
6. Opportunities And Constraints For Providers And Distributors

6.1 Overview and approach

The comments set out in this section are drawn principally from industry interviews conducted during April and May 2003. Interviews were conducted with current manufacturers and distributors of medium and long term savings and investment products and their trade bodies. The full list is given in appendix 1 but they include:

- ABI, IMA, BBA and AIFA;
- Life companies, friendly societies and fund managers;
- IFAs, banks, tied salesforces, retailers, and direct distributors;
- A small number of third party administrators and other influencers.

We have also set out our own interpretation of current opportunities and constraints facing the supply and distribution aspects of the market.

The purpose of the analysis is to provide qualitative support for the quantitative inputs into our modelling work described in sections 7 and 8, as well as providing some of the background for the conclusions set out in section 9.

6.2 Industry Context

The proposals flowing from the Sandler review are being considered by a retail financial services industry that faces considerable other challenges in the form of:

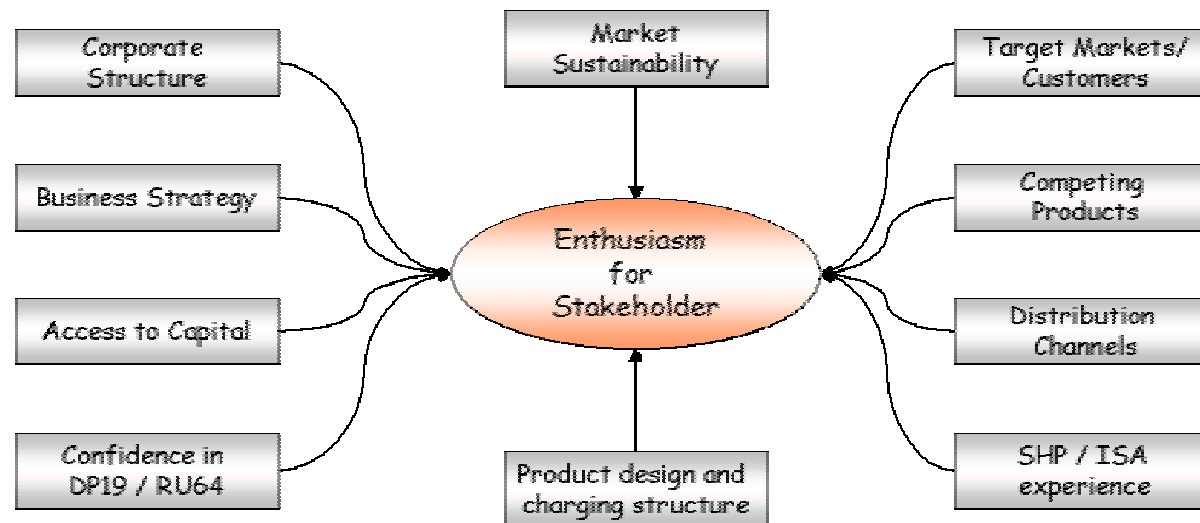
- An extended period of poor stock market performance that has had a detrimental effect on solvency, new business and consumer confidence;
- A generally poor experience of Stakeholder pensions that, whilst bringing about considerable improvements in industry efficiency, has caused a significant decline in industry profitability and has resulted in many companies subsequently withdrawing from the market or being prepared only to take on high value business;
- Significant changes in the prudential requirements for the banking and insurance sector, deriving from both international items, such as Basle 2 and International Accounting Standards developments on Fair Value, and from domestic initiatives by the FSA to move to risk-based capital requirements – all of which are focusing attention on the capital needed to support retail financial business and its overall profitability. A particular emphasis from the FSA is in the need to ensure wider business risks are understood and provided for. Investing significant sums in IT and distribution so as to be able to provide Stakeholder products would currently be seen as a particularly risky venture considering the experience of Stakeholder pensions and the uncertainty around many aspects of the business;

- Other regulatory and Government changes that require considerable management attention and that are changing the nature of the retail financial services market, including depolarisation proposals, changes to pensions proposed in the DWP Green Paper, and bringing general insurance within the scope of FSA regulation.

