

Consultation on “stakeholder” saving and investment products regulations

June 2004



HM TREASURY



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investment products regulations

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PREFACE

STAKEHOLDER PRODUCTS

P.1 This consultation document seeks views on proposed legislative measures for implementing the Government's policy to specify simple, low-cost and risk-controlled "stakeholder products". This consultation refers to the deposit account and medium term products. Stakeholder products are intended to help drive competition in the industry and to improve access to financial services for those on lower incomes.

P.2 The Government's policy is that it should be possible for consumers to invest in a suite of simple low-cost products following a recommendation of the Sandler Review¹. To that end, it is proposing to introduce legislative measures to make the necessary changes to existing regulation to allow these simplified products to be sold. These products are to be known as "stakeholder products", as recommended by the Sandler Review. The proposed legislative measures necessitate an amendment to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

P.3 Drafts of the proposed order ("draft Order") and regulations ("draft Regulations") are attached at Annex A and B respectively.

P.4 A regulatory impact assessment, including a competition assessment and small firms' impact test is attached at Annex C.

P.5 A summary of the questions that this paper asks of respondents appears at Annex D.

P.6 The Government has already announced that the stakeholder pension will be the pension product of the new suite of stakeholder products. The stakeholder pension is already tightly regulated, but in order to make it suitable to be sold via the basic advice process the Government decided that it should be lifestyled, whereby assets in the fund are gradually moved from equities towards less volatile assets such as fixed income or cash as the policyholder nears retirement. The Government is still considering the detail of the new lifestyling requirement and proposals will be announced and consulted upon shortly.

P.7 The Treasury would be grateful for any comments on the draft Order, the draft Regulations, the RIA (including the competition assessment and small firms' impact test) to be sent by September 10th 2004 to the following address:

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¹ *Medium and Long-Term Retail Savings in the UK – A Review*, July 2002, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

PREFACE

P.8 Please ensure that all responses provide details of the organisation whose views it represents (where applicable).

P.9 Unless respondents indicate to the contrary, it will be assumed that they have no objection to their response being made public.

P.10 The document can be accessed via the Treasury's website (www.hm-treasury.gov.uk/stakeholder). Paper copies are available free of charge by contacting:

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EXECUTIVE SUMMARY

Purpose of this Consultation

The purpose of this consultation paper is to ask interested parties whether from an operational point of view the draft Order and draft Regulations adequately capture the policy intent as set out in the Government's response to the consultation on Sandler 'stakeholder' product specifications¹, and further set out in this paper.

Background

Following a recommendation of the Sandler Review, in February 2003 the Government published and consulted on its proposals for a suite of simple, low cost, risk-controlled 'stakeholder' investment products² to be sold through a simplified sales process³.

Stakeholder products are aimed at driving competition in the retail financial services industry and at increasing access to the market for those on lower incomes.

In July 2003, the Government published its response to the February 2003 consultation⁴ and the FSA published a feedback statement on Discussion Paper 19⁵, which outlined three sales process options.

In line with recommendations from respondents, the Government decided that the stakeholder product range should include a short-term product in the form of a cash deposit account (re-branded CAT-marked cash ISA), medium-term investment products including a unit-linked and smoothed investment option, and a long-term pension product. The Child Trust Fund (CTF) would also be made available within the suite.

It also set out certain principle-based investment restrictions relating to the medium and long-term products, and undertook to decide the level and structure of the charge caps that would apply to the products once the FSA had determined the detail of the streamlined sales process.

To this end, the FSA began market-testing a "filter questions" approach to the sales process through which consumers receive basic advice. In December 2003, the FSA published initial results from this research, and concluded that it needed to carry out a second stream of research in order to ensure that the process delivered an adequate degree of consumer protection.

In addition, the Government commissioned Deloitte to undertake independent charge cap research during 2003. The research examined the trade-offs between consumers, distributors and providers of a range of charge caps applied to the medium-term and long-term (pension) products. Separate research was also conducted into the charge cap for the Child Trust Fund.

¹ *Government response to the consultation on Sandler 'stakeholder' product specifications*, July 2003, HM Treasury and DWP ("Government response document (July 2003)").

² *Proposed product specifications for Sandler 'stakeholder' products*, February 2003, HM Treasury and DWP.

³ *Discussion Paper 19, Options for regulating the sale of 'simplified investment products'*, February 2003, FSA.

⁴ Government response document (July 2003).

⁵ *Feedback Statement on DP19 – Options for regulating the sale of 'simplified investment products'*, July 2003, FSA.

As announced in December 2003, the stakeholder medium-term products will be brought into the ISA regime as one of the qualifying investments within the 'stocks and shares' component, provided they satisfy the cash-like test. In addition, all ISA life insurance products will be allowed into the 'stocks and shares' component, subject to a similar cash-like test. The existing ISA insurance component will cease to exist from April 2005. Transitional rules will be put in place to protect existing ISA insurance policies and allow investors to continue to make contributions to those policies if they wish, although all contributions to that policy will be treated as subscriptions to either a 'stocks and shares' or 'cash' ISA from April 2005.

The Inland Revenue have today issued PEP and ISA bulletin, number 15, to all PEP and ISA managers. This sets out the detail of the Inland Revenue's proposals, including the transitional rules, draft regulations and a partial regulatory impact assessment. It can be found at www.inlandrevenue.gov.uk/isa/bulletin15.htm.

The Legislative Measures

The Government has considered the independent research, the many responses to the product consultation and the outcome of the FSA's consumer testing of basic advice, and has prepared the draft Order⁶ and draft Regulations⁷ in the light of this evidence.

Under the Financial Services and Markets Act 2000 ('the Act') an activity is a "regulated activity" if it is an activity of a specified kind which is carried on by way of business and relates to an investment of a specified kind⁸. "Specified" means specified in an Order made by the Treasury.

To that end, the draft Order will create a new "specified kind of activity" to be inserted into the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the principal Order), setting out the core elements of an activity corresponding to the basic advice process that the FSA has been researching. The specified kinds of products to which the activity relates include the short and medium-term stakeholder products described in the draft Regulations.

Only those persons authorised to do so by the FSA may engage in a specified kind of activity⁹. Therefore, in order to give basic advice, providers will have to first obtain the FSA's authorisation.

It should be noted that it is not the intention of the draft Order and draft Regulations to preclude the possibility of the FSA extending the use of a simplified advice process to other products in the future, if the FSA concluded this was justified. Rather, the effect of the draft Order and draft Regulations is to set out one particular group of products – stakeholder products – in relation to which the FSA's basic advice process may be followed.

The Department for Work and Pensions, which is responsible for stakeholder pension legislation, is preparing changes to stakeholder pension regulations and will shortly be consulting on these changes.

The Inland Revenue (IR) has prepared regulations for the general CTF scheme. The Child Trust Funds Bill received Royal Assent on Thursday 13 May 2004 and is now the Child Trust Funds Act 2004. Full details can be found at <http://www.ir.gov.uk/ctf/>.

⁶ Pursuant to sections 22(1), 22(5) and 428(3) of and paragraph 25 of Schedule 2 to the Act.

⁷ Pursuant to section 428 and 429 of and paragraph 26 of Schedule 2 to the Act and article 52(A) of the principal Order.

⁸ Section 22 of the Act.

⁹ Section 19 of the Act.

Charge Cap

The independent research carried out by Deloitte has been published to coincide with this consultation. Together with the FSA's consumer testing, and responses to the Government consultation in 2003, it forms the evidence on which the Government's charge cap decisions have been made.

Basic Advice Process

Also to coincide with this document, the FSA is publishing a consultation paper setting out the regime for giving basic advice. The FSA's proposed rules should be read alongside the present draft regulations.

DRAFT ORDER COMMENTARY

1.1 The draft Order inserts a new article 52B to the principal Order, making the basic advice process for selling the stakeholder product range a specified kind of activity, and therefore a “regulated activity” for the purpose of the Act.

1.2 New article 52B describes the core features of the activity to which the FSA’s basic advice process relates, the details of which are set out in full in the FSA’s consultation paper.

Articles 1 and 2 1.3 Articles 1 and 2 set out the citation and commencement date of the draft Order and state that it amends the principal Order.

Article 3 1.4 New Article 52B is intended to encapsulate the core elements of the FSA’s basic advice process.

1.5 New Article 52B states that providing basic advice to a retail consumer on a stakeholder product is a regulated activity where the consumer is asked questions to assess whether a stakeholder product is appropriate for him and, if a stakeholder product is assessed to be appropriate for him, the product is described to him, a recommendation is given to him, and he indicates that he has understood the description and recommendation.

1.6 It is not intended that the detail of the FSA’s basic advice process should be described in Article 3. The FSA’s basic advice process may also be required in selling other ‘specified kinds of investment’ under the principal Order. The aim of Article 3 is to describe the core features of an activity encompassing a basic advice process accurately so that, when followed in relation to the new stakeholder products, the activity is a “specified kind of activity” and therefore a regulated activity under the Act.

Respondents are asked to comment on whether the activity as described in Article 3 adequately captures the core features of the FSA’s basic advice process and whether it could create problems or difficulties.

Article 4 1.7 This Article allows firms which are currently authorised by the FSA to offer ‘full’ advice a fast-track route to FSA approval that will enable them to offer ‘basic advice’. This is to ensure the least burdensome and most cost-effective process for industry. The requirement is for the firm to write to the FSA confirming its intention to offer ‘basic advice’, and for the FSA to acknowledge receipt of the firm’s intentions.

Respondents are asked to comment on the proposed fast-track approach to authorising firms to offer ‘basic advice’.

Article 5 I.8 Article 5 provides for supplemental amendments to other instruments in respect of appointed representatives and activities to which the exemptions given to certain professions do not extend. The effect of the amendments is that basic advice is an activity for which appointed representatives do not need their own Part 4 permission, but members of the professions will need such a permission since it is to be added to the list of non-exempt activities.

Respondents are invited to comment as to whether this Article allows appointed representatives to provide basic advice.

2

DRAFT REGULATIONS COMMENTARY

Regulation 1 2.1 Regulation 1 sets out the citation and commencement date of the draft Regulations.

Regulation 2 2.2 Regulation 2 sets out key definitions to assist in the interpretation of the Regulations.

Regulation 3 2.3 Regulation 3 explains the link between the draft Order and the draft Regulations, and sets out the meaning of stakeholder products.

Regulation 4 2.4 Regulation 4 sets out the defining features of the short term cash product (the re-branded CAT-marked cash ISA). The short term cash product is aimed at those in the target market who wish to save without exposure to equity or property risks.

2.5 Regulation 4 (a), (b), (d), (e) and (f) reflect the existing features of a CAT-marked cash ISA. The account must consist of cash only, with a minimum payment of £10 irrespective of frequency (except where an account manager permits a smaller payment). The maximum period for an account manager to carry out withdrawal instructions and to provide the consumer with the required funds is 7 days.

