7 INVESTMENT

Investment decision-making

7.1 Investment decisions in the retail savings industry have a considerable impact on the UK economy. Approximately £800 billion is held in the products covered by this Review[1], while domestic life companies and investment vehicles in general owned 25 per cent of UK quoted equities in 2000[2]. This is a substantial pool of capital, the allocation of which clearly has important implications for the UK capital markets and the functioning of the broader economy.

7.2 The quality of investment decisions also determines whether individual savers obtain satisfactory financial outcomes appropriate to their specific circumstances.

7.3 In recommending the creation of the Review, the Myners Review of institutional investment argued that the functioning of the retail savings market was unlikely to apply effective competitive pressure on investment decision-making. It cited:

- the end-consumer's lack of understanding of the issues;
- financial incentives to advisers and providers that are unrelated to investment performance; and
- a focus for competition in the with-profits business on factors such as historic bonus levels and the Free Asset Ratio which are only loosely related to investment performance.

7.4 There is prima facie evidence to suggest that these concerns are valid.

7.5 First, the retail savings industry is characterised by a lack of correlation between price and performance: consumers are often paying premium prices without receiving superior performance in return. This is evident in Figure 7.1 below, showing gross annual UK unit trust performance over the last 10 years, plotted against current charges.

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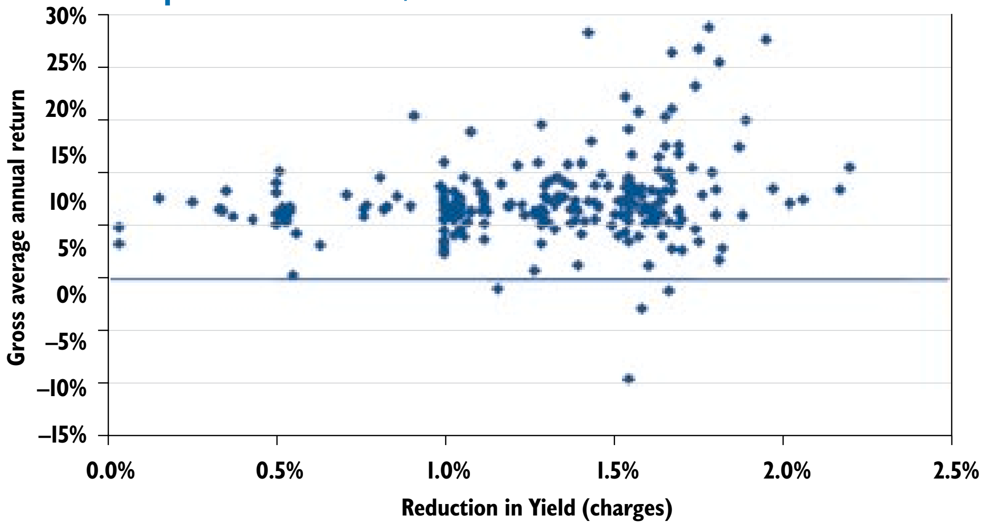
[1] In 1999, the funds under management in products covered by the Review were £860bn. 1999 is the most recent year for which appropriate figures for the relevant categories of life and pension products are available. See Chapter 2 for more detail.

[2] ONS Share Ownership Report, 2001. The figure for share ownership includes shares held in some funds that are outside the scope of this Review. In particular, funds associated with self-administered occupational pensions managed by life insurance companies are included, as well as general insurance investment holdings.

Figure 7.1: Gross performance versus charges – UK all companies unit trusts/oeics



Source: Booz Allen Hamilton analysis of data from Standard and Poors.

7.6 Associated with this is a surprising predominance of active management, notably among advised sales. Figures for new unit trust/oeic sales in 2001 show that 93 per cent were actively managed funds. Moreover, for funds sold to the consumer via IFAs, this figure rises to 97 per cent. The contrast with the institutional world is striking: in the UK, around 75 per cent of institutional funds under management are actively managed, and in the US the figure is lower still[3]. This discrepancy at the aggregate level is hard to justify given that institutional investors have typically much greater resources and expertise in the form of professional staff and dedicated investment consultants to devote to identifying superior active managers. The bulk of with-profits funds are also actively managed.

7.7 Many of the studies cited in this chapter refer to unit trusts/oeics; this is because data on them is much more widely available than for other investment products.

Types of investment decision and who takes them

7.8 There are three distinct groups involved in investment decision-making (consumers, advisers and product providers), and the role of each needs to be considered.

7.9 Investment decisions can be broadly divided into a hierarchy of:

- asset allocation: between the broad asset classes of equities, bonds, cash, property and alternative assets, and between geographical markets or particular equity sectors; and
- security selection.

[3] Mercer Investment Consulting.

7.10 At the highest level, any decision to save incorporates an asset allocation decision, typically between cash and equity-related products.

7.11 Investment decisions are also made at the stage when products are chosen. The nature of the investment decisions, and the involvement of the various parties, depends on the type of product. In general:

- for with-profits products and managed funds[4] (unit trusts/oeics or unit-linked), and some investment trusts, the consumer (and/or his adviser) is responsible only for the primary asset allocation decision: that is, to invest in a diversified portfolio of assets. Thereafter, the precise basis of asset allocation and the subsequent security selection are left to the provider; and
- for other unit trusts/oeics or unit-linked life funds (other than managed funds), and most investment trusts, the consumer is effectively taking the asset allocation decision, although he may not understand it in these terms. Thereafter, security selection is the province of the provider.

7.12 It is important to understand the relative impact of these two sorts of decisions on the performance of an individual's investments. A widespread consensus exists among investment theorists that, in most circumstances, the asset allocation choice is the critical element in determining long-run overall investment performance. A recent study which surveyed the literature[5] concluded unambiguously that, for the individual investor with a long-term, buy-and-hold investment style (the vast majority of clients of IFAs), the asset allocation decision is by far the most important factor in determining returns.

7.13 In other words, asset allocation allows investors to trade off risk against expected returns to find the combination of asset classes which suits their investment objectives. Historical data shows that corporate bonds have been riskier investments than government bonds, and that equity investments have been riskier still. Higher levels of risk are compensated for by the prospect of higher average returns – the so-called "risk-return trade off".

7.14 A recent study examined historical data on returns on different asset classes in sixteen markets around the world[6]. Figure 7.2 shows the performance, over different lengths of time, of equities, government bonds and cash (short term government bills) for the UK. Each bar in the diagram displays the average inflation-adjusted return from holding an asset category over different periods up to the present day. Over intervals of one to ten decades up to the current time, equities outperformed government bonds and bills in all ten periods considered. Over the last century, equities also outperformed in the other fifteen countries studied.

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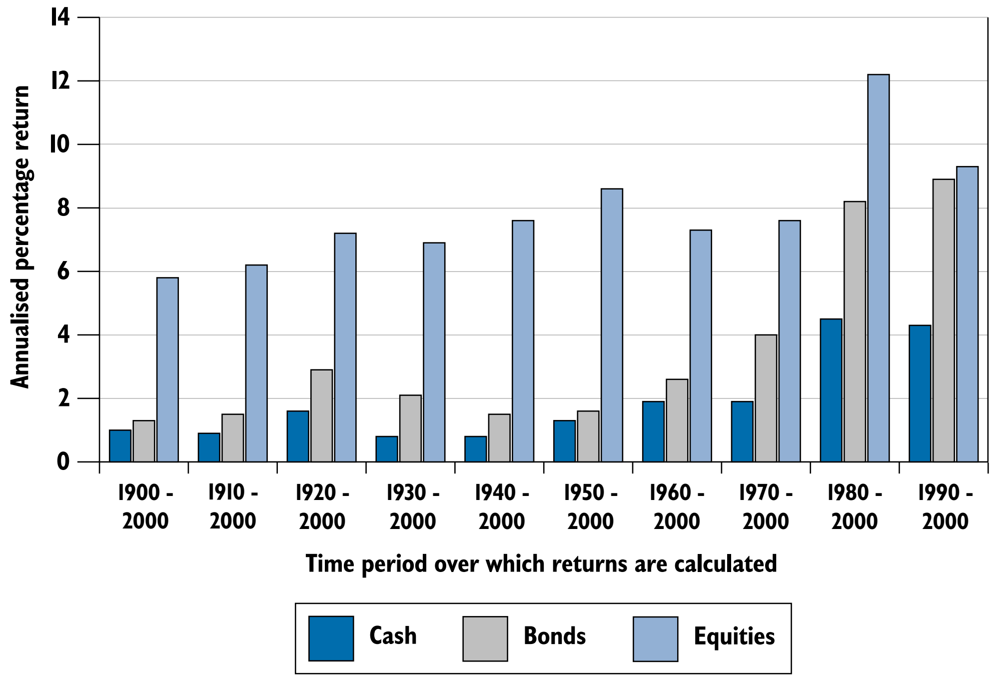
[4] The term "managed" denotes a fund where the fund manager makes the asset allocation decision. Note that this term denotes nothing about whether the fund is actively or passively managed.

