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THE COMPETITIVE PROCESS IN THE RETAIL SAVINGS INDUSTRY

- 9.1. At the outset, the Review identified certain key features of the retail savings industry:
- there are very large numbers of almost identical products. These products are typically complex and opaque;
 - price and performance are generally hard to compare and in many cases are not even identifiable at all. There are wide ranges in the prices of identical products; and
 - there are persistent concerns about the effects of commission-driven selling.
- 9.2 Each of these points to underlying problems with the competitive process in the industry. The Review's analysis has therefore been directed towards understanding the nature of competition in the industry, the incentives created for participants, and their impact on:
- investment behaviour; and
 - outcomes for consumers more generally.
- 9.3 In brief, the Review has found that although consumers are not a uniform group, the majority find retail savings products difficult to understand, and are reluctant to purchase them. To overcome this, the industry uses commission-remunerated advisers in order to distribute the products largely through face-to-face contact.
- 9.4 This has two important implications:
- precisely because consumers find the products and their features difficult to understand, they also have difficulty in assessing the quality of the advice they receive; and
 - because commission wraps up the cost of advice with the cost of the product, consumers typically perceive advice to be free.
- 9.5 Consequently competitive rewards to advisers for the delivery of superior advice are limited. At the same time, competition between providers tends to focus more on persuading advisers to recommend their products rather than on seeking to communicate the merits of these directly with the end consumer, since the latter is difficult to do effectively.
- 9.6 This, in turn, raises questions about the commercial and behavioural incentives created for:
- distributors; and
 - product providers;
- and to what outcomes these incentives lead.

- 9.7 This chapter examines these incentives and the impact they have on outcomes for consumers. It then considers the important related issue of industry inefficiency and its causes.¹

Incentives for distributors

- 9.8 The main source of income for distributors of retail savings products is commission. Because commission is charged *ad valorem*, distributors' income increases in step with the value of savings they generate. In other words, the more a consumer has to invest, the more revenue a distributor can earn.
- 9.9 Meanwhile, distribution costs are driven principally by the amount of time that advisers have to spend with customers. To some extent, clients with more money to invest will take more time; nevertheless:
- the extra time is not proportionate to the sums involved: it increases more slowly; and
 - however little the client has to invest, there is a minimum amount of time that needs to be spent on the transaction.
- 9.10 Consequently, profitability for a distributor is, unsurprisingly, directly related to the amount that the customer has available to invest, and this leads the industry to focus upon more affluent consumers.
- 9.11 Such a focus would exist regardless of whether the sales process is regulated. But Conduct of Business (COBs) regulation does set a floor for the cost of advice by setting minimum quality standards. The higher the standard that it sets for advice, the higher this floor will be and therefore, other things being equal, the higher the minimum level of income at which a consumer can be profitable for a distributor.
- 9.12 Distributors also have significant incentives to seek to develop long-term relationships with their customers, as a means of both stimulating revenues and reducing the cost of advice.
- 9.13 In theory, this should motivate advisers to provide sound long-term investment advice, particularly on asset allocation, and seek out good value products, in order to deliver demonstrably superior outcomes for the consumer over time. However, in practice consumers find it difficult to gauge the quality of the advice they receive.
- 9.14 Consumers are generally not discerning or sophisticated investors. They find it extremely difficult to assess likely future investment performance, and rely heavily on past performance which is a poor guide to future outcomes. They also have inappropriately short time-scales for measuring performance.
- 9.15. Consumers also find cost difficult to understand, as the FSA found in its preparatory research for the Comparative Tables. The rewards to advisers for providing superior advice are therefore limited. Additionally they tend to focus

¹ Drawing upon the analysis conducted for the Review by Booz Allen Hamilton

on product-based advice, finding products which either offer some sort of tax planning advantage or which add apparently differentiable features such as additional protection. There are several reasons for this:

- the benefits of such products can be relatively easily explained to consumers as being to their advantage;
- they fit comfortably within the scope of advisers' expertise, given their product and tax-focused training; and
- the possibility of tax advantage, in particular, is likely to be of interest to higher-income consumers who are the target market.