2.6 Regulation 4 (c) requires that interest accrues on the account on a daily basis at a rate that is not less than the Bank of England base rate minus 1 per cent per annum. This replaces the current requirement that interest must not be less than the Bank of England base rate minus 2 per cent per annum.

Comments are invited on the change to the interest rate margin on the cash deposit product.

Regulation 6 and 7 2.7 Regulations 6 and 7 relate to the medium term product characteristics and conditions.

2.8 The medium-term product (both life and collective investment scheme options) is subject to certain investment restrictions. There is a 60% maximum limit on total equity and property exposure. The limit provides firms with a signpost of acceptable fund design, and allows flexibility in catering to consumer preferences. It is also simple for consumers to understand, and relatively easy to enforce.

2.9 The Government has tried to take a pragmatic view of the rebalancing of the equity and property cap that providers will need to undertake from time to time. Providers will have 3 months in which to correct any breaches of the equity and property limit.

2.10 There are also certain principle-based restrictions on investment risk. The principles-based approach is intended to allow individual fund managers a degree of flexibility, encouraging innovation in product design. Fund managers will be able to respond to changing market conditions and exercise professional judgement in fund selection, rather than be rule-bound and rigid in making investment decisions. At the same time, fund managers have a clear set of principles against which the products can be assessed.

2.11 The minimum amount that providers must accept on a single occasion is £20, and single pricing is required.

Feedback is invited on any operational difficulties envisaged in implementing the regulations for minimum contributions.

Respondents are asked to consider whether the timeframe over which firms will be expected to adjust to rising markets to ensure their funds do not over-expose investors to equity and property risk is workable and reasonable.

2.12 Regulation 7 (1) (b) sets out the principles that fund managers must follow in investing funds or selecting investment options for the unit-linked medium-term product. The term “reasonable cautious investor” has been purposely avoided, as our consultation found that the interpretation of this term could change from time to time and mean different things in relation to different products. The intention of the regulation is to allow firms to invest in up to 60% in equities and property at all times.

2.13 The intention of the policy is that investments must be diversified across asset classes, markets, sectors and securities. Firms must not expose investors to a high proportion of high-risk bonds such as those which are long-dated or sub-investment grade. This has been dealt with in a general way in Regulation 7 (1) (c).

Respondents are invited to consider whether the proposed regulations provide sufficient clarity to achieve the policy intent.

Regulation 8

2.14 Regulation 8 stipulates the additional requirements for the smoothed investment fund. This provides an entry-level product for consumers who want to invest in equities and who also want to benefit from the smoothing of investment returns which can help to avoid the extreme peaks and troughs which equity markets can experience.

2.15 The same principle-based investment restrictions and charge cap that apply to the unit-linked medium-term product will also apply to the smoothed product. The capped management charge must be explicit.

2.16 The smoothed investment fund shares characteristics with both with-profits funds and unit-linked funds. The Government recognises the significant reforms to with-profits funds and their regulation that have emerged from the FSA’s with-profits review, some of which are still subject to consultation. Some of those features have been incorporated into the smoothed investment fund. Regulation 8(1)(a) includes the need to produce information to enable the consumer properly to understand the essential elements of the insurer’s commitments under the policy. The information must not be narrower in scope or less detailed in content than that required for the Principles and Practices of Financial Management document that applies to with-profits policies. The intention is to enable the consumer to have a clear picture of the nature of the fund and how investment returns, charges and smoothing interact to deliver a unit price.

2.17 Regulation 8(1)(b) requires providers to make this information available to anyone who requests it.

Respondents are asked whether these information requirements for the smoothed investment fund are sufficient to enable consumers to understand the product they are buying.

2.18 The smoothed investment fund is effectively a smoothed unit-linked fund with a 100/0 structure. The effect of Regulation 8(1)(c) is that all investment returns, net of charges, are ultimately distributed to policyholders. The fund will not share in the profits and losses of the business as a whole. Returns to shareholders, where appropriate, and to other providers of capital will be met by means of an explicit charge to the fund.

2.19 The smoothed fund will be unitised, with smoothed unit prices published on a daily basis. It will be for firms to decide on the best means of publication and the timing of valuation.

2.20 The intention is that smoothing will be funded from a separate smoothing account held within the policyholders' fund. The balance of the smoothing account must be neutral in the long run, but product providers will be able to set their own parameters for smoothing and for charging for smoothing. These will have to be explicitly set out as part of the information provided to consumers. Providers should review their approach on a regular basis. Any changes must also be notified to policyholders.

2.21 Where a fund provider is required to provide additional capital to fund smoothing because of a deficit in the smoothing account, the provider may impose a charge on policyholders which is additional to and separate from the charge cap. The provider must account clearly for the movement of and payment for any supporting capital required, and notify policyholders if an extra charge is to be applied. In order not to signal to investors when upward smoothing is taking place, prudent providers may wish to make a consistent charge for smoothing capital, with any surplus capital being returned to policyholders through the investment return. The charge for smoothing capital can be expressed either as an additional and explicit management charge or as a percentage reduction in the investment return.

2.22 Regulation 8(1)(d) requires providers to develop target ranges for payouts to provide an element of predictability for consumers in terms of surrender or maturity values. The target can be expressed in terms of asset share. The FSA is currently considering the response to its consultation on target ranges as part of Consultation Paper 207, 'Treating Policyholders Fairly.'

The precise requirements of smoothing and of target ranges for payouts have not been specified in the regulations to allow providers to adopt their own policy and to explain it to consumers. We have decided not to impose a single smoothing model. Do respondents support this approach or should the parameters of smoothing be more tightly defined?

2.23 Regulations 8(1)(e) and 8(1)(f) provide that the only guarantee that applies to the smoothed investment fund is the return of no more than 101% of the total value of the units allocated under that contract in the event of the death of the insured. We believe that this is fairer than returning premiums paid, since in many cases the smoothed value is likely to be higher.

Respondents are asked whether they are content with limiting guarantees in this way.

2.24 With a smoothed daily unit price, there should be no need to impose a Market Value Reduction. The Government has also decided not to impose a requirement to disclose unsmoothed asset share on maturity or surrender. The scope for selection against the fund during periods when it is being smoothed upwards makes this impractical.

Respondents are asked whether the structure of the smoothed investment fund provides sufficient reassurance for consumers, while still being practical for providers to deliver.

Regulation 9 2.25 Regulation 9 details the permitted reductions in investors' rights and investment property. The Government recognises that firms need to be able to provide stakeholder products at an economically viable price. However, the Government is also mindful of the fact that, before the stakeholder pension was designed, pension costs were extremely high relative to the value of contributions. The reduction in charges on personal pension products that have resulted from the pricing pressure exerted by the stakeholder pension product and the disclosure regime surrounding it provided by the FSA would suggest that charge capping has benefited consumers. The Government concludes that charge capping is an essential element in preventing consumer detriment, particularly as these products may be distributed through basic advice.

2.26 The charge cap that will apply to the medium term product is a 1.5 per cent annual management charge for the first ten years that the product is held, starting with the day on which the first contribution is made by the investor. Thereafter, the charge cap will be a 1 per cent annual management charge.

2.27 We have consulted at length on the status of all costs associated with the distribution and administration of these products. Respondents to our consultation wanted clarity on the status of costs and we have tried to address that in Regulation 9, and again the Government has tried to take a pragmatic view.

2.28 The key highlights from Regulation 9 are:

- The 1.5 per cent charge cap is expressed as 3/730 per cent of the fund's value for each day on which it is held.
- The 1 per cent charge cap is expressed as 1/365 per cent of the fund's value for each day on which it is held.
- Charges may be calculated at a fund level rather than at the individual level, as long as they are calculated on a daily basis;
- Stamp duty, stamp duty reserve tax and other charges incurred by the manager directly or indirectly in or consequent upon the sale of purchase of investments held for the purposes of the investment scheme are excluded from the charge cap;
- Advance corporation tax charges on income received into the fund are excluded;
- Dilution levies are excluded from the charge cap;
- For the smoothed product, the cost of smoothing is excluded from the charge cap.

2.29 The independent charge cap research by Deloitte states that where a charge needs to be made for smoothing, between 0.1 per cent and 0.2 per cent per annum is "economically fair" and the Government expects firms to charge within or below that range for smoothing.

Respondents are invited to comment on the status of costs outside the charge cap.



DRAFT ORDER

Order made by the Treasury, laid before Parliament under paragraph 26 of Schedule 2 to the Financial Services and Markets Act 2000 for approval by resolution of each House of Parliament within twenty-eight days beginning with the day on which the Order was made, subject to extension for periods of dissolution, prorogation or adjournment for more than four days.

STATUTORY INSTRUMENTS

2004 No.

FINANCIAL SERVICES AND MARKETS

Financial Services and Markets Act 2000 (Regulated Activities)(Amendment)(No *) Order 2004

<i>Made</i> - - - -	<i>2004</i>
<i>Laid before Parliament</i>	<i>2004</i>
<i>Coming into force</i> - -	<i>April 2005</i>

Whereas, in the opinion of the Treasury, one of the effects of the following Order is that an activity which is not a regulated activity (within the meaning of the Financial Services and Markets Act 2000(a)) will become a regulated activity;

The Treasury, in exercise of the powers conferred upon then by sections 22(1) and (5) and 428(3) of and paragraph 25 of Schedule 2 to the Financial Services and Markets Act 2000 hereby make the following Order:

Citation and Commencement

1.This Order may be cited as the Financial Services and Markets Act 2000 (Regulated Activities)(Amendment)(No *) Order 2004, and comes into force on 6 April 2005.

Amendment of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

2.The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(b) (“the principal Order”) is amended as follows.

Providing basic advice on stakeholder products

3.After paragraph 52A of the principal Order, insert—

(a) 2000 c. 8.

(b) S.I. 2001/544, as amended by S.I. 2001/3544, S.I. 2002/682, S.I. 2002/1310, S.I. 2002 /1776, S.I. 2002/1777, S.I. 2003/1475, S.I. 2003/1476 and S.I. 2003/2822.

“CHAPTER XIA
PROVIDING BASIC ADVICE ON STAKEHOLDER PRODUCTS

The activity

Providing basic advice on stakeholder products

52B.—(1) The activity of a person (P) providing basic advice to a retail consumer on a stakeholder product is a specified kind of activity.

