

## The Review's interest in the regulatory system

- 5.1 Assessing the effectiveness of the regulatory regime is not within the remit of this Review. The Review is concerned with regulation to the extent that it impacts upon the competitive dynamics of the industry.
- 5.2 The retail savings industry has argued strongly, both to the Review and more widely, that regulation is an important context for a substantial number of the problems of the industry identified earlier. The arguments made are that:
- regulatory activity has led to higher compliance costs, which may explain the industry's failure to improve efficiency in recent years;
  - complex regulatory requirements contribute to the complexity of the market; and
  - rising compliance costs make it more expensive to serve customers and have led the industry to reduce its targeting of low/middle income customers, who therefore save less.
- 5.3 For the Review, the two types of regulation of particular relevance are:
- regulation of the sales process, carried out by the Financial Services Authority (FSA); and
  - product regulation (or quasi-regulation) by the Government through the creation of CAT standards and stakeholder pensions.

## Impact of the regulatory system on costs

- 5.4 Whilst the regulatory regime has not eliminated the undesirable incentives created by commission, it has certainly made it much more difficult for dishonest or negligent practices to persist in the industry. It has effectively forced a considerable increase in quality.
- 5.5 The argument is frequently made that these changes have been accompanied by a significant increase in compliance cost, and evidence of changes in compliance practice tends to support this contention.
- 5.6 Work commissioned by the Association of British Insurers (ABI) has argued that there are essentially three key drivers of increased compliance or regulatory costs.
- 5.7 First, there has been an increase in compliance activity within firms. Compliance departments are now a feature of most large distributors, and even small IFA firms usually either have their own compliance officers, or buy compliance services from networks. Ten years ago this was not the case, with even the larger organisations having little central compliance activity.

- 5.8 General management involvement in supervision has also increased. Direct sales forces (DSFs) were traditionally managed by senior salespeople who would spend the overwhelming bulk of their time running their own book of customers whilst having limited supervisory responsibilities. Today, such roles are effectively full-time management positions, with only a minimal amount of client contact. The ratio of staff to supervisors has fallen sharply. A typical supervisor has fewer than 10 staff under him; ten years ago the figure would have been closer to 20. In addition, central compliance departments have grown in size for DSFs and larger IFA organisations.
- 5.9 Second, there has been an increase in training and competence costs. Prior to the early 1990s, there was little training activity in the industry. Training and competence requirements gradually increased during the 1990s to include both more stringent qualifications for advisers and ongoing requirements for continuing professional development.
- 5.10 Third, there has been an increase in time spent per client, on both analysis of the client's needs in the "fact-find", the subsequent development of recommendations, and on fulfilling the more stringent documentation requirements. The ABI analysis argues that sales time per client has gone from 1 hour to 5.5 hours from 1990 to 2000 for DSFs, and from 2.5 hours to 6 hours over the same period for IFAs.
- 5.11 Based on this, the ABI analysis argues that the total costs of advice have approximately doubled over the period, with the breakeven case size increasing from £80 Annual Premium Equivalent for DSFs in 1990 and £180 for IFAs, to over £800 for both methods of distribution. The implications of this analysis, if it is right, is that consumers who cannot afford to save more than £70 per month, or make an £8,500 lump sum investment, are broadly unprofitable to service.
- 5.12 The precise numbers generated by this analysis are open to criticism on a number of grounds:
- most significantly, they are produced by a highly simplified model, which simply divides the industry into IFAs and DSFs;
  - there is no segmentation by size, so no account can be taken of the very significant differences in cost structure between large, regional and small IFAs, or of the impact of networks. Nor are bancassurers, as opposed to DSFs, modelled explicitly;
  - no account is taken of differences in product mix or customer mix and the resultant impact on compliance costs (pensions raise particular compliance issues because of their complexity); and
  - more broadly, attempting to quantify "industry practice" in 1990 on matters such as training and supervision costs is difficult and inevitably subjective, at least to a degree.

- 5.13 Nonetheless, many of the underlying qualitative observations about changes in supervisory roles and increases in training costs are generally agreed to be correct. The Review is satisfied that the picture of sharply rising compliance costs is accurate.
- 5.14 But it does not follow from this that the rise in compliance costs is undesirable or inappropriate. The introduction of the Conduct of Business (COBs) regime was specifically intended to improve substantially the quality of advice and information provided by the industry, in the face of the major concerns raised by pensions mis-selling and analysis of the industry more broadly. Moreover, it is readily acknowledged that raising quality can have a positive impact on sales through an increase in consumer confidence.
- 5.15 It is true that such quality improvements will inevitably increase costs, absent counterbalancing improvements in efficiency. In that sense the ABI's findings should not come as a surprise. But the key questions are:
- why the counterbalancing improvements in efficiency have not been made; this is considered in Chapter 9;
  - whether the operation of the regulatory system somehow creates unnecessary costs, which have no clear connection with quality improvements; and
  - how ways can be found to ensure that consumers below the rising minimum breakeven point can continue to access savings products, without substantially reversing the quality improvements created by the new regime.

## The FSA

- 5.16 The 1986 Financial Services Act required a designatory agency to oversee Self-Regulatory Organisations (SROs), such as the Personal Investment Authority which was responsible for regulating retail markets. The Securities and Investment Board (SIB) was incorporated to carry out this function. On 28th October 1997, the SIB changed its name to the Financial Services Authority (FSA) and on 1st June 1998, was additionally given powers under the Banking Act to monitor the activities of banks. On 1st December 2001, the Financial Services and Markets Act 2000 (FSMA) came into force, at which point the various SROs were legally brought together under the FSA as a single regulator.
- 5.17 The FSA's statutory objectives are, in summary, to:
- maintain market confidence in the UK financial system;
  - promote public understanding of the financial system;
  - secure the right degree of protection for consumers; and
  - contribute to reducing financial crime.

- 5.18 The FSA regulates the markets through high-level principles, and then in increasing detail through rules, supported by more specific guidance on the interpretation and application of these rules.
- 5.19 When making rules, the FSA must follow certain procedural requirements, which include:
- consultation (FSMA, s.155): generally, draft rules issued for consultation must be accompanied by a cost-benefit analysis of the proposals. They must also be accompanied by a statement of the FSA's reasons for believing that the proposed rules are compatible with its objectives; and
  - competition scrutiny of the FSA's rules, guidance, codes and practices (FSMA, Part 10, Chapter III).

### FSA ACTIVITIES

The FSA's activities include:

- *Authorisation*. The FSA must authorise or approve all firms (or individuals) before they can carry on a regulated activity.
- *Supervision*. The FSA supervises the prudential soundness of investment firms.
- *Enforcement*. The FSA investigates and, where appropriate, disciplines authorised firms that have acted in breach of the FSA rules or other FSMA requirements. It also has various criminal prosecution powers, including powers to prosecute persons who engage in regulated activities without authorisation.
- *Consumer education* (see chapter 3).
- *Industry training*. The main functions of industry training include standards development (setting training and competence policy, including minimum standards for regulated firms and examination standards), and training implementation (giving assistance to regulated firms on the training and competence requirements, and offering training and distance learning).

- 5.20 The guidelines under which the long-term retail savings industry operates are to be found in the Conduct of Business regulations (COBs), which form part of the Business Standards block of the FSA Handbook of Rules and Guidance. COBs includes rules and guidance on many areas of interaction with clients and between firms, including:
- inducement and soft commission;
  - clear, fair and not misleading communication;
  - financial promotion;
  - advising and selling;
  - product disclosure;

- dealing and managing;
- reporting to customers; and
- record keeping requirements.

5.21 Industry concerns about increased costs are principally directed towards the rules on advising and selling.

## Regulation of sales and advice

5.22 The principal driver of the increase in regulatory costs, apart from training and competence, is the requirements placed by the regulatory system on the advice process itself. Particular attention has been focused on the so-called “fact-find” in which the adviser collects information about the consumer.

5.23 Understanding the “fact-find” requires further analysis of the regulatory regime.

5.24 The COBs regime essentially embodies two major principles:

- “know your customer”; and
- suitable advice.

Much of the detail of regulation simply clarifies the application of these principles in particular circumstances.

5.25 Given that these principles are broadly stated, how they are interpreted and understood, both by the industry and by regulators, is crucial. Industry beliefs and behaviour have been guided by regulatory practice to date, with the Pensions Review having a particularly formative impact. However, the FSA is in the process of changing its regulatory approach. The analysis below therefore looks at:

- the two major principles;
- past regulatory practice;
- the FSA’s new approach; and
- the specific issue of guidance, which is important in a system of broad principles.