[5] Ibbotson, R. G., Kaplan, P. D. 'Does Asset Association Policy Explain 40, 90 or 100 Per Cent of Performance?' *Financial Analysts Journal*, 2000.

[6] Dimson, E., Marsh, P., Staunton, M., *Triumph of the Optimists*, 2002.

Figure 7.2: Historical performance of equities, government bonds and cash in the UK



Source: "Triumph of the Optimists", Dimson, E., Marsh, P, Staunton, M., 2002.

7.15 This dramatically illustrates why the mix of asset classes chosen has such a substantial impact on overall portfolio returns over the long run.

Investment decisions: consumers

Excessive focus on past performance and lack of attention to charges

7.16 A recent survey[7] found that people seeking to invest in a unit trust/oeic have general objectives about investment performance, normally expressed as a desire to obtain a better return than that provided by a building society or bank account and to obtain "value for money".

7.17 However, when the survey went on to ask why investors had chosen the particular funds they did, past performance was the most common response. Past performance also underpinned many of the other reasons cited, such as press recommendations. Only 14 per cent of respondents cited "reasonable charges" to explain their choice of fund.

7.18 A focus on investment performance is hardly surprising; past performance is useful in most consumer purchase decisions. The argument is often made that for the best performing actively managed funds, superior performance should significantly outweigh any premium in charges. Figure 7.3 shows:

- the performance of the average UK unit trust over the ten years to 2002 (statistically adjusted for comparability[8]);

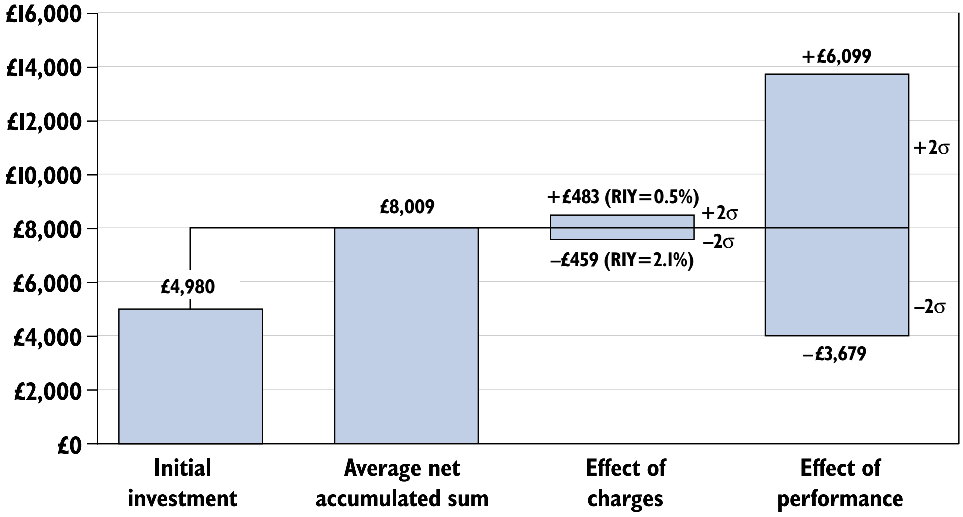
[7] AUTIF Survey, 2001.

[8] Performance over ten years or, where the fund has existed for only a shorter period, performance relative to the fund's sector for that period, multiplied by the sector's ten year average.

- how that performance was affected by charges. Thus, had the customer selected a fund with charges two standard deviations lower than the mean, they would have gained around £500 return over and above the average fund as a result of its low charges;

- how that performance was affected by levels of investment success. Thus, the fund with performance two standard deviations above the mean gained in the region of £6,000 above the average fund.

Figure 7.3: Charges versus performance as a driver of return – UK unit trusts/oeics



Source: Booz Allen Hamilton analysis of data from Standard and Poors.

7.19 In other words, if a fund is a truly superior performer, it will still be well worth investing in it even if its charges are above average. The difficulty is that taking advantage of this is only possible if the best performing funds can be identified in advance. Research suggests strongly that raw data on past performance alone is no guide to future performance[9,10,11]. Identification of likely future out-performance requires highly sophisticated and time-intensive analysis of performance data and fund managers' styles. Only a tiny minority of consumers have access to this sort of analysis. Yet without doing so, simply looking at past performance is of minimal value.

7.20 Moreover, it can be positively unhelpful to consumers, to the extent that it leads them to disregard variations in charges between providers. The impact of charges is indeed much smaller than that of investment performance – but it is also much more predictable. Two results of this are observed.

[9] Carhart, M., 'On persistence in Mutual Fund Performance', *Journal of Finance*, vol. LII, p. 57, 1997.

[10] Mark Rhodes, "Past Imperfect? The performance of UK equity managed funds", FSA Occasional Paper 9, 2000.

[11] Gruber, M. J., 'Another Puzzle: The Growth in Actively Managed Mutual Funds', *Journal of Finance*, vol. 51, p. 783, 1996.

7.21 First, it leads to insufficient competitive pressure on price. This is evident from the persistence of wide variations in fund charges, and is most striking for passively managed funds, where unit trust/oeic annual charges vary from 0.3 to 2 per cent, and initial charges from 0 to 5.5 per cent, between one provider and another. It is true that some trackers are more efficient than others, and they use different tracking techniques, but not so as to justify such wide variations in price. The variations contrast sharply with the institutional market for tracker funds, where price variations are typically little more than a few basis points. This reflects the greater sophistication of institutional buyers.

7.22 Second, it leads to consumers paying premium prices for funds with good past performance records, which are not in fact justified by subsequent performance achieved. This is demonstrated in Figure 7.1. If anything, the concern must be that, observing the increasing dispersion of returns as price rises in Figure 7.1, consumers were in fact paying more money to take on more risk.

Inhibitors to comparing performance after charges

7.23 In order to compare the value for money of prospective investments, investors need to be able to compare a reasonable estimate of expected performance after charges. And in addition to the difficulty of identifying future out-performing funds discussed above, both price and historical performance are extremely hard to compare across products.

7.24 Surveys of investor knowledge consistently show that retail investors do not understand how disclosed charges affect net returns.[12]

7.25 The difficulties consumers have in understanding charges are not simply due to lack of financial knowledge. Disclosure practices in the savings industry make it very hard to compare the price of financial services offered by different companies.

7.26 Explicitly identified charges, expressed as a percentage of funds invested, typically include the following components:

- initial charge (there may alternatively be an exit charge, or "delayed initial charge"), which covers commission to IFA, administration, regulation, compliance and advertising costs (up to 6 per cent for unit trusts). Discounts are available from some brokers; and

- annual management charge, which includes continuing costs of fund management and renewal commission to IFAs (typically 0.5 to 1.5 per cent for unit trusts).

[12] Kevin James, "The Price of Retail Investing in the UK", FSA Occasional Paper 6, 2000.

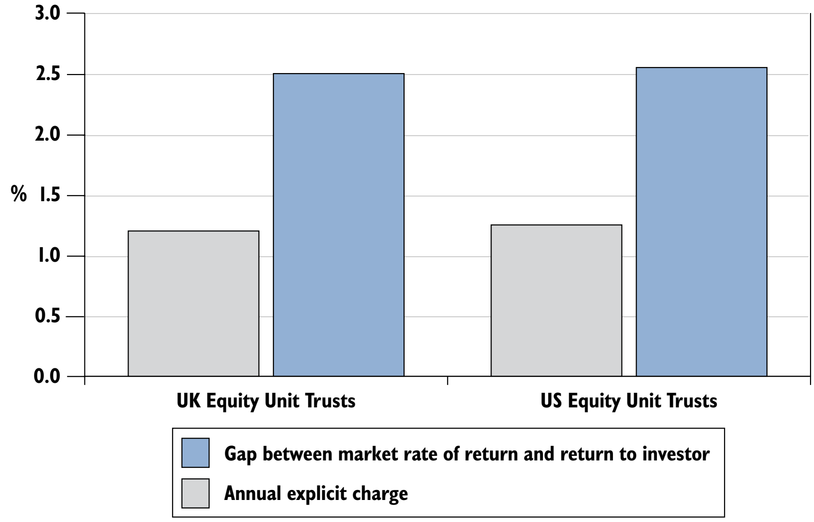
IMPACT OF UNDISCLOSED COSTS

Figure 7.4 below gives some idea of the impact of undisclosed costs. It illustrates the gap between the market rate of return on equities and the average return provided to investors by unit trusts in the UK over 1987–1998. This gap is composed of three elements:

- explicit charges (the annual management charge);
- undisclosed costs (principally dealing costs); and
- underperformance as a result of unsuccessful stock selection decisions (to the extent that this occurs).

