has already been highlighted in this report. In order to succeed, the design of the Child Trust Fund must be such that it facilitates the investment of capital in the new venture. Should the product prove unattractive to investors, the Government could find itself with few providers willing to enter the market and inadequate capital allocated to maintain the flow of business.

The position on capital is further complicated by the FSA's implementation of the integrated Prudential Sourcebook ("PSB"). This will have two important characteristics.

Firstly the stated intention is to have a uniform approach to capital requirements across financial institutions with different legal structures – this should reduce the significance of whether the Stakeholder products are offered as insurance products, unit trusts or other vehicles. Note that our analysis has assumed the continuation of a "lighter-touch" for non-insurance products.

Secondly, the PSB will emphasis its risk-based approach to capital requirements, rather than adopting a formulaic methodology. This is very important for the Sandler project since it is likely that the charged-capped nature of the Stakeholder products may, under the risk-based approach, expose the providing institutions to significant capital requirements. Since at the time this report was prepared the FSA had not set out full details of the risk-based capital methodology (other than the general comments in CP136 as amplified in CP195) the analysis in this report has not attempted to incorporate any future changes. Nonetheless it is possible that providers of Stakeholder products will be required to set up significantly greater provisions and capital than that assumed in section 7. If this is the case then the financial results will be significantly worse and the supply of the products would be materially affected.

8.6.2 Sales Regulation

Throughout this report we have highlighted the uncertainty that exists in the way in which CTF products will be sold. It is the view of many of the potential providers and distributors that the bulk of the new business will be sold through responses to direct offers, ie without the need for advice, whether full advice in its current form or the simplified sales process being developed by the FSA. The experience of many providers currently active in the children's savings market has shown direct marketing to be an effective method of reaching parents. Distributors hoping to participate in this market also hope to be able to sell without the need for advice. For some distributors, the need to provide advice in any form would limit severely their enthusiasm for market entry. The financial results shown above make allowances for direct offer business and not the cost of advice in any form. At the time of writing, EU initiatives would appear to inhibit direct marketing of financial services products and the approach taken by the FSA to the Child Trust Fund may imply the need for guided self-help, both of which would increase the cost of sale and decrease the profitability of these contracts at any given charging level.

Risks also arise in the development of new distribution. We have pointed to the opportunity to market these products through high street retailers. However, some of these organisations have to date been relatively inactive in the savings market and their ability to take on the role described above could be inhibited by perceptions of risk and reward and the confidence with which they can interact with a provider.

8.6.3 Market reactions and perceptions

The financial services market, and particularly the attitudes of potential consumers and distributors, is heavily influenced by general commentary in the media – both informed and otherwise. Adverse commentary can cause significant and unwarranted affects on either a particular company or on a product type. For the CTF initiative to succeed it will be important to ensure not only that informed criticism would be unwarranted, but also that general reactions are favourable. A concerted and united campaign by all interested parties may be needed once the full set of proposals have been agreed.

8.6.4 Consumer response

At present levels of savings and investment are being affected by low consumer confidence. Some of this is driven by economic conditions, some by the lack of confidence and understanding of financial products. Consumer response to CTF is perhaps the biggest unknown in this analysis. Consumer education, marketing and clarity of information will be critical to engagement of the consumer, particularly if traditional advisors are not active in selling these products.

9. Appendix One - Information And Data Sources

The data required for this report has been obtained from a number of different sources. The main one has been views and data collected from providers, distributors and industry bodies during meetings conducted for this project.

These organisations are listed below and Deloitte & Touche would like to thank them for input to the project, in particular in providing detailed information on costs of manufacture and distribution and experience in related markets:

Aegon / Scottish Equitable	Financial Services Authority	National Consumer Council
Association of British Insurers	Financial Services Consumer Panel	National Savings
Association of Investment Trust Companies	Foreign and Colonial	Nationwide
Axa Sun Life	HBOS	Post Office
Children’s Mutual	HSBC	Sainsburys
CIS	Homeowners Friendly Society	Virgin
Family Assurance	Mothercare	

The following research also informed our analysis:

