ABI's response to 'Financial Services and Markets Act two-year review: Changes to secondary legislation'

Our comments relate to Chapter 4 (The Impact of FSMA on Employers Offering Pension Products), Chapter 8 (Changes to the Regulated Activities Order) and Chapter 9 (Other Secondary Legislation).

We would welcome the opportunity to discuss the issues raised in this paper more fully with HMT officials.

CHAPTER 4: The Impact of FSMA on Employers Offering Pension Products

We welcome HM Treasury's proposals to examine the unnecessary obstacles that the FSMA places in the way of employers who wish to provide good faith advice to their employees about workplace pensions. The ABI has been calling for change to the existing Financial Promotion rules governing what an employer can and cannot say to their employees on pensions since April 2002, and it has formed a key plank of our Employer Action Plan.

Our research shows that employer provision in pensions works:

- 43% stakeholder pension contracts sold (to September 2002) were workplace-based;
- employer involvement played a part in 87% of stakeholder sales; and
- ABI research shows that an employer contribution can increase take-up five fold – taking it from 13% where there is no employer contribution to 69% where there is a 5% contribution.

The workplace also happens to be a logical place through which to provide pensions. All those not saving, or not saving enough, are in work or of working age. And the requirement for all but the smallest employer to provide a stakeholder pension or some other form of pension has further solidified the link between pensions and the workplace. We also have the best chance of building economies of scale by selling through the workplace.

Yet at present the infrastructure that has been developed to deliver pensions through the workplace is not fulfilling its potential. One significant reason for this is that many employers are failing to promote their workplace pension, largely (though not exclusively) because of fears over liability. We consider that change to FSMA is essential if Government is serious in its desire to enable employers to do more to promote the value of pensions, and provide better information about them.

Allowing employers to promote stakeholder pensions or Group Personal Pensions (GPPs) provided through the workplace is a necessary step which could:

a. remove the complexity and confusion caused by the application of different rules for different types of pension arrangements;

b. liberate employers from the fear of liability from actively promoting their workplace pension scheme; and, in so doing,
c. boost take-up, and overall savings, in workplace pensions.

Removing complexity and reducing confusion

Currently, the rules on financial promotion that govern what employers can say to their employees about their workplace pension vary according to the type of pension under discussion.

In theory, any communications promoting an investment such as a pension must be made or approved by an FSA-authorised person. But the promotion of occupational pensions – whether defined benefit or defined contribution – falls outside FSMA regulation so employers are free to promote them as they see fit, without the need to worry about potential liability. Employers providing a GPP or optionally designating a stakeholder scheme, however, are caught by FSMA so employers must tread carefully.

What's more, the different regimes may be seen to apply to pensions that have few significant differences, save for their title. For instance, an employee who can join an occupational money purchase pension scheme with a 6% employer contribution, and an employee who can join a GPP with a 6% employer contribution will face the same issues in reaching any decision to join the scheme. Given this, it would seem sensible for the regulatory environment to be closely aligned.

The current complexity breeds confusion, and leads to inaction on the part of employers – many of whom may have combinations of different types of scheme, and who therefore have to juggle the different rules when speaking of their different schemes. The FSA has recognised this and has published a guide for employers[1] which has the intention of bringing clarity to this murky world. Despite being written in simple language this guide attempts to explain a complex system and necessarily errs on the side of caution, and so it is unlikely to encourage an employer to promote membership of their scheme.

Promotion of workplace pensions is a voluntary and non-core activity for employers. As such, reform of the overly complex system is necessary, and any such reform should be guided by the need to bring **simplicity** where confusion currently abounds, and make it straightforward and clear to employers what they are able to say to their employees.

Liberating employers from fear of liability

Active employer engagement in pensions works. For example, a modest employer contribution of just 5% of salary can increase scheme membership levels from 13% to 69%. We need to see more employer involvement in

[1] *Helping your employees with their pension options – a guide for employers offering stakeholder pensions or group personal pensions*, FSA.

pensions. Yet ABI research[2] found that 42% of employers were not promoting their workplace pension to employees due to fears over potential liability.