Advisers also have an incentive, other things being equal, to sell higher commission products.

- 9.16 Advice on tax matters and product features is needed. But an excessive focus on them means that the pressure from customers on the industry for efficiency and superior long-term investment performance is muted.

Incentives for product providers

- 9.17 Partly as a result of the nature of incentives for advisers, the focus of competition between providers of long-term savings products is not principally directed towards either administrative efficiency or product simplicity. The reasons for this are clear.
- 9.18 Price competition in the industry is not intense. Consumers find prices extremely difficult to assess and may in fact not even be conscious of the concept of "price" for a savings product. They therefore tend not to seek out cheaper products particularly actively. This is illustrated most powerfully in the range of prices for passively managed UK equity funds. While there are minor differences in quality between such funds (such as the level of tracking error), these cannot explain the variation in prices, which range from 0.3 per cent to 2 per cent annual charge. In place of price, brand has a considerably greater influence on the behaviour of the consumer.
- 9.19 The above observations on the intensity of price competition are not universal, and there are some product providers (particularly in the ISA market) who compete aggressively on price. But these are very much in a minority.
- 9.20 Advisers are better placed to assess the price-performance trade-off, but they have only weak incentives to seek out keenly priced products, since their clients will tend not to value the fact that they are doing so.
- 9.21 It could be argued that even if those buying the products are not price-sensitive, providers still have the usual commercial incentives to reduce costs, because this will translate into higher margins. This may be true for unit-linked business or mutual funds, but is not generally so for with-profits providers. Lower expenses tend simply to mean lower charges to the with-profits fund, from which shareholders benefit only indirectly and in small measure.

- 9.22 In particular, providers have little incentive to minimise regulatory compliance activity, especially if they also operate a direct sales force (DSF). The costs of compliance are not directly measurable, since there is no clear distinction between those activities which are purely for compliance purposes and those which simply represent sound managerial practice. Nevertheless, it is widely recognised in the industry that compliance costs are material, representing perhaps 15-20 per cent of the costs of a life company with a DSF. The regulatory system requires authorised companies to make judgements about the appropriate level of compliance necessary to meet standards which are only broadly defined. The sanctions both in financial and reputational terms for failing to meet regulatory standards can be considerable. The penalties for excessive compliance activity – increased costs – are much smaller, for the reasons outlined above. This means that providers, behaving perfectly rationally, tend to incur unnecessarily high compliance costs.
- 9.23 In theory, an ability to produce sustainably superior long-term investment performance should be the principal basis of competition in the industry. In practice, this is extremely difficult to deliver. Moreover, for life companies, investment performance is generally too opaque for this to be a meaningful competitive variable. And for mutual funds, where investment returns are considerably more transparent, a short-term focus predominates.
- 9.24 Critically, incentives towards product simplification are also limited for providers. A simple product, competing in a universe of complex ones and sold in a regulated environment, offers little advantage: the duty of providing suitable advice means that advisers cannot simply point consumers in the direction of the simplest product, but have to show that they have considered the (complex) alternatives properly. Indeed, if the focus of advisers is on additional features and tax planning, a simpler product may have limited appeal.
- 9.25 Going further, it has been plausibly argued to the Review that providers do not just have disincentives towards simplicity, but that the requirement to recoup commissions from product charges actually creates a positive incentive towards complexity and opacity.
- 9.26 The above observations about provider incentives are particularly relevant when, as has been generally the case for the last two decades, financial markets are growing strongly. In such an environment, providers can earn rising income without having to improve efficiency or increase market share, because their charges are related to the value of assets under management.
- 9.27 Clearly the incentives described above do not apply uniformly to all types of product providers; for example, the different charging regimes that apply to mutual funds and life companies mean that the former have a sharper motivation to engineer cost efficiencies. Nevertheless, to a greater or lesser extent, the Review observed these incentives in operation across the full range of providers.