### *Know Your Customer*

5.26 The “know your customer” rule states that:

*“Before a firm gives a personal recommendation concerning a designated investment to a private customer, or acts as an investment manager...it must take reasonable steps to ensure that it is in possession of sufficient personal and financial information about that customer relevant to the services that the firm has agreed to provide” (COB 5.2.5R).*

Further,

*“A firm must make and retain a record of a private customer’s personal and financial circumstances that it has obtained in satisfying COB 5.2.5R” (COB 5.2.9R).*

- 5.27 Guidance is given on these regulations, stating that a firm *“may design and use a process suitable for the market in which it transacts business. This process is often described as ‘fact-finding’ and the document which records this process is known as the ‘fact-find’” (COB 5.2.11G).*
- 5.28 In short, there is no defined regulatory requirement to conduct a “fact-find”, but this is the vehicle used by the industry to satisfy the requirement to “know your customer”. Moreover, there is no specific guidance as to what questions must be asked in order to satisfy the regulator that the adviser has complied with COBs, except with regard to affordability<sup>1</sup>. Therefore, judgment is required from adviser firms as to what information should be obtained and, crucially, to what level of detail, to meet the requirement to “know your customer”.
- 5.29 Yet generating the “fact-find” is one of the major drivers of the cost of sales, since it affects critically the key component of cost: the amount of time that the adviser has to spend with the consumer.
- 5.30 Not surprisingly, the Review found a wide range of approaches in the industry to the completion of the “fact-find”. The perception of required content in the “fact-find” varies between firms, and the length of “fact-find” ranges from 6 to upwards of 30 pages, with consequent impact on costs. Firms tend to adopt either:
- a blanket approach: an adviser obtains a high level of detail for all aspects of a client’s circumstances. The Review has seen “fact-find” questionnaires of up to 30 pages, in which the adviser is required by his compliance function to answer every question. Sections will only be omitted at the client’s request; or
  - a focused approach: a short preliminary assessment is undertaken, from which the adviser agrees with the client the areas of interest and priority. The adviser then concentrates upon those areas to gather sufficient information about the client’s circumstances.
- 5.31 Evidence suggests that IFA firms are more likely than DSFs to take a focused approach to the “fact-finding” process. Reasons offered by industry participants for this include:
- lower levels of training and competence in DSFs require more compliance controls;

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<sup>1</sup> “In assessing whether a private customer can afford an investment, due regard should be given to that customer’s current level of income and expenditure and any likely future changes” (COB 5.2.11G).

- the more overt sales cultures in DSFs lead naturally to the asking of more questions in order to generate more cross-selling opportunities; and
- a more intense level of regulatory scrutiny, arising from the fact that DSFs were responsible for the majority of pensions mis-selling cases, has led to more comprehensive “fact-finds”.

5.32 As a general rule, however, the competitive environment means that the incentives on the industry, regardless of distribution channel, are to make the “fact-find” more rather than less elaborate. The sanctions for not doing so are perceived to be potentially very serious – the Pensions Review (see below) has played a key part in shaping this view. Conversely, the rewards for seeking to minimise the “fact-find” are limited: there is no obvious competitive advantage to firms with lower compliance costs, since competition in general does not focus on issues of price and efficiency.

#### **PORTABLE “FACT-FINDS”**

The FSA is launching a research project later this year, with a view to developing an interactive tool to help consumers to establish generic needs for themselves, by leading them through a hierarchy of questions. This would then link to Comparative Tables and the FSA website’s information on the other factors consumers should consider when purchasing financial products. Its purpose is also as an educational tool.

There are practical difficulties that this approach presents with regard to the adviser’s duty of care to the customer: for example, if a customer had not properly executed some element of the process and was sold an unsuitable product as a result, it is not clear where (if anywhere) responsibility for mis-selling might lie. But assuming problems of this nature can be overcome, this could lead to the development of a standardised, portable “fact-find” with the potential to reduce the face-to-face time involved in the advice process.

This method would not fundamentally change the economics of advice: there would still be a fixed cost element, which regulation would continue to affect substantially. Nor would it address wider issues of consumer weakness or commission-remunerated advice. But it would clearly be a helpful development, since a reduction in the costs of an initial meeting with an adviser could:

- lower industry costs generally and thereby at the margin improve access to advice for lower-income consumers; and
- encourage more shopping around for advice, as consumers’ transaction costs for so doing would be lower.

The Review is very supportive of this work.

## *Suitability*

- 5.33 The other key principle of the advice regime is that an adviser must not make a personal recommendation for a customer to buy a product, unless *“the recommendation or transaction is suitable for the private customer having regard to the facts disclosed by him and other relevant facts about the private customer of which the firm is, or reasonably should be, aware”* (COB 5.3.5(2))<sup>2</sup>.
- 5.34 Suitability and its counterpart, mis-selling, are crucial concepts in defining industry compliance practice and hence costs. Yet suitability is not defined in the regulations. Industry participants have therefore formed their views of what is required to meet the suitability standard by reference to how regulators have in practice supervised their businesses. In particular, their notion of mis-selling has been substantially shaped by the Pensions Review. This is considered in the following section.

## *The Pensions Review*

- 5.35 Pensions mis-selling arose because advisers (largely from the tied agent sector) persuaded consumers to leave their occupational schemes, which provided additional benefits such as death-in-service payments and employer contributions, and instead take out personal pensions policies, which did not. Firms that sold pensions to people who would have been better off staying in or joining their employer’s scheme were considered by the regulator to have mis-sold a pension, unless they could prove to the contrary.
- 5.36 At the end of 1994, the regulator at the time, the Personal Investment Authority (PIA), instructed firms to contact all people who had taken out personal pensions between 29 April 1988 and 30 June 1994, who may have been mis-sold pensions. It further instructed them that they must compensate consumers where those firms had broken the rules in force at the time and where, as a consequence, the consumers had suffered a loss.
- 5.37 The regulator designed review procedures that firms were obliged to follow in determining whether or not consumers had suffered a loss. As a huge number of cases were involved, those consumers who had already retired or were close to retirement were given higher priority, ahead of cases involving those further away from retirement. If the check showed that a firm had not followed the rules at the time and a consumer had suffered a loss as a result, the firm was obliged to inform the consumer and offer redress.
- 5.38 The burden of proof in these procedures was clearly placed on advisers. Crucially, the key test they needed to pass, if a personal pension appeared to have been mis-sold, was to show full documentation of the sales process, including a detailed and accurate gathering of facts about the consumer’s circumstances. If this was lacking, mis-selling was deemed to have occurred.

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<sup>2</sup> Additionally, for the tied agents of provider firms, no recommendation should be made if *“there is no suitable product available from the products...the firm is able to sell”* (COB 5.3.6(2)).

- 5.39 It is estimated that almost two million claims were made during the course of the Pensions Review, although not all of these involved financial loss. The FSA's own latest estimate is that compensation will amount to some £11.8 billion, in addition to administrative costs of £2 billion.
- 5.40 The incentive effects of an exercise on this scale has had a powerful impact on the attitudes of compliance departments; not surprisingly, it has led to a strong focus on meeting the suitability requirement through the collecting and recording of information about consumers and the sales made to them.
- 5.41 The general supervisory approach of the PIA tended to reinforce this. It attempted to visit all regulated UK firms and inspect their practices as documented, to determine whether they met the required standard. Typically, all departures from this standard were noted in an often lengthy letter to the firm, requiring action to remedy these, with little distinction being made between minor and more serious breaches and with a general focus on the more easily detectable lapses of poor record-keeping.

### *Impact of regulatory approach*

- 5.42 The result of the system described above is a situation in which:
- there is no written regulatory requirement for a lengthy and heavily documented sales process; but
  - on the basis of past experience industry participants believe this to be required, if they are to avoid future regulatory sanctions.
- 5.43 These attitudes are reinforced by a system of redress for consumers, which is designed to be easily accessed and consumer-friendly.

#### **CONSUMER REDRESS**

The process for consumer redress is as follows:

- the client complains to the provider of advice;
- where the complaint cannot be resolved, a letter of deadlock is issued, and the complainant has the right to approach the Financial Ombudsman Service;
- the Ombudsman sets a date for a hearing;
- in the event of the Ombudsman finding in favour of the adviser, the client may pursue the matter in a court of law; the Ombudsman's finding is binding on the adviser; and
- the Ombudsman will set a level of compensation commensurate with the financial loss the individual has suffered, and sometimes compensation for any inconvenience or distress caused.

## *Current changes in regulatory practice*

- 5.44 The FSA has made clear that it wishes to change the way in which supervision is conducted.
- 5.45 In contrast to the PIA approach described above, the FSA is moving to a risk-based system that will make use of information from various sources to identify the highest risk advisers, products and services. The new approach is intended to make the most efficient and economic use of resources in supervising the industry. Routine visits will no longer be a supervisory tool. Firms complying quickly and effectively with regulations will be rewarded with less regulatory attention, and resources will be allocated on the basis of regulatory priorities.
- 5.46 More than 80 per cent of the total of over 11,000 regulated firms will be classified as “low impact”. At the other end of the spectrum, the FSA will have a close relationship with high impact firms. A high impact firm would be classified as such because of its size, measured against the impact indicators for its particular sector (e.g. total assets/liabilities, funds under management, or premium income).
- 5.47 Under the PIA regime, there was a significant focus on documentary issues, and the industry has been critical of what it viewed as the PIA’s preoccupation with documentary accuracy. Many industry participants have claimed that PIA supervisors were insufficiently commercially aware, and that their documentary focus resulted in regulatory overload. Supervisors are now expected to deal with issues by focusing on “outcomes”. The supervisor will establish at the outset what he or she wants to achieve. This will be communicated to the firm, and the supervisor and the firm will work together to resolve the outcome.
- 5.48 Extensive changes in management have been implemented. The FSA has also acted to drive significant cultural change among staff engaged in retail conduct of business supervision:
- a clear signal has been given by senior management in both public and private forums on repeated occasions that cultural change is needed;
  - senior management has articulated its “Vision and Values” which sets out the new approach;
  - staff are being trained in the approach; and
  - objectives throughout the organisation have been rewritten. In particular, one of the formal objectives for supervision over the coming year is that a significant proportion of firms, relevant trade associations and other key stakeholders consider that the new approach has delivered improvements in a way that is consistent with the Principles of Good Regulation.

- 5.49 As a documentary focus adds costs to the industry, but does not necessarily enhance protection of consumers, the Review is strongly supportive of these measures and their focus on more serious risks. It is important that they are seen to be effective if understandable industry scepticism about the degree of change is to be tackled.

#### **FSA UNDERSTANDING OF ITS IMPACT ON INDUSTRY COSTS**

The FSA is required to undertake a cost benefit analysis for all changes it makes to regulation. However, there is no general requirement to calculate the impact of the regulatory regime, although the FSA does publish its own costs, together with such international comparisons as are available, within its annual report. Some of the FSA's European counterparts have been unable to provide information on their regulatory costs, however. Calculating compliance costs to the industry that arise as a direct result of UK regulation (other than the cost of funding the FSA) has proved difficult. It is impossible to draw a clear distinction between activities which are imposed by regulation and those that simply represent sound commercial practice. Additionally, regulatory requirements have by now become inbuilt into firms' systems and processes. Separating out the real costs of regulation therefore becomes extremely difficult.