Explicit charges can be separated out. The other two elements cannot, because while dealing costs in the shape of broking commission are a single and unambiguous number, other dealing costs – the "spread" between the price paid for the security and a reference price in the market, for example – are not. Taken together, the impact of undisclosed costs and unsuccessful stock selection were substantial (2.5% per annum, over the period studied) and considerately greater than the explicit charges.

Figure 7.4: The price of investing



Source: Kevin James, "The Price of Retail Investing in the UK", FSA Occasional Paper 6, 2000.

A separate study[13] confirmed that, adding together all the different types of fees and charges, the full costs of mutual fund investment may be as much as 3 per cent per year, or even more. It is therefore no surprise that mutual funds around the world tend to underperform the index on an after fees and costs basis.

[13] Dimson, E., Marsh, P. Staunton, M., *Triumph of the Optimists*, 2002.

7.27 But these are not the only costs of investment. There are two further categories of cost which are charged directly to the fund:

- additional expenses, which include trustees' fees, registrars' costs, custody expenses, audit fees and regulators' fees. These depend on the size of fund; expressed in the same terms as explicit charges (i.e. an annual charge as a percentage of funds under management), these can vary from 0 to 0.9 per cent for unit trusts, with an average of 0.14 per cent; and

- dealing costs, including brokers' fees and stamp duty. The magnitude depends on levels of fees and turnover of holdings (for unit trusts, it is estimated to be equivalent to an annual charge of between 0.5 and 2 per cent[14]).

7.28 In particular, as identified by the Myners Review and the Government's subsequent statement on the subject[15], transaction costs are an important and poorly understood area which have a significant impact.

7.29 There is no disclosed measure of cost which includes dealing costs. The treatment of the "additional expenses" category varies depending on the type of the product, which adds to complexity.

7.30 Additionally, measures of cost are themselves complex. There are two measures in common use which seek to capture overall cost:

- **reduction in yield** (RIY) = the percentage point amount that explicit fees and charges subtract from the gross return to a fund; and

- **total expenses ratio** (TER) = total net operating expenses/funds under management.

7.31 Essentially, RIY seeks to capture the price of the product to the consumer, while TER is a measure of the costs incurred by the provider. Neither is convenient for wide cross-product comparisons.

7.32 RIY has a number of problems:

- it varies according to how long the investment is held because of the combined effect of initial and annual charges;

- it only includes explicit charges (although for life products, custodians' fees and trustees' fees are also included); and

- it is not comparable across life funds and unit trusts because of differing tax treatments (and, less significantly, because of differences in the treatment of allowable expenses, e.g. the different treatment of custodians' fees and trustees' fees in unit trust and life insurance product RIY calculations).

[14] Chapman, J. in "Comparing the Charges", Money Management, April 2001.

[15] HM Treasury statement, "Broking Commissions", 27 July 2001.

7.33 TER, on the other hand, is a poor surrogate for price to the consumer, since it does not include the initial charge. This can have significant impact, especially if the holding period is short.

7.34 Neither RIY nor TER includes the impact of dealing costs.

7.35 Further complexity is introduced by confusing and, crucially, product-specific technical jargon:

- unit trusts commonly have a "bid-offer spread", which is effectively an initial charge, and some have an exit charge;
- life products often use the term "allocation rate" to describe a similar process, with the added complication that a positive allocation rate can be used to create the equivalent effect to a discount;
- some regular premium life policies involve the purchase of "capital units" in early years which have a higher annual management charge applied to them than "normal" or "accumulation units" (although companies adhering to the standards set out by the ABI's "Raising Standards" initiative will have phased these out by 2004); and
- oeics may make "dilution levies" on investors who are buying or selling shares in the fund to cover the dealing costs if the manager has to buy or sell securities as a result of large movements into or out of the fund.

7.36 In response to these information difficulties, in October 2001 the FSA launched Comparative Tables. They are web-based and contain information on product charges and terms, but not past performance, and are designed to help consumers compare similar products available from various providers. There is a table for each product class. The consumer specifies the size of investment and holding period, and the table calculates the projected costs (in pounds) arising from explicit charges, using an assumed growth rate.

7.37 There are significant challenges in compiling these tables. A choice must be made between maximising accuracy and comparability on the one hand, and improving accessibility and comprehensibility on the other. Because of the complexities set out above, tables that would enable a full and accurate comparison of all retail savings products would be difficult for a lay person to understand. The FSA has sought to strike the most appropriate balance between extremes in this area, working with consumers to ensure that the tables can be used effectively by their target market of "able average"[16] consumers.

[16] Based on the broad categories "sophisticated", "able average" and "struggler" used by Reflexions Communication Research in their work for the FSA.

7.38 Thus:

- comparisons are limited to single product classes in order that the tables should not be unwieldy;
- dealing costs are not included. The FSA was initially attracted to including dealing costs, given that these might form a significant part of the hidden costs of some investment products; however, the idea received little support from the industry on the grounds that they would be difficult to project forward;
- charges are shown using "the effect of deductions in pounds on projected returns" approach described above. Consumer testing with RIY was particularly unsuccessful, consumers seeing it either as an annual management charge or as a one-off charge on the premium. But the difficulty with the FSA's approach is that costs (in pounds) are not expressed in the same terms as the marketing literature discusses investment returns (i.e. annual percentage returns), obscuring the relationship between cost and net performance; and
- the underlying growth assumptions for life and unit trust/oeic products have to be adjusted for the different tax treatments, preventing like-for-like comparisons of returns.

7.39 The Comparative Tables are nevertheless valuable sources of independent data and are greatly to be welcomed; the evaluation exercise currently in hand will yield information on what use consumers are making of them.

7.40 At the same time, there is some information which, though valuable, is not suitable for inclusion in the Comparative Tables. The Review believes it would be a mistake for the Comparative Tables to become the FSA's sole publication of information gathered from providers:

- for example, the Personal Investment Authority published information on commission levels in the Disclosure Report and on persistency in the Persistency Survey. This data is still collected but there is a question over whether the FSA will continue to publish it; and
- in the US, large quantities of data on mutual fund performance are generated from their annual reports. In the UK, mutual fund (unit trust/oeic) annual reports are by regulation filed with the FSA but the equivalent analysis is not produced.

7.41 The Review believes that the FSA should explore ways of publishing such data gathered from providers as a contribution to achieving a competitive environment which will best serve consumer and wider interests.

Bias in favour of active management

7.42 One of the key decisions an investor must make is whether his investments should be managed actively or passively. Active management is appropriate where the investor believes that:

- there are systematic inefficiencies in the market concerned that can be exploited;
- he can identify those investment managers capable of doing so; and
- the benefits available outweigh the incremental costs involved.

7.43 It follows that the choice between active and passive management must be made on a market-by-market basis. There will be no hard and fast rule as to which is more appropriate, though broadly speaking, the more liquid and well-researched a market is, the less likely it is that these criteria apply and therefore the harder it is to make the case for active management (although it should be noted that some active management is necessary for efficient equity markets).

7.44 One would logically expect to find that institutional investors as a group made greater use of active management than retail investors, since they typically have greater resources and professionalism to bring to bear in the investigation and selection of managers. In fact the reverse is the case. Figures for new retail unit trust sales in 2001 show that 93 per cent were of actively managed funds, whereas only around 75 per cent of UK institutional funds are actively managed. In the US, this figure is lower still, at nearer 60 per cent[17].

7.45 It is particularly noteworthy that for funds sold direct to consumers (i.e. unadvised sales) the proportion of passive management was 25 per cent, which is essentially the same proportion as in the institutional world. This is consistent with a situation in which the more knowledgeable consumers, who feel able to buy direct, are aware of the difficulty of identifying superior managers. This in turn suggests that advisers are playing an important role in guiding (or not challenging) retail investors' preference for active management. This is considered below.

7.46 Large numbers of retail investors who are not in a position to identify superior managers are nonetheless investing in actively managed funds. This is of concern because the average actively managed fund underperforms the market index after charges.[18]

Timescales of performance measurement

7.47 The evidence suggests that consumers tend to use inappropriately short timescales over which to assess the performance of their investments.

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[17] Mercer Investment Consulting.

[18] See, for example, Gruber, M.J., 'Another Puzzle: The Growth in Actively Managed Mutual Funds', *Journal of Finance*, vol. 51, p. 783, 1996; also Dimson, E., Marsh, P., Staunton, M., *Triumph of the Optimists*, 2002.

7.48 Studies of unit trust/oeic sales show that net fund inflows are highly sensitive to the fund's performance over the preceding year[19]. This is encouraged by press comment and financial marketing; even published and internal performance league tables on medium- to long-term investments, such as ISAs, investment trusts, unit trusts, oeics and life funds, highlight performance over one year, and even over three to six months.