Competitive pressure from shareholders

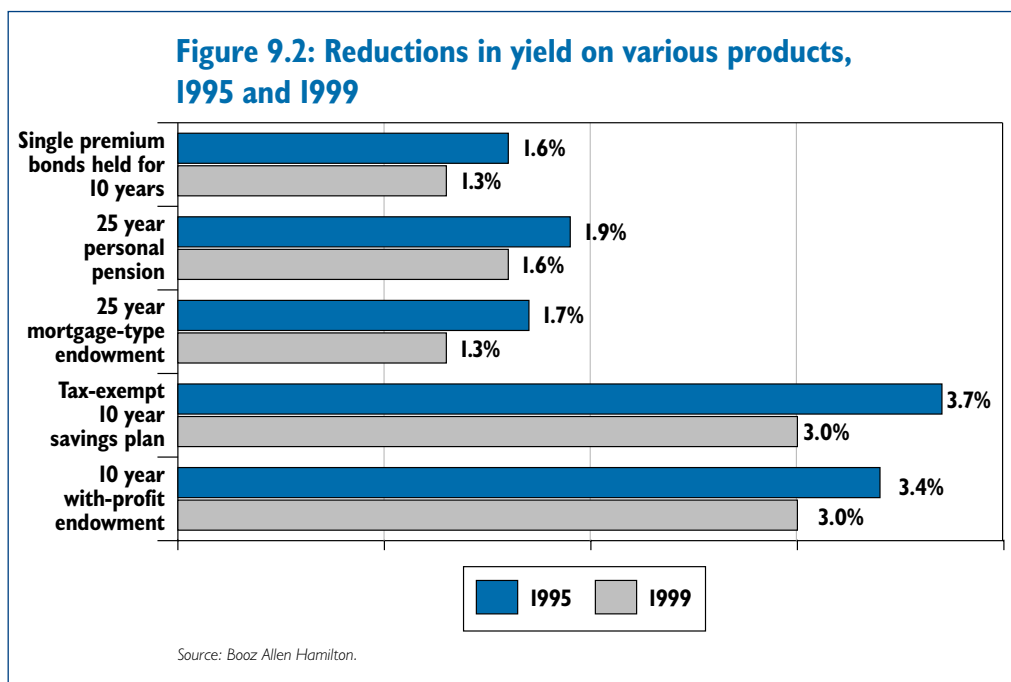
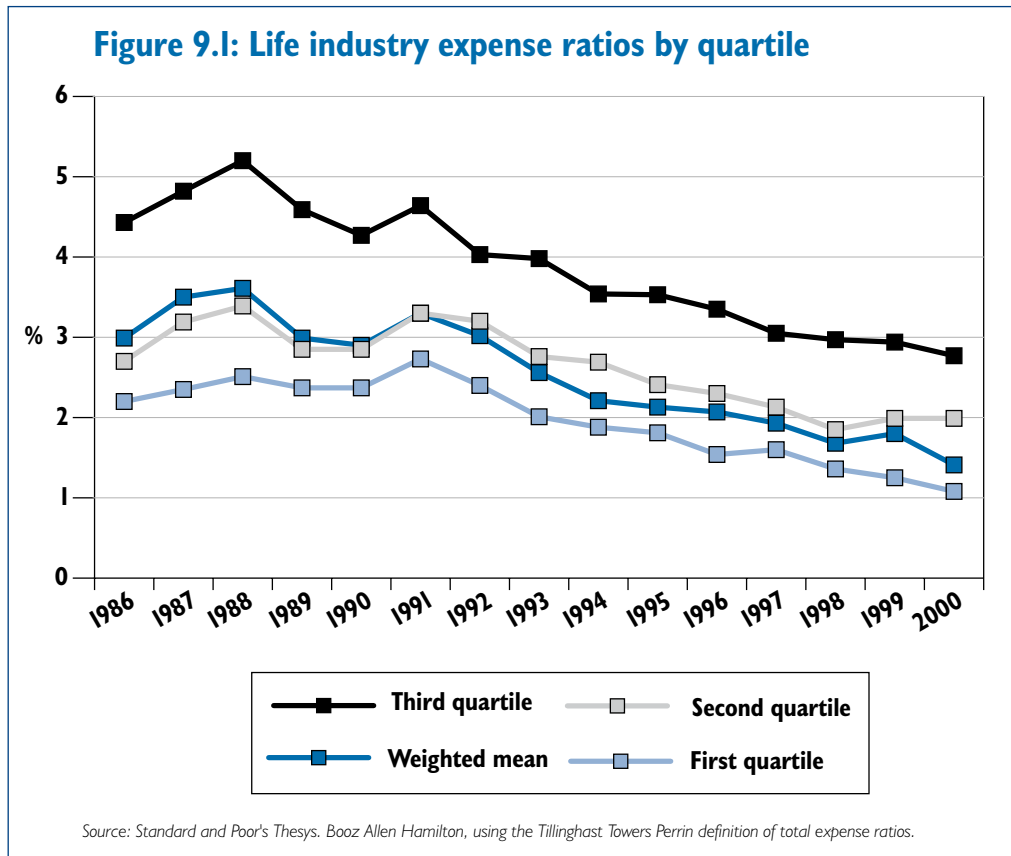
- 9.28 The analysis to date has described the incentives arising from competition for consumers. There are also forces acting in the life industry, in particular, which inhibit the proper functioning of pressures to deliver superior shareholder value.
- 9.29 This arises from the lack of clarity about life companies' financial performance. It is extremely difficult to determine a) how well a life company is performing and b) how it compares to competitors, including those based in other countries. Without this basic information, it is difficult for shareholders to exert effective pressure on life companies to improve their financial performance.
- 9.30 This is, like much else in the life industry, a complex area. There are three methods of reporting financial results:
- statutory, which is used for regulatory returns and therefore for solvency measures. Under this method both costs and revenues are reported in the year in which they occur (although there is limited deferral of policy acquisition expenses);
 - modified statutory, used for annual reports to shareholders. Under this method, the costs of acquisition can be spread over the life of the product subject to certain constraints. Reserving strain, caused by prudent statutory reserving requirements, can also be reduced by using less conservative assumptions and by removing certain liabilities required for solvency purposes only; and
 - achieved profits, which use "embedded value" and the previous "accruals" methodology. Here, future revenues (and costs) are discounted back to the present, making certain assumptions about such variables as persistency. This provides a measure of the profitability of the new business that the life company has written in the present year. Any variances from these assumptions generated in future years are reflected in the achieved profits statement.
- 9.31 The introduction of achieved profits reporting as a standard accounting measure for the life industry represents a positive step, as it is a more accurate and informative way of presenting the accounts. But its use is far from universal.
- 9.32 International comparisons are difficult, given that different accounting standards are used outside the UK. Embedded value is not generally used on the Continent, other than in France, and general levels of embedded value disclosure are low. Elsewhere, Canada is on a par with the UK but the US has only slowly introduced the concept. Australia and South Africa, whilst not using embedded value accounting, do have their own similar variants, which follow broadly the same concept. (e.g. "margin on services" in Australia).