(2) For the purposes of paragraph (1), P provides basic advice when—

- (a) P asks the retail consumer questions to enable P to assess whether a stakeholder product is appropriate for that consumer;
- (b) relying solely on the information provided by the retail consumer in response or related to the questions referred to in sub-paragraph (a), if P assesses that a stakeholder product is appropriate for the retail consumer—
 - (i) P describes that product to that consumer;
 - (ii) P gives a recommendation of that product to that consumer; and
- (c) The retail consumer has indicated to P that he has understood the description and recommendation in sub-paragraph (b)

(3) In this article—

“retail consumer” means any person who is advised by P on the merits of opening or buying a stakeholder product in the course of a business carried on by P and who does not receive the advice in the course of a business carried on by him;

“stakeholder product” means—

- (a) an account which qualifies as a stakeholder child trust fund within the meaning given by the Child Trust Funds Regulations 2004(a);
- (b) rights under a stakeholder pension scheme within the meaning given by section 1 of the Welfare Reform and Pensions Act 1999(b);
- (c) an investment of a kind specified in regulations made by the Treasury.

(4) Sections 428 and 429 of and paragraph 26 of Schedule 2 to the Act apply to any regulations made under sub-paragraph (c) of the definition of “stakeholder product” in paragraph (3).

(5) This article is subject to the exclusions in articles 54A and 55.

Transitional

4.-(1) Part 4 of the 2000 Act shall apply in the case of persons who have permission at the date this Order comes into force to carry out the activity specified in article 53 of the principal Order and who wish to carry out the activity specified in article 52B of that Order as set out in paragraph (2).

(2) Where P is a person to whom paragraph (1) applies

- (a) the procedures established under sections 44 and 45 in respect of application for permission shall not apply in respect of permission to carry out the article 52B activity,
- (b) P shall be deemed to have such a permission if he has notified the Authority in writing of his wish to undertake the activity and the Authority has acknowledged receipt of P’s notification in writing from the date of the acknowledgement.

Supplemental amendments of secondary legislation

(a) S.I. 2004/1450
(b) 1999 c. 90.

5.-(1) Notwithstanding the power in section 39(1) of the 2000 Act, the Financial Services and Markets Act 2000 (Appointed Representatives) Regulations 2001(a) are amended as set out in paragraph (2).

(2) In regulation 2(1) (descriptions of business for which appointed representatives are exempt) after sub-paragraph (b) insert -

“(ba) an activity of the kind specified by article 52(B) of that Order;” .

(3) Notwithstanding the powers in sections 327(6) and 428(3) of the 2000 Act, the Financial Services and Markets Act 2000 (Professions) (Non-Exempt Activities) Order 2001(b) is amended as set out in paragraph (4).

(4) In article 4 after paragraph (e) insert –

“(ea) article 52B (providing basic advice on stakeholder products);”.

Signatory text

Two of the Lords Commissioners of Her Majesty’s Treasury

[date]

EXPLANATORY NOTE

(This note is not part of the Regulations)

This Order amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544) by inserting a new article 52B into the Order.

This provides that providing basic advice to a retail consumer on a stakeholder product is a regulated activity where the consumer is asked questions to assess the suitability of a stakeholder product for him and, if a stakeholder product is assessed to be appropriate for him, a description of that product is discussed with him, a recommendation is given to him and he certifies in writing that he has understood the description and recommendation.

Transitional provision is made for existing Part 4 permissions in respect of the article 53 activity to have effect as from the date the order comes into force as permission also for the article 52B activity.

Supplemental provision is made to include the Article 52B activity in the list of activities for which appointed representatives do not need Part 4 permission and in the list of activities for which certain professions are not exempt from requiring permission.

Regulations will be made defining other stakeholder products in addition to the stakeholder child trust fund account and rights in a stakeholder pension scheme which are defined in the Child Trust Fund Act 2004 (c. []) and the Welfare Reform and Pensions Act 1999 (c. 90) respectively.

(a) S.I. 2001/1217
(b) S.I. 2001/1227



DRAFT REGULATIONS

STATUTORY INSTRUMENTS

2004 No.

FINANCIAL SERVICES AND MARKETS

Financial Services and Markets Act 2000 (Stakeholder Products) Regulations 2004

<i>Made</i> - - - -	2004
<i>Laid before Parliament</i>	2004
<i>Coming into force</i> - -	April 2005

The Treasury, in exercise of the powers conferred upon them by sections 428 and 429 of and paragraph 26 of Schedule 2 to the Financial Services and Markets Act 2000^(a) and article 52B(3) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001^(b) hereby make the following Regulations:

Citation and commencement

1. These Regulations may be cited as the Financial Services and Markets 2000 (Stakeholder Products) Regulations 2004 and come into force on 6 April 2005.

Interpretation

2.—(1) In these Regulations—

“the 2000 Act” means the Financial Services and Markets Act 2000;

“account-holder” means the holder of a deposit account;

“Bank of England base rate” means the rate announced from time to time by the Monetary Policy Committee of the Bank of England as the official dealing rate, being the rate at which the Bank of England is willing to enter into transactions for providing short-term liquidity in the money markets;

“the Conduct of Business Rules” means the Conduct of Business Rules made by the Financial Services Authority under section 153 of the 2000 Act;

“contract of insurance” means a contract—

- (a) which, or any part of which, is of one or more of the following kinds—
- (i) life and annuity,
 - (ii) linked long-term, and

^(a) 2000 c. 8.

^(b) S.I. 2001/544, as amended by S.I. 2001/3544, S.I. 2002/682, S.I. 2002/1310, S.I. 2002/1776, S.I. 2002/1777, S.I. 2003/1475, S.I. 2003/1476 and S.I. 2003/2822.

- (b) which is carried out by an insurer who has permission, as the case may be, under—
- (i) Part 4 of the Financial Services and Markets Act 2000, or
 - (ii) paragraph 15 of Schedule 3 to that Act,
- to effect or carry out contracts of insurance of that kind, and
- (c) is not a with-profits policy and does not include rights in a with-profits fund ;
- “deposit account” means a deposit account with a deposit-taker and includes a share account with a building society within the meaning of the Building Societies Act 1986^(a);
- “deposit-taker” means—
- (a) a person who has permission under Part 4 of the 2000 Act to accept deposits, or
 - (b) an EEA firm of the kind mentioned in paragraph 5(b) of Schedule 3 to the 2000 Act which has permission under paragraph 15 of that Schedule (as a result of qualifying for authorisation under paragraph 12 of that Schedule) to accept deposits;
- “dilution levy” has the meaning given by the handbook made by the Financial Services Authority under section 153 of the 2000 Act;
- “insurer” means—
- (a) a person who has permission under Part 4 of the 2000 Act to effect or carry out contracts of insurance, or
 - (b) an EEA firm of the kind mentioned in paragraph 5(d) of Schedule 3 to that Act, which has permission under paragraph 15 of that Schedule (as a result of qualifying for authorisation under paragraph 12 of that Schedule) to effect or carry out contracts of insurance;
- “investor” means a member of a collective investment scheme which complies with regulation 5 or a policyholder of a linked long-term contract which complies with regulation 6 as the case may be;
- “investment property” means the scheme property of a collective investment scheme which complies with regulation 5 or an underlying fund which complies with regulation 6 as the case may be;
- “investment scheme” means a collective investment scheme which complies with regulation 5 or a linked long-term contract which complies with regulation 6 as the case may be;
- “investment trust” has the meaning given by section 842 of the Income and Corporation Taxes Act 1988^(b);
- “land and buildings” means interests in any land or buildings which satisfy the conditions in rule 5A.8.5R of the Collective Investment Schemes Sourcebook made by the Financial Services Authority under section 153 of the 2000 Act;
- “linked long-term contract” means a contract of long-term insurance as specified in paragraph 3 of Part 2 of Schedule 1 to the principal Order;
- “manager” means the manager of a collective investment scheme referred to in regulation 5 or the insurer of a linked long-term contract referred to in regulation 6 as the case may be.
- “the principal Order” means the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;
- “relevant collective investment scheme” means an authorised unit trust scheme, an authorised open-ended investment company or a recognised scheme, as the case may be, as defined in section 237(3) of the 2000 Act;
- “relevant investments” means—
- (a) shares issued by a company wherever incorporated and officially listed on a recognised stock exchange;

^(a) 1986 c.53.

^(b) 1988 c.1.

- (b) units in a relevant collective investment scheme where a substantial proportion of the scheme property is invested, directly or indirectly, in shares, as set out in paragraph (a) or land and buildings; and
- (c) rights under a contract of insurance where a substantial proportion of the assets of the fund held in respect of that contract is invested, directly or indirectly, in shares as set out in sub-paragraph (a) or land and buildings;

(d) and

“units” means the rights or interests (however described) of the members of a relevant collective investment scheme.

(2) The definitions of “deposit-taker” and “insurer” in paragraph (1) must be read with—

- (a) section 22 of the 2000 Act,
- (b) any relevant order under that section, and
- (c) Schedule 2 to that Act.

Meaning of stakeholder product

3. These Regulations specify kinds of investment for the purposes of sub-paragraph (c) of the definition of “stakeholder product” in article 52B(3) of the principal Order and accordingly an investment of one of these kinds is a stakeholder product for the purposes of article 52B of that Order.

Certain deposit accounts

4. A deposit account (“the account”) is a stakeholder product if the following conditions are fulfilled—

- (a) the minimum amount which account-holder may deposit on a single occasion is £10, except where the deposit-taker permits a smaller payment;
- (b) the deposit-taker permits as a means of payment to the account payment by—
 - (i) cash;
 - (ii) cheque;
 - (iii) direct debit;
 - (iv) standing order;
 - (v) direct credit (other than standing order);
- (c) interest accrues on the account on a daily basis at a rate that is not less than the Bank of England base rate minus 1 per cent per annum (“the interest rate”);
- (d) when the Bank of England base rate increases, the interest rate must be raised within one month of the date of that increase;
- (e) on the instructions of the account holder, any cash and interest held in the account is transferred or paid to the account holder within a period which may not exceed seven days (“withdrawal instructions”); and
- (f) there is no limitation on the frequency in which an account holder may issue withdrawal instructions.

Units in certain collective investment schemes

5.—(1) Units in a relevant collective investment scheme are a stakeholder product where that scheme has the characteristics and complies with the conditions set out in regulation 7.

Rights under certain linked long-term contracts

6.—(1) Rights under a linked long-term contract are a stakeholder product where the insurer ensures that the fund held in respect of that contract (“the underlying fund”) —

- (a) has the characteristics and complies with the conditions set out in regulation 7; and
- (b) where the investment returns are smoothed, complies also with the conditions set out in regulation 8.

(2) For the purposes of this regulation and regulations 8 and 9, investment returns are smoothed when the insurer offers the product on the basis that the amount in respect of the investment returns earned from time to time by the underlying fund to be attributed [by or] under the contract to the policyholder will be managed and attributed with a view to reducing the volatility of such returns over given periods, and “smoothing”, “smoothed” and “unsmoothed” are to be construed accordingly.