7.49 This was confirmed by interviews with providers and fund managers who were emphatic that as little as one year's underperformance was cause for concern, with two years' leading to a serious drop off in volumes of new business.

7.50 As noted above, past performance alone is a poor guide to future performance. Using very short term past performance to choose which fund to buy is particularly inappropriate. Short time scales for performance measurement also lead to poor decisions by investors who already hold funds and undertake a review of their performance with a view to exiting failing funds and making new investments.

7.51 Interviews with IFAs confirmed to the Review that consumers tend to base their decisions to hold or sell funds on short-term measures of performance.

7.52 There will be cases when it may be justifiable for consumers to assess investment performance over the short term. But in most instances it is misguided, particularly if the investor lacks the information to separate the effect of poor investment management performance from generally falling markets. Studies of long-run investment performance warn that although equities are likely to deliver superior future long-run returns relative to cash or bonds, equity investment involves material levels of risk, and this superior performance is by no means guaranteed even over periods as long as twenty years – which may exceed the investment horizon of many investors. Switching on the basis of much shorter-term performance is likely to increase the likelihood of underperformance by:

- wrongly identifying managers as failing. In the most extreme case, this method of selection leads to consumers buying a fund at its peak of success and exiting as soon as it falls, in order to buy another fund at the peak of its success; and
- increasing the level of charges incurred by consumers, to the extent that the funds they buy may have upfront charges.

Investment decisions: advisers

7.53 According to the FSA's Conduct of Business regulations, a tied adviser may only advise on the products of the company he represents (although when selling a new product he is expected to take into consideration the investments already held by the customer). This means that tied advisers can only advise on asset allocation in the context of the sale of a new product.

[19] Chevalier, J. and Ellison, G., 'Risk Taking by Mutual Funds as a Response to Incentives', *Journal of Political Economy*, vol. 105, p. 1167, 1997.

Many of the investment issues discussed in this section are therefore applicable to IFAs rather than tied advisers, who will not give this "whole of portfolio" advice (although this limitation may not be clear to the customer).

7.54 It is not possible to disaggregate precisely which aspects of consumers' behaviour reflect their own preferences and which reflect the advice given by advisers. But it is clear that in practice, given the lack of investment expertise of the bulk of consumers, advisers play a very significant role.

A TYPICAL PROCESS OF INVESTMENT ADVICE

On the basis of information obtained from the client, and with general consideration of the level of relevant state benefits, existing arrangements, affordability or cost, taxation and risk, the IFA works through the following process:

- consideration of the relevance of different types of product, from the range of life assurance, health insurance, savings, investment and pension;

- assessment of how a portfolio of such products could best meet the client's overall needs; leading to

- specific product recommendations to deliver this financial package.

If a need for an investment product has been identified, it is at this final stage that the adviser recommends a provider and, if appropriate, investment selection. This involves choices between with-profits, unit-linked and unit trust/oeic products, and, less commonly, investment trusts; also, where relevant, between managed and market-specific funds. Allocating money to funds which are neither with-profits nor managed involves an asset allocation choice.

To map the client's risk preference onto an appropriate product, the adviser often adopts the approach of placing funds on a spectrum of risk, with "lower risk" with-profits or fixed interest products towards one end, and "higher risk" unit trusts/oeics at the other. Within the unit trust/oeic category, finer risk distinctions are commonly drawn: from "large cap" domestic funds at the least risky end of the equities spectrum, through smaller companies funds to special situations funds and international funds. The appropriate allocation between these categories is determined in a highly subjective process, often with the client expressing a risk attitude on a 1 – 10 scale, which the adviser translates into a corresponding division of funds.

IFAs draw on various sources of information when choosing products. Research commissioned by the FSA into how advisers choose products[20] identified three broad approaches:

- product panel: advisers choose products from an approved list, which may be developed from in-house research or commissioned from a third-party supplier;

- recommended lists of products: use of the list is not mandatory and no approval is required to select providers not on the recommended list; and

[20] Cap Gemini Ernst & Young, "Polarisation research: IFA use of panels", CGEY, 2002.

- firms not using panels: in most cases advisers are provided with access to software tools to aid research, the most widespread being Common Trading Platform, Aequos and Synaptics. These services allow advisers to filter products available in the market according to criteria which they specify, e.g. fund performance across the board, volatility, terms of contract, compatibility with client's attitude to risk, appropriateness for size of investment and charges. Other common sources of information are the product tables in trade magazines and journals and web-based research tools such as Standard and Poors' Micropal.

IFAs also apply their knowledge of historic product provider strategy, gained from marketing literature, their experience of the industry, senior colleagues, training, and conferences at which fund managers explain their approach. Small IFA firms may have a relationship with a stockbroker whom they use as a source of investment information (and to whom they will refer clients who want advice on stock selection).

Adviser qualifications

7.55 In order to qualify as a financial adviser it is necessary for an individual to pass one of a range of examinations approved for the purpose by the FSA. The Financial Planning Certificate (FPC) from the Chartered Insurance Institute (CII) accounts for four fifths of the total market for advisers' entry level qualifications[21]. Clearly examinations define the minimum level required, and it is open to advisers to have a higher level of expertise than that strictly needed to pass the exam. But the vast majority of advisors hold only FPC, with only a minority pursuing more advanced investment papers[22]. This suggests that the level of investment knowledge required by the FPC is in fact a benchmark of what is necessary to practise as an IFA. An outline of the FPC syllabus is contained in Annex A.

7.56 There is a clear lack of material on investment fundamentals in the FPC. Only one unit out of nine considers savings and investments explicitly and this focuses almost entirely on categories of products (investment bonds, investment trusts, guaranteed bonds, maximum investment plans, endowments, unit trusts, oeics). There is little qualitative and no quantitative discussion of the investment principles that should guide portfolio construction (asset allocation, risk/return trade off and timescales) and these are absent from the syllabus. The complexity of charges and their impact on performance are simply noted, and then charges are discussed in detail only within product categories. Research commissioned by AUTIF into the

[21] Calculated using examination completion estimates for 2000 and 2001 from the Chartered Insurance Institute, the Securities Institute and the Institute of Financial Services. There are two other main entry-level adviser qualifications, the Certificate for Financial Advisers (CeFA) from the Chartered Institute of Bankers and the Investment Advice Certificate (IAC) from the Securities Institute. The FSA also recognises a variety of other qualifications although most relate to overseas regimes.

[22] On top of the entry-level examinations advisers may pursue more advanced qualifications. The most common higher-level qualification is the Advanced Financial Planning Certificate (AFPC) administered by the CII. Out of 77,000 active advisers, 5,660 are AFPC qualified. This qualification includes an option to pursue advanced investment modules although the take up of these is low relative to other modules; over the period from January 1999 to April 2001, only 21 per cent of those advisers taking AFPC passed one of the advanced investment modules.

investment content of adviser qualifications concluded that the FPC in particular failed to assess the competence of advisers in respect of investment matters, though modest improvements have been made recently[23].

7.57 The FSA is in the process of reviewing the current adviser qualifications regime. The FSA aims to determine the competencies and standards to be assessed for each activity that it regulates, and to approve appropriate tests for them. Having set out a single framework for qualifications in the financial services industry, the FSA intends to focus on specific competence areas starting with that of investment advice. The Review welcomes the work of the FSA in this area.

Product focus replaces asset allocation

7.58 Both the investment advice process described above and the syllabus of the FPC have a strong focus on product categories (bonds, unit trusts, with-profits) rather than on the underlying assets. This is not easily compatible with a sound approach to asset allocation:

- it does not "look through" the product choice to the underlying assets – for example, with-profits are often treated as a low risk pseudo-asset class, rather than a mixed asset fund including cash, property, bonds and equities, which should be part of an overall asset allocation strategy across an investment portfolio;
- it ignores the effects of portfolio diversification. If an investor purchases two funds with high volatility but which are relatively uncorrelated, then the resulting portfolio will be substantially lower risk than either of the funds;
- it does not challenge investors' natural bias towards domestic markets. The clear academic consensus is that risk reduction through international diversification outweighs currency risk, although this is not the perception of investors and IFAs; and
- it will tend to deal inadequately with issues of risk, equating a particular risk preference with a particular product class.

7.59 The infrequent use of asset allocation software is noteworthy in this regard. The relationship between long run prospective returns and asset strategy can be modelled with simple software tools, which are available on investment websites, or in more sophisticated packages designed for IFAs to use with clients. Such tools are widely used in the institutional market, and in the US some pension plan providers use this approach to produce personalised projections at point of sale (and thereafter) to illustrate the range of potential outcomes given different contribution levels, investment terms and investment strategies. However, asset allocation software is rarely used by IFAs; most rely on their own experience coupled with limited use of "tried and tested" tools, predominantly in hard copy form.

[23] The Cattellyst Consultancy, "Analysis of Approved Examinations for Financial Advisers", 2001.