- 9.33 Moreover, even in the UK, mutual life companies do not report on an achieved profit basis, since all surplus ultimately returns to policyholders. So broad industry comparisons covering mutual and proprietary companies are not possible.
- 9.34 In addition, while achieved profits is generally held to be a superior accounting basis, its use is not without difficulty. In particular, since it is built on estimates of future profits, assumptions on issues such as persistency and costs play a key role in determining the results. This means that for a proper assessment of company performance, it is essential to have clear and, equally importantly, consistent reporting of:
- the original assumptions used; and
 - how these change, from one year to the next, on the basis of actual experience.
- 9.35 This is currently not the case. Companies adopt different assumptions. They disclose both the assumptions and changes to them with varying levels of clarity.
- 9.36 Equally important, the existence of inherited estates clouds financial comparisons. As explained in Chapter 6, as matters stand, no clear value can be placed on inherited estates. Given the size of the pool of capital involved, this introduces a significant element of opacity and uncertainty into company valuations.
- 9.37 It is therefore unsurprising that shareholder scrutiny of life company performance lacks intensity. Weak shareholder pressure, arising from this opacity, also tends to weaken the market for corporate control in this sector.
- 9.38 Taken together, the primary competitive pressures acting on providers serve to create an industry characterised by:
- limited resistance to upward pressure on commission payments, because of the need to capture distribution;
 - a tendency to add extra features to products and to proliferate products, principally to meet the sales needs of advisers;
 - a focus on getting these new products as quickly as possible to market, as they can easily be copied;
 - an emphasis on achieving and promoting short-term past investment performance²; and
 - significant attention paid to branding.