Revising the financial promotion rules should therefore aim to provide employers with **certainty** in the shape of straightforward clear guidelines within which they are free to communicate the benefits of their workplace pension, without fear of the threat of prosecution.

Any change to loosen the rules around financial promotions must be communicated to *all* employers, with special care taken to ensure that the message reaches smaller employers. No matter how cleverly drawn an exemption is, it will come to nothing if it is not communicated by a means appropriate to the intended audience. Accordingly, a revised FPO should be able to be explained in clear and simple terms which are easily understood by employers, regardless of their size. The dissemination of the Pensions Information Pack, due to be piloted in DWP's Workplace Pilots in summer 2004, may help in this regard.

Boosting take-up and savings

Employer promotion boosts take-up of workplace pensions. ABI Members' experience confirms that employer endorsement of a scheme is a crucial determinant of take-up. So making it easier for employers to actively promote their workplace pension scheme will assist in boosting take-up, and will also help in raising the overall amounts that employees are saving for their retirement.

In addition, employees trust their employers more than they trust others. When asked whether they trusted their employer to keep their word when it comes to pensions, 67% of workers said they did. To build on this trust, revised rules on financial promotions should allow employers offering GPPs and stakeholder pensions greater scope to promote their schemes.

***Simplicity* and *certainty* must be the guiding principles when considering how best to reform the rules surrounding financial promotion. Any revision of the rules must aim to endow employers – regardless of size – with the tools to give to their employees common sense information and guidance about the pension schemes they offer, and the benefits of joining.**

Too often employees do not appreciate the benefits that they are foregoing through not joining their workplace pension scheme. Aspects of the Government's Informed Choice agenda will help in this regard (e.g. the various forecasting initiatives) but they should be complemented by measures which enable employers to promote the benefits of their own pension scheme. Such measures should be presented in a positive tone to encourage employers to assist their employees.

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[2] *Workplace Advice – A Discussion Document*, ABI, April 2002

We are supportive of DWP's investigation into the positive impact that a number of initiatives, such as auto-enrolment and auto-increment can have on scheme take-up and levels of contributions. Efforts to facilitate wider exploration of these benefits should not be inhibited by the development of proposals around what an employer can say.

What employers should be able to say

It is clear that the current regime does not strike the right balance between allowing employers offering GPPs or stakeholder pensions to promote membership of their workplace pension, and safeguarding employees' interests. Sweeping away all the FPO rules would appear to create real simplicity but a blanket exemption prompts concerns about consumer protection, raising the possibility that some employers may go beyond their expertise in recommending specific courses of action to their employees.

We consider that the rules governing what employers offering GPPs or stakeholder pensions can say to their employees should be loosened, rather than removed. In general, employers do not want wide-ranging powers to advise their employees on all aspects of investments; nor are they qualified to give it. If they wish to get involved with pensions it is to provide simple, commonsense information to employers about the pension offered to them at work - changes to the FPO should enable them to do this, and no more.

Unfortunately one rule does not fit all. There are significant differences in what an employer should be able to say in promoting their pension scheme depending on whether they make a financial contribution to it, and what form this contribution takes. In this regard we wish to see better alignment between the rules for employers with GPPs and stakeholders and those with occupational schemes. The table below illustrates what we consider employers with differing financial commitments to their workplace GPP or stakeholder pension should be able to say under a revised FPO in response to an employee asking whether they should join the workplace scheme

Employee's question	Scheme details	Employer's answer	Conditions
'Should I join the scheme?'	Unconditional employer contribution	(Unequivocal) Yes.	None.
	Employee contribution matched by employer contribution	Yes, because of the employer contribution it's a very good deal **but…**	….you need to be able to afford your contribution.
	Voluntary contribution	In general, you should consider this as regular saving for retirement makes sense. Seek advice if you're unsure about this.	Not applicable.