Hence, it has not been possible for the FSA to calculate the total cost of regulation in the UK, or provide clear comparative data from other markets. While appreciating the difficulties involved, the Review believes that this is an area of great importance. The FSA should continue to investigate ways of calculating these costs and measuring the economic impact of regulation.

#### *Guidance*

- 5.50 Clearly in a regulatory system based on broad principles with considerable room for interpretation, guidance from the regulator plays an important role. This is particularly the case at a time when technological advances offer the potential for new initiatives from the industry that could generate cost savings in the market. Without some form of comfort from the regulator that new processes will not be deemed "non-compliant" after their introduction, companies will be reluctant to incur systems development and implementation costs. Failure to give guidance in such circumstances could, therefore, be a real barrier to innovation in the industry.
- 5.51 FSA practice is to classify guidance as either "general" or "individual".
- 5.52 "General" guidance applies to more than one firm or individual, and the FSA is usually required to undertake formal consultation on proposed general guidance.
- 5.53 The Supervision Manual (Chapter 9 of the FSA's Handbook of Rules and Guidance) sets out the process by which firms may apply for "individual" guidance. Individual guidance is:

*“guidance that is not given to persons or regulated persons generally or to a class of regulated person. It will normally be given to one particular person, which relates to its own particular circumstances or plans.... A person may need to ask the FSA for individual guidance on how the rules and general guidance in the Handbook, the Act or other regulatory requirements apply in their particular circumstances.”<sup>3</sup>*

- 5.54 The FSA expects individual guidance to be necessary only where there is doubt or ambiguity. Rule 9.2.5 says:

*“The FSA will aim to respond quickly and fully to reasonable requests. The FSA will give high priority to enquiries about areas of genuine uncertainty or about difficulties in relating established requirements to innovative practices or products. What constitutes a ‘reasonable request’ is a matter for the FSA. It will depend on the nature of the request and on the resources of the firm or other person making it. The FSA will expect the person to have taken reasonable steps to research and analyse a topic before approaching the FSA for individual guidance”.*

- 5.55 The Review heard a number of claims from the industry that a general unwillingness by the FSA to provide guidance has inhibited the industry from introducing new ways of working. It is far from clear whether this reflects a continuing problem, or merely a historical problem which continues to live in the collective memory for a period, even after it has been corrected. Given the anecdotal nature of the evidence, it is not possible to establish this definitively. But this is an issue of some significance, given its potential impact on innovation in the industry. The issue is therefore considered further in the section of the report dealing with recommendations (Chapter 10).

## Product regulation

- 5.56 In recent years, the Government has sought to deal with concerns about value for money in retail savings products by introducing a form of product regulation through voluntary benchmarking i.e. CAT marks and stakeholder. These two separate initiatives are often bracketed by the industry using the expression “the one per cent world”.

### *CAT standards*

- 5.57 The concept of a CAT standard was introduced by the Government in April 1999 at the same time as the launch of Individual Savings Accounts (ISAs). The aim was to benchmark minimum standards in order to encourage savings from those consumers who were unsure how to get the best deal from the range of ISAs on offer. The Government’s policy aim was that everyone saving through ISAs should be able to get good value for money. In order to be designated as a CAT product, minimum standards for Charges, Access and Terms had to be met. Since then, the CAT principle has been extended to residential mortgages (March 2000).

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<sup>3</sup> FSA Handbook, Chapter 9 – “Individual guidance”, 9.12G and 9.13G.

5.58 The system is largely self-policing, on the principle that the reputational damage to a company claiming to be selling a CAT product which did not in fact meet the standards would be greater than any possible benefit. Ultimately, such a company could be subject to FSA sanction for misleading consumers.

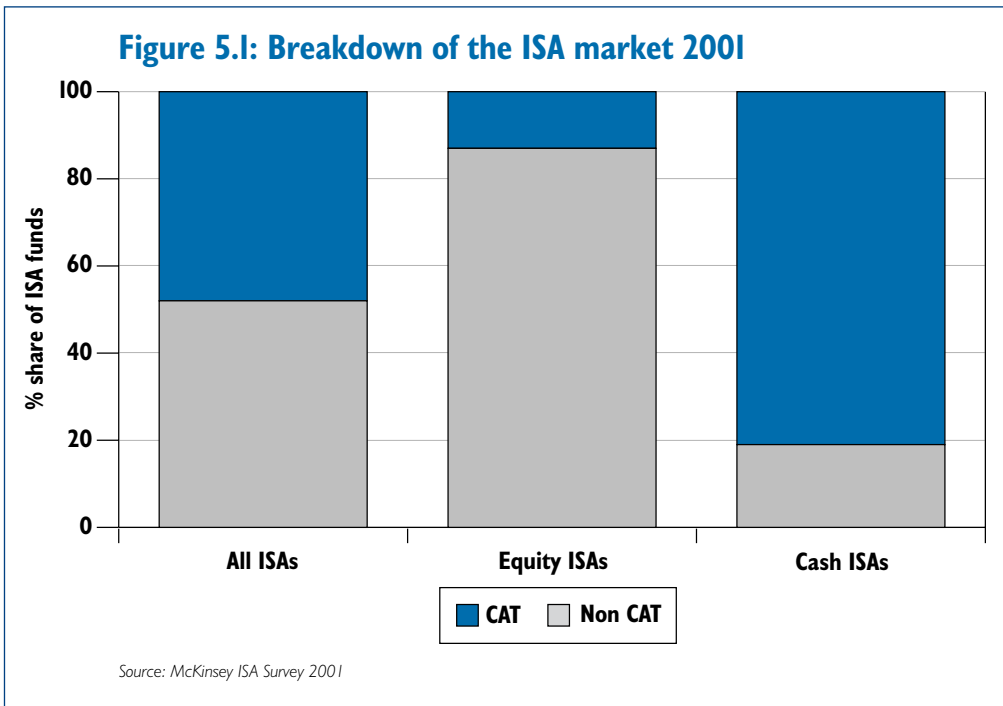
5.59 There are three kinds of CAT ISAs: cash, insurance and equity. The latter covers unit trusts, oeics and investment trusts. Table 5.1 sets out the comparable CAT standards.

**Table 5.1: Summary of comparable CAT standards**

	Cash ISA	Insurance ISA	Equity ISA
CHARGES	<ul style="list-style-type: none"> <li>(i) No one-off or regular charges of any kind (e.g. withdrawals; ATM use);</li> <li>(ii) Replacement charges allowed (e.g. lost cards).</li> </ul>	<ul style="list-style-type: none"> <li>(i) Annual charge &lt;3 per cent of fund value;</li> <li>(ii) No other charges.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Total charge no more than 1 per cent of net asset value per year;</li> <li>(ii) No other charges.</li> </ul>
ACCESS	<ul style="list-style-type: none"> <li>(i) Minimum transaction &lt;£10;</li> <li>(ii) Withdrawals within 7 working days or less.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Minimum premiums no greater than £25 per month or £250 per year.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Minimum saving no more than £50 per month or £500 lump sum per year.</li> </ul>
TERMS	<ul style="list-style-type: none"> <li>(i) Interest rate no lower than base rate – 2 per cent;</li> <li>(ii) Upward interest rate changes within a month; downward may be slower.</li> <li>(iii) No other conditions.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Surrender values should reflect, over time, the value of the underlying assets of the fund;</li> <li>(ii) No specific surrender penalties;</li> <li>(iii) After 3 years surrender values should at least return the premium.</li> </ul>	<ul style="list-style-type: none"> <li>(i) Fund at least 50 per cent invested in shares and securities which satisfy the tax regulation requirements and are listed on EU stock exchanges;</li> <li>(ii) Single pricing for both units and shares;</li> <li>(iii) Literature to highlight investment risk.</li> </ul>

5.60 The over-riding aim of the CAT regime is to define straightforward, clear, easy to understand and fair products that offer good value. The intention is that consumers should be able to buy CAT products with little or no advice.

5.61 Penetration of CAT marking has been varied. 81 per cent of the cash ISA market is in CAT products, but in equity ISAs only 13 per cent are CAT designated (Figure 5.1). The comparable figures for 2000 were 83 per cent and 17 per cent respectively, showing that both categories experienced small reductions in market share in 2001 over 2000.



5.62 More important is the extent to which CATs have changed provider and consumer behaviour, by creating pressure for greater simplicity and lower charges. A review of product pricing of CAT ISAs shows that the majority of CAT funds have a RIY of 1-1.5 per cent whereas non-CAT funds average 2-2.5 per cent. However it appears that this is generally a case of funds which were already lower-cost adopting the CAT badging, rather than producers reducing prices to conform with CAT terms. There is also no clear evidence of major changes in consumer behaviour, with consumers actively seeking CAT products.

5.63 The vision behind the CAT marks is a highly desirable one: a market characterised by a small number of simple products available at modest cost, enabling consumers to be more confident and more effective, and as such, exert pressure on price and quality.

5.64 But the industry has limited incentives to introduce such products in the current regulatory environment. Advised sales of CAT products are effectively subject to two sets of regulation: both product and sales regulation. The Review makes proposals for an alternative regulatory approach to the sale of products of this sort which have the potential to move the market considerably closer to the vision behind the CAT concept.

### *Stakeholder pensions*

5.65 Stakeholder pensions were introduced by the Government in April 2001. Their purpose was to encourage people with no existing pension provision to take out a pension by making available a simple, cheap and easy to understand product.