Determination of consumer risk preference

7.60 As noted above, asset allocation is the key determinant of the long run overall risk and return of an investment portfolio. The observed lack of attention paid to asset allocation by consumers and their advisers tends to be accompanied by a superficial treatment of risk. Qualitative interview evidence suggests that, as described above, IFAs typically determine consumer risk preferences by asking the client to place themselves on a scale of 1 – 10, depending on how much volatility they are comfortable with and how much they can bear to lose overall; the IFA then translates that into a range of products. Such a discussion inevitably glosses over the costs of risk aversion in terms of returns foregone.

7.61 This can lead to what has been termed "reckless conservatism". Analysis suggests that the opportunity costs of conservative strategies may greatly exceed the downside risk of more aggressive strategies. A recent study[24] illustrated this effect by making projections of the likely range of outcomes from investing in low, medium and high-risk funds. It found that the potential opportunity costs of a low risk fund were more than twenty times greater than the possible losses from the high risk fund.

7.62 This argues for a more comprehensive and quantitative discussion of long run asset allocation, where risk and return are explicitly traded off using appropriate tools to show the client the relationship between them.

Preference for active management

7.63 The analysis above has already noted consumers' proclivity for active management. Data from a mystery shopping exercise analysed by the Review suggested that consumers' preference for active funds is shared by their advisers. 50 out of 54 (i.e. 92 per cent) of fund recommendations for a lump-sum investment were for active funds. Interviews with IFAs confirmed the existence of this preference.

7.64 It would be implausible to attribute this preference for active management, which is materially greater than that demonstrated by institutional investors, to superior expertise on the part of IFAs.

[24] Bacon & Woodrow, "Comparative Tables: report prepared for the Financial Services Authority", 1999.

ADVISERS' INVESTMENT RECOMMENDATIONS

As part of its work on depolarisation for the FSA, Charles River Associates (CRA) commissioned a mystery shopping exercise which was undertaken from August to October 2001[25]. Each 'shop' entailed an individual with no existing investments, and an appetite for equity investment, approaching an advisor about investing a lump sum of either £15,000 or £30,000.

CRA's report for the FSA was concerned with adviser recommendations at the level of product types and providers, but their data also included fund recommendations in many cases. Analysis of the data substantiated the observation that advisers rarely recommend passive funds.

Adviser type	Adviser recommendation		
	Passive not used	Passive used	Total
IFA	37	2	39
Tied	12	2	14
	49	4	53

The figures show that only 2 of 39 IFA recommendations, and 2 of 14 recommendations by tied advisers, included a passively managed fund.

Investment decisions: providers

7.65 For providers, high volumes of new business are achieved by a high ranking in league tables of past performance, even over short periods. Clearly, given product providers' needs to sell products in a competitive market place, they have to respond to the consumer and adviser preferences identified above, though it can be argued that providers contribute to the shaping of these preferences through their marketing strategies.

Unit trust/oeics and linked funds

7.66 A primary business objective for unit trusts/oeics and linked funds is top quartile performance relative to peer group over rolling three-year periods. This objective is translated into a required performance against an appropriate benchmark, either peer group or sector index; the level of risk appropriate to delivering this performance is then decided. Portfolio parameters (permitted divergence from index stock weightings) are then set for the fund managers. The extent to which this process is formalised and quantitative varies between fund management houses.

7.67 Asset allocation for managed linked funds or unit trusts/oeics will generally be assessed relative to the average distribution of the relevant peer group.

[25] "Polarisation: research into the effect of commission based remunerations on advice", Charles River Associates, January 2002.

7.68 Different providers allow fund managers greater or lesser degrees of freedom to take risks in asset allocation and stock selection, though always with the peer group or index as a reference point.

7.69 Providers and fund managers generally acknowledge that the short-term risks of deviating from the peer group in terms of not gaining new business outweigh any rewards for long-term out-performance. Consequently, these incentives are likely to encourage herding, as observed in the institutional market. This means that normal movements of capital in response to changing market conditions operate more slowly and also with a greater degree of uniformity.

7.70 It is generally assumed that retail funds have higher tracking errors (performance relative to the relevant index) than institutional funds because they are free from the requirement on pension funds to match liabilities and are usually smaller sized funds. Typical values might be 2 to 3% or higher for retail funds, compared to around 1% for institutional funds. However, interview evidence suggests that over recent years a new class of actively-managed retail funds has emerged with tracking errors as little as 1 per cent in some cases.

7.71 Fund managers argue that this is in response to consumer demand; either that funds which diverge too far from the index prove unpopular, or that investors are increasingly employing a "core and satellite" approach, where the funds are divided into a cautiously-managed "core" supplemented by smaller, more adventurously-managed "satellites". This may well be true, but it leads to undiscerning retail investors paying charges appropriate for active management in return for management which is quasi-passive since the permitted tracking errors are so narrow. Where consumers are knowledgeable and information is readily available, market mechanisms could be expected to redress this inefficiency. However, as the Review has noted, this is not the case with retail savings.

7.72 The widespread aim of top quartile performance in league tables for measurement periods of 1 to 3 years contrasts with the commonsense observation that different customers will have different timescales. In an efficient marketplace one would expect some fund managers to compete on the basis of longer-term performance strategies, whereas others would concentrate on trading and spotting short-term trends, according to their comparative advantage. However, such differentiation of fund investment objectives on the basis of timescales is not generally observed.

7.73 When this was discussed with Chief Investment Officers, several stated that they believed that they could deliver better investment returns if they were judged over longer timescales; however, they were resigned to the fact that this was not the way to attract funds from IFAs and investors.

With-profits funds

7.74 Strategic asset allocation for with-profit funds is normally determined by the actuarial function of the life office, having regard to the fund's liability profile and policyholders' reasonable expectations. Again, reference will be made to the strategy of competitors[26]. Fund managers will typically be permitted some degree of tactical discretion around the strategic benchmark.

7.75 The great majority of life companies use in-house fund managers to manage the with-profits fund. However, it is becoming more common to establish a contractual relationship between the life office and the fund manager, where a fund management mandate is agreed between them and remuneration may vary modestly according to performance. Some life offices are experimenting with contracting out the management of alternative asset classes such as private equity where there is a perceived need for specialist expertise not available from the in-house fund manager.

7.76 After the asset allocation decision has been made, the money is managed by fund managers according to the mandate specified by the life company.

7.77 The overwhelming bulk of with-profits money is managed actively. Yet with-profits products are intended to be long-term products, to be held for at least ten years, and in many cases for considerably longer. Both investment theory and studies of historical data show that the probability of a single manager outperforming the market after charges over this timescale is negligible.

7.78 These effects are likely to be mitigated in the case of a with-profits fund by a number of factors: large purchasers of active management will be able to obtain extremely low fund management charges, some funds trade less often (in recognition of this issue), and life offices have historically had less well-paid fund managers. In general, they also have economies of scale through their unit-linked businesses. But the fact remains that many are using active management exclusively, which suggests a lack of competitive pressure. This may alter with greater transparency and as life companies move their fund management onto a contractual basis and experiment with out-sourcing parts of this activity.

Future investment trends

7.79 A recent study[27] estimates that the future annualised equity risk premium, relative to government bonds, is not far from 3 per cent. The authors note that with 3 per cent annual cost and performance drag, an equity mutual fund might give a final value that is no greater than direct ownership of government bonds. This should lead to a growing appreciation of the advantages of buy-and-hold strategies, and a move towards favouring funds that choose either a demanding out-performance objective, or alternatively a low cost structure.

[26] Performance of with-profits funds is anonymously disclosed and compared in an annual survey by the WM Company. The information is strictly confidential and available only to survey participants.

[27] Dimson, E., Marsh, P. Staunton, M., *Triumph of the Optimists*, 2002.

Summary

7.80 The Review has sought to draw attention to various aspects of investment decision-making by, or on behalf of, consumers, which give rise to concerns.

7.81 Some of these, such as excessive reliance on past performance as a predictor of future performance, corresponding neglect of the impact of charges, a bias in favour of active management, short timescales for judging investment performance and inadequate attention to long-run asset allocation represent failings on the part of the purchaser and/or his adviser. As a generalisation, neither party possesses sufficient expertise in investment matters. That said, providers reinforce these preferences in their marketing.

7.82 These consumer and adviser characteristics, in turn, influence the behaviour of providers. There are observable retail fund management trends towards herding and quasi-passive management, and a lack of pressure on costs.

7.83 Irrespective of where they reside, these concerns have their origins in the weak competitive processes widely evident in the retail savings industry. Improving the quality of investment decision-making, leading to better outcomes for consumers and more efficient allocation of capital, ultimately rests upon the creation of a market with clearer and more effective competition on the basis of price and quality.