An employer who offers a GPP or stakeholder pension with an unconditional employer contribution would be free to promote membership of their scheme. And an employer offering a matched contribution could promote their scheme (and employee contributions up to the maximum matching rate) as long as they referred to the issue of affordability with employees. Mentioning such factors should not be mandatory but should protect employers from liability.

Finally, where the employer does not make a contribution, they should not be able to promote the scheme and should only be able to make general statements such as 'saving for retirement makes sense'. If the employee has further questions or concerns the employer should suggest seeking financial advice.

Employees may also ask their employers additional questions relating to (i) how much they should save; and (ii) how they should invest contributions to their pension. It is important that such choices do not get in the way of an employee's decision to start a pension. In response to question (i), the employer should be able to refer to the conditions outlined in the table above i.e. you should save as much as you can afford but you need to consider access to savings too. In response to (ii), there may be scope to expand the role of a default fund (which is a legal requirement for stakeholder pensions). If providers were permitted to specify a default fund for Personal Pensions with the same level of risk to the provider as for stakeholder pensions then this could help to simplify the choice for employers, perhaps enabling them to say 'the workplace pension comes with a default fund selected by the pension

provider. If you're unsure about which investment to choose then you should consider this or, alternatively, get financial advice'.

Our answers to the specific questions posed in HMT's Consultation Document about this topic reflect these comments. In summary, we consider that:

- any exemption should apply to both real and nonreal time promotions;
- an exemption without restrictions has attractions in terms of simplicity and clarity but should be rejected. The crucial determinant in what an employer is able to say should depend on the type of employer's financial contribution to the scheme;
- the provision of information to employees (e.g. on affordability) is not mandatory but reduces the risk for employers. Employers should be able to provide generic information on choices [pension, AVCs and ISAs] and factual information about the employer's scheme, but should not advise on product choice as such;
- limiting an exemption to employers who do not gain commercially from promotion of their scheme may have unintended consequences and needs to be carefully considered; and
- there should be no restriction on which employer's representatives can promote the employer's pension schemes.

Q10: Do you agree that there should be an exemption for both real time and nonreal time promotions made by employers (option 1(c))? If not, which of options 1(a) and (b) do you prefer?

Yes. We agree with the arguments laid out in HMT's Consultation Document that there should be an exemption for both real time and nonreal time promotions made by employers (option 1(c)). To exclude one type of promotion and not the other is likely to lead to more rather than less complexity for both employers and employees, and this is even more likely to be the case for smaller employers. The upshot of this confusion would be that many employers would simply decide not to promote their schemes, with negative consequences for levels of scheme take-up.

Excluding both types of communications will enable a clear and simple message to be given to employers that they are able to deliver information to their employees about their workplace pension without fear of contravening FSA rules. Moreover, as HMT rightly point out, there exists a precedent for exempting promotion of workplace-related financial services from regulation in the shape of promotion of occupational pension schemes and employee share schemes. Application of a similar exemption for promotion of GPPs and stakeholder pensions would therefore not represent the imposition of a wholly new regime, and if the regulatory regime is deemed to work satisfactorily for these two types of investment, why should it not be extended?

Worries that such an exemption would represent a removal of consumer protection should be eased since important aspects of protection would remain. For instance, as HMT note, it would remain a criminal offence to make misleading statements and all documents from pension providers to employees would still have to conform to FSA's conduct of business rules.

Q11: Do you agree that any exemption should be subject to conditions and not be unrestricted?

Whether to restrict any exemption depends on a trade-off between the desire for simplicity and the need to maintain a degree of consumer protection.

In terms of our desire for a clear and simple regulatory system we recognise the attraction of a blanket exemption (option (2b)). However, such an exemption may not adequately protect consumers.

We consider that an employer making a financial contribution is the key determinant in limiting an exemption. In particular, there should be a presumption that an employer can promote their workplace GPP or stakeholder pension to encourage employees to take advantage of an employer contribution. The type of contribution should determine exactly how much latitude employers have in promoting their scheme, and any conditions which should apply. The table on p.5 gives further details.