5.66 Stakeholder pensions are defined contribution schemes that must meet minimum standards. Specifically:

- the maximum annual charge is 1 per cent of the fund charged on a daily basis;
- the running costs must be provided within this charge;
- additional charges may be made for individual advice, purchasing annuities and income draw-down arrangements;
- the minimum contribution is £20 per month; and
- annual benefit statements have to show the benefit value, the contributions paid and the annual percentage rate of the charge.

There is no explicit limit on investments in particular asset classes or prescription of investment strategy, but in practice the charge cap has meant that the great majority are passively managed.

5.67 Employers were obliged to provide access for employees to a scheme by October 2001 unless any of the following exemptions apply:

- the firm has less than five employees;
- a group personal pension exists with employer contributions of at least 3 per cent of the employee's basic pay;
- an occupational pension scheme exists that all employees can join; or
- the employee concerned does not earn more than the lower earnings limit or is employed for less than three months.

5.68 The maximum contribution limits are the same as for personal pensions (on a scale from 17.5 per cent to 40 per cent of earnings depending on age, or £3,600 per year if higher). Proof of earnings is needed to support contributions in excess of £3,600 and contributions may continue for five years based on a particular level of earnings.

5.69 Members of occupational schemes are permitted to contribute to stakeholder schemes provided they earn less than £30,000 per year. Policies can also be bought by those not working and for children.

### *Impact of stakeholder pensions*

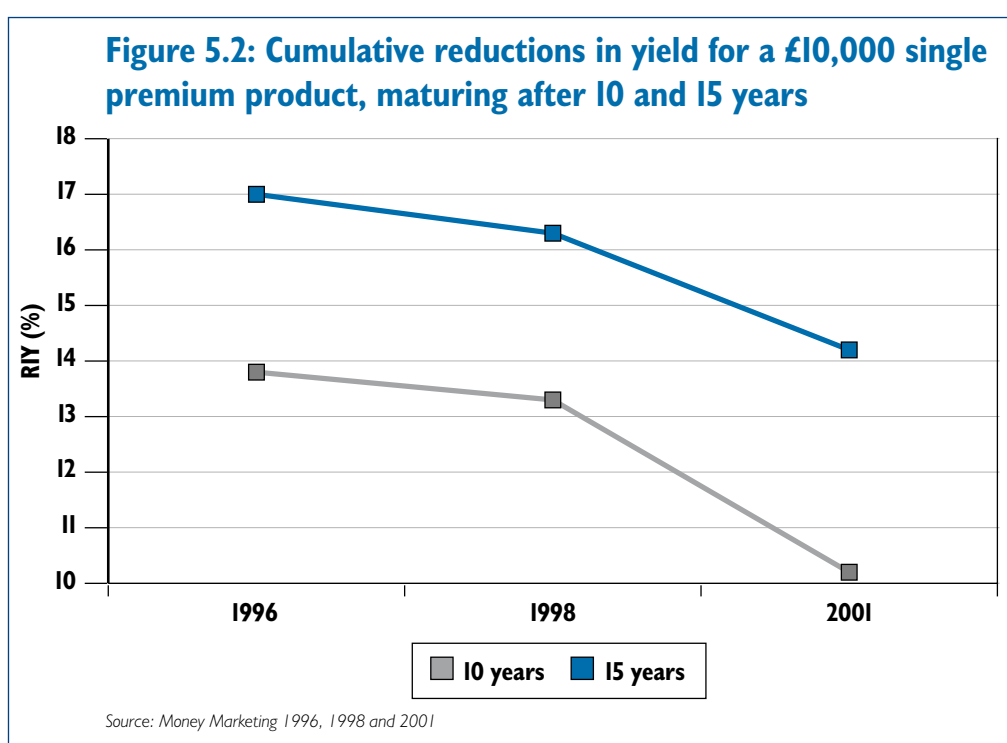
5.70 Figures to the end of December 2001 show that approximately 91 per cent of employers who are required by law to give access to a stakeholder scheme have actually designated a scheme. However, the number of policies sold to the same date was only some 631,000. Early indications are that stakeholder sales have therefore been relatively slow but there are signs that there has been some success in reaching the target market. It is estimated that approximately 50 per cent of these early sales have been to people with earnings in the £10,000 to £20,000 range.<sup>4</sup> However, it is not known whether these are people without existing pensions provision.

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<sup>4</sup> ABI, "1st Anniversary Analysis of Stakeholder Pensions", March 2001.

5.71 The most significant impact of stakeholder pensions has been the creation of considerable downward price pressure across the whole pensions market. Figure 5.2 shows the cumulative reduction in yield (RIY) on a £10,000 single premium unit linked product over both 10 and 15 years.

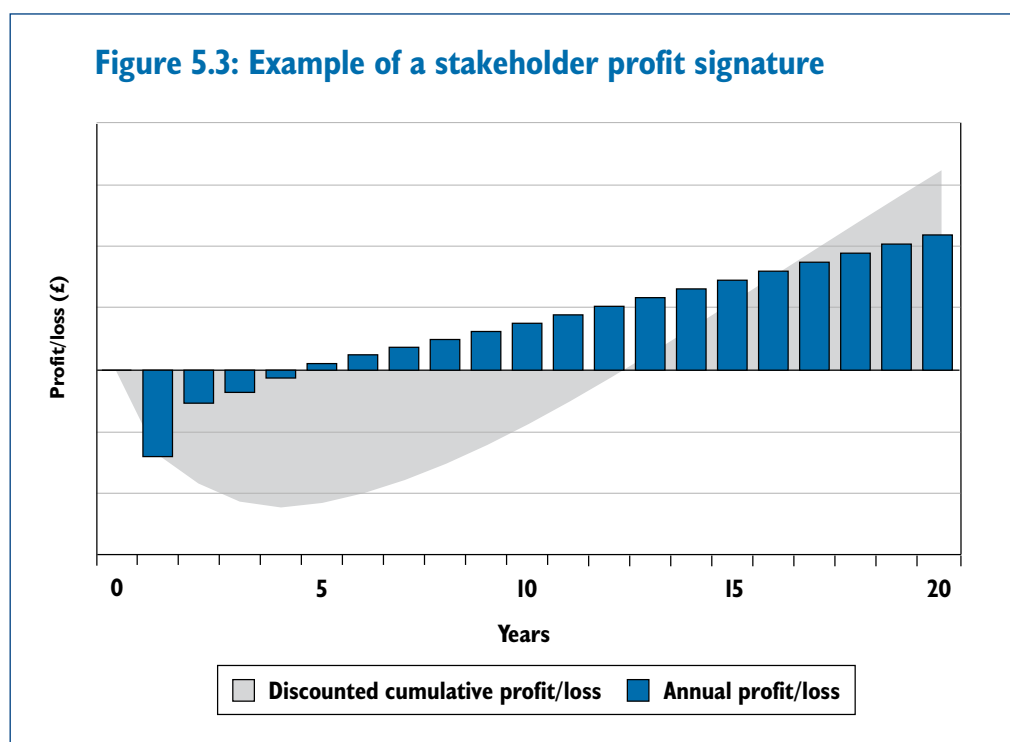
5.72 Non-stakeholder pensions have little in the way of additional features that would justify a significant price premium over stakeholder products. It therefore has become increasingly difficult for providers to justify charges for non-stakeholder pensions that are significantly higher than 1 per cent annual or equivalent. This process began some time prior to the actual introduction of stakeholder as a result of the regulator's statement known as Regulatory Update 64 in 1999, which explained that "the planned introduction of stakeholder pensions is a consideration which must be taken into account when giving advice on suitability".



5.73 The price pressure created by the 1 per cent cap has prompted widely expressed industry concerns:

- the industry has argued that a charge of 1 per cent is not sustainable for pensions, and will ultimately lead to all but a small minority of pensions providers exiting the market;
- it has also argued that, even in investment products, 1 per cent is not sufficient for actively managed investment products, thus mandating passive management through the back door; and
- it has expressed concern that it is being subjected to product regulation as well as COBs regulation, instead of one substituting for the other.

- 5.74 On the other hand, it is clear that a number of industry participants are making considerable efforts to re-engineer their businesses, in order to reduce costs sufficiently to be profitable with 1 per cent annual charges.
- 5.75 The economics of stakeholder pensions, as with any long-term retail savings product, raise complex issues that are highly sensitive to the assumptions made about the future. In particular, the volume and persistency of the business is crucial. The Review has seen some confidential modelling of stakeholder profitability carried out by providers, that supports the generally held view in the industry that the pay back period for stakeholder products is in the order of 10 – 15 years. Figure 5.3 below illustrates the shape of a typical stakeholder profit signature. The graph shows the net cash flows for each year following the stakeholder product sale. After four years of initial cash outflows, the product begins to generate a profit, but on a cumulative discounted basis, the product must be held for some 12 years for it to break even.



- 5.76 The Review recognises that the more narrow the margins, the greater the incentive for both product providers and distributors to focus their sales efforts on products other than pensions. At the same time, the charge caps are a welcome development in a market that hitherto has experienced limited price pressure. It is inevitable and indeed desirable that as part of this process, less efficient players come under pressure either to improve their efficiency or to exit the market. In most markets the normal competitive process has a similar effect.
- 5.77 The charge cap is not the only issue. Stakeholder pensions sales are also hampered by wider features of the market that are outside the scope of any stakeholder-specific regulations. In particular, although stakeholder pensions may themselves be relatively simple, they continue to operate in a particularly complex environment:

- the pensions tax regime, to which stakeholder pensions are still subject, is extremely complex, as set out in chapter 8;
- the interaction between occupational and personal pensions is also not straightforward. This means that buying pensions without advice can often be problematic, and potential customers of stakeholder pensions often find such advice difficult to afford; and
- as with CATs, charge-capped products are unattractive to commission-remunerated advisers; where the regulatory regime permits flexibility, they will tend to prefer selling more expensive products with higher commissions.