7.84 Measures to improve the competitive pressures in the industry are discussed in Chapter 10, which sets out the Review's recommendations. These include proposals, such as in the area of adviser qualifications, aimed specifically at investment issues.

8 TAX

The importance of the tax system

8.1 The complexity of retail savings products, leading as it does to consumer confusion and the consequent need for advice and regulation, has been identified as one of the key problems facing the industry. The historical evolution of the tax system over many years has inevitably played an important part in creating this complexity.

8.2 Many of the distinctions between products which consumers find confusing – between different types of pension, for instance – are created by the tax system. Taxation also makes individual products, such as qualifying life policies, difficult to understand because the taxation rules are themselves complicated. Furthermore, it tends to distract attention away from the more fundamental features of charges and investment performance.

8.3 The competitive dynamics of the industry are also influenced more directly by tax structures which, usually for historical reasons, have the often unintended effect of advantaging the provision of certain products by certain types of company.

Complexity of the tax system

8.4 The tax regime is complex in three principal ways. First, different categories of savings product have fundamentally different tax treatments, as illustrated in Table 8.1.

Table 8.1: Tax treatments of different savings instruments

Type of saving	Simplified summary of tax treatment
Life insurance	Saving out of taxed income (post-1984) Some tax on fund income Some tax on some withdrawals for non-qualifying policies held by higher-rate taxpayers
Pensions	Tax relief on contributions No tax on fund income (but dividend tax credit is not reclaimed) Tax on withdrawals (except for tax-free lump sum)
Collective and direct investment in shares and securities	Saving out of taxed income Income tax on interest and dividends Capital gains tax on real gains over allowance
ISAs	Saving out of taxed income No tax on fund income (and dividend tax credit is reclaimed) No tax on withdrawals or gains

8.5 Second, even within a given category of savings products, there are sub-categories with different tax rules applied to them. For example,

- within life products, there are both qualifying and non-qualifying policies;

- within pensions, there are currently some eight different tax regimes; and
- within mutual funds, investment trusts are treated differently to unit trusts/oeics.

The tax system often thereby creates product distinctions which otherwise would not exist.

8.6 Third, the detail of the tax treatment for a given product is often complicated. This is especially true of life insurance policies, where, for instance, complex rules determine the tax liability when the policy matures or is surrendered.

8.7 The result of this, when added to the general complexity of long-term financial products, is considerable consumer confusion. In one survey, over a third of consumers who manage their own financial affairs admitted to feeling unsure about how tax affects their savings.[1] In another survey, run monthly until January 2002, a number of financial questions were asked of a sample of financial decision-makers.[2] The tax-related questions reveal a low level of understanding amongst consumers responsible for their own financial affairs. In January 2002:

- 81 per cent did not know whether there were tax penalties for withdrawing savings from an ISA within two years;
- 70 per cent did not know the annual allowance for ISA-investments;
- 57 per cent did not know whether ISAs were free of all income and capital gains tax; and
- 53 per cent did not know that pension benefits were taxed.

8.8. The resulting confusion contributes to consumer weakness. The more confused consumers are by a complicated tax system, the more reliant they will be on third-party advice.

8.9 Complexity has a number of other effects.

8.10 It increases the cost of saving by adding to the requirement for advice. As FSA research conducted as part of its consultation on polarisation has shown, the need for assistance on tax-related issues is one of the main reasons for individuals seeking advice.[3] The fact that the tax system adds material differences between products is particularly relevant here because it generates a need for additional decisions. The need for advice also gives rise to more regulatory activity, which further increases the cost of saving.

[1] Apathy survey sponsored by the IMA (Investment Managers Association), May 2001.

[2] The Financial Awareness & Consumer Education Tracking Study (FACETS) sponsored by the IMA.

[3] FSA, "Polarisation Consumer Research – Report of research studies carried out by IFF Research Ltd., ORC International Ltd. and NOP Solutions", p. 2, p. 15, January 2002.

8.11 Tax complexity can also weaken competitive forces by distracting attention away from the real economic costs and benefits of different products: charges and performance. The Review has found that a considerable proportion of adviser time and expertise is expended on understanding the tax system and on interpreting it to consumers. This contributes to the insufficient attention given to investment issues in both adviser qualifications and in the process of advice itself.

8.12 Tax complexity also makes comparisons between different products more difficult. The (pre-tax) investment performance of unit-linked life policies and unit trusts are determined in essentially the same way. But their performance cannot be easily compared because their tax treatments are different.

Evolution of the tax system

8.13 Complexity is not the deliberate result of decisions by policy-makers, but of historical evolution. Successive governments have used tax to tackle consumer reluctance to save, which has led to a series of changes in the tax treatment of various products over the years. However, as new tax regimes have been introduced, incumbent regimes have rarely been completely removed. In some cases, such as older pension regimes, there has been a "grandfathering" process, with existing products retaining the old tax treatment. In other cases, such as Life Assurance Premium Relief, there has been only a partial dismantling. This process has played an important part in generating the complexity described above.

Tax as an incentive to save

8.14 Both governments and the savings industry have shared the hope that savings propensity can be enhanced through tax-based incentives because consumers will wish to benefit from what is effectively a gift from the Government.

8.15 There has been considerable academic work to test this proposition. Its conclusions can be very broadly summed up as follows:

- there is little evidence that tax incentives can significantly increase the overall *level* of saving;
- but they can significantly affect its *allocation*.

8.16 The usual approach of those investigating these issues has been to analyse savings behaviour after the introduction of a new tax incentive. Clearly such analysis cannot be entirely definitive, because there is no easy way to tell how much individuals would have saved had the tax incentive not been introduced (and also because it is difficult to disentangle the effects of tax changes from those of accompanying marketing – see paragraph 8.22).

8.17 Some recent analyses have found a small positive effect of tax incentives on levels of saving. For instance, an analysis of the introduction of TESSAs reports that 15 per cent of TESSA saving constituted new saving (rather than simply transfers from other forms of saving).[4] A similar analysis on the 401(k) United States savings plan reports a figure of between 0 per cent and 30 per cent.[5]

8.18 Broadly, though, there is a degree of consensus in the research that there is little evidence of tax incentives increasing the level of savings.

'There is no clear evidence that the level of taxation, along with other factors affecting the rate of return, does generally affect the level of household saving.'[6]

'Looking at the evidence, there is little to support claims for large savings effects from tax incentives.'[7]

'[Tax incentives] have not however been shown to have a beneficial effect on overall savings levels.'[8]

'...Targeted tax incentives, which only increase the rate of return to saving in particular forms, are likely to result simply in portfolio reallocation.'[9]

8.19 As the final quote above suggests, however, the same literature does find that taxation can significantly affect the composition of household saving. The OECD report cited above finds that taxes do have an important effect on the decisions of households as to how to save, "since the tax system can introduce a bias in favour of particular assets".[10] There are some clear examples of this effect.

8.20 For instance, tax incentives appear to have affected pensions savings in many countries:

- positive examples here include the high levels of take-up of registered retirement savings plans in Canada, personal pensions in the UK and Individual Retirement Accounts in the US;[11] and
- New Zealand provides a negative example. It removed tax incentives for pensions (and moved to treating them like other forms of savings) in the late 1980s. Though the overall impact of this change is hard to judge, it is clear that it led to a sharp fall in pensions saving: many companies wound up their schemes, or made them less generous, and pension fund assets fell from 17.9 per cent of GDP to 15.7 per cent of GDP between 1987 and 1989.[12]

[4] Blundell, R., 'Tax Policy Reform: Why we need microeconomics', *Fiscal Studies*, pp. 108-110, 1995.
[5] Engen, E. and Gale, W., 'The effects of 401(k) plans on household wealth', 2000.
[6] OECD, *Taxation and Household Saving*, p. 189, 1994.
[7] Besley, T. and Meghir, C., 'Tax-based savings incentives', IFS, 1998.
[8] Oliver, Wyman & Company, "*The future regulation of UK Savings & Investment: Targeting the savings gap*", September 2001.
[9] Banks, J. and Tanner S., *Household Saving in the UK*, 1999.
[10] OECD, *Taxation and Household Saving*, pp. 191-2, 1994.
[11] For references, see Whitehouse, E., 'The Tax Treatment of Funded Pensions', p. 36, 1999.
[12] Davis, P., *Pension Funds*, pp. 87-8, 1995.

8.21 The removal of Life Assurance Premium Relief in 1984 in the UK was followed by a gradual decline in the number of households with life insurance (from 77 per cent in 1984 to 66 per cent in 1996) which would have been even starker had endowment mortgages not grown in popularity over the '80s.[13] The removal of the premium relief is unlikely to be the sole cause of the decline (which had started before 1984) but it was almost certainly a contributory factor.

8.22 A number of researchers have also suggested that tax changes affect savings less because consumers respond directly to the economic incentive of the tax change, and more because of what accompanies tax changes:

- information campaigns from the Government to explain the new regime;
- marketing campaigns from providers; and
- decisions by advisers to promote tax-advantaged products because of the criticism to which they would be open if they did not recommend them.