Characteristics and conditions applicable to certain stakeholder products

7.—(1) The characteristics in relation to an investment scheme are—

- (a) no more than 60 per cent in value of the investment property, calculated in accordance with paragraph (3), consists of relevant investments;
- (b) the investment property should be selected and managed having regard to the need to achieve a balance between—
 - (i) the opportunity for the investor to benefit from growth in the value of investments generally ; and
 - (ii) control of the risk of loss of value in the investments; and
- (c) the manager has regard to—
 - (i) the need for diversification of the investment property, in so far as appropriate to the circumstances of the investment scheme;
 - (ii) the suitability for the purposes of the scheme of any investment option proposed.

(2) The conditions with which the investment scheme must comply are—

- (a) the minimum amount which an investor may contribute to the investment scheme on a single occasion is £20, except where the manager permits a smaller amount;
- (b) the manager must permit as a means of payment to the investment scheme payment by—
 - (i) cheque;
 - (ii) direct debit;
 - (iii) standing order;
 - (iv) direct credit (other than standing order).
- (c) the value of an investor’s rights in the investment scheme and the value of the investment property may be reduced in the circumstances and to the extent set out in regulation 9; and
- (d) where the stakeholder product is—
 - (i) units in a relevant collective investment scheme, it must be a requirement of that scheme that the purchase and sale price of those units shall, at any given time, not differ from each other and that price must be made available to the public on a daily basis;
 - (ii) rights under a relevant linked long-term contract which are expressed as shares in funds, it must be a requirement of that contract that the purchase and sale price of those shares shall, at any given time, not differ from each other and that price must be made available to the public on a daily basis.

(3) For the purposes of the calculation set out in paragraph (1)(a), the following provisions apply—

- (a) where any of the investment property is invested in units in a relevant collective investment scheme, only such of the assets of that scheme as are invested, directly or indirectly, in relevant investments shall be taken into account; and
 - (b) the calculation shall be taken as an average over a period of 3 months.
- (4) When calculating the average over a period of 3 months for the purposes of paragraph (3)(b) (“the average”), where the manager has specified under paragraph (5) that the calculation is to be carried out weekly or monthly—
- (a) where the average is to be calculated weekly, it is to be carried out on such day of the week (“the specified day”) as has been so specified by the manager (except that, where that day is not a working day, the average is to be calculated on the next working day), and the average on each subsequent day prior to the next specified day is to be taken to be the average on the previous specified day; and
 - (b) where the average is to be calculated monthly, it is to be so calculated on such date in each month (“the specified date”) as has been so specified by the manager (except that, where that date is not a working day, the average is to be calculated on the next working day), and the average on each subsequent day prior to the next specified date is to be taken to be the average on the previous specified date.
- (5) For the purposes of paragraph (4) above—
- (a) the frequency, which must be daily, weekly or monthly, with which the average is to be calculated; and
 - (b) where the average is to be calculated using weekly or monthly figures, the day of the week or, as the case may be, the date in the month on which it is to take place,
- must be specified in writing by the manager; and the specification may not be amended during the period of 12 months after the date on which it is made.

Additional conditions applicable to smoothed linked long-term contracts

8.—(1) The conditions under this paragraph are—

- (a) the manager must, on the request of each investor who is also a policyholder or of anyone else requesting it provide the information necessary to enable a person making such a request properly to understand the essential elements of the insurer’s commitment under the terms of the policy. The information provided must not be narrower in scope or less detailed in content than the equivalent information that is to be provided for with-profits funds in accordance with Rules and Guidance contained in paragraph 6.10 of the Conduct of Business Rules ;
- (b) the manager must make available to each investor and anyone else requesting it information on its policy on and charges for smoothing;
- (c) no payment may be made or property attributed from the underlying fund to any person other than an investor, except for permitted reductions in the investor’s rights and investment property in accordance with regulation 9;
- (d) the manager must manage the underlying fund with the aim of attributing to each investor on the maturity or surrender of his rights under the linked long-term contract a value that falls within a target range which is notified to each investor before he enters into the linked long-term contract;
- (e) except as provided for in sub-paragraph (f), there is no guarantee of the value of a investor’s rights under the linked long-term contract;
- (f) the manager may guarantee that, on the death of an investor, the value of an investor’s rights under the linked long-term contract are no more than 101 per cent of the total of the value of the units allocated to that contract.

Permitted reductions in investor's rights and investment property

9.—(1) The value of an investor's rights in an investment scheme may be reduced in the circumstances, and to the extent, set out in paragraphs (3) to (5).

(2) The value of the investment property may be reduced in the circumstances, and to the extent, set out in paragraph (9).

(3) To the extent that an investor's rights in an investment scheme are represented by a fund allocated to him to the exclusion of other investors, the value of those rights may be reduced by the making of deductions from that fund no greater than, at the choice of the manager—

- (a) the relevant percentage of its value for each day on which it is held; or
- (b) the proportion attributable to the investor's fund of the relevant percentage of the value of the investment property for each day on which the investor's fund is held for the purposes of the scheme.

(4) To the extent that an investor's rights in an investment scheme are represented by a share of funds held for the purposes of the scheme, the amount of that share not being determined by reference to a discretion exercisable by any person, the value of those rights may be reduced by the making of deductions from that share no greater than, at the choice of the manager—

- (a) the relevant percentage of its value for each day on which it is so held; or
- (b) the proportion attributable to the investor's share of the relevant percentage of the value of the investment property for each day on which the investor's share is held for the purposes of the scheme.

(5) To the extent that an investor's rights are represented by rights under a linked long-term contract to which regulations 6(1)(b) and 8 apply, the value of those rights may be reduced by the making of deductions from those rights no greater than, at the choice of the manager—

- (a) the relevant percentage per day of the value of the investor's rights under that contract; or
- (b) the proportion attributable to the investor's rights of the relevant percentage of the value of the underlying fund for each day on which the investor has rights under that contract.

(6) When calculating the value of the rights of an investor for the purposes of paragraphs (3) to (5) above, where the manager has specified under paragraph (7) that such rights are to be valued weekly or monthly—

- (a) where such rights are to be valued weekly, they are to be valued on such day of the week ("the specified day") as has been so specified by the manager (except that, where that day is not a working day, the rights are to be valued on the next working day), and the value of the rights on each subsequent day prior to the next specified day is to be taken to be the value of the rights on the previous specified day; and
- (b) where the rights are to be valued monthly, they are to be so valued on such date in each month ("the specified date") as has been so specified by the manager (except that, where that date is not a working day, the rights are to be valued on the next working day), and the value of the rights on each subsequent day prior to the next specified date is to be taken to be the value of the rights on the previous specified date.

(7) For the purposes of paragraph (6)—

- (a) the frequency, which must be daily, weekly or monthly, with which rights are to be valued; and
- (b) where valuation is to take place weekly or monthly, the day of the week or, as the case may be, the date in the month on which it is to take place,

must be specified in writing by the manager; and the specification may not be amended during the period of 12 months after the date on which it is made.

(8) For the purposes of paragraphs (3) to (5), 'the relevant percentage' means—

- (a) during the period of 10 years beginning with the day on which the first contribution is made by the investor to the investment scheme or linked long-term contract (as the case may be), 3/730 per cent;

(b) otherwise 1/365 per cent.

(9) The value of the investment property may be reduced—

- (a) where any stamp duty, stamp duty reserve tax or other charges (including any dilution levy) are incurred by the manager directly or indirectly in or consequent upon the sale or purchase of investments held for the purposes of the investment scheme, by the amount of those charges;
- (b) where any advance corporation tax is deducted from any income received by the manager in respect of investments held for the purposes of the investment scheme, by the amount so deducted;
- (c) where any charges or expenses are incurred by the manager directly or indirectly in maintaining or repairing any land or buildings in which the investment property is invested;
- (d) where any charges or expenses are incurred by the manager directly or indirectly in complying with an order of the court or any other requirements imposed by law by the amount of those charges or expenses;
- (e) to the extent that the manager incurs any expenses in complying with a requirement—
 - (i) to arrange for the investor to receive a copy of the annual report and accounts issued to investors by any company, unit trust, open-ended investment company or other entity in which the investment scheme is invested directly or indirectly (“the relevant entities”), or
 - (ii) to arrange for the investor to attend, vote or receive any other information issued to investors by the relevant entities,by the amount of such of those expenses; and
- (f) in respect of a linked long-term contract referred to in regulation 6 which is subject to smoothing, by the amount of the charges or expenses incurred by the manager in providing funds to smooth investment returns but only when the provision of such funds is in accordance with the manager’s stated policy on smoothing.

(10) Where the value of the investment property is reduced by reference to an amount of charges or expenses referred to in paragraph (9), then, for the purposes of calculating any reduction in the investor’s rights under paragraphs (3), (4) or (5), the value of those rights is to be calculated after the deduction of any such amount.

Signatory text

Two of the Lords Commissioners of Her Majesty’s Treasury

[date]

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations define the term “stakeholder product” for the purposes of article 52B of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544).

Regulations 1 and 2 contain provisions for citation, commencement and interpretation of these Regulations. Regulation 3 sets out that the Regulations specify the relevant stakeholder products.

Regulation 4 provides that a deposit account will be a stakeholder product provided that it complies with certain requirements as to the minimum deposit, the time allowed for withdrawals, the interest payable, the frequency of withdrawals and the methods of making deposits.

Regulations 5 provides that units in a collective investment scheme (“the scheme”) will be a stakeholder product provided that the scheme complies with certain requirements set out in regulation 7.

Regulation 6 provides that rights in linked long-term contracts will be a stakeholder product provided that the fund held in respect of the contract complies with certain requirements set out in regulation 7 and, where the investment returns are smoothed, regulation 8.

Regulation 7 sets out the requirements applicable to units in collective investment schemes and rights in a linked long-term fund. These relate to the types and proportions of investment held and assumptions by the manager as to the requirements of the investor as to risk and diversification. Provision is also made for methods of payment to the scheme, a charge cap and minimum contributions.

Regulation 8 sets out the additional requirements to be satisfied where the returns under a linked long-term contract are smoothed. These are the application of the Conduct of Business Rules issued by the Financial Services Authority in respect of with-profits funds, the distribution of all returns earned to policyholders, single-pricing where the rights are represented by shares and a requirement for that price is made available to the public, the prohibition of any guarantees save for a guarantee to return no more than 101% of the units allocated to the policyholder’s contract on his death and an aim to manage the fund so that the value of a policyholder’s rights are within specified target ranges on maturity or surrender.

Regulation 9 sets out the detailed requirements for the charge cap applicable to the stakeholder collective investment schemes and linked long-term funds.