5.78 The FSA has sought to address the advice problem by the creation of “decision trees” which allow stakeholder pensions to be sold outside the regulated advice regime.

### *Stakeholder decision trees*

5.79 The use of decision trees was developed by the FSA as a tailored form of regulation for execution-only transactions designed to facilitate the sales of stakeholder pensions. Decision trees set out a series of standard questions to assist consumers in making decisions without engaging in the full process of regulated advice.

5.80 Those taking customers through decision trees do not need to be fully (i.e. FPC3<sup>5</sup>) qualified. They are nonetheless subject to the FSA’s training and competence regime in that they must be trained satisfactorily to carry out the job of giving factual information to customers on stakeholder products. Importantly, if customers require advice as to the suitability of the product for their particular circumstances, unqualified decision tree “walkers” must pass the enquiries on to qualified advisers, and the process then falls within the COBs advice regime.

5.81 Decision trees are a new development, having only been introduced in April 2001. The FSA is currently carrying out research on their impact. They are clearly a helpful initiative to assist consumers in buying products without the full process of regulated advice. At the same time, the constraints on the process, in particular on what can be said without triggering the full advice regime, may limit their usefulness.

## **Other Government intervention: the private pensions regulatory regime**

5.82 There is also a substantial body of Department for Work and Pensions (DWP) regulation of the features of private pension schemes. This is mainly directed at occupational schemes, which are outside the scope of this Review, but some areas of regulation impact on personal pensions: namely contracting out, transfers and preservation.

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<sup>5</sup> FPC3 is the Chartered Insurance Institute’s Financial Planning Certificate Paper 3.

5.83 Contracting-out applies to the overlap of both occupational and personal pensions with the state pension. The objective of contracting out is to allow individuals to move out of the state second scheme (State Earnings Related Pension Scheme, or SERPS, and from April 2002, State Second Pension) into the private sector. Contracted-out pensions are governed by some highly complex regulations, including:

- the Reference Scheme Test: a statutory standard that sets the benchmark for benefits payable to scheme members and their widows or widowers. It maintains a link with the state benefits foregone;
- requirements to mirror the state benefits foregone in other ways, including provision of survivors' benefits, compulsory indexation, unisex annuity rates, and no tax-free lump sum; and
- age-related rebates: these are designed to ensure that older workers retain an incentive to stay contracted-out.

5.84 The legal right to transfer from an occupational pension, as an alternative to preserving accrued pension rights, was introduced in 1985. Since then, a variety of regulations affecting both preservation and transfers have been put in place. The calculation of transfer values is highly complex, especially where the individual is moving from a defined benefit (DB) to a defined contribution (DC) scheme; contracting-out requirements also have a significant impact on transfers. As a result, transfers are widely acknowledged to be among the most complex areas of pensions.

5.85 The principle of preservation is that early leavers must be given a fair share of the benefits they would have received if they had stayed with the same employer until retirement. However, whilst the principle is simple, the legislation now in force is highly detailed and complex. The initial legislation on preservation and the numerous subsequent amendments and additions have moved from no preservation prior to 1975 to the current position of preservation after two years, with full revaluation, plus statutory treatment of contracted-out rights.

5.86 The Review has not sought to make recommendations in these areas, as they are currently being considered by the review of pensions simplification commissioned by the DWP and led by Alan Pickering. The Review is, however, strongly supportive of all efforts to simplify regulations in this area.

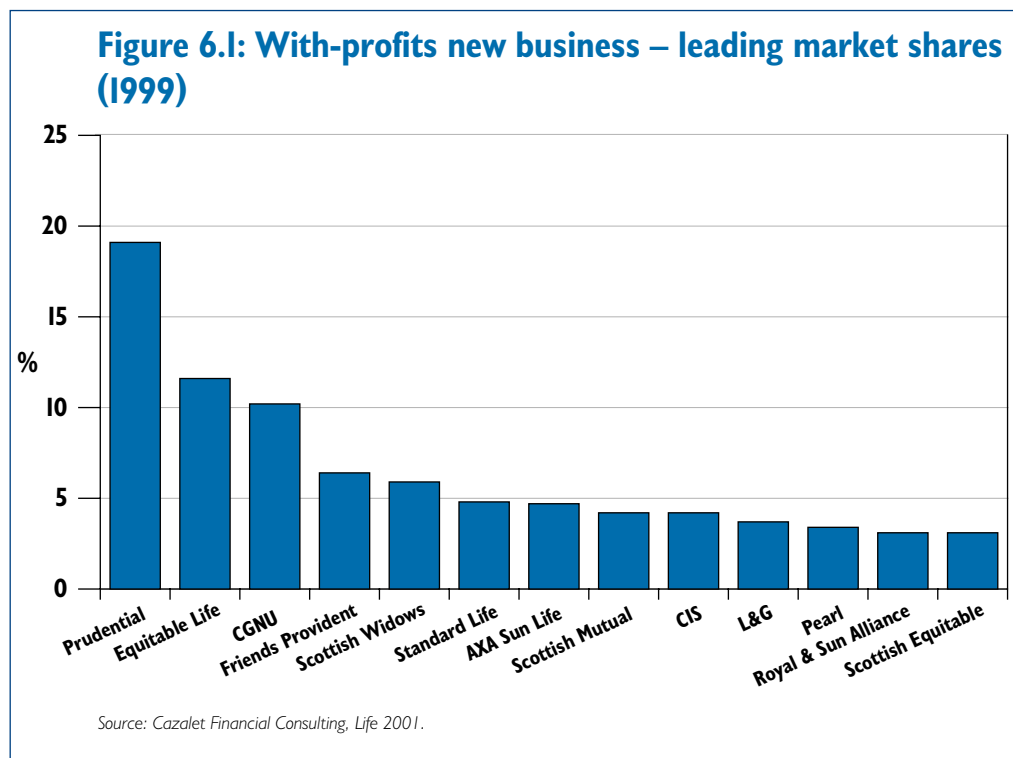
## Summary

5.87 Sales regulation has driven a significant improvement in the quality of advice and information provided by the retail savings industry. Not surprisingly, in the process it has also had a significant impact on cost structures, through requiring greater compliance activity, higher spending on training and competence, and a lengthening of the time spent with each customer.

- 5.88 The two requirements of “know your customer” and “suitability” are key determinants of the impact of the regulatory system on the cost of sales. There is no written regulatory requirement for a lengthy and heavily documented sales process; but on the basis of past experience, industry participants believe this to be required, if they are to avoid future regulatory sanctions. The FSA is changing its supervisory approach in ways which should assist the industry in minimizing excessive regulatory compliance. But this has further to progress, and it is important that this change is both pursued vigorously and communicated to the industry.
- 5.89 The system of sales regulation did not create the problem that advice has a fixed cost: this is inherent in the nature of advice. But it does set a floor for reductions in this fixed cost through its setting of minimum quality standards. This has meant that it is difficult for lower/middle-income consumers to access advice. This issue has affected the penetration of two recent Government initiatives seeking to deal with concerns about value for money in retail savings products by introducing a form of product regulation through voluntary benchmarking: CAT marks and stakeholder.
- 5.90 Penetration of CAT marking has been varied. The vision behind the CAT marks is a highly desirable one: a market characterised by a small number of simple products available at modest cost, enabling consumers to be more confident and effective, and as such, more demanding on price and quality. However, the industry has limited incentives to introduce such products in the current regulatory environment. Advised sales of CAT products are effectively subject to two sets of regulation: both product and sales regulation. The Review makes proposals in Chapter 10 for an alternative regulatory approach to the sale of products of this sort which have the potential to move the market considerably closer to the vision behind the CAT concept.
- 5.91 Stakeholder pensions have also had to contend with some of the features of the market outlined in the Review’s earlier analysis: in particular, complexity and commission-remunerated distribution. The Review’s proposals for an alternative regulatory approach seek to address this issue.

## Overview

- 6.1 With-profits policies represent a major part of the UK long-term savings market. There are approximately £1.5 trillion pounds of assets in pension and life insurance funds and, of this, over £380 billion is in with-profits funds<sup>1</sup>. The market is relatively fragmented. There are over thirty companies currently managing with-profits funds, although as can be seen in Figure 6.1, in 1999, the top thirteen providers collectively accounted for more than 84 per cent of new with-profits sales<sup>2</sup>. The market is roughly split two thirds to proprietary companies and one third to mutuals<sup>3</sup>.



## Origins of with-profits

- 6.2 The origins of with-profits date from the late eighteenth century. Life insurers found that, as a result of excessive caution with their mortality assumptions, they were making mortality profits. These were then distributed back to the remaining policyholders, initially by way of reduced premiums, and later as enhancements to the guaranteed benefits by way of regular bonuses.
- 6.3 Through time, other sources of profit, in particular investment profits, became more significant. In particular, the performance of equity investments to which with-profits funds were exposed gave rise to substantial additional returns after the Second World War. However, because these returns were dependent

<sup>1</sup> ONS and FSA, 2000 figures.

<sup>2</sup> Cazalet Financial Consulting, *Life 2001*, 2001.

<sup>3</sup> Cazalet Financial Consulting, *Life 2001*, 2001.

upon the market value of assets, they could not be guaranteed, and therefore the final (“terminal”) bonus was developed as a mechanism to distribute these non-assured profits.

### *Key characteristics of with-profits*

6.4 There is a wide range of different forms of with-profits policy, but there are four main features:

- the contractual form of a life insurance policy;
- smoothing of investment returns;
- guarantees; and
- participation in the providing company’s profits (or losses).

These are considered in more detail below.