8.23 It is likely that these kinds of effects have played a part in the evidence on TESSAs and 401(k)s referred to above, for instance.

8.24 Moreover, such effects as tax has are likely to be concentrated away from lower/middle income consumers, who are usually those the Government wishes to target:

- survey evidence suggests that the lack of understanding of tax-related issues is more acute amongst lower-income groups. Figure 8.1 below shows the percentage within each income bracket giving the right answer for a range of tax-related survey questions;
- understanding tax often requires advice. It is typically uneconomic for advisers to serve lower-income groups, and the cost of obtaining advice can dissuade less affluent consumers from seeking it;
- the indirect effects mentioned in paragraph 8.22 are likely to have more impact with higher-income, better informed consumers who have access to advice; and
- focus group research suggests that lower/middle income consumers tend to think that tax breaks are irrelevant to them as they do not save enough for tax issues to affect them materially.[14]

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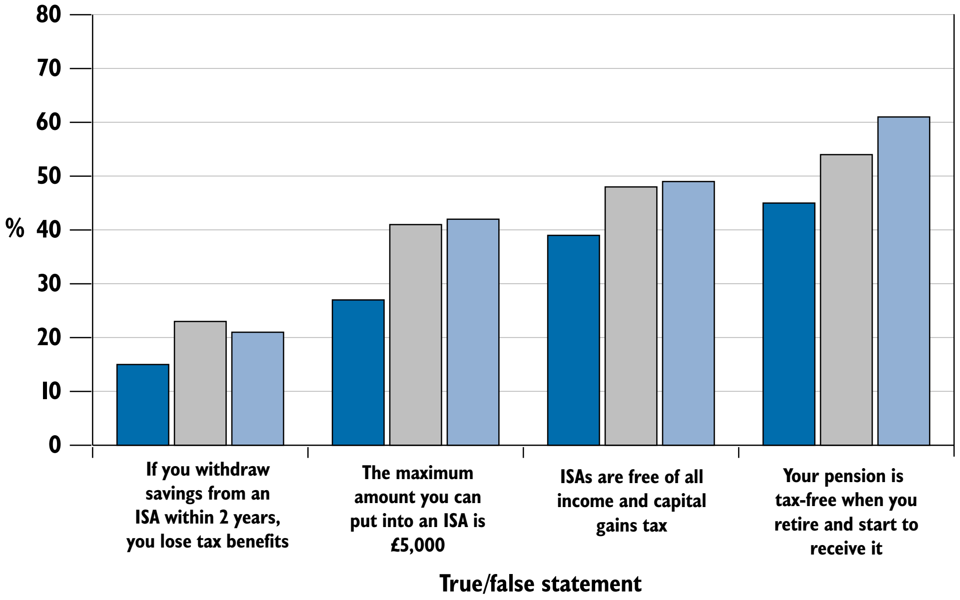
[13] Banks, J. and Tanner S., *Household Saving in the UK*, pp. 51-3, 1999.

[14] Kempson, E. and Whiley, C. *Understanding Small Savers II*, Pearl Welfare Study Programme, especially pp. 67-8, 2000.

Figure 8.1: Percentage of individuals in different salary bands answering true/false question correctly



Source: The Financial Awareness & Consumer Education Tracking Study (FACETS) sponsored by the IMA.

8.25 Other research suggests that the term "tax" may have negative associations for savings among less well-informed consumers even if it is in fact being used in the context of a tax break. Some focus group evidence further concludes that, for such groups, matching schemes (such as the Savings Gateway scheme currently being piloted by the Government) may be more suitable than tax-based incentives.[15] The Review believes that, in the light of this research, schemes structured as matching schemes could offer a more effective means of affecting savings behaviour.

Implications

8.26 Introducing tax-based savings incentives inevitably leads to greater complexity in the savings arena. This complexity has costs: it makes savings products harder to understand, increases the need for advice (and therefore regulation), and disenfranchises many potential savers. The evidence also suggests that tax incentives are unlikely to encourage significant new saving, especially amongst those who most need to save more, although they may direct savings towards particular tax-advantaged vehicles.

[15] These themes have emerged from a number of studies, including research commissioned this year by IFA-Promotions. See also DSS, "Pensions and Retirement Planning", pp. 95-6, 1998.

8.27 The evidence therefore suggests that, in future, governments should avoid introducing new tax incentives if their aim is to increase aggregate savings levels. This is unlikely to be successful, and, indeed, is more likely in the long run to reduce saving by increasing complexity. The overriding policy goal in this area, instead, should be one of reducing complexity and distortions in the taxation of savings products.

Pensions taxation

8.28 The basic principles underlying the taxation of pensions are that:

- pensions contributions are taken out of pre-tax income (so are tax-advantaged);
- no tax is paid on the fund (though it is no longer possible to reclaim a dividend tax credit);
- on retirement, some of the fund may be taken as a tax-free lump sum; and
- annuitised payments made from the remainder of the fund are then taxed as income.

8.29 However, in practice, pensions taxation has become extremely complicated. The tax system distinguishes between different types of pension:

- (approved) occupational schemes;
- (approved) personal pension schemes; and
- unapproved schemes.

8.30 Within these categories, there are a number of "grandfathered" benefit structures (that is, benefit structures no longer open to new investors). These reflect a gradual process of imposing limits on the amount of pension tax relief available to individuals. Each time the rules were changed, individuals who were already investing in a pension were allowed to continue to accrue benefits under the old rules. The result is:

- four regimes for approved occupational schemes (pre-70, 70-87, 87-89, 89-present); and
- two regimes for approved personal pensions (pre-88, 88-present).

8.31 There are also two sorts of unapproved schemes: funded and unfunded.

8.32 There are therefore eight basic Inland Revenue regimes for pensions. And, when all the ancillary variables are taken into account, there are over twenty different sets of taxation rules that may apply to an individual's pension.

8.33 In addition, in order to attain approved status (and thus qualify for tax-advantaged treatment) a pension scheme must meet a number of fairly complicated conditions on contribution and benefit levels which depend on the type of pension. For example, in the 1970-1987 regime, the maximum lump sum is 1.5 times final salary, whereas in the post-1989 regime, it is limited to 2.25 times the initial pension or 3/80ths of the final salary for each year of service but with an earnings cap on that final salary.

8.34 Pensions taxation introduces considerable complexity into the retail savings market:

- it makes pensions difficult to understand, thus blunting the incentive to save, increasing the reliance on advice, and leading to a degree of consumer disengagement;
- it distorts the broader advice process, as advisers need to ensure that their clients' savings are in the particular scheme that maximises the tax advantage;
- it leads to a higher administrative and regulatory burden for product providers and Government; and
- it creates arbitrary advantages for particular groups (depending on the time at which they happened to enter their pension scheme).

8.35 There are a number of options for simplification of pensions taxation across the board.

8.36 First, the number of pensions tax regimes could be reduced. The greater the reduction in number, the more substantial the benefits would be.

8.37 Such simplification would have many advantages:

- employers and scheme administrators would find their administrative burden reduced;
- advisers would be able to focus more on investment needs than on complex pensions tax issues;
- regulators would have a framework that lent itself to a comprehensible compliance regime; and
- complexity as a whole would be reduced for everyone, including consumers.

8.38 Such radical simplification, requiring as it would the merger of existing rules, would also provide the opportunity to ensure that the rules associated with pensions were in themselves simple. Current limits on contributions and (especially) benefits are complicated functions of salaries. Of course, limits of some kind are essential. But the Review believes there is no intrinsic need for these to be complicated.

8.39 The pensions tax regime has also distorted competition by creating an artificial barrier to the provision of pensions by companies that are not life insurers.

Until recently, non-life companies wishing to provide approved pensions have been explicitly required by Inland Revenue rules to create what is known as an "irrevocable trust". The creation of an irrevocable trust is a complex and time-consuming exercise, so much so that unit trust companies wishing to provide pensions have chosen to set up life company subsidiaries (itself not a simple operation) in order to provide pensions. The recent introduction of the IPA (see below) does not seem to have removed this obstacle.

INDIVIDUAL PENSION ACCOUNTS (IPAs)

Individual Pension Accounts (IPAs) were an initiative launched in April 2001 with the goal of levelling the playing field in pensions provision. In particular, the intention was to make it easier for non-life companies to provide pensions. The crucial feature is that the non-life collective investment vehicles are given a Stamp Duty Reserve Tax (SDRT) exemption within the framework of an IPA. This exemption enables non-life companies to mimic the effective exemption enjoyed by life companies: life pensions can change what assets they are linked to without incurring any charge for SDRT.