- DWP Family Resources Survey
- Nestlé Family Monitor – Money in the Contemporary Family July 2001
- Royal Liver UK Financial Awareness Report Sept 2002
- NFU Mutual Research
- ABI – CTF, Looking at The Economics
- Institute of Fiscal Studies – The Savings Gateway and The CTF – Is Asset-Based Welfare ‘Well Fair’ Oct 2001
- Baillie Gifford – Survey of parents saving for children
- Alliance & Leicester – Wealth Tracker Index

- Abbey National – Savings Insight
- Fidelity Investments – ISA holder research
- Research provided by a number of industry respondents to this study (Homeowners Friendly Society, Family Assurance, The Children's Mutual, Virgin, AITC)
- Joseph Rowntree Foundation Research – Assessing financial products for people on the margins of financial services

10. Appendix Two - Costs Included In Price Cap

It has been assumed that under all the charging structures modelled in this report, the costs that they cover are similar to those for Stakeholder pensions. It has therefore been assumed that companies are not allowed to make any additional charges in respect of the following costs:

- Distribution and Marketing including:
  - Product Development
  - Advertising and Promotion
  - Advice
  - Acquisition
  - Capture of Client data
  - Completion and submission of application

- New business processing including:
  - Processing of application
  - Compliance activity
  - Issue of contract documentation

- Ongoing administration including:
  - Collection and investment of premiums
  - Contract Accounting
  - Investment management, excluding stamp duty and any other costs associated with buying or selling
  - Account servicing (statements, updates, quotes etc.)

- Claims administration including:
  - Processing of instructions
  - Realisation of funds excluding any costs associated with selling assets
  - Payment
  - Update of records

- Fund Management excluding stamp duty and any other costs associated with buying or selling

However they may make additional deductions from the fund to cover the following:

- Dealing costs - these are the costs associated with buying and selling scheme assets and include the stamp duty incurred in these transactions.
- Inland Revenue refunds - if the contributions paid into a plan exceed Inland Revenue limits, those contributions have to be removed from the fund and refunded to the contributor.

11. Glossary

AMC or Annual Management Charge
A charge that is levied by the provider as a proportion of funds under management. A 1% AMC means that the consumer is charged 1% of the value of his contract each year. This is usually taken monthly, with the result that the reduction in yield is not always equal to the AMC even if it is the only charge on a financial services product.

Annual Premium Equivalent
A method of expressing the amount of business sold by a provider encompassing both regular and single contribution business. Regular contribution business is given a weight equal to the expected annual contributions. Single contribution business is given a value of 1/10th of this single contribution.

Anti-selection
A consumer may know more about his personal circumstances than the provider offering the contract and enough about the contract to know that he or she can gain an advantage. The provider offers contracts and contribution rates priced according to the average consumer they believe will take out each type of contract. Anti-selection refers to the case where the consumer believes that his personal circumstances differ from the average and are therefore not reflected in the terms offered so he is able to make use of this to his advantage. The result can be detrimental to the performance of the provider.

CP166
A consultation paper issued by the Financial Services Authority on reforming polarisation (see also depolarisation). The outcome is expected to lead to distributors adopting one of three main business models:

- Tied advice (acting as an appointed representative of just one provider). These advisors will remain restricted to selling the products of the provider or group to whom they have tied, albeit that the provider can ‘adopt’ the products of other organisations if not available from themselves.
- Directly authorised distributors who are restrict their advice and marketing to either a limited range of products and/or a limited number of providers (often referred to in the market as ‘multi-ties’).
- Independent financial advisors able to advise on products across the whole market.

Depolarisation
See CP166 above.

Discount rate
Money received today is worth more than the same amount of money received in one year’s time because of the interest that could be earned on the capital in the interim. When putting a present value on future cashflows, these therefore need to be reduced in value to take account of this. The discount rate is the percentage of the cashflow that is taken off its value for each year that it is delayed.

DP19
A discussion Paper issued by the Financial Services Authority in order to consider the options for regulating the sale of “simplified savings products”. Various options are being considered. This report has assumed that the second option, that of guided self-help, will be adopted which will include the requirement for the use of filter questions to identify the suitability of the customer to the product being offered.