As a result, existing market players whilst generally acknowledging the validity of some of the analysis and conclusions of the Sandler review are concerned about the likely viability of the Stakeholder products initiative. This is discussed in more detail in sections 4 and 5.

During the industry research, a number of themes emerged that led to different degrees of enthusiasm among market players for the new Sandler market, as summarised in the Chart below.

Chart 6.1 – Drivers of enthusiasm



The analysis highlights the fact that finding a price cap structure and level that appears to deliver a satisfactory return to the industry and the consumer is only part of the equation for the market to succeed. Brief comments on some of these drivers are set out in the following paragraphs.

6.3 Corporate Structure, Business Strategy and Access to Capital

A wide variety of institutions operate in the UK market for medium and long-term retail savings. Unsurprisingly different institutions have different attitudes towards this market and have different objectives for their continued participation in it. It is important to recognise these differences when assessing the likely level of supply of Stakeholder products.

These differences in objectives can usually be summarised by different required rates of return and payback periods from capital invested in projects. For major, multi-national financial organisations, capital required for UK projects has to compete against potential other ventures outside the UK. In the last few years there have been several high-profile examples of such organisations reducing their investment in the UK market – presumably because of the comparative unattractive nature of investing capital in the UK market. Capital earmarked for the UK also has to compete against other potential projects. Conversely there are other organisations, frequently mutual or quasi-mutual in nature, that are totally focused on the UK retail savings market and have a strategy that seeks to achieve continued, sustainable growth, rather than maximising the absolute return on available capital. In addition to the objective measures such as required rate of return and payback periods on capital it is evident that different institutions have different degrees of enthusiasm for the Stakeholder products project. Such enthusiasm appears to increase the more focused the institution’s business strategy is on the UK, mass-market and retail market. Current, and intended future, distribution channels also affect the institution’s enthusiasm.

The current pressures on the retail financial services market are listed above. Many institutions are short of capital, and hence need to ensure it is invested in the most appropriate project. Institutions who have comparatively greater access to capital appear to have a more enthusiastic approach to the Sandler project than those who have other more pressing considerations.

As described in sections 2 and 3 regarding our terms of reference and our selected methodology, we have not set out to model which particular individual organisations, or types of organisations, would be expected to offer Stakeholder products under certain circumstances, such as different levels for the eventual price cap. It is possible that an eventual combination of product design, regulatory regime and price cap may be attractive to some institutions but not to others – for reasons other than ability to meet pure marginal administrative costs within the price cap.

These issues are important in the context of our analysis because, as shown in section 7, any entry into the Sandler market is likely to be characterised by relatively high capital investment, long payback periods and restrained levels of profitability.

6.4 Confidence in DP19 / RU64

This research investigated the potential impact of alternative price caps before the detail of the “quid pro quo” of reduced regulatory costs for distribution have been defined. At present the FSA is consulting on possible sales regimes under its Discussion Paper 19.

Although the proposals in DP19 are aimed at reducing the costs of actually selling a product to a customer, the industry will still be faced with significant costs in accessing the customers in the first place. A common view expressed in the industry is that the need for high volumes will result in channels such as high street operations and worksite marketing as being most viable. This is explored quantitatively in section 7.

It has also been pointed out as part of our research for this report that although the initial sales process could be made more efficient through the DP19 proposals, it is difficult to make the ongoing administration of the business more efficient than on other products. Further it is possible that the general increase in consumer interest in financial affairs will lead to a general increase in post-sale interaction between consumers and providers. Indeed the FSA is shortly to make recommendations on “post-sale information”, and one industry player mentioned that customer enquiries have increased significantly in the last few years.