² Since individual funds can be separately promoted, this tends to encourage further proliferation, since this increases the probability of the provider having a top-performing fund which can then be promoted, to the benefit of the overall brand.

Industry efficiency

9.39 It is noteworthy that, in contrast to many other industries, the unit costs of the life industry have risen significantly in recent years. It is common practice in the industry to discuss efficiency in terms of costs (or prices to consumers) in relation to assets under management. On this basis, using measures such as the Total Expense Ratio (TER) or the Reduction in Yield (RIY) on various products, there have been improvements as shown in Figures 9.1 and 9.2:



- 9.40 But this is hardly surprising. While these are sensible measures for a consumer seeking to compare the price of one product against another at a particular point in time, they are entirely inappropriate for seeking to determine changes over time in efficiency, because they measure the change in industry costs relative to the growth in financial markets. If financial markets grow faster than costs, TERs and RIYs will fall, even if the underlying costs are actually rising. By analogy, the prices of houses have risen more rapidly than the costs of maintaining them. Maintenance costs relative to the value of the property have therefore declined. But no one would suggest that on this basis, property maintenance has become more efficient.
- 9.41 A more representative picture of UK life industry cost performance emerges in Figure 9.3, which shows administrative expenses and invested assets per contract over the period 1986–2000. All figures are in constant (2000) £.
- 9.42 In 1986, administrative expenses per contract were £32 which, when set against £1,893 of assets, produced an expense ratio of 1.75 per cent. By 2000, this ratio had fallen below 1.0 per cent. Yet expenses per contract rose over the period by 5.7 per cent per annum in real terms. It is an interesting fact that assets per contract grew more rapidly over this period, leading to the expense ratio decline, but this should not obscure the decrease in underlying administrative efficiency.
- 9.43 A similar picture emerges with distribution costs (Figure 9.4). Over the same period, acquisition expenses per contract grew by 10.8 per cent per annum in real terms.