6.5 Contractually, a with-profits policy is a form of life insurance, paying out a guaranteed amount if the policyholder dies. The legal status of with-profits policies is discussed further in paragraph 6.34. In reality, however, the great majority are essentially savings products with a nominal insurance content.

6.6 The key characteristic of with-profits products is their smoothing of returns. While the exact rules and methods used vary between insurers, smoothing will principally be effected by holding back some of the returns when markets are buoyant and using these to boost contract values when returns are poor. This has the effect of reducing the volatility of policy returns. Smoothing is generally at the provider’s discretion, although this is governed by the need to “treat customers fairly”<sup>4</sup>. Smoothing has a number of characteristics:

- it is normally inter-generational, but can also be within generations, between different policy types or policies of different lengths;
- it can also be achieved by modifying the value of policies held to maturity at the expense of those that have been surrendered early; and
- in theory, it should balance in the long term, i.e. have no net cost other than the costs of administration.

6.7 With-profits policies also typically feature guarantees: a minimum payout level for the policy, provided the contract is not broken, traditionally defined as the policy not being surrendered before maturity. The guaranteed amount is often raised through the lifetime of the policy through the addition of regular (“reversionary”) bonuses.

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<sup>4</sup> The requirement of firms to treat customers fairly is one of the FSA’s high level principles. While “fairness” does not have an objective definition in this context, the FSA has set out a number of behaviours this includes. Amongst these is the “honouring of representations, assurances, and guarantees where this leads to a legitimate expectation in the mind of the customer” (FSA discussion paper, “Treating customers fairly after the point of sale”, p.13, June 2001). This requirement, along with the requirement to “pay due regard to consumers’ interests”, essentially encompasses (and supersedes) the concept of “Policyholders’ Reasonable Expectations” which applied to insurance business prior to December 2001.

- 6.8 Traditionally, the costs<sup>5</sup> of providing these guarantees have not been charged directly to policyholders – instead the costs have either tended to be met by the inherited estate<sup>6</sup>, or have been met implicitly through the asset mix (with more weight in bonds than would otherwise be required and so a lower long run investment return).
- 6.9 A further feature of with-profits policies is their complex interrelationship with the provider's business. There are interconnections at several points.
- 6.10 The first interconnection is the with-profits fund's participation in the provider's business. As their name implies, with-profits policies have traditionally been associated with providing capital for, and sharing in, the profits and losses of other businesses of the provider, although there is no necessary connection between a smoothed investment return and such profit participation. As noted above, this originated in the sharing of mortality profits. Although investment profits are the dominant area of returns today, many with-profits policies still share in wider business profits and losses, most notably in mutual companies.
- 6.11 The second interconnection is participation by the shareholders of proprietary providers in the payouts from the with-profits fund to policyholders. This is often referred to as the "90/10" model, under which shareholders receive typically 10 per cent of bonus distributions, with the remainder going to policyholders. In recent years a few companies have moved to what is known as the "100/0" model, where 100 per cent of the bonuses are distributed to policyholders and shareholder returns are instead funded by way of an explicit charge to the fund. The 90/10 model remains the dominant model in the market at present. The justification for the 90/10 model is principally that shareholders stand ready to provide capital for the fund should it be required, and part of their share of the bonus payouts is in return for this. However, in general, shareholder funds have not been committed to underpinning with-profits funds, as these tend to have built up sufficient internal capital.
- 6.12 The third interconnection is through the charging of costs. Historical practice has been for the costs which the provider incurs in managing the with-profits business to be charged directly to the with-profits fund. This exposes policyholders, rather than shareholders, to the benefits of cost efficiencies and the risks of cost overruns. Conventionally, the non-investment risks and cost risks are described in the industry as "business risk". Some proprietary firms have now developed with-profits policies which are insulated from business risk and share only in investment profits, but a wide range of differing practices remain.
- 6.13 A typical asset composition of a with-profits fund overall might be 65 per cent equities, 10 per cent property, and 25 per cent fixed interest. However,

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<sup>5</sup> To give a guaranteed payout level, a provider needs to have sufficient capital to support the guarantee. There is, therefore, an opportunity cost attached to using this capital in this way, rather than putting it to other uses.

<sup>6</sup> Inherited estate does not have a statutory definition, but is the term used to describe the assets in a with-profits fund which are in excess of those required to meet payout values. A fuller discussion can be found in the FSA document "A description and classification of with-profits policies", October 2001.

there are wide variations around these averages, even amongst the well-established funds, where the combined equity and property proportion can vary between 65 per cent and 90 per cent. Aside from the investment objectives of the fund, the factors that will affect the relative asset weightings include:

- a general desire to have a high weighting in equities due to their historic long run outperformance of other assets;
- the need to match assets with liabilities arising from any guarantees that may exist on policies; and
- the need to demonstrate regulatory solvency, under a range of adverse conditions.

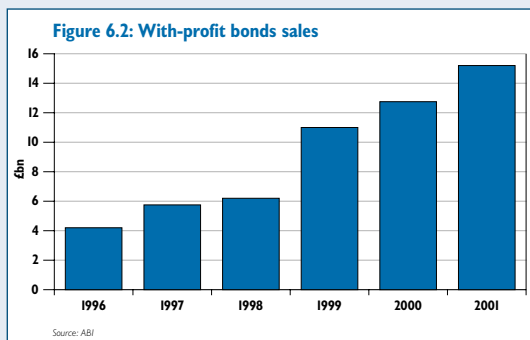
### DIFFERENT TYPES OF WITH-PROFITS POLICIES

With-profits policies divide into several categories. The key dimensions are:

- whether the policy is regular or single premium;
- whether the policy is conventional or “unitised”; and
- whether the policy is open-ended or has a fixed redemption date.

The type of with-profits business written in the past twenty years has evolved from largely regular premium, conventional with-profits (CWP) towards single premium unitised with-profits (UWP). At the same time endowments have fallen away and with-profits bonds have become the predominant area of new sales.

CWP policies have a guaranteed amount from the outset, which usually increases over the life of the policies through the addition of bonuses. This guaranteed amount is payable on death or maturity. These guarantees rarely apply if the policy is surrendered, when the provider will have a high level of discretion as to the payout value.



UWP policies were introduced in the 1980s. By giving policyholders units in a with-profits fund, the policy looks more akin to a unit trust and so is designed to be easier to understand. It also gives more flexibility in terms of timings of purchases and switching between with-profits and unit-linked funds. The stock of in-force with-profits business is now fairly evenly split between CWP and UWP policies. However, 87 per cent of new business is written in unitised form<sup>7</sup>.

Prior to the 1990s, with-profits investment policies tended to be written as endowment policies, which have a defined term. Pensions policies are also usually now written in the form of an endowment, although a pension will tend to have more flexibility in the maturity date.

<sup>7</sup> FSA, “A description and classification of with-profits policies”, October 2001.

The alternative is a whole life policy which is open-ended, having no defined maturity date at which benefits can be taken other than at death. The taking of benefits before then is therefore technically a surrender (although providers may offer certain dates at which policies can be cashed in without penalty). This type of policy is the basis for with-profits bonds, which are sold as single premium investments, and became the predominant form of with-profits business written during the 1990s.

A variety of methods have been used in the past to track the starting point for determining what would be a fair payout to a policyholder on surrender, maturity or retirement. The most common method today is the use of asset shares. The asset share can essentially be thought of as the premiums paid on the policy, plus the returns these earn, minus charges<sup>8</sup>.

Returns to the policyholder in with-profits are delivered by way of "bonuses". Bonus policy will be set out in the representations to the policyholder, although this will normally be fairly loosely defined to allow the provider discretion in setting and changing bonuses. In most modern policies, the aim will be to pay out smoothed asset share. Bonuses are normally delivered in two parts. Regular reversionary bonuses are declared which usually increase the guaranteed payout value. Many different methods can be used for this, but the guaranteed value of the policy will usually be well below the unsmoothed asset share. At encashment, the policy value will then be raised to its smoothed asset share value by way of the final terminal bonus.

If policies are encashed before maturity (or non-guarantee dates in the case of with-profits bonds), the provider may reduce the payout value below the guaranteed value. With CWP policies, the insurer is likely to have wide discretion in the calculation of this value. For UWP policies, a more explicit method, using surrender charges and, if necessary, a market value reduction (MVR) tends to be used. The application of a MVR is usually driven by movements in the market value of assets and, in particular, when a policy's resultant unsmoothed asset share has fallen below the face value of units. A MVR is generally not intended to generate surrender profits for the insurer, but instead to prevent policyholders selecting against the fund (to the disadvantage of those who remain) and to protect the solvency of the fund.

6.14 The industry maintains strongly that with-profits products deliver considerable benefits to customers. In support it cites:

- the continuing popularity of with-profits products;
- in particular, the popularity of their smoothed equity returns; and
- figures showing that with-profits products have delivered good historic returns for consumers.

6.15 The Review readily acknowledges that:

- there is a real aggregate benefit from using pooling between different generations of policyholders to reduce risk, enabling a higher equity component to be maintained over the life of the

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<sup>8</sup> The full range of factors that can contribute to asset share are: premiums, the investment returns on the assets, and profit or losses from other sources; minus expenses, other costs, tax, and charges for exceptional items. However, some providers use the term "asset share" to incorporate the effects of smoothing. A fuller discussion can be found in the FSA document "A description and classification of with-profits policies", October 2001. For clarity, the Review uses the terms "smoothed asset share" and "unsmoothed asset share".

product instead of having to reduce the equity component (and hence returns) as maturity is reached; and

- with-profits products have allowed investors of even relatively small sums to get access to professional asset allocation and invest in a diversified way across a broad range of asset classes (the significance of asset allocation is explored in Chapter 7).