Hence the industry is concerned that while one aspect of the overall process may become cheaper under the DP19 proposals, significant components of their overall costs will remain unchanged – but to be met by products with lower levels of charges.

In addition there is considerable uncertainty within the industry as to whether the FSA's intention of not requiring distributors/providers to describe the potential existence of Stakeholder products when attempting to distribute other products will be achievable. (In the run-up to the introduction of Stakeholder Pensions the FSA introduced this requirement for pensions products through Regulatory Update 64.)

These two related topics are extremely important and hence are discussed in more detail in section 4 above. In summary many institutions are wary of the Sandler product initiative because of concern that future regulatory actions may differ from the current intentions stated by Treasury, FSA and the Financial Ombudsman Service.

6.5 Market Sustainability

The financial services market has seen a prolonged period of new initiatives being launched by Government and regulators, such as the introduction of PEPs, their replacement by ISAs, the introduction of Stakeholder Pensions, and the pensions initiatives set out in the Green Paper. The financial structure of Stakeholder products is such that the providers will be reliant on the business remaining a significant component of the market for many years in order to recoup their development and distribution costs (this is illustrated in section 7). There is some scepticism as to whether a suitable period of stability will indeed follow the introduction of Stakeholder products. General enthusiasm within the industry appears to be influenced as to whether or not there is a perception that market conditions will remain relatively stable after the Stakeholder products are introduced.

6.6 Target Markets and Distribution Channels

Institutions with most enthusiasm for the Sandler project tend to be those with marketing strategies focused on the "mid-mass market" sector, particularly those with high street or other mass distribution presence. Even within such segments, many institutions expressed a view that Stakeholder products will continue to need to be "sold" rather than being actively demanded by the target market (and as such the critical elements of expense will be finding and selling to customers, rather than administration).

Further, the impact of distribution, regulatory and administrative costs are expected to be such that even institutions with a "mass-market" approach are likely to concentrate on seeking larger case sizes. Companies are also concerned about the right level of income and assets at which it is appropriate to sell equity-backed products to the target market. Hence concentrating on individuals that can afford the larger case size is one method that can be used to limit the danger of selling products that may be perceived to be inappropriate regardless of their compliance with the eventual regulatory system.

It was interesting to note that although there is a theoretical case to be made for new forms of distribution to be used for Stakeholder products at present there appears to be very limited enthusiasm for developing such channels, although some manufacturers of products do believe that such new channels will emerge. Of these potential new channels worksite marketing was described as being the most likely channel to be developed further, albeit that some commentators have reservations about its success and market reach.

6.7 Competing Products

Manufacturers have choices as to what products to provide, and distributors have choices as to what products to offer to customers. The greater the options open to manufacturers or distributors the lower the apparent enthusiasm for Stakeholder products. For example with high street or other mass distributors it is clear that even though a significant infrastructure may be in place, only a certain range and volume of products can be distributed actively. Hence the distributor is likely to seek to sell those products that are most profitable from their perspective. Similarly manufacturers that are active across the range of financial services products may decide that their limited capital is best deployed in providing alternative financial products.

6.8 Experience with Stakeholder Pensions and CAT-marked ISAs

It is not surprising that the majority of the institutions are considering the proposals for Stakeholder products in the light of their own, and perceptions of the industry's experience of both Stakeholder Pensions and Cat-Marked ISAs.

On Stakeholder Pensions the general reaction has been that the levels of business have been such that expected returns have not been made. In addition although distribution costs are starting to fall, manufacturers have found that the product is simply un-economical to provide through traditional, individual customer-based distribution channels. There has been lower than anticipated growth in both business sold through the worksite and that sold direct. As a result distribution costs remain high.

The most significant impact of Stakeholder Pensions has been the “halo/contagion” (the virtue or vice depending on one's perspective) effect that the price cap has had on other pension products – an impact enforced by RU64 described previously.