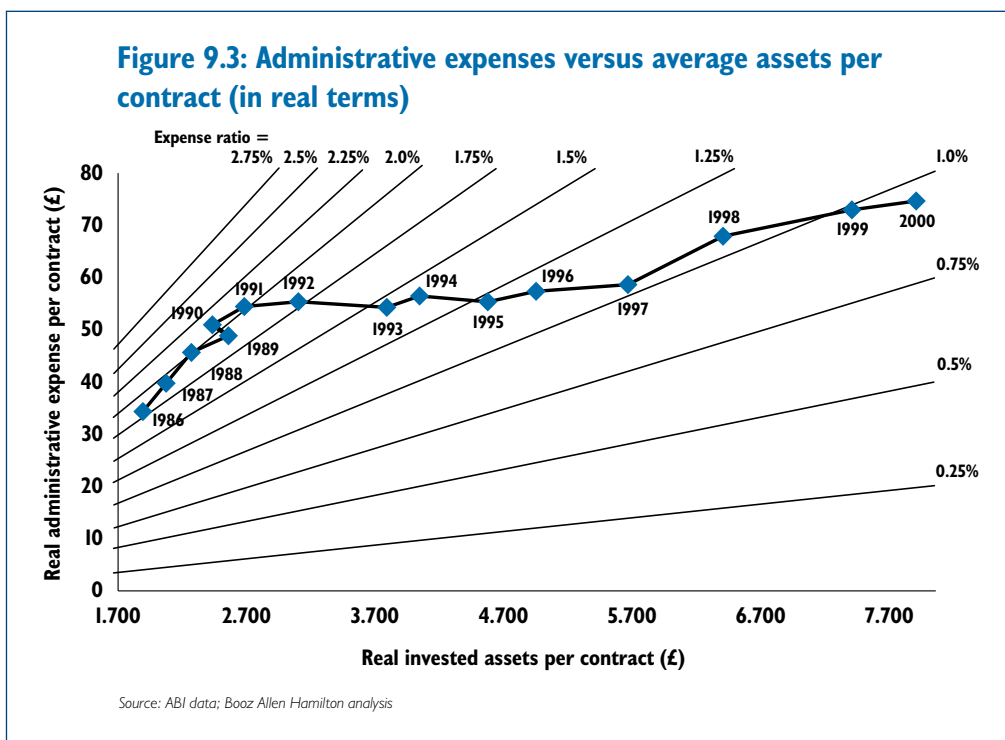
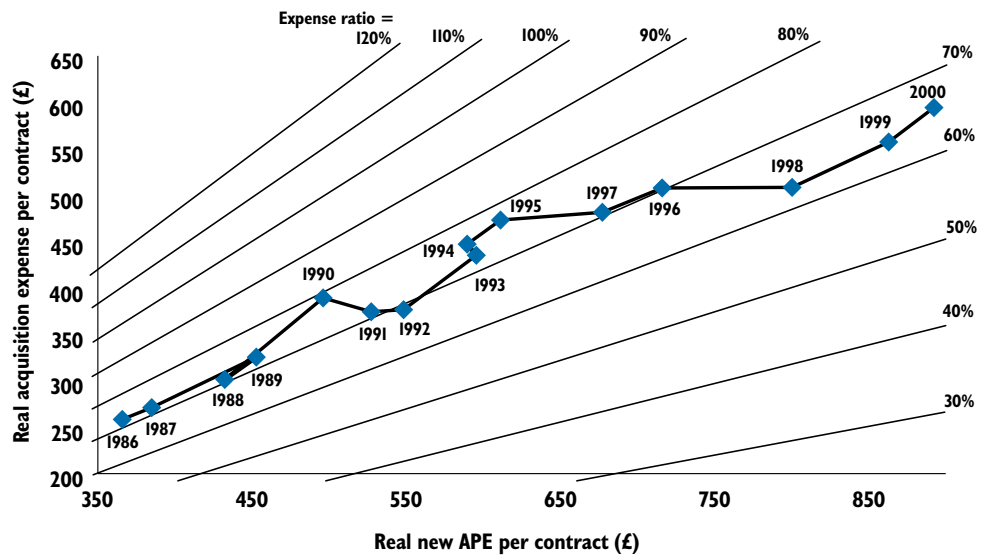


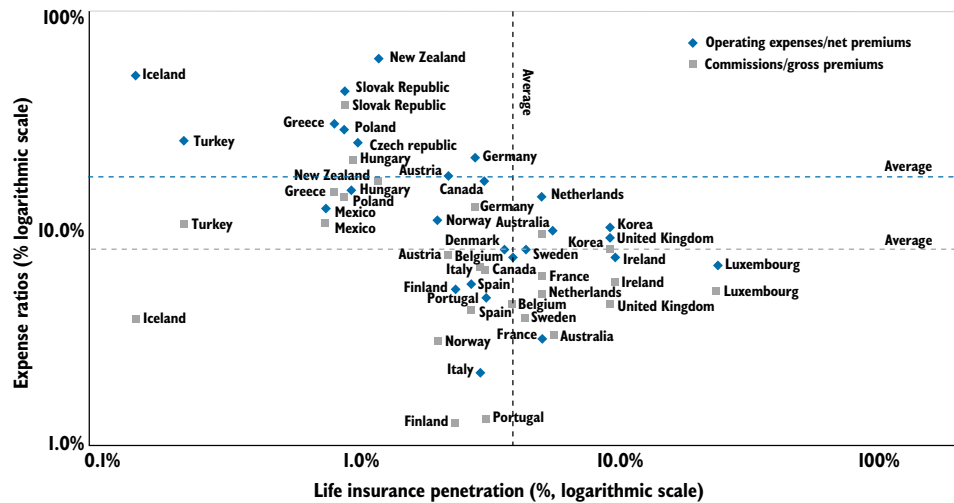
Figure 9.4: Distribution costs versus real average assets per contract (in real terms)



Source: ABI data; Booz Allen Hamilton analysis.