As well as ensuring that employers promote only schemes to which they themselves make a financial commitment, limiting an exemption in this way would help to address suitability concerns for someone joining an employer's workplace pension. If an employer is contributing to an employee's pension, issues surrounding whether it is worthwhile joining a pension are reduced. Employers who do not make a financial contribution to their employees' pensions should not be permitted to promote the workplace scheme.

Q12: Do you agree with the conditions outlined in paragraph 4.31?

The answer to Q.11 covers much of this ground. We consider that:

- employers should be given greater latitude where they make a financial contribution to an employee's pension – but only in relation to unconditional or matched employer contributions;
- informing employees of their right to seek financial advice should be highlighted but legislation is not required;
- limiting an exemption to employers who do not gain commercially from promotion of their scheme may have unintended consequences and needs to be carefully considered. Employers offer workplace pensions to receive commercial benefit and pension companies may offer legitimate – and much appreciated – assistance and services to employers to help them administer their pension scheme (e.g. payroll software). Would such assistance constitute a 'direct commercial benefit'?

Q13: Do you think that there should be other conditions?

No.

Q14: Do you think that the exemption should contain an additional condition restricting the ability of employers to provide individual advice to employees?

Some means of circumscribing an employer's ability to provide individual advice to employees is needed. For instance, we do not wish to see employers giving advice over decisions relating to issues such as transfers-in, contracting-out or investment choice.

Our response to this issue is covered above where we argue that the exemption from the FPO should be framed with a general presumption that employers making a financial contribution can promote their scheme but in doing so they should mention certain relevant factors. This approach would enable employers to give general statements to their employees such as 'you should bear in mind the need to have access to easily accessible savings when considering how much you ought to save in the workplace pension'.

Other methods of communication could be employed to inform employers of the correct boundaries about which they should be talking to their employees. Possible means for the dissemination of this information might include the proposed Pensions Information Pack for employers, which could detail a comprehensive list of 'what an employer should / should not say to their employees about pensions'. The regulator – whether it be FSA or the new pensions regulator – could provide standard wording for these aspects. Obviously, there will be a need for the message which is disseminated through the Pensions information Pack to reflect any revision of the FPO.

Q15: If so do you think that limiting the ability of employers to make promotions by a requirement that they do not provide pensions advice in relation to an employee's individual circumstances is an appropriate condition?

Yes.

Q16: Do you think that limiting the ability of employers to make promotions by reference to the definition of the activity of advising in article 53 RAO is an appropriate condition above?

No.

Q17: Do you think that limiting the ability of employers to make promotions by prohibiting reference to unfavourable comparisons with other pensions is a viable alternative condition above?

We consider that employers should be able to promote the positive aspects of their workplace pension scheme, e.g. mentioning factors such as the employer contribution and (potentially) lower Annual Management Charge.

Q18: Do you agree that there should be no restriction on which employer's representatives can promote the employer's pension schemes?

We agree that there should be no restriction on which employer's representatives can promote the employer's pension schemes.

A flexible approach will suit both larger employers who are likely to employ HR professionals to promote the employer's pension, and smaller employers who will welcome the ability to delegate this activity to their colleagues or other individuals.

This flexibility should extend to 'agents of the employer', as it would enable trained but non authorised staff to participate in fulfillment of schemes on behalf of employers who do not have either the time or inclination to do so themselves. This is similar to the notion of 'fulfilment agencies' that operate successfully in the USA to encourage take-up within 401k contracts. It is very important that this is the case and that prescription is limited.

In addition, ABI research reveals that certain key figures within the company have a critical role to play in boosting take-up of workplace pensions. Such 'key influencers, for example Union representatives, should not be excluded from the actively promoting the workplace pension scheme on behalf of the employer.