6.16 However, the Review is sceptical of the argument that the high sales of with-profits policies are themselves proof that consumers value the product features. As is generally acknowledged, retail savings products are “sold rather than bought”. Nor is it clear whether consumers actually understand the smoothed return proposition. Recent FSA research<sup>9</sup> found that when smoothing was explained to consumers as a process whereby providers held back and re-delivered returns at their discretion, they did not find this an attractive concept.

6.17 The Review also does not find the data on with-profits performance conclusive. A number of studies have been produced attempting to assess how performance of with-profits products have compared with alternative investment vehicles. The results have been mixed, with some studies arguing that with-profits payouts compare favourably while others claim the reverse<sup>10</sup>.

6.18 This inconclusive outcome highlights the opacity of with-profits products and the difficulties of establishing their true comparative performance. For example:

- with-profits providers have been able to boost payouts to policyholders who hold to maturity at the expense of those who surrender early. Maturity returns therefore only give a partial picture of performance;
- the period selected for the comparison will influence the results - one would expect with-profits to show a better comparative performance in times of bear markets;
- use of the inherited estate can mask underlying performance;
- more generally, with-profits performance is made up of many different elements, including investment performance, guarantees, life insurance, and use of the inherited estate. The extent of these elements varies from one policy type to another, and the lack of disclosure makes it impossible to assess the magnitude of these individually; and

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<sup>9</sup> Conquest Research - set out in FSA with-profits Issues Paper 3, “Disclosure to consumers”, January 2002.

<sup>10</sup> For example, a Money Management survey in January 2001 found no consistently superior performance between with-profits and managed funds. Figures provided by the ABI showed average returns on with-profits policies during the last ten years were around 10 per cent, similar to the average returns on unit trusts in the balanced managed sector. Analysis by John Chapman (Greig Middleton Financial Services Limited, “Should with-profits be closed down?”, July 2001) showed investment in a UK equity tracker would have produced a 17 per cent higher return than investment in with-profits average asset mix.

- it is not easy to define a suitable comparator. With-profits itself is a collection of products rather than one clear genus. Even within individual product types there are complications. The different tax treatment of product types can cloud comparisons, as can different product features such as the life insurance element and guarantees inherent in with-profits products. Even if all these factors are successfully controlled for, there is still a difficulty in finding a suitable comparator in terms of investment objectives (and hence underlying asset mix). The most similar types of product, such as balanced managed unit trusts and lifestyle/target funds remain relatively few in number and are relatively young products, limiting the extent to which any sensible comparisons can be drawn.

6.19 The Review therefore believes that no clear conclusions can be drawn from data on payout levels.

6.20 It is also argued in some quarters that the criticisms of with-profits products relate to “old style” products – regular premium, endowment contract, conventional with-profits policies – for which a relatively small amount of new business is written, and so any problems identified are in fact largely historical. It is true that certain specific problems are associated with “old style” with-profits funds and policies, and it is also true that the industry has, of its own volition, made considerable improvements to these products. However, the Review has found that there are generic features of with-profits products which continue to cause concern. These are considered below. In addition, while there may be little in the way of new business being written in many of the products with more detrimental features, there remains a considerable stock of these products in force and therefore they cannot be ignored, especially from the perspectives of investment issues and, more generally, competition between providers.

6.21 The Review’s analysis of with-profits products has considered:

- the structure of the products; and
- the functioning of the with-profits market.

Issues raised by the investment strategies of with-profits funds are considered in Chapter 7.

## **The structure of with-profits products**

6.22 The structure of with-profits policies has been subject to criticism for some years. This has prompted a number of reviews from within the industry, and last year the FSA set up a review<sup>11</sup> to look at practices in the with-profits sector, with particular focus upon the exercise of provider discretion and the extent of transparency and disclosure in the industry. This is therefore an area in which considerable work is already under way.

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<sup>11</sup> For details, see the FSA document, “Feedback statement on the with-profits review”, May 2002.

- 6.23 Much of the criticism of with-profits has focused on issues of fairness and consumer protection. The FSA has statutory responsibilities to secure the right degree of protection for consumers and promote public understanding of the financial system. It is appropriate that they should examine with-profits products with these issues in mind, and the Review strongly supports the governance and other reforms which the FSA set out in May 2002.
- 6.24 It is also worth noting that the ABI has been engaged for some time on the “Raising Standards” initiative, a major part of which seeks to improve the workings of the with-profits industry through the development of voluntary codes of best practice.
- 6.25 The Review has been concerned to avoid duplication of the work of others on with-profits, in particular that of the FSA. However, by virtue of its particular remit and its freedom from statutory and commercial constraints, the Review has a complementary perspective to bring to bear on the subject of with-profits. Specifically it has considered with-profits products principally from the perspective of promoting:
- competition; and
  - investment efficiency.
- 6.26 The analysis and recommendations of the Review should be seen in this context, and not as a package of measures principally aimed at limiting consumer detriment. This is more properly for the FSA. However, the Review’s work is complementary to that of the FSA: strong competition and effective investment processes are very much in consumers’ interests.
- 6.27 The Review’s concerns about the structure of with-profits products arise from:
- the general opacity of the product;
  - the conflicts of interest which it raises in its current form;
  - the 90/10 structure; and
  - inherited estates.

### *Opacity*

- 6.28 The most significant concern of the Review is that the extreme opacity of the product, as it currently exists, serves to inhibit effective competition. The gross return on with-profits products is composed of four very different elements:
- the underlying investment return;
  - smoothing of this return either up or down;
  - the contribution from participation in the provider’s other business; and
  - the charging of costs.

- 6.29 Even once a policy has matured, although policyholders can see what the overall return on their money has been, they do not know how these four components have contributed to it. They are unable to determine whether a good return has been as a result of superior investment performance, or whether in fact their underlying investment return has been poor and has been smoothed up using the fund's reserves. They have no understanding of the extent of smoothing or how it has been applied. During the life of the policy, they usually cannot even establish if the policy is performing well, since the final payout on the policy may well form a significant part of the total return. In other words, assessing the quality of the product or its investment strategy is realistically impossible. In terms of consumer scrutiny, it certainly cannot be compared to a managed mutual fund, even though such a fund may be operating quite a similar investment strategy.
- 6.30 Focus on price and costs is equally weak. Charges are also not routinely reported to customers as they are for unit-linked funds or unit trusts, and there is no clear notion of one with-profits product being cheaper than another. It is also striking that with-profits products tend to pay large up-front commissions and with-profits bonds were found by the FSA to be subject to commission bias<sup>12</sup>. The Review is concerned that product opacity and high charges are linked phenomena.
- 6.31 There has also been concern, particularly in light of the problems with Equitable Life, that regulatory reports do not give sufficient detail of disclosure about the solvency of with-profits funds. As part of its review, the FSA has put forward proposals to address these deficiencies.
- 6.32 It should also be noted that with-profits policies have historically made widespread use of technical terminology which has been:
- confusing – terms such as “reversionary bonus” and “terminal bonus” are difficult for ordinary consumers to understand; and
  - inconsistent between one provider and another – terms such as “asset share” are widely used by firms, but mean different things.

### *Conflicts of interest*

- 6.33 With-profits products create inherent conflicts of interests in proprietary companies, particularly over the selection of investment opportunities.
- 6.34 A with-profits policyholder exchanges money for a contractual promise of benefits. The assets in the fund therefore belong to the insurer, not the policyholder. The legal position of the policyholder is similar to a deposit account saver, where the ownership of the assets also passes to the provider firm in exchange for a contractual promise. However, for a deposit account, the contract is very clearly defined with the provider retaining little discretion and the payout is closely related to the amount invested. In contrast, the

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<sup>12</sup> FSA, CP121, “Reforming polarisation: making the market work for consumers”, January 2002.

“promise” contained in a with-profits contract is generally vague and not well defined. The return to the policyholder can be heavily influenced by the company’s internal decisions and exercise of discretion.

6.35 At the same time, these rather vague contractual rights contrast with the rights of the insurer’s shareholders (for proprietary firms). The duties of directors to act in the best interests of their company and its members are unambiguous, and these interests do not always coincide with those of policyholders.

6.36 The inherent conflicts of interest, coupled with high levels of provider discretion and the difficulties of applying effective scrutiny, raise concerns about policyholder interests. For example:

- with-profits money might be invested in ventures which have strategic value for the business as a whole, but do not themselves earn an adequate return;
- with-profits money could be invested in a venture from which the profit extraction favours shareholders; or
- cost allocations for projects could be made in ways which are unfavourable to policyholders.

6.37 The principal governance arrangement to counterbalance these sorts of concerns is the appointed actuary<sup>13</sup>, whose role is to protect policyholder interests. But:

- the appointed actuary is appointed by the board (and historically has often served on the board, particularly in the case of mutuals) and this can undermine his independence; and
- the legal power of the actuary depends on the articles of association of the company, and can in some cases be fairly limited – for example, the company may be under no obligation to take account of his advice.

6.38 More generally, there will continue to be concerns about conflicts of interest as long as the opacity of the product means that customers or their representatives cannot exercise proper scrutiny over use of the assets.

### *The 90/10 structure*

6.39 The 90/10 structure has the merit of aligning policyholder and shareholder interests, since both participate in the payouts of the with-profits fund.

6.40 However, in this structure, costs are charged directly to the fund. This means that incentives toward efficiency are weak, because there is no effective disclosure of costs.

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<sup>13</sup> The FSA is reviewing the role of the appointed actuary and wider governance arrangements for life companies. See the FSA Feedback Statement, “Future role of actuaries in the governance of life insurers”, May 2002.

