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Dear Chancellor

It is of fundamental, and growing, public importance that Britain should have a savings industry that is both efficient and widely trusted. The long-term welfare of millions of people depends on it, as does the effective operation of our capital markets.

The industry has achieved considerable success in encouraging a wide range of consumers to save for the long term and to benefit from equity market returns in recent decades. It has also made a significant contribution to the UK economy as a source of employment and growth. But there are, nonetheless, grounds for concern:

- The savings marketplace is generally daunting for the consumer, with much jargon and a vast range of subtly differentiated products. Information on underlying costs and performance is often opaque – or even, in the case of many with-profits products, entirely absent.
- Consumers rely heavily on advice from intermediaries, although they have almost no understanding of the costs of obtaining this, and are unable to gauge its quality. Moreover, the advice itself is often compromised by the incentive effects of commission paid by product providers.
- Partly as a result, competitive forces do not always work effectively to deliver value. Charges for near-identical products can differ widely. In comparison with institutional behaviour, the prevalence of active management for retail funds is surprisingly high. The investment performance of unit trusts bears no relationship to their charges – and in fact the average UK unit trust underperforms the market by 2.5 per cent a year.
- There are correspondingly weak pressures on productivity and business performance. The British life insurance industry, for instance, has seen its real unit costs increase considerably over the past decade.
- Consumers require substantial regulatory intervention to protect their interests, although the cost of this contributes to pricing many lower/middle income savers out of the market altogether.

- Product choice remains heavily shaped by obscure differences in tax treatment which have built up over time. These may originally have been introduced to encourage savings, but have had the effect of considerably increasing complexity.

Plainly, this Review alone cannot hope to remedy all these problems. It strongly supports the continuing efforts of the industry, the Government and the FSA – with all of which it has worked closely – to make improvements.

Nevertheless, the Review sets out a clear vision, the driving principle of which is simplification. Simplification is the dominant theme of the Review because it is the key to delivering effective competition and to empowering the consumer.

The Review's recommendations are set out in Chapter 10. The main elements are as follows:

- The inherent tendencies toward complexity in the savings market, and the consequent need to regulate the sales process, have made it uneconomic for the industry adequately to serve lower-income consumers. Product regulation provides an alternative means of consumer protection. But a double layer of regulation is not needed. I recommend an extension of the present approach to regulation, which makes it more flexible and multifaceted. For many products, the present regulatory approach should remain. But it should be augmented by the introduction of a suite of simple regulated products – with capped charges, restrictions on investment profile, the ability to exit on reasonable terms, and so on – and, for these products, the present approach of regulating the advice process should be removed altogether. This will make a substantial difference to the economics of providing savings products to the mass market, stripping out substantial elements of cost. It will also help entrench a model of simple, low-cost products on which powerful competitive forces can operate, building on the existing stakeholder pension and CAT-marking regimes.
- With-profits products have been a particular focus for the Review because they exemplify some of the problems in the market in particularly stark form. The concept at the heart of with-profits – an investment product, which is both pooled and smoothed – has merit. In practice, however, with-profits products are extremely opaque; effective competitive forces on performance or costs are essentially absent; providers can exercise wide discretion in the use of the funds with almost no effective scrutiny by policyholders; and large inherited estates can distort the market. Not all these problems can be solved overnight. But my proposals, building on the FSA's parallel work on disclosure and governance, essentially strip with-profits down to the core concept. The prize is a demystified model in which the interests of providers and customers are much better defined, in which performance is transparent, unnecessary jargon is removed, and on which effective competitive pressures, for the first time, can properly operate.

- The key problem in distribution remains the delivery of advice, which the consumer only pays for indirectly and opaquely. This creates multiple distortions. Developing further the FSA's current proposals in this area, my key objectives here are to create stronger commercial incentives for IFAs to become genuinely independent, and to promote a properly functioning market for advice. I am keen to see advisers' rewards, even if not paid in the form of an upfront fee, being negotiated between the adviser and his client, rather than determined by negotiation between adviser and provider, from which so many perverse incentives flow.
- Historic tax structures continue to have a powerful, and often unintended, influence on savings product flows. Many products are sold on the basis of tax advantages, rather than on the underlying investment benefit, and the sheer complexity of the tax regime for savings products, as it has evolved over decades, adds greatly to the need for consumers to seek expensive advice. I make a number of specific proposals to level the playing-field for savings products. But looking forward, I am also sceptical of the effectiveness of tax incentives as a means of promoting overall saving, especially when weighed against their additional cost and complexity. The Government's overall objective in this area, as elsewhere, should be simplification. In particular, simplifying the present regimes for pensions taxation – of which there are eight – is a major challenge, which the Government has already rightly identified.
- The Review was specifically asked at the outset to examine the applicability to this industry of principles of investment, analogous to those for pension funds proposed in Paul Myners' report last year. The retail and institutional markets are somewhat different. Nevertheless, I believe it would be valuable for such principles (different in specific formulation, but closely aligned in philosophy) to be adopted in the retail savings industry – which itself manages over £800 billion in assets and owns a substantial proportion of the UK equity market.

The work of the Review has coincided with a number of investigations of the industry by the FSA and others. Whilst these have been focused on specific perceived problem areas, the broad remit and scope of this Review have given it a unique perspective. In particular, it has been able to concentrate its attention on issues of efficiency, investment performance and competition, and on the underlying drivers of commercial behaviour.

It has identified formidable challenges. But it has also sought to propose a clear agenda for Government, for the Regulator and for the industry. It offers a robust basis for the future of the savings industry – one in which effective competitive forces can be made to work for the benefit of consumers, the wider economy and ultimately, the industry itself.

## **Acknowledgements**

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I am also extremely grateful to the FSA for its support and contribution, and to consultants Booz Allen Hamilton for their assistance in the analysis of the industry.

Finally, I should like to extend my thanks to Daniel Oppenheimer, Secretary to the Review, and his team for the enthusiasm, insight and clarity that they brought to the work of the Review.

*Yours sincerely*

*Ron Sandler*

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