CHAPTER 8: Changes to the Regulated Activities Order

We suggest a minor change to the Regulated Activities Order to amend the definition of a “qualifying contract of insurance”.

Under the current wording, the definition in Part 1 (General), Section 3 (Definitions) has the effect of turning some term assurance policies into “qualifying contracts of insurance” (investment products) depending on the age of the customer and the term for which cover is required.

This follows through to the FSA’s handbook. Sales of those term assurance products that are defined as qualifying contracts are subject to the Conduct of Business sourcebook (COB), designed for investment business. Sales of other term assurance products are not currently regulated by the FSA but will be subject to the new Insurance Conduct of Business sourcebook (ICOB) from 14 January 2005.

The definition of qualifying contracts of insurance is clearly intended to distinguish between contracts of long-term insurance with an investment element and those designed to provide protection. Sections (i), (iii) and (iv) of part (b) of the definition achieve this. But it is not clear what additional benefit is provided by section (iii).

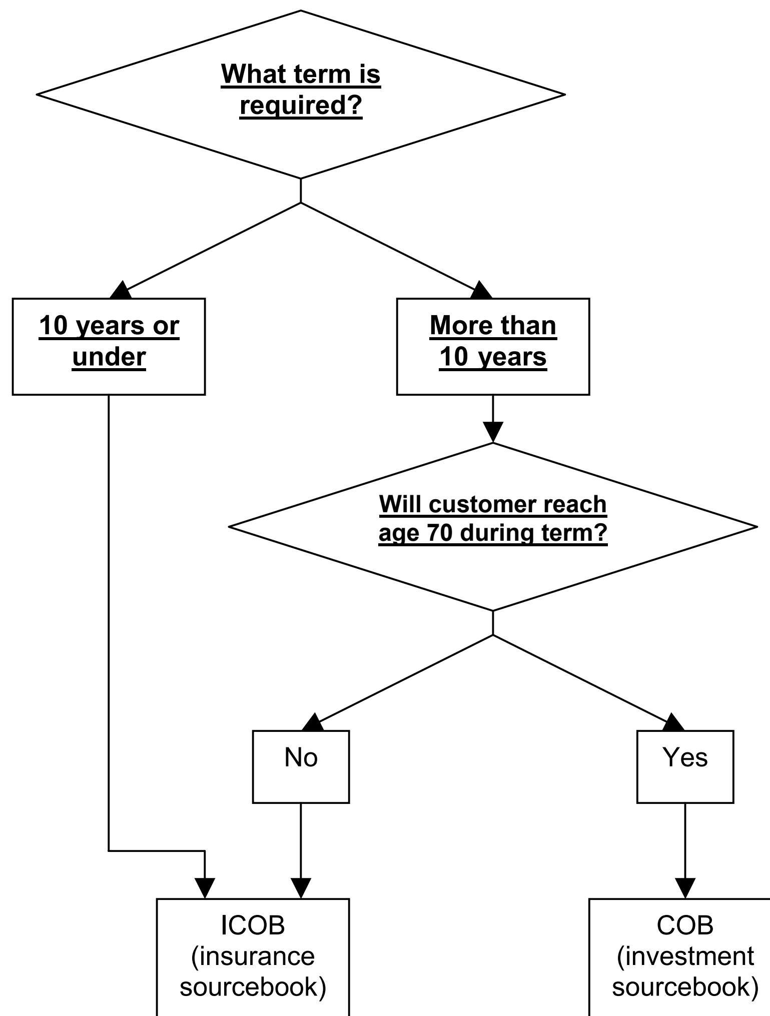
The definition in the Regulated Activities Order appears to have been taken from section 10 of Schedule 1 of the Financial Services Act 1986. When Act was being considered, the ABI pointed out to the Department of Trade and Industry in January 1986 that a ten year test was an arbitrary dividing line for the purpose of distinguishing between an investment type contract and a pure protection contract. Although our records show that the DTI was going to consider the matter further, the final result was still unsatisfactory.