A further interesting input from Stakeholder Pensions has been the experience of using “decision trees”. As the recent report from the FSA has shown, the use of decision trees has not been a total success. Consumers appear confused as to what level of advice, if any, they have received. Individual companies have their own experiences, and some have decided to stop using decision trees for Stakeholder pensions and to revert to using full fact-finds.

Finally, many institutions have been disappointed with the level of Government advertising or other projects to increase general awareness of the products – especially since the initiative was meant to be a significant component in achieving the Government's policy objectives. With the low level of charges it was felt that individual companies could not afford to spend significant funds on such exercises, and so a significant role for Government was foreseen.

Many companies entered the Stakeholder pensions market on the basis of expecting high volumes of sales through the worksite – encouraged by implicit or explicit Government action. There was also an expectation that significant “cross-selling” of higher-margin protection business could be sold on the back of the Stakeholder pension. Neither expectation has been fulfilled.

As a result of the above experiences the majority of the institutions can be described as “once bitten, twice shy”. In particular there is a strong desire to ensure that all aspects of the Stakeholder products proposals (regulatory regime, product designs, and price caps – together with possible supporting Governmental initiatives) are developed together.

Amongst specialist providers of ISAs it was generally felt that the CAT-mark initiative had not had a material impact on the market, in particular it is not accepted that the introduction of the CAT standard had stimulated consumer demand for investments.

6.9 Product design and charging structure / level

Of all the product design issues outlined by Sandler, the most critical in swaying industry opinion will be the price cap. However, there are other factors that will influence some, including:

- Any regulated minimum contribution level that has to be set;
- The degree to which firms can differentiate through fund offerings;
- The success in defining a with profits option within the new product range.

However, the 1% price cap remains the most contentious of product design issues. Industry has tended to argue against a 1% annual charge cap. Some have resisted the general principle, asserting that the industry is competitive and that charge caps are purely distortive. Others have argued against the specific level, arguing that a 1% annual charge would:

- Generate insufficient returns to capital;
- Require unfeasibly long break-even periods; and
- Result in the products not being marketed to those on low to medium incomes.

Those arguing in favour of a flat rate 1% charge assert that:

- It has driven efficiencies through its application to Stakeholder pensions by putting pressure on providers' margins;
- Comparative reduction in yield figures show it is good value for consumers as well as being simple for them to understand;
- It does allow efficient firms to make reasonable returns to investment- there are over 40 providers of Stakeholder pensions, and 1.2 million have been sold, implying that a 1% model is a viable business proposition; and
- That higher charges would not in fact substantially increase take-up among lower income consumers.

In section 7 of this report we set out our financial analysis of 1% and other charge caps. This financial analysis is carried out both from the perspective of the institution, through investigation of capital required, breakeven periods and returns on capital, and from that of the consumer, by looking at effective reduction in yields ("RiY") for various hypothetical consumers.

This analysis illustrates the following financial consequences of alternative charging structures and levels:

- A single level annual fund charge will result in RiYs that are higher for long-term savers and lower for short-term savers than if charges more closely reflected actual costs;

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- Charging structures that more closely reflect actual costs lead to significantly reduced capital requirements – in theory such lower requirements should lead to lower charges on consumers.

In addition other comments have been made on the general subject of the charging structure that can be summarised as follows:

- There is scepticism as to whether any charging structure can by itself generate increased demand for savings products;
- Despite the Inland Revenue's planned simplification of the pensions regime it is still expected that distributing, selling and administering pensions will remain a harder task than for shorter term savings. The differential in costs between pensions and other savings should be reflected in a differential in the charging structure or level.
- Concern that different types of organisation will be at relative advantages / disadvantages depending on the structure of any price cap. For example, investment trusts accrue a large proportion of their charges initially as a result of stamp duty. The ability of investment trusts to recoup this from the fund or directly from the customer could be seen as a barrier to entry for such organisations.

There is general acceptance that whatever charging structure is adopted it will need to be simple and transparent. Some aspect of charge on contributions paid was regarded as complying with these requirements.