REGULATORY IMPACT ASSESSMENT

REGULATORY IMPACT ASSESSMENT FOR THE INTRODUCTION OF STAKEHOLDER PRODUCTS

Purpose and Intended Effect

i) Objective

The policy aims to increase access to savings and investment products for those on lower or medium incomes and to drive competition in the UK financial services market. The policy is a key plank in the Government's wider savings strategy.

ii) Background

In June 2001, the Government commissioned Ron Sandler to identify the competitive forces that drive the retail financial services industry and to suggest policy responses to ensure that consumers are well served.

The Sandler review¹ found three overriding problems in this sector:

- complexity and opacity caused by the huge range of products and product types, charging structures, complicated tax treatments, wide use of technical terms and lack of price and performance transparency;
- problems of access whereby the needs of those on lower or medium incomes are not catered for sufficiently; and
- weak consumers who are unable to drive the market effectively.

The review made a range of recommendations, including the creation of a suite of simple, low-cost, risk-controlled savings and investment products.

The design of the stakeholder products will address many of the issues identified in the Sandler report. In turn the products will help to resolve consumers' concerns that are currently discouraging them from saving, and in particular, that investments are complicated, opaque and high cost.

Furthermore, the Financial Services Authority (FSA) is developing a 'basic advice' process that will enable stakeholder products to be sold within a shorter process. This will enable providers to offer these savings and investment products at a reduced cost than is currently possible. In turn these cost savings will increase firms' ability to serve more customers viably in the low-middle income groups.

The proposals also build on the 1999 Welfare Reform & Pensions Act, which introduced the stakeholder pension. This resulted in providing good value retirement

¹ *Medium and Long-Term Retail Savings in the UK – A Review*, July 2002. A copy is available on-line at http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

savings vehicles for those who currently have limited/ no access to them, or for whom existing products and arrangements offer poor value for money.

In February 2003 the Government issued a consultation document on stakeholder products². In July 2003 the Government's response to the consultation was published.³

The FSA will be consulting on the 'basic advice' process on the 17th June 2004 – the content of this RIA assumes that a 'basic advice' process is implemented by the FSA. The Department for Work and Pensions will be consulting specifically on the stakeholder pension shortly, and will include a separate Regulatory Impact Assessment (RIA). However, to ensure that this RIA is as comprehensive as possible, this assessment includes the most up-to-date information available on the stakeholder pension, although it is provisional and may be amended by the Department for Work and Pensions for the pension product only.

iii) Risk Assessment

In 2002, the Government's green paper on pensions made an estimate of the numbers of people undersaving for retirement. "Our estimates suggest that there are likely to be around 3 million people who are seriously under-providing for their retirement. Depending on their expectations and circumstances, a further group of between 5 and 10 million people may wish to consider saving more or working longer."⁴ Furthermore, longer life expectancy means higher levels of savings are needed to support longer average retirements.

The Sandler review argued that complexity and opacity of the retail savings market contributes to consumers' confusion and reluctance to save, particularly in the low-middle income segments of society. Issues included:

- i) wide and inconsistent use of technical terms by the industry;
- ii) products' price and performance are generally hard to compare; and
- iii) complex charge structures that are opaque to consumers.

The review drew attention to the inefficient and weak competitive pressure in the retail savings market. Improving efficiency in the retail savings market would lead to better outcomes for consumers, and a more efficient allocation of capital.

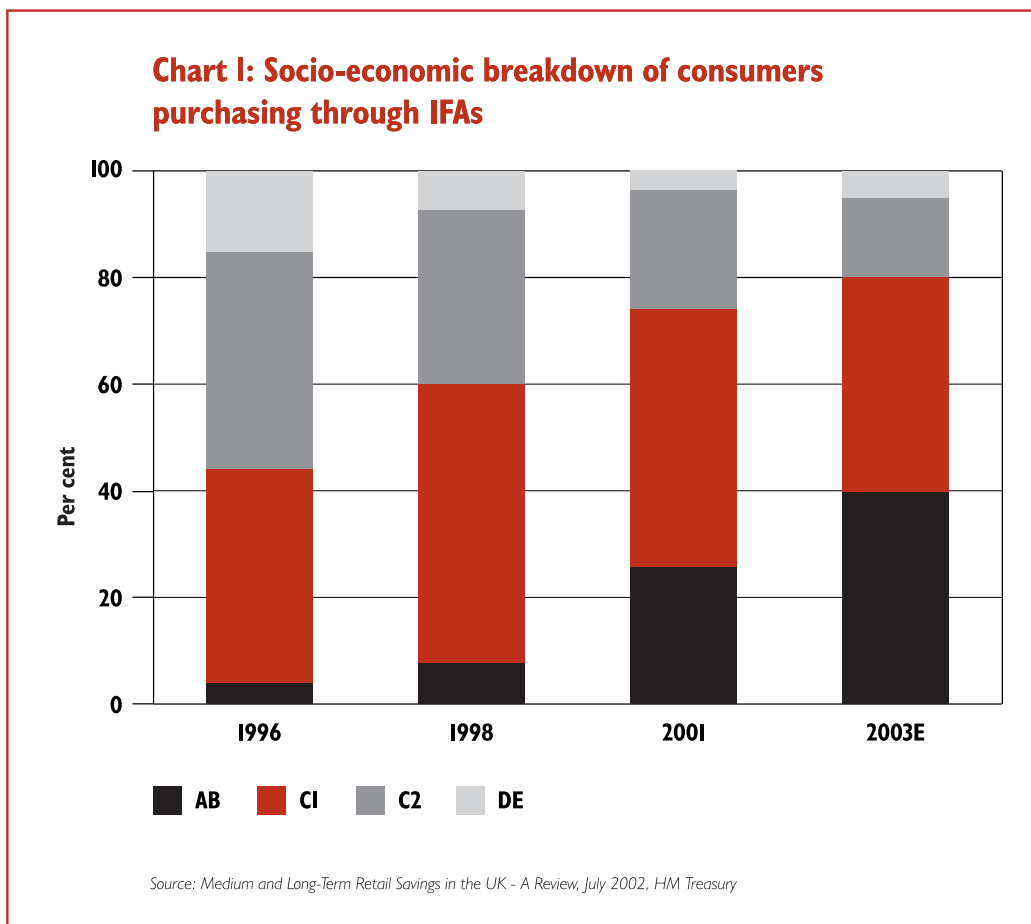
The review also found that, while the significant majority of consumers find savings products confusing, it seems that greater financial sophistication is correlated with greater levels of affluence and higher socioeconomic class.

² *Proposed product specifications for Sandler "stakeholder" products*, February 2003, HM Treasury. A copy is available on-line at [http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation\(240Kb\).pdf](http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation(240Kb).pdf)

³ *Government response to the consultation on Sandler 'stakeholder' product specifications*, July 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/12836/govt_response_sandler_doc.pdf#page=1

⁴ *Simplicity, security and choice: Working and saving for retirement*, December 2002, Department for Work and Pensions.

Those customers on low-middle incomes cannot be advised cost effectively by the retail financial services industry. This has led to a large proportion of the population being excluded from purchasing savings and investment products through an advised sales process. Research conducted by an Independent Financial Adviser (IFA) network found that AB consumers accounted for 23 per cent of the customer base of this network in 2001, with this figure projected to rise to 40 per cent by 2003⁵.



Insufficient savings will have a negative impact on any individual's quality of life throughout their life, and especially in retirement. Widespread under-saving also has serious consequences for the Government and society. Furthermore, the problem of insufficient saving is one that can be rectified more easily early on in a person's life. This policy aims to reduce the risk of insufficient savings.

The stakeholder products are designed to stimulate savings activity, especially by increasing access for lower to middle income groups, where under-saving is more acute, due to limited access to financial services, expensive advice and unsuitable savings products.

⁵ *Medium and Long-Term Retail Savings in the UK – A Review, July 2002, HM Treasury.* A copy is available on-line at http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

This policy seeks to redress some of these market problems by proposing a suite of products designed to:

- minimise the risk of consumer detriment caused by high charges and complex features; and
- limit the investment risk to which consumers will be exposed through product regulation.⁶

Higher levels of savings will mean that more people will be more able to meet their financial needs throughout their entire life.

Options

Option 1 - Not act in response to Sandler's recommendations, and maintain the status quo.

Option 2 - Implement Sandler's recommendation to develop specifications for a suite of simple, low-cost, risk controlled savings and investment products.

The Government outlined in July 2003 that the 'stakeholder suite' would include:⁷

- a. A deposit account;
- b. A medium term investment product, with a smoothed investment option.
- c. A modified stakeholder pension;

The Child Trust Fund would also be available within the suite.

The deposit account will be similar to that of a CAT-Standard cash-ISA.⁸ There will be a set of minimum standards for this account. The key feature is that the interest rate offered by firms cannot be lower than 1% below the Bank of England Base Rate. This will help to ensure that the consumer's return is higher than the rate of inflation.⁹

The unitised medium term product has been designed to limit the amount of risk to the investment through product regulations. The maximum amount that can be invested in equities and property is 60%, and there is a further requirement to diversify assets to spread the risk, and to help prevent the scenario whereby one equity failure will put the entire investment at risk. The remaining 40% will be invested in less volatile assets such as bonds and cash.

⁷ *Government response to the consultation on Sandler 'stakeholder' product specifications*, July 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/12836/govt_response_sandler_doc.pdf#page=1

⁸ CAT standards for ISA savings and investment products will be discontinued on the introduction of the *stakeholder* suite of products in April 2005.

⁹ Inflation is a measure of the change in the general level of prices charged for goods and services bought for the purpose of consumption.

The stakeholder pension will require a lifestyled default fund, so investments can move into less volatile assets as retirement approaches. This means, for example, that 5 years before retirement money will gradually be transferred from equities to less volatile assets such as bonds and cash, again to reduce the risk associated with the investment. The pension specifications will be outlined fully in the Department for Work & Pensions (DWP) consultation, which will be published shortly.

Consequences of each option

Option 1 –

Maintaining the status quo has no economic costs and benefits associated with it, since it also provides the baseline against which we are measuring the policy change. However, it remains important to understand the consequences this might have.

The Government is concerned many UK individuals are potentially under saving for retirement; savings levels are especially insufficient amongst those on moderate incomes. Current estimates of the possible size is as follows:

Table 1: Government target group

Individuals who are seriously under saving	3 million
Individuals who may wish to save more for retirement	5-10 million
Possible size of target group	8-13 million

Note: based on DWP's estimate from "Simplicity, security and choice: working and saving for retirement", DWP, Dec 2002.

For those individuals that are served, competitive forces in the industry do not always work effectively to deliver value-for-money investment products. This is especially so in the Government's target market. Consequently, if no action is taken the current low level of savings will persist, which is undesirable for consumers, the financial services industry and Government.

Furthermore, consumers on lower or medium incomes will continue to be unable to access financial services through regulated advice, and the market will remain opaque and driven by industry.