We propose that section (b)(iii) of the definition should be deleted, as shown in below. The effect of the change would be to move the boundary between investment and non-investment insurance in order to ensure that all term assurance products are covered by the same regulatory regime.

If this change is not made, there will continue to be an arbitrary dividing line through one of the simplest of all insurance products. This will have a direct effect on the way in which term assurance can be offered to customers, since before a sale can even begin the adviser will need to know whether the customer’s circumstances and needs are likely to suggest a term assurance product offered under the investment rules or under the insurance rules.

The diagram below sets out the process for determining which rules would apply when selling a term assurance policy, based on the definition in the Regulated Activities Order and the requirements of the FSA handbook.

Figure 1: Decision Tree for selling a Term Assurance Policy



The diagram shows which sourcebook should be used to complete the sale, depending on the details of the product to be sold. However, this decision may need to be taken early in the sales process, since the adviser must determine first whether he will in fact be authorised to make the sale. An adviser authorised only for investment business would be able to sell term assurance only to customers who would want more than ten years' cover and who would reach at least the age of 70 during the term. An adviser authorised only for insurance business would be able to sell term assurance only to customers who would not reach 70 during the term, or who required cover for ten years or under. If an adviser is authorised for both investment and insurance business, he would need to show both initial disclosure documents or use the Combined Initial Disclosure document.

The table below shows the range of possibilities that could arise, depending on the age of the customer and the period of cover required.

Figure 2: Rules to be applied for term assurance sales to different customers

Customer	Policy Term required	Investment Rules (COB)	Insurance Rules (ICOB)
Age 44	25 years		✓
Age 45	25 years	✓	
Age 59	10 years & 1 day		✓
Age 60	10 years		✓
Age 60	10 years & 1 day	✓	
Age 70 or 80	10 years		✓

A policy term of 10 years 0 days would fall within the Insurance COB rules but a term of 10 years and 1 day would fall within the Investment rules. This is because a 10-year policy starting on 1 January would expire on 31 December, so the death would potentially occur "within ten years of the date on which the life of the person in question was first insured under the contract". As the table illustrates, the rules do produce some apparently arbitrary effects.

Even where an adviser is authorised to sell both investment and insurance business, he will have to follow different procedures according to the final product being sold. For example, the COB and ICOB sourcebooks set out different detailed requirements on product disclosure, knowing the customer and assessing suitability, as well as on the documentation to be provided at point of sale. There are also different requirements affecting non-advised sales, sales by post and internet-based sales.

Given these complexities, firms may choose not to offer certain term assurance policies to certain customers. Firms authorised only for general insurance business will have to restrict access in this way in order to remain within the law. This is likely to mean that customers aged 60 or above would only be able to obtain life cover for ten years or under. It is difficult to see how limiting access to a basic form of insurance can be in the interests of customers, particularly given the likely demand for longer term policies in light of increasing life expectancy.

There may also be difficulties for employers seeking to provide cover for staff who wish to work beyond the normal retirement age. Providing the

cover required could cause some group schemes to be classed as investment business.

We understand from member companies that policies meeting the "qualifying contract" definition represent only a small proportion (a few percent) of all term assurance contracts sold. This is another argument for clarifying how they are treated in regulatory terms. It is also likely that sales have been deliberately limited, in order to simplify the compliance requirements on firms.

Our proposal would provide that all term assurance policies with no investment value would all be treated in the same way, regardless of the period of cover required or the age of the applicant. The provisions in ICOB for a statement of demands and needs to be prepared, for advisers to provide the reasons for any advice given and for specified details about the contract to be provided in advance should provide a level of consumer protection in line with the minimal level of risk posed by term assurance products.