6.41 The 90/10 structure also contributes to opacity. The justification for shareholders receiving 10 per cent of payouts of the fund is that shareholders stand ready to provide capital for the fund should it be required, and part of their share of the bonus payouts is in return for this. It is true that with-profits funds need to have capital underpinning them, and the provision of this capital should be properly remunerated. However, this should be related to the quantum of capital and the level of risk involved. An arbitrary figure of 10 per cent of bonus declarations is clearly not the result of such a pricing process; nor is it clear why the payment for risk should be related to fund payouts. The result of this structure is a further obscuring of the financial performance of the fund. It is also noteworthy that, in practice, shareholder funds are generally not committed to underpinning with-profits funds, as these tend to have built up sufficient internal capital.

### *Inherited estates*

6.42 Inherited estates initially arose as actuarial assumptions about future investment and mortality risks proved to be too cautious, meaning policy payouts were substantially below what they could have been. Whilst the practice of chronic underpayments largely died out some years ago, this was not before the inherited estates had grown to a substantial size<sup>14</sup>. Many of these remain, with their values further boosted by the investment returns the assets receive. The existence of an inherited estate to underpin the capital supporting a with-profits fund enables a higher proportion of investment in equities. The inherited estate also provides the insurer with a discretionary resource available for a variety of uses, such as bolstering bonus payments, supporting investment in new activities or even paying mis-selling fines.

6.43 It is not possible to say precisely how large the inherited estate is for a given provider. The term inherited estate is not a statutory concept and does not have a universally agreed definition<sup>15</sup>, although it is generally understood to mean the excess of assets in the fund over and above the amount required to meet liabilities (including the liabilities arising from needing to make payouts in line with expectations generated). The FSA is looking at establishing a consistent set of accounting rules to enable the calculation of inherited estate sizes<sup>16</sup>.

6.44 Much of the public debate has focused on issues of the attribution and re-attribution of the inherited estates, and related questions of fairness. As part of its work, the FSA is reviewing the mechanisms by which policyholders' and shareholders' interests in the inherited estate should be determined.

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<sup>14</sup> A report by the Consumers' Association ("Profits at the consumers' expense: life insurance company with-profits funds" February 2001) estimated that, in total, inherited estates stood at £45 billion. Declines in the equities markets since that report was published will have depressed the current value of the inherited estates.

<sup>15</sup> Inherited estate does not have a statutory definition, but is the term used to describe the assets in a with-profits fund which are in excess of those required to meet payout values. Some commentators also describe this capital as "orphan assets", although again there is no statutory definition of this.

<sup>16</sup> FSA with-profits Issues Paper 2, "Regulatory reporting", November 2001.

- 6.45 The Review has a somewhat different interest in the subject of inherited estates. Since the size of inherited estates is not generally known, they are effectively a pool of essentially free capital that the provider may use, in a wide variety of ways subject to regulatory constraints. This distorts competition and increases opacity still further.
- 6.46 Inherited estates can provide capital for investments that have a strategic benefit for the shareholder business. Because of the advantages that these assets deliver to incumbents, their existence tends to act as a barrier to entry to new entrants, thus dampening broader competitive pressures in the industry. And because their use is poorly scrutinised, it has been argued to the Review that inherited estates give rise to an inefficient use of capital.

## Competition in with-profits

- 6.47 The structure of with-profits products influences the basis upon which with-profits providers compete with each other.
- 6.48 Ideally, competition should focus on the actual investment returns of the with-profits fund and the cost efficiency of the provider (reflected in the level of charges). But the opacity of the product makes it impossible to determine what these are. The high level of discretion available to providers to make use of inherited estates means that even if figures on costs and investment were known, their relevance would be limited.
- 6.49 Instead, competition in with-profits has concentrated upon:
- historic payout performance – specifically, payout at maturity, which has been used as the measure of the “return” on the policy; and
  - financial strength – as both a measure of risk, as well as an indicator of terminal bonus potential (on the basis that financial strength correlates with ability to weather times of poor returns and support payouts).
- 6.50 As a basis for competition, neither measure is satisfactory. The focus on payout at maturity gives at best only a partial picture of the performance of policies. While a lack of the necessary data means exact numbers cannot be determined, there is evidence that a large proportion of policies are not held to maturity:
- the last survey of persistency undertaken by the PIA in 2000 found that for some products/distribution channels, persistency after four years is around the 60 to 70 per cent mark;
  - an OFT report<sup>17</sup> found that perhaps fewer than half of all life insurance policies were held to maturity; and

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<sup>17</sup> Office of Fair Trading (OFT), “Fair trading and life insurance savings products”, 1993.

- analysis by Cazalet Financial Consulting suggested that 70 per cent of endowment policies written in the 1980s will not be held to maturity.

6.51 This means that the value of a policy if surrendered early should also be of interest to potential investors considering the choice of alternative providers. However, very little information has historically been given about this. This has led to widespread concern that surrender values have been poor, and the suggestion that life offices have made “surrender profits” which have then been used to boost the headline maturity payout figures. Evidence of poor surrender values for endowment policies exists in the form of the traded endowment policy (TEP) market, which allows policyholders to sell their policies for more than surrender value. While the Review received several submissions that argued surrender values had moved towards “fair” levels, it also found that sophisticated investors were still taking out with-profits policies in order to benefit from the “maturity windfall” gained at the expense of the early leavers.

6.52 Comparison of with-profits payouts with deposit account returns is also common practice. This is of concern as it supports the impression that with-profits policies are “virtually as safe as”<sup>18</sup> as deposit accounts. It is clear that many investors do not appreciate the extent to which with-profits funds are invested in equities, nor the extent to which their returns are dependent on the discretionary final bonus declaration. Research of consumers undertaken for the FSA<sup>19</sup> found limited understanding of the investment profile of with-profits funds and the nature of the risk involved. The case of Equitable Life, where many policyholders were surprised to discover their policy values were affected by the guarantees given to other policyholders, further illustrates this point.

6.53 Financial strength is also problematic as a focus of competition. The most frequently used measure of financial strength of with-profits providers is the Free Asset Ratio (FAR). This is a measure of the company’s assets relative to its liabilities. There is more than one way to calculate the FAR, but even when a standard calculation is used, it is still open to a number of criticisms:

- the current limited amount of information disclosed by firms in regulatory returns means the FAR can only be calculated for the company as a whole, and not the individual with-profits funds contained within it; and
- FAR is an imprecise measure, since it is dependent on a judgement of the value assigned to the liabilities by the appointed actuary of the firm. The value will also be dependent on a number of other

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<sup>18</sup> See the report of the with-profits bond working party, The Actuarial Profession, 2001.

<sup>19</sup> Conducted by Conquest Research. Details can be found in the FSA’s with-profits review Issues Paper 3 “Disclosure to consumers”, January 2002.

factors, such as the type of assets held to back those liabilities, the extent to which liabilities are reinsured, and the transfer of non-profit business<sup>20</sup> to subsidiary companies.

- 6.54 There are other measures of financial strength, such as rating agency assessments, but again these will contain an element of judgement. In addition, the importance of financial strength in determining payouts and smoothing should not be overemphasised; while a strong balance sheet unquestionably enhances the ability to smooth, actual payouts will be dependent on a wider range of policy considerations.
- 6.55 There is also concern that with-profits providers have used some misleading characteristics to make their products attractive. These include high first year bonus rates (which will only apply if the policy is held to maturity and may well be offset by lower subsequent bonus rates), and promotional emphasis on the “tax free” nature of payouts (when in reality with-profits products are not tax advantaged for standard rate tax payers). In addition there is unease about the way charges are presented which may appear to give with-profits an unfair advantage over other products. Research for the FSA also found that IFAs’ decision on where to place with-profits bond business was significantly influenced by the level of commission offered by the provider.
- 6.56 The problem of assessing past with-profits performance against other products was discussed above. The absence of any effective performance comparisons between with-profits products and their alternatives clearly limits the extent to which any sensible judgement can be made about the benefits which these products have delivered to consumers. It also highlights the feature that underlies most concerns about with-profits – namely, their opacity.

## Summary

- 6.57 The Review has identified a series of concerns about with-profits products from the perspective of competition and efficiency.
- 6.58 The extreme opacity of the product, as it currently exists, serves to inhibit effective competition. Even once the policy has matured, although customers can see what the overall return on their money has been, they are unable to determine whether it has been as a result of good investment performance, or whether in fact their underlying investment return has been poor and has been smoothed up using the fund’s reserves.
- 6.59 Focus on price and costs is weak. Charges are not routinely reported to customers in the way that they are for unit-linked funds or unit trusts, and there is no clear notion of one with-profits product being cheaper than another.

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<sup>20</sup> “Non-profit” business is that undertaken by a firm where the policyholders do not share in the profits or losses of the provider firm, for example, term assurance.

- 6.60 With-profits products place under the provider's control a pool of capital separate from that of shareholder subscribed (or earned) capital which represents an alternative source of investment capital for the business and an alternative place to charge expenses. The originators of this pool of capital – the policyholders – have very little information about how it is invested and how expenses are charged to it. This can both distort competition and also lead to inefficient capital allocation. The existence of the appointed actuary does not remove these concerns.
- 6.61 In the 90/10 structure that is still the norm for most proprietary firm funds, incentives for cost minimisation are weak. Opacity is further increased by the unclear nature of the 90/10 payment and its lack of relationship to any genuine assessment of risk to which shareholder capital is exposed.
- 6.62 The existence of inherited estates also raises concerns for the Review, specifically, regarding their lack of visibility and the efficiency with which they are used. The inherited estates can be used to meet excess costs in the with-profits fund, weakening incentives to minimise these, or to invest in ways which benefit shareholders disproportionately.
- 6.63 The main basis for competition between with-profits products has been payouts to maturity and financial strength. But these give only a very partial picture at best of the true performance of the fund. Important issues such as the actual investment returns of the with-profits fund and the cost efficiency of the provider are obscured.
- 6.64 The Review believes that a new model of with-profits products must be devised to address these concerns. The key features of such a model are set out in chapter 10.