9.44 It is true that when compared to other OECD countries, expense ratios in the UK life industry are not obviously out of line, as Figure 9.5 shows. But the real unit cost increase in recent years still requires explanation.

Figure 9.5: Distribution and manufacturing expense ratios versus life insurance penetration in OECD countries



Source: OECD Insurance Statistics Yearbook 1992-1999, Booz Allen Hamilton analysis.

Causes of unit cost increase

9.45 A number of factors lie behind the decline in the efficiency of the life industry over the last decade. Whilst some of these are wholly or partially outside the industry's control, collectively they have served to increase:

- product complexity; and
- industry costs.

Product complexity

- 9.46 The analysis above identified the incentives on the industry to proliferate products and to make these complex and opaque. Certain market and environmental factors have added to complexity in the industry, most notably:
- the shift from life products to pensions;
 - the shift to independent distribution; and
 - changes in tax regimes.
- 9.47 The business mix in the life industry has shifted over time from life products to pensions, which are fundamentally more complex products. This is due to a series of changes in the broader environment:
- the introduction of personal pensions, and coincident changes in employment patterns and employer attitudes to pensions; and
 - the withdrawal of Life Assurance Premium Relief in 1984, reducing consumer demand for life products.
- 9.48 Distribution has shifted increasingly from DSFs to independent intermediaries. The intermediary channel is highly fragmented with many small firms and diverse commission structures. This contrasts markedly with the DSF model, where control of the sales process and reward structure lies more directly with the provider. The proliferation of commission structures accompanying the shift in distribution is a further driver of complexity.
- 9.49 The tax system for retail savings products has generally become more complicated over the period. Certain tax treatments (such as Life Assurance Premium Relief or PEPs), were only removed for new products whilst remaining for existing products, and new tax regimes, such as ISAs, were introduced. The proliferation of different pensions tax regimes in the 1980s will also have had an effect.

Industry costs

- 9.50 In addition to the forces adding to product complexity there are also structural factors that impede efficiency improvements in the life industry.
- 9.51 Long-term retail savings products typically have very long lives: often forty years or more. Meanwhile, the shelf life of actively sold products is typically only around five years. Thus over time, a provider's portfolio of in-force products will tend to proliferate. Manufacturers can have several hundred different products in force, of which only around 10 per cent are still sold. Establishing a single set of customer service processes for all products of a similar class, implemented on a single IT system is highly complex, especially with older products supported by legacy systems. Thus, administration costs tend to be additive as a new product is introduced, typically with a new set of customer processes on a bespoke system.

THE PROBLEM OF LEGACY SYSTEMS

The life industry was one of the first to use computers. At many companies, core administration systems date from the 1960s and by modern standards, they are inflexible and inefficient. The long-term nature of the products means that it is hard to decommission systems while associated policies are in-force. Effectively addressing the legacy system problem requires that companies also rationalise their product portfolios. There are numerous examples of firms that have redeveloped their core policy administration systems without such rationalisation and have seen little efficiency benefit from so doing. As new systems merely replicate the complexity of the back book, the associated administrative complexity persists in customer services operations. Some providers have as many as 17 core IT systems.