Proposed Amendment to the Regulated Activities Order

<u>Part I (General), section 3 (Interpretation)</u>

"qualifying contract of insurance" means a contract of long-term insurance which is not -

(a) a reinsurance contract; nor

(b) a contract in respect of which the following conditions are met -

(i) the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity;

~~(ii) the contract provides that benefits are payable on death (other than death due to an accident) only where the death occurs within ten years of the date on which the life of the person in question was first insured under the contract, or where the death occurs before that person attains a specified age not exceeding seventy years;~~

(iii) the contract has no surrender value, or the consideration consists of a single premium and the surrender value does not exceed that premium; and

(iv) the contract makes no provision for its conversion or extension in a manner which would result in it ceasing to comply with any of the above conditions.

CHAPTER 9: Other Secondary Legislation

Disclosure of information by permitted Persons

Q 42: We welcome views on the proposed change to the Disclosure regulations. Do you think that independent actuaries should be able to disclose information to others, in either of the situations outlined in (a) or (b) above, or both, or not at all

The draft legislation envisages that independent actuaries will be permitted to disclose information to the FSA for the purpose of enabling or assisting the FSA to discharge any of its public functions on the same basis as other persons already covered by the Disclosure Regulations.

It additionally envisages independent actuaries being permitted to disclose information for the purpose of enabling or assisting them to discharge their functions under FSMA, any underlying regulations and FSA rules.

We have consulted the Institute of Actuaries, as well as our own membership. On the basis that disclosure would relate solely to non-confidential information (namely, information not falling within s. 348(2) FSMA) and that disclosure would remain at the discretion of the actuary (taking into account good faith and relevance considerations), the Association does not oppose extension of the Disclosure Regulations in the form envisaged.

Swiss Insurers

Q 43: In relation to the proposals above should the existing exemptions be removed or limited? If so to what degree? Please provide reasons for your responses.

It is not possible to answer this question without any authority without HM Treasury providing more detailed information regarding whether the proposed changes are intended essentially as a “tidying” measure or have real implications for Swiss insurers in terms of capital requirements.

The 1989 Agreement effected between the EEC and the Swiss Confederation on direct insurance other than life insurance (“the 1989 Agreement”), negotiated in detail solvency and other requirements that were necessary and sufficient for establishing reciprocal arrangements across Europe. The 1989 Agreement excludes Swiss general insurers selling direct insurance through a UK branch from threshold conditions concerning close links, adequate resources and suitability. Prior to the issue of the HM Treasury consultation, Swiss insurers were not aware of any suggestions that the FSMA exemptions exceed the scope of the 1989 Agreement.

If the review of the legislation has brought into question the FSA’s lack of adequate supervisory powers and authority over threshold conditions, then we recognize the desire to close any technical loopholes. However, with regard to supervision, the 1989 Agreement enshrined home state supervision rather than supervision at branch level. As such, any unilateral moves by the UK in

this regard needs to be approached with caution, given the possibility of legislative overlap with the EU Solvency I and II Directives.

One particular company has raised concerns about the possible application of more stringent capital requirements under the adequate resources principle. In line with the 1989 Agreement, Zurich Insurance Company must hold in reserve assets equalling liabilities, comply with “Close Links” reporting requirements and provide the FSA with group solvency calculations. They contend that this provides adequacy of capital at the ultimate parent level. However, they are concerned that the UK branch could be expected to hold technical reserves both locally as an authorised UK entity and also at the Swiss parent company level. It should also be borne in mind that Zurich Insurance Company is in a somewhat unique position in that they own other UK insurers, including Eagle Star Insurance Company. There may, therefore, be a need to look at each Swiss insurer on an individual basis, rather than adopt a blanket approach.

The consultation paper does not make it clear how any adopted proposals would be implemented, given that it is stated that there would be no amendment to the FSA Handbook, Rules or supervisory practices. We, accordingly, seek further clarification as to how the proposals would be taken forward and, moreover, seek confirmation from the FSA that supervisory practices would not change.

Finally, we assert that HM Treasury should engage further with the industry on this matter to clarify the intention that lies behind, and the implications that may arise from, these proposals. Any decision to restrict or remove the scope of the current exemptions, could be counterproductive if it leads insurers to consider possible relocation outside of the UK.

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