Option 2 –

Some firms may decide not to enter the market as they may regard the cost economics as unviable for their business model, which may have an impact on the overall level of competition

Furthermore, for the intended outcome to occur it will be necessary for the following market behaviours to be realised:

- Distribution channels to emerge that embrace 'basic advice';
- Distribution channels to emerge that engage with low and moderate income consumers and others who do not currently save;
- Consumers to trust the stakeholder brand, new channels and the providers;
- Marketing effort on the part of Government, providers and distributors.

Many of these issues will be market dependent, and are impossible to predetermine. However, the Government is currently evaluating the most appropriate way to ensure that this outcome is realised. The Government is still evaluating the level of marketing that is appropriate for the product suite.

Costs and Benefits

Although firms will not be required to offer stakeholder products, it is likely that institutions that service the mass retail market will have the most positive attitude towards stakeholder products. It is also probable that larger firms who can benefit from economies of scale will offer stakeholder products.

Almost all of the adult population, many of whom need or want to save, or indeed already do save, will be eligible to purchase a stakeholder product. However, it is unlikely that all individuals will do so, as other considerations, such as their level of indebtedness and protection needs will constrain the size of the market. Furthermore, the market size will be sensitive to various factors; for example, the marketing/sales method adopted by the industry will have a significant impact on the number of policies sold.

The chart in Appendix A shows the market size that could emerge under different scenarios. Deloitte¹⁰ assumes that the FSA's basic advice process filters out those who:

- do not have three months income in cash;
- are struggling with debt commitments;
- are aged over 70,
- those with income of less than £10,000 per annum and aged over 45, and
- those under 45 with income of less than £5,000 per annum.

This leaves a potential pool of 12.1 million consumers who might benefit from investing in stakeholder products.

Deloitte estimates that the market for stakeholder regular contribution products (the medium term and pension product) has a potential market size of £802 million in new business per annum. This would equate to approximately 13% growth on current new business levels.¹¹ Appendix B explains how this market estimation has been derived.

¹⁰ HM Treasury commissioned Deloitte to conduct research into the impact of different charge cap on consumers and the retail savings industry in March 2003. The research, *Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products* – July 2003, is available on-line at www.hm-treasury.gov.uk/stakeholder

¹¹ *Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products* - July 2003, Deloitte. A copy is available on-line at www.hm-treasury.gov.uk/stakeholder

Option 2 – Introduction of stakeholder products and deregulation¹²

In 2003, Deloitte was commissioned to conduct independent research into the market impact of different charge caps in the stakeholder suite. Below is a cost benefit analysis which incorporates Deloitte's work¹³. Sources of other information have been referenced accordingly.

Costs on firms of Option 2

There will be no requirement for firms to provide stakeholder products. Therefore, the firms that choose to enter the market for stakeholder products will be those who anticipate that it is profitable for them. Indeed, this is very much separate to a firm's rationale for entering the fully advised retail financial services market.

The charge cap for the medium term product has been capped at 1.5% AMC for the first 10 years of the product, then reducing to 1% AMC¹⁴. "The Sandler review argued that while in a fully competitive market charge caps would be neither necessary nor desirable, price control is an essential component of a regulated product in a market that is distinguished by lack of price competition and consumer weakness."¹⁵ The charge cap for the medium term product has been set at a level that the Government believes will allow consumers to have the opportunity to purchase a transparent, low-cost investment, whilst allowing efficient firms to sell these products viably.¹⁶

a) Set up costs

These represent the one-off costs of setting up the business to be able to write medium and long- term stakeholder products. They are incurred once in year 1 irrespective of the volume or variety of different products that are sold or the number of sales channels that are used.

Deloitte, following consultation with the industry, suggests an average cost of £10 million per provider¹⁷ that includes recruitment and re-training of sales staff and initial marketing, although this would be lower for some specialist

¹² Deregulation - The time it takes to sell stakeholder products through the FSA's basic advice process is expected to be significantly shorter than the current process. In effect, providers would be subject to a streamlined sales process, which will be more cost efficient.

¹³ There are many underlying assumptions to Deloitte's work, please refer to Deloitte's report – *Assessing The Likely Impacts Of Charge Caps On Retail Investment Products* - published today for full details of how the cost and benefits are derived. It copy is available on-line at www.hm-treasury.gov.uk/stakeholder

¹⁴ Although the product is designed for a consumer investing for 5-10 years, there is no set time horizon.

¹⁵ *Proposed product specifications for Sandler "stakeholder" products*, February 2003, HM Treasury. A copy is available on-line at [http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation\(240Kb\).pdf](http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation(240Kb).pdf)

¹⁶ This is based on the assumption that 'basic advice' is available.

¹⁷ This is an average indicative figure, and will differ from firm to firm, and will be dependent on their current product offering. However, £10m is regarded as a realistic average, and includes the cost of systems expenditure, product development expenditure, initial marketing spend and the recruitment and/or retraining of sales staff. The £10m figure is included as part of Deloitte's profitability analysis. The profitability analysis includes a wider range of costs, including on-going costs. A copy of Deloitte's research is available on-line at www.hm-treasury.gov.uk/stakeholder

niche providers. It is difficult to estimate how many providers will enter the market. Based on consultation with the industry and the possible sizes of the stakeholder market under different charge caps, Deloitte estimates that three providers would be a low estimate, ten a high one and six a medium figure. This would result in total set-up costs of £30 million, £100 million and £60 million respectively. All set-up costs are expected to be recouped from future profits.

Niche providers may be able to provide stakeholder products to their specified market with considerably less initial costs, but will incur significant cost to reach outside their special affinity. It is unlikely these firms will seek to provide stakeholder products to the wider market.

b) Ongoing cost

There will be initial and annual administration cost to each new contract sold. Again, firms are expected to recoup all of this cost from future profits.

- c) The stakeholder deposit account replaces the current CAT-mark cash ISA. It has been decided that the interest rate offered to consumers cannot be below Bank of England base rate, minus 1%. (previously 2% under CAT). The reduced charge cap will favour consumers by reducing the potential loss they could incur. The majority of CAT-mark cash ISAs currently offered on the market all operate within 1% so we do not expect any reduction in profitability associated with this product.

Benefits to firms of Option 2.

a) Increase sales

We anticipate industry will benefit from increased sales of investment products: Deloitte estimated 458,000 new medium term and pension contracts per annum (245,000 medium term and 213, 000 contracts). This equates to £802 million of new regular contributions per annum. Appendix B explains how these figures have been derived. Providers that choose to enter the market would be those that anticipate it will be economically viable for them to do so. Profits are obviously an important benefit to firms.

b) Sales achieved through the 'basic advice' process (deregulation)

The reduction in the cost of advice benefits the industry by reducing salary, training, compliance, monitoring and supervision costs and reduced sales time per client.

Length of sales process

Sales through basic advice will be quicker, and, being less complex, require less supervision than sales through full advice. Estimates of sales time for full advice and basic advice are given in the table below.

Table 2: Estimated sales time (hours)

Task	Current DSF	Current Bancassurer	Simplified Sales
Total adviser time	6.2 hours	4.7 hours	1.2 hours

Source: FSA

Salary levels and training costs

Staff conducting only basic advice will not be required to have a specific qualification (but will need to be competent for the role that they perform). They are likely to be paid a lower salary than would be paid to a qualified adviser; and to receive less training. Estimated salary levels and training costs are given in the table below.

Table 3: Salaries and training costs

	Qualified Adviser	Basic advice Staff
Salary	£32,000	£20,000
Supervisor	£35,000	£35,000
Overhead rate	75% salary	75% salary
Training cost per sale	£50 per sale	£25 per sale

Source: FSA

Cost savings will depend on the extent to which firms use different staff for basic advice than they otherwise would use for full advice. Industry responses suggest that most firms will use existing (non-advisor) staff or recruit new staff for basic advice. As a conservative estimate, it is assumed that 25% basic advice sales are made using qualified advisors and 75% using basic advice staff.

Total benefit

The table below shows the estimated costs of full and basic advice.

Table 4: Estimated sales costs

	Estimated average costs of full advice via direct sales force (£)
DSF ¹⁸	485
Bancassurer ¹⁹	317
	Estimated average costs of basic advice (£)
Using qualified adviser	203
Using staff who are not qualified adviser	126

Source: FSA

Assuming a 50:50 split between DSFs and bancassurers and a 25:75 split between qualified advisers and basic advice staff, the average cost saving is (approximately) **£400 – £145 = £255**

Source: FSA

Deloitte estimates that 458,000 new regular contribution medium-term and pension contracts could be sold per annum. The cost saving, however, can only be apportioned to those customers who would have entered the savings market anyway with full advice, irrespective of stakeholder products, but would have purchased an alternative savings product. In consultation with the FSA, we estimate that 70% of the 458, 000 would fall into this category. Consequently, the average cost saving (of stakeholder products sales via simplified sales process compared to sales via the current sales process) to the industry for medium term and pension products is therefore:

$$320,600 * £255 = \mathbf{£81,753,000}$$

Cost to consumers of Option 2.

- a) Some consumers may otherwise have bought a non-stakeholder product that could have resulted in a better outcome for them. For example, a consumer may purchase a product under streamlined advice that they would not have purchased if they had been through full advice.
- b) There are also other factors. For example, a consumer may decide to purchase a medium term investment product when they could potentially have been better reducing their debt commitments. However, this would be dependent upon each individual's specific circumstances.

¹⁸ DSF – Direct Sales Force

¹⁹ Bancassurer is a company or group offering a range of financial services to its customers. Usually applied to banks having subsidiary insurance companies.

Benefits to consumers of Option 2

- a) The primary beneficiaries of the new products will be consumers who are currently excluded from the market but who have the potential to be saving, or indeed could enhance their current savings provision. It is estimated the stakeholder market will produce 245,000 new medium term regular contributions and 213,000 new pension contracts per annum, although not all of these will necessarily have been excluded from the market within the status quo. (Appendix B explains how these figures have been derived). This is a total market size of 458,000 new contracts, which is £802 million new regular contributions per annum in monetary terms.

This represents a positive increase in savings activity from current levels, and will benefit consumers.

As well as explaining the base case scenario of 458,000 contracts, Appendix B provides sensitivity analysis to show the range of business growth. Overall, the market growth of stakeholder products has also been assessed under different sensitivities, as the table below summarises.

Table 5: Market growth range

Scenario	Market growth		
	Number of contracts sold	£m New contributions pa (regular contribution business)	Growth in % on current new regular contribution business levels
Base case	458, 000	802	13
50% of base case (number of contracts and average case size)	229, 000	201	3
150% of base case (number of contracts and average case size)	687, 000	1805	30

Source: Deloitte

The consumers of stakeholder products stand to benefit financially from the potential higher rate of return, although *some* consumers may potentially expose their capital to a higher level of risk. For example, a consumer may decide to purchase a stakeholder medium term product rather than depositing their money in a standard deposit savings account.