FPC
The Financial Planning Certificate (FPC) is the minimum qualification required to practice as a financial advisor.

IRR
The Internal Rate of Return is the discount rate that, when applied to future cashflows, gives a total present value of zero for the all cashflows.. In effect, the IRR shown for any investment represents the return earned on the investment.

Lapse
When consumers withdraw their funds and close their contract, they are said to lapse. Lapse rates refer to the percentage of consumers who do this each year.

Menu
A document provided to consumers in the early stages of the sales process. It would set out an outline of the services the adviser is offering and their fees. Commission rates would also be compared to the average rates available in the market. As yet, the precise nature of the ‘menu’ has yet to bet set down by the FSA.

MVA
Market Value adjusters (MVAs) are discretionary adjustments made by the company to the value of the contract when a payment is made at death, surrender or maturity. In theory these can be positive or negative but in practice the term is usually used to refer to a negative adjustment.

Open-ended
The total value of contracts that can be sold at any time is not restricted. New contracts can be taken out without existing contracts being surrendered.

Overheads
Expenses that are incurred irrespective of whether any contracts are sold or not. Examples include senior management and channel management and the cost of corporate infrastructure. These are normally fixed in nature.

Paid up
Contracts that still have a value but to which the customer is no longer contributing. Paid up rates refer to the percentage customers that become paid up in each year.

Payback period
If a provider sells a large number of contracts at a given point in time, this is the subsequent period it takes for the provider to recoup his initial investment. Before the payback period is reached, the total expenses of the provider outweigh all the charges received to date.

Persistency
A generic term referring to the rate at which contracts remain on the books, and hence do not become paid up, transfer or surrender.

Profit signature
The pattern of the profit earned in each year following sale of the contract. Typically this may be a large negative in year one due to the large initial expenses followed by a gradual improvement in profitability as the charges grow.

PUP
Paid Up Contracts (PUP) refer to those contracts to which the customer is no longer contributing (but which still have a positive value).

PVFP
The Present Value of Future Profits (PVFP) is the value a provider places on a future stream of profits (or losses). Profits expected to be earned in future years are discounted before being summed.

Regular contribution
Contracts that receive contributions at regular intervals. This is typically monthly but may also be quarterly, annual, or at other regular intervals.

Required rate of return
The rate of return that is required by a provider before he will enter the market. If the internal rate of return is greater than the required rate of return then the provider will be encouraged to participate. If it is less then he will not.

Reserves
The funds that the provider has to hold in order to be able to meet his future liabilities.

RU64
Regulatory Update 64 was issued by the Financial Services Authority in advance of the release of Stakeholder Pensions to require advisors offering alternative pensions to also make their customers aware of these lower priced alternatives.

Solvency margin
The amount of capital that a provider holds in excess of its liabilities.

Surrender
When a customer opts to terminate his contract and withdraw his funds, albeit that these may subsequently be transferred to another provider.

T&C requirements
The level of training and competence that is required of sales staff before they can be allowed to sell financial products.

Termination
This is the process of winding up a contract.

Tied
Tied distributors are permitted only to sell the products of the manufacturer/provider/marketing group to whom they are tied, although under the new rules envisaged by CP166, companies or groups to whom such distributors are tied will be able to 'adopt' products from other companies or marketing groups .

Up front (or initial) charge
A charge that is applied to contributions and is analogous to the bid-offer spread on unit trusts (or a lower than 100% allocation to the investment fund). Unless specifically stated to apply for a designated term (e.g the first five years of contributions), it will apply to every contribution made during the lifetime of the contract. It will also normally be applied in the event of a transfer of funds from one provider to another, thereby 'doubling' the contribution percentage deducted from any individual's investment.

With Profits
A type of policy that aims to smooth the returns to policyholders. Payouts are designed to be less than the actual returns achieved in times when these are high and more than actual returns when these are low. The guaranteed payout is typically a fairly low proportion of the total payout, with the remainder being made up of discretionary bonuses (although with traditional contracts these bonuses act to increase the level of guarantee on the contract).

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