However, IPAs have not been taken up with enthusiasm by providers, in part because of uncertainty about whether the rules require the IPA to sit within a pension set up under the normal rules. Twelve months after their introduction, just one provider had taken the opportunity to offer them to its customers.

8.40 In addition, fees charged by life insurers for managing pensions are exempt from VAT, while similar charges by non-life companies do not enjoy this exemption. This further disadvantages non-life companies in the pensions arena.

Life insurance taxation

8.41 Life insurance companies and their products are subject to a separate and different taxation regime, for historical reasons. Life companies are not usually taxed directly on the profits made from life insurance. Rather, they are taxed on the investment income and gains derived from the investment of premiums and reserves. This has an important implication for the tax treatment of life insurance products from the consumer's perspective: unlike other savings products, the investment returns are effectively taxed within the fund, rather than as part of the customer's personal tax liability.

8.42 As part of this approach, life products have historically enjoyed favourable tax treatment which has gradually been reduced. But some elements remain, specifically:

- the "qualifying life policy" regime; and
- the 5 per cent withdrawal rule.

The qualifying regime

8.43 Before 1968, when the qualifying regime was introduced, all life policies enjoyed significant tax advantages: there was tax relief on the premiums paid into life policies, and no tax to pay on receipt of the proceeds of the policy, so that tax was limited to that which was paid in the fund itself. The broad aim of the qualifying regime was to ensure that only life policies with a reasonably significant protection element received the tax advantages that life insurance had traditionally enjoyed.

8.44 In 1984, premium tax relief on new life assurance policies was abolished. But qualifying policies are still tax-advantaged for higher-rate taxpayers because they are not liable to any tax on receipt of the proceeds of the policy.

8.45 To count as "qualifying" (and therefore to be eligible for the tax advantage), a policy needs to satisfy a number of complex conditions when it is bought. Broadly, it must either be a pure protection policy, or satisfy the following:

- *longevity*: premiums must be payable for ten years or more;
- *regularity*: premiums must be payable annually or more frequently;
- *even-spread*: premiums must be evenly spread (defined in a precise way); and
- *protection*: the sum assured must be at least 75 per cent of the total premiums payable during the term.

8.46 Though a policy is certified as qualifying (or not) when it is bought, ongoing conditions have to be met while the policy is held for it to maintain its qualifying status.

8.47 It is clear that the qualifying regime for those policies that are not pure protection policies adds to complexity, both because of the details of the conditions (confusion about which can lead to costly mistakes), and because it increases the number of different types of policies. It also makes it difficult to compare regular premium savings products offered by life companies with equivalent non-life investment.

The 5 per cent withdrawal rule

8.48 Historically, the tax rules associated with partial withdrawals of funds from life policies caused practical difficulties for providers. The tax rules were therefore changed in 1975 so that not all withdrawals incurred an immediate tax charge. The new rules were purely formulaic – the tax payable on withdrawals was not related to the gain associated with the withdrawal – and allowed small withdrawals to be taken into account for tax purposes only when the final proceeds of the policy were taken.

8.49 The rules work by giving the policy an annual withdrawal allowance of 5 per cent of the total premiums paid up to that point. This notional allowance is allowed to accumulate if it is not used up. So, for instance, on a single premium policy, after year 4 of the policy, there is a withdrawal allowance of 20 per cent of the lump-sum investment (provided no withdrawals have been made up to that point). Any withdrawal is set against the allowance available at the time of the withdrawal. If the withdrawal lies within the allowance, no tax is paid on the withdrawal (until the proceeds of the policy are finally taken). If the allowance is exceeded, then the whole of the excess (not just the gain associated with the excess) is chargeable to tax.

8.50 Inflation was high when the rule was introduced, so a 5 per cent tax-deferred withdrawal did not in itself amount to a particularly attractive feature of a product. In times of lower inflation since, however, the 5 per cent tax-deferred withdrawal has become an attractive feature of the product, because it enables high-income earners near retirement to move income into their retirement years, when their tax liabilities are likely to be reduced. This feature is promoted in marketing literature and advice.

Effects of life product taxation

8.51 The 5 per cent rule and the qualifying regime are unsatisfactory for a number of reasons.

8.52 They increase complexity and introduce additional product distinctions (between qualifying and non-qualifying policies).

8.53 The actions which they encourage serve no obvious public policy objective, whilst advantaging a particular type of provider:

- the qualifying life policy rule advantages savings involving a nominal life insurance element over other forms of saving; and
- the 5 per cent rule advantages lump sum saving through a life insurance company rather than through other investment managers.

8.54 Both regimes are regressive, in that their benefits are focused on higher-rate taxpayers:

- on qualifying policies, higher-rate taxpayers pay the same tax as basic-rate taxpayers, and even non-taxpayers; and
- the tax planning feature of the 5 per cent withdrawal rule is attractive to those who are higher-rate taxpayers at the time of withdrawal, and especially attractive to those who become basic-rate taxpayers at the time they take the proceeds of their policy.[16]

[16] Aside from these regressive features, both the qualifying regime and the 5 per cent rule also interact with the age-related personal allowance. Withdrawals within the 5 per cent allowance and gains on qualifying policies are not considered when calculating the age-related personal allowance, and therefore do not erode that allowance in the way that they might if they were so taken into account. This is an advantage of life products for those over 65 whose income lies within a very specific band.

8.55 Finally, and significantly, the regime is an example of how differences in tax treatment distort competition by distracting adviser, and ultimately consumer, attention onto the tax features of the product, rather than the more fundamental features of investment performance and charges.

Unit trusts/oeics and investment trusts taxation

8.56 The tax system creates unnecessary differences between investment trusts and unit trusts/oeics.

8.57 There are two significant differences in tax treatment which disadvantage investment trusts relative to unit trusts/oeics:

- though investment trusts are allowable IPA investments, they are not, unlike unit trusts/oeics, exempt from Stamp Duty Reserve Tax (SDRT) within the IPA framework. For this reason, investment trusts effectively cannot compete in the pensions arena; and
- fees for managing an authorised unit trust/oeic are exempt from VAT, but fees for managing an investment trust are not. This makes it more difficult for investment trusts to compete with unit trusts/oeics.

8.58 It is true that there are some important differences between investment trusts and unit trusts/oeics:

- investment trusts are closed-ended, while unit trusts/oeics are open-ended;
- investment trusts, though they are required to have an independent board, are not required to have a separate management function, while unit trusts/oeics are;
- investment trusts are not subject to the same borrowing limits as unit trusts/oeics; and
- investment trusts are not directly regulated by the FSA, while unit trusts/oeics are.

8.59 However, it is not obvious why these distinctions should lead to the differences in tax treatment.

The Individual Savings Account (ISA) regime

8.60 The Review has argued that the provision of new tax incentives is an inappropriate means of seeking to stimulate greater levels of aggregate saving. However, application of this principle to existing, as opposed to prospective, tax incentive regimes requires caution. The ISA regime, introduced in 1997, is now an established feature of the savings landscape: the term is well-recognised and the concept is widely understood. This reflects the considerable investment that has been made in delivering and supporting ISA products. The Review believes that dismantling the regime would not be desirable.

8.61 However, there is a particular aspect of the ISA regime which adds complexity: the maxi/mini distinction. This was devised in response to market conditions that now appear likely to change. Savers may either subscribe to a maxi-ISA, in which case they have one provider who covers their whole annual ISA allowance, or subscribe to mini-ISAs, in which case they can have different providers for each of the components of ISA-investment. This regime was deemed necessary in order to maximise the number of providers competing to provide ISAs. Since not all providers could offer cash, life insurance and equity, simply having a single (maxi-)ISA would advantage those that could.

8.62 However, this problem largely exists because of the polarisation rules. In the event that polarisation were to be abolished, the case for mini-ISAs would be considerably weaker.

Summary

8.63 The current taxation regime for long-term savings, as it has evolved over many years, exerts a number of unsatisfactory influences on the market:

- increased consumer confusion, exacerbating the problem of consumer weakness;
- increased cost of accessing retail savings products;
- shifting the basis of product competition towards tax features; and
- muting competitive forces by making comparisons across product categories difficult.

8.64 As a general principle, the Review is persuaded that the use of tax mechanisms to increase aggregate savings levels is undesirable and likely to be ineffective (although it acknowledges that tax incentives can have the effect of directing savings towards the more tax-advantaged vehicles).

8.65 The Review has identified a number of specific concerns:

- the pensions tax regime is extremely complex, and creates barriers to pensions provision by non-life companies;
- the 5 per cent rule and the qualifying policy rule create additional complexity and unnecessary differences between life and other products;
- investment trusts are disadvantaged relative to unit trusts/oeics; and
- the maxi/mini aspect of the ISA regime is a complicating feature which is unlikely to be necessary in a depolarised world.

8.66 The review believes there is considerable scope for simplification of these tax treatments. Proposals to this effect are set out in Chapter 10.