For the medium term product, assuming an overall return of 8.1% on equities and 4.5% on bonds, a stakeholder medium-term product, with a maximum 60% equity exposure and 40% invested in bonds, the annual expected nominal return on the investment can be estimated as 6.7%²⁰.

Independent of charges and inflation, there is therefore a nominal per customer benefit of 6.7% as outlined in the table below²¹:

Table 6: Nominal Average returns for the stakeholder medium term product.

Product	Average returns in %
Equities	8.1
Bonds	4.5
Stakeholder Term Medium Product (60% Equities & 40% Bonds)	6.7

Source: Deloitte

It is assumed within this figure that a consumer is not saving in an alternative medium term savings or investment vehicle. For those that do then this net benefit could be lower. However, it is complex to quantify, and would be dependent, for example, on the investment performance and charges of their existing product, and the value that they associate to other forms of advice processes they may have previously used.

- b) Consumers of stakeholder medium term products, including those who choose to substitute into the market, could benefit from lower charges. A charge cap will ensure that the reduction in yield²² (RIY) to the consumer from charges imposed by the provider is at a reasonable level, yet being consistent with allowing efficient firms to make a reasonable return on their capital.

The average current charges for medium-term financial products are in the region of a 5% up-front charge and a 1% annual management charge (AMC). Deloitte have produced a model to analyse the impact of charge caps on the market and the associated reduction in yield for consumers. The model is used to produce the table below, which shows the benefits to consumers of having lower charges on a medium term financial product. The charge cap for the pension product will be analysed in a separate RIA by the Department for Work and Pensions.

²⁰ The 8.1% and 4.5% are derived from Deloitte's proprietary economic model, The Smith Model, calibrated to market information at the time of modeling. *Assessing The Likely Impacts Of Charge Caps On Retail Investment Products* – July 2003, Deloitte. A copy is available on-line at www.hm-treasury.gov.uk/stakeholder

²¹ This assumes that a customer is not saving in an alternative savings or investment vehicle.

²² Reduction in yield occurs as a result of charges levied by the financial services provider.

Table 7: Regular contributions stakeholder medium term product

	RIY in %		
Term	5% Contribution Charge, 1% Annual Management Charge	Stakeholder - 1.5% Annual Management Charge for 10 years, followed by 1% Annual Management Charge	Difference in RIY % (= consumers' savings)
1	10.59	1.58	9.01
3	4.45	1.58	2.87
5	3.09	1.58	1.51
7	2.50	1.58	0.92
10	2.05	1.58	0.47
20 ²³	1.52	1.21	0.31

Source: Deloitte

They will also benefit from the ease of access to their investments due to the presence of charge controls at the point of entry and exit. This will reduce the consumer detriment caused, for example, by lock-in periods or having to pay charges to gain access to the savings when required, that exist with some other investment products.

- c) There will also be time saving benefits to consumers from the reduction in the length of the sales process. The FSA have designed and 'consumer tested' the stakeholder basic advice process. The results indicate that the basic advice process compared to current sales process takes on average 2 hours less to complete. The time saving to consumers in monetary terms is £10.50; this is quantified by taking 50% of an assumed average net wage of 10.50 an hour²⁴.
- d) The financial services market: The introduction of the stakeholder products could have a "halo effect" on the existing products. That is, the benefit of lower charges and increased efficiency could spread across the market. This is beneficial to all consumers of financial services products.

Summary of Benefits to the Consumer of the Medium Term Product

Expected Number of products Purchased Per Annum	245 000
Average Consumer Contribution	£120
Nominal Average Expected Return Per Annum (net of maximum management charge) until year 10²⁵	5.12%

²³ Although the product is designed for a consumer investing for 5-10 years, there is no set time horizon.

²⁴ This is based on the mean gross earnings from the 2002 New Earnings Survey, adjusted for real earnings growth to 2004 and tax/ national insurance. The consumer saving also assumes that an individual values basic and full advice equally - if they do not then the benefit to the consumer will alter.

²⁵ The nominal average expected return will be higher after year 10 as the charge cap reduces from 1.5% AMC to 1% AMC.

The Government

The gains to the Government will come from enhancing the ability and flexibility for all to save for their future needs, and certainly for those on low-middle incomes. Increasing efficiencies in the retail financial service market will occur by tackling information asymmetries and enhancing competition. There will also be a long run fiscal policy gain through a higher level of savings amongst the UK population.

Small Firms' Impact Test

The Small Business Service (SBS) and HM Treasury are currently working together and will monitor the situation as it develops. Based on the information presented in this RIA and the consultation that has already taken place, the SBS is content that there appears to be no significant or complex impact on small firms in general.

Competition assessment

The Office of Fair Trading requires a competition assessment to be carried out on all policies that impact on competition in a given market in order to determine that the policy does not work to the detriment of competitive markets. The proposals will impact upon the retail financial services industry. The proposals may generate changes in the industry but firms are not required to offer stakeholder products and the proposals are explicitly aimed at increasing rather than reducing competition. As a result we do not anticipate that these changes will have a significant negative impact on competition.

The retail financial services industry includes a wide range of companies (e.g. banks, building societies and life insurance companies). Not all companies will decide to offer stakeholder products but of those who do, we anticipate that while a number of companies may offer the full range of stakeholder products others may only offer some of the products. Some companies (e.g. life insurance companies) *may* also sell products through intermediaries (e.g. banks, supermarkets). Consequently some banks may therefore distribute, but not manufacture, certain stakeholder products.

With regard to the supply of stakeholder products, it may be possible for some of the larger firms in this industry to establish a significant market share of sales (e.g. 20% or more) of one particular product. In particular, the larger companies may be able to benefit from economies of scale. If we consider the whole stakeholder product range, however, we expect that the market shares of stakeholder product sales for any one company would be less. With regards to demand for stakeholder products, consumers will have different needs so that while some may make comparisons with a limited range of alternative savings products, others (e.g. those with higher incomes) may compare them with a broad range of financial products currently on offer. It is also important to remember that the sale of stakeholder products is voluntary, and takes place under a different selling environment from the status quo.

Thus, while some companies may face high set-up costs, these will be incurred after an assessment that a suitable return can be made over the costs involved. In this regard, the introduction of stakeholder products alone should not force any companies out of the retail financial services industry nor should stakeholder products (which will be just one part of the wide range of financial products already on offer) be enough on their own to prevent entry to the retail financial services industry.

It is intended that stakeholder products will be regulated by a charge cap. In the context of these proposals, the charge cap will be a key consideration in whether a firm decides to enter the market, and will help to determine the number of firms who do so. If the charge cap is set too low this may result in firms deciding not to offer stakeholder products, which may subdue competition between providers for customers. If fewer companies enter the market, those that do will be able to establish larger shares of stakeholder sales; costs may therefore fall as these firms benefit from economies of scale. The consultation will allow representations on the stakeholder policy. The Government envisages a review of the short term and medium term products, including the charge cap, three years after the policy comes into force in April 2005, to see if the policy intent has been met.

We would welcome views from interested parties on this assessment.

Enforcement and sanction

The existing level of enforcement and sanction that already exists for deposit accounts, stakeholder pensions and medium term investment products will apply to the new suite of stakeholder products as well. There will be a variety of different bodies undertaking the enforcement of different parts of the policy. In practice this means that the enforcement bodies for specific elements of the products will be the Financial Services Authority, the Occupational Pensions Regulatory Authority, the Financial Ombudsman Service, the Pensions Ombudsman, the Inland Revenue or the Banking Code Standards Board, as well as self-regulation and whistle-blowing undertaken by the retail financial services industry.

Consultation

The Government consulted on stakeholder products in the February 2003 consultation document entitled *Proposed product specifications for Sandler "stakeholder" products*, and the Government responded in July 2003 in the *Government response to the consultation on Sandler "stakeholder" product specifications*.

The consultation proposals took forward one of the main recommendations of the Sandler Review of Medium and Long Term Savings in the UK, which called for the creation of a new suite of simple, investment-restricted, low cost, investment products to be sold via a simplified sales process.

The Government consulted widely on its proposals. In addition to the formal consultation, meetings were held with over 40 fund management and life insurance firms, banks and building societies, consumer groups and others to discuss the issues raised. The Financial Secretary also held a seminar for key stakeholders and officials spoke at a number of conferences.

The majority of respondents to the consultation came from providers and distributors. In determining the appropriate way forward, the Government has sought to balance these views with those of the other major stakeholders, including consumer representatives.

The consultation process has been extremely helpful in developing the policy in terms of the product specifications to ensure that the proposals meet the needs of the consumer, yet are able to be implemented as simply as possible by industry.

Monitoring and review

The Financial Secretary will review the policy for the short and medium term products to ensure that the policy intent has been achieved. In particular, the level of the charge cap will be reviewed to ensure that the market is working as intended.

Summary

The Government is concerned a significant proportion of the UK population could be under-saving due to, for example, a lack of access to financial products; the cost of which can be high for individuals. Indeed, the current UK financial services market cannot service the low-middle income segments of society cost effectively. The services and products it currently offers the public are inadequate to meet some consumers' needs. Tackling these problems will bring substantial benefit to consumers, the Government and industry. Implementing Ron Sandler's recommendations is a key step.

The benefits from the introduction of stakeholder products are substantial but not all are easily quantifiable. A summary table of costs and benefits of the two options is shown below. There are also many positive externalities to wider participation in savings schemes and in higher levels of savings.

The Government recommends the introduction of stakeholder products.

Option 1 – Not to act in response to Sandler's recommendations
<p>The current status quo would remain. In summary this would mean:</p> <ul style="list-style-type: none">• Inefficiency and weak competitive pressures in the retail savings market would continue.• Complexity and opacity would continue to contribute to consumer reluctance to save, and would continue to exacerbate the problem of under-saving.• Continued limited access for those on low-middle income, potentially exacerbating problems of under saving in these segments.• Potential for under saving is likely to persist.

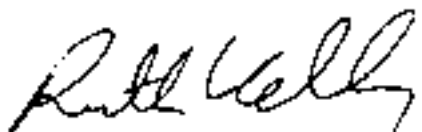
Option 2 – Introduction of stakeholder products and deregulation	
Cost	<p>Firms</p> <ul style="list-style-type: none"> ○ Set up costs – estimated at £60m, but recouped in future profits. ○ Ongoing costs – recouped in future profits <p>Consumers</p> <ul style="list-style-type: none"> ○ Some customers may have bought an alternative product to stakeholder that may have had a different offering that could have created a preferred outcome for them.
Benefits	<p>Firms</p> <ul style="list-style-type: none"> ○ Stakeholder market – potential increased sales, estimated 458,000 new contracts per annum. ○ Basic advice process – reduced cost of sales process, estimated cost savings of £81,753,000 when compared to full advice. ○ Increased profit created by an increased number of customers under the new product regime. <p>Consumers</p> <ul style="list-style-type: none"> ○ Choice of simple, low-cost, risk controlled savings and investment products. ○ Investment returns earned by consumers. ○ Charge cap – potentially increased investment returns to consumers for the medium term and deposit account products owing to the RiY being capped. ○ Basic advice process – time saving to the consumer of 2 hours (£10.50) per sale process. ○ Possible halo effect – benefit of lower charges and increased efficiency spread across market.

	<p>Government</p> <ul style="list-style-type: none">○ Reduce risk of insufficient savings.○ Positive externality of individuals having the necessary savings to meet their short, medium and long term financial needs.
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We would welcome views from interested parties on this assessment.

Ministerial declaration -

I have read this regulatory impact assessment and am satisfied that the benefits justify the costs.

A handwritten signature in black ink, appearing to read 'Ruth Kelly'.

RUTH KELLY MP

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Appendix A

Number of Individuals (million)	Low Income	Moderate Income	High Income	Low/High Income	Total GB Adult Population	% Population
Single Filters						
Total Population with no filters	15.44	13.53	8.42	7.03	44.43	100%
Total Population with at least 3 months savings	6.35	5.22	3.66	4.59	19.82	45%
Total Population with at least 6 months savings	5.00	3.84	2.35	2.77	13.95	31%
Total Population with at least 12 months savings	3.46	2.35	1.03	1.84	8.68	20%
Total Population with cost of debt including mortgage <40% income	13.19	11.79	7.92	6.46	39.36	89%
Total Population with cost of debt including mortgage <20% income	11.29	10.07	5.85	4.71	31.93	72%
Total Population with no debt	7.37	6.91	.81	1.18	16.28	37%
Total Population prepared to take risks with savings	5.20	4.47	5.53	3.77	18.97	43%
Combined Filters						
1. Total Population with at least 3 months savings excluding those with > 40% debt and not in difficulty with repayments	6.27	5.21	3.66	3.76	18.91	43%
2. As 1. but excluding those aged over 70, those with income of less than £10000 pa and aged over 45 and those under 45 with income of less than £5000pa	1.78	3.31	3.48	3.55	12.13	27%
3. As 2. but excluding those unwilling to take risks	.83	1.64	2.57	2.12	7.16	16%
Source: Assessing The Likely Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003						

Appendix B

The stakeholder market

The size of the **stakeholder** market is difficult to estimate precisely and depends on a large number of variables. One of the critical factors would be the design of the filter in the FSA sales process. FSA's work on a basic advice process is published today.

Deloitte assumes that the sales process filters out those who do not have three months cash, are struggling with debt commitments, are aged over 70, those with income of less than £10,000 per annum and aged over 45, and those under 45 with income of less than £5,000 per annum. This leaves a potential pool of 12.1 million consumers who may have the potential to buy stakeholder products, although it is recognized that other filters may also be applied (for example, inadequate life cover or a consumers resistance to risk)

Of the pool of 12.1 million -

- Group A - 4.2 million are saving less than 5% of their income;
- Group B - 7.9 million are already saving in excess of 5% of their income.

Medium-term products (i.e. regular contributions savings)

By looking at:

- past sales figures for savings endowments;
- the savings activity and potential of the pool of 12.1 million.

An assumption of 3% of those who currently save very little or nothing and 1.5% of the larger group who already save would appear to be a prudent starting point for sizing the supplementary stakeholder market.

If these numbers can be persuaded to buy a stakeholder savings plan each year, this will yield a total new market of approximately **245,000 new contracts**. This is without any business being generated from the remainder of the population.

If spread evenly across the four segments of the Market considered by Deloitte (in practice, increasing the savings activity of the lower income segments more than the higher income segments who already save), the 245,000 contracts would be distributed as follows:

Table 1 – Mix of possible savings plan buyers

Low income	Moderate income	High Income	Low/High Income
42,000	70,000	64,000	69,000
17%	29%	26%	28%

Note: Low/high income group - Individuals with total gross income from earnings, investment income, benefits and pensions less than £22,000 and with household income of £25,000 or more. Also included in this group are a small number of individuals who have recorded high personal incomes but low household incomes in the research.

It is important to stress that this number is drawn from an analysis of what might be reasonably achievable rather than an assessment of what any given charging level might achieve. Inherent in the analysis is an assumption that the charging level for stakeholder products is sufficiently attractive to the industry to begin targeting those with low to moderate incomes and those who do not currently save.

Analysis of current average contributions to savings endowments, current average contributions to equity ISAs, and average total savings for the 12.1 million across four income groups - Low income, Moderate income, High Income and Low/High Income – suggests that the likely average contributions is £120pm.

If on average, the 245,000 new savers can be persuaded to save on average £120pm (on average 7% of their incomes and the weighted average of the monthly contributions shown immediately above), this would generate a market value (measured in new contributions pa) of **£355million**.

Pension products

In addition to the savings activity outlined above, analysis of data relating to pensions – sale of pension contracts activity per year, and proportion of the four income groups in pension schemes – and employment rate amongst the 12.1 million suggests that with the support of new distribution and active marketing, it may be possible to attract 3% of those with no pension and 1.5% of those with existing pensions to buy a new stakeholder pension each year (the retired were excluded from this calculation). This will yield a total market of approximately **213,000 new contracts**.

If the same penetration rates are applied to all four segments (in practice, increasing the savings activity of the lower income segments more than the higher income segments who already save), the 213,000 contracts would be distributed as follows:

Table 2 – Mix of possible pension buyers

Low income	Moderate income	High Income	Low/High Income
46,000	48,000	58,000	61,000
22%	23%	27%	29%
<i>Note: Low/high income group - Individuals with total gross income from earnings, investment income, benefits and pensions less than £22,000 and with household income of £25,000 or more. Also included in this group are a small number of individuals who have recorded high personal incomes but low household incomes in the research.</i>			

Combining the current averages for the four income groups, allowing for those employers who do contribute to match the individual contribution (and then rounding), leads to average contribution of £175pm. If new savers can be persuaded on average to save £175 per month, this will generate a market value (measured in new contributions pa) of **£447million**.

Total market size

	Average contribution pm	Number of new contracts pa	Total business value pa
Medium term	£120	245,000	£355m
Pension	£175	213,000	£447m
Total market size		458,000	£802m

This compares to current market sizes of in excess of £4.3bn of new regular contribution life and pension business²⁶ and an estimated £2bn of regular savings ISAs²⁷ in 2002.

£802million of new regular contributions implies market growth of approximately 13% on current new business levels.

For these base case results to emerge, it will be necessary for the following market behaviors to be realised:

- Distribution channels to emerge that embrace DP19²⁸ regulation;
- Distribution channels to emerge that engage with low and moderate income consumers and others who do not currently save;
- Consumers to trust the stakeholder brand, new channels and the providers;
- Marketing effort on the part of Government, providers and distributors.

In turn for much of this to emerge, the profitability of the products must be such to attract capital to the market and the potential size of the market must be sufficient to warrant investment and be seen to be capable of supporting competition.

Summary source: Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003

²⁶ ABI Statistics

²⁷ IMA Statistics

²⁸ Discussion Paper 19, FSA,

Appendix C

Market size sensitivities

The following table shows how different market sizes and values could emerge under different results to those described above.

Table 1 – Market size sensitivities

	Number of contracts 000 pa	£m New Contributions pa (regular contributions business)	Average Contributions £pm
Base Case	458	802	146
50% of (base case) number saving	229	401	146
150% of (base case) number saving	687	1203	146
50% of average contributions	458	401	73
150% of average contributions	458	1203	219
Worst of both (50% of base case number saving and 50% of average contributions)	229	201	73
Best of both (150% of base case number saving and 150% of average contributions)	687	1805	219

The worst case described above implies only 3% market growth with few new customers and low average contributions. Any or all of the following could result in this scenario occurring:

- The existing industry lacks confidence in the FSA's DP19 rules and new players are nervous of entering the market;
- Media discourage consumers from buying and industry analysts discourage capital investment;
- The stakeholder brand lacks punch with consumers;
- The economy becomes more uncertain;
- Employers lack confidence in allowing worksite marketing;
- The price cap is set at a level that discourages investment in distribution to the mass market;
- Few new sales channels developed or those that do are not trusted by the consumer;
 - Banks do not embrace change
 - No new sales forces emerge
 - Worksite marketing fails under DP19
 - Retailers lack punch
 - Direct offers not persuasive.

By contrast the best case results in almost 30% market growth. For this to be realised, all or most of the following will be necessary:

- DP19 option 2 is endorsed and clarity emerges from the Financial Ombudsman Service regarding the potential for future misselling;
- The media is convinced of and promotes the consumer benefit;
- Industry analysts are convinced of the potential profitability of the contracts and encourage capital investment;
- Consumers are attracted by the simplicity and transparency of the contracts and are encouraged to increase their level of saving;
- Economic stability and an improvement in stock market returns;
- Pensions simplified;
- Focus on regular savings;
- Channels emerge quickly and target a wide range of consumers;
 - New 'home service' style
 - Employers support worksite
 - Banks embrace
 - Retailers support
 - Direct offers attract the top end of the market.

Summary source: Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003

D

SUMMARY OF QUESTIONS

DRAFT ORDER

D.1 Respondents are asked to comment on whether Article 3 adequately captures the core features of the FSA's basic advice process, and whether it could create problems or difficulties.

D.2 Respondents are asked to comment on the proposed streamlined approach to authorising firms to offer 'basic advice'.

DRAFT REGULATIONS

D.3 Comments are invited on the change to the interest rate margin on the cash deposit product.

D.4 Feedback is invited on any operational difficulties envisaged in implementing the regulations for minimum contributions.

D.5 Respondent are asked to consider whether the timeframe over which firms will be expected to adjust to rising markets to ensure their funds do not over-expose investors to equity and property risk is workable and reasonable.

D.6 Respondents are invited to consider whether the proposed regulations provide sufficient clarity to achieve the policy intent.

D.7 Respondents are asked whether these information requirements for the smoothed investment fund are sufficient to enable consumers to understand the product they are buying.

D.8 The precise requirement of smoothing and of target ranges for payouts have not been specified in the regulations to allow providers to adopt their own policy and to explain it to consumers. We have decided not to impose a single smoothing model. Do respondents support this approach or should the parameters of smoothing be more tightly defined?

D.9 Respondents are asked whether they are content with limiting guarantees in this way.

D.10 Respondents are asked whether the structure of the smoothed investment fund provides sufficient reassurance for consumers, while still being practical for providers to deliver.

D.11 Respondents are invited to comment on the status of costs outside the charge cap.

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