- 9.52 Were the industry able to transfer older generations of policyholders to the newer forms of policy, this would be soluble. But the contract-based nature of life products inhibits this. Contract law prohibits long-term savings providers from unilaterally changing terms and conditions. Even where it can be shown that transferring policyholders between product types does not lead to consumer detriment, or may even enhance policyholder benefits, companies cannot proceed without securing policyholder approval. Transferring products is a lengthy, complex and costly exercise, which few industry participants are willing to undertake.
- 9.53 The problems of legacy systems and portfolio rationalisation also serve as barriers to consolidation in the industry. For a merger to enable significant reductions in administration costs, legacy systems and product portfolios more generally need to be merged. The expense and difficulty of this exercise makes consolidation considerably less attractive.
- 9.54 There has also been an increase in the level of customer contact with the industry, driven by a number of factors:
- the number of UK policies in-force has remained largely constant in the years 1986-2000 at around 110 million. However, customer numbers have increased over the period, because of the shift from defined benefit occupational schemes, where the customer was a single scheme manager, to GPPs, personal pensions and stakeholder pensions, where there are many individual customers;
 - the number of third-parties with whom many providers are dealing has increased because of the growing importance of IFAs in distribution; and
 - as a result of mis-selling, followed by regulatory intervention such as the Pensions Review, customers have become more demanding of information and standards of service.
- 9.55 At the same time, the business mix has shifted from life products to pensions, which are fundamentally costlier to administer. There has also been a corresponding move to linked business, which is more administratively demanding (e.g. daily valuations).

TECHNOLOGY IN DISTRIBUTION

Given the importance of distribution in driving the economics of the industry, measures to improve efficiency in distribution are highly desirable. Automation is an obvious candidate. Technology has the potential to reduce the time, and therefore the cost, involved in:

- gathering information about the client, through standardisation;
- providing information about available products; and
- communication between providers and advisers in the purchase and ongoing management of products.

Portals have been set up to promote efficiency in the market by providing IFAs with a direct link to providers for both quotes and transactions: the Exchange, AssureWeb and Lynx. These have been highly successful as a means of providing quotes for life products, but do not feature unit trust products, using a hyperlink to funds supermarkets instead. More importantly, although heavily used for quotes by IFAs, these services do not allow products actually to be purchased online: separate services have been created in some cases for this, but their usage is still very low.

This is an important limitation. There are considerable frictional costs in the communication between manufacturers and distributors. The Review was told that 20 per cent or more of application forms submitted by intermediaries are incomplete and require rework, which generates costs. An electronic system of communication would assist in dealing with this problem.

The mutual fund industry relies heavily on paper-based transaction methods, with only one portal, EMX, providing electronic services. However, this is essentially limited to messaging and does not provide a full settlement service. This results in an inefficient process particularly when compared to mutual funds settlements overseas. The absence of electronic settlement is due to a failure to sign up sufficient subscribers initially, because of the high minimum investment required and some regulatory barriers, now removed. It is hoped that portals in the mutual fund industry will develop more fully.

In part, this situation is the result of the fragmented nature of the industries concerned. IFAs, many of whom are small, generally lack the capital to make meaningful investments in IT. Providers have the capital, but to be successful, portals need to be based on common standards across providers and distributors, and again fragmentation is a barrier: there are considerable co-ordination difficulties in agreeing such standards with so many different firms involved in the market. The requirement for the industry to overcome these barriers is paramount, and greater effort needs to be devoted to this area.

9.56 Perhaps most significantly of all, there has been substantial regulatory intervention over the last decade, requiring an upgrade in the quality of advice and customer service more generally. This has driven increases in the cost of interacting with consumers:

- an increase in dedicated compliance staff within firms, with sales manager roles now being full-time management positions;

- the creation of a training and competence regime which did not exist prior to the early 1990's; and
- an increase in time spent per client, both in analysing client needs in the fact-find, and in developing recommendations.

Industry structure

9.57 The continuing fragmentation of the industry has hampered progress towards greater efficiency through economies of scale, as well as increasing the co-ordination difficulties of industry-wide technology initiatives.

9.58 Unit trusts/oeics are a highly fragmented industry with over 140 providers of these products currently active in the UK. In 1992 the top 10 providers had 46 per cent of the funds under management, and by May 2002, this share had fallen to 44 per cent.

9.59 There has been considerable demutualisation and merger and acquisition (M&A) activity in the life industry, as the graphs below show. Since 1990, 70 life companies have demutualised, and there has been a similar number of mergers or acquisitions. However, the industry remains fragmented. This is partly because the level of M&A, though seemingly high, is modest relative to the number of players. There are over 340 life companies in the UK (including friendly societies), grouped into almost 150 entities, although only about 50 of these are still active in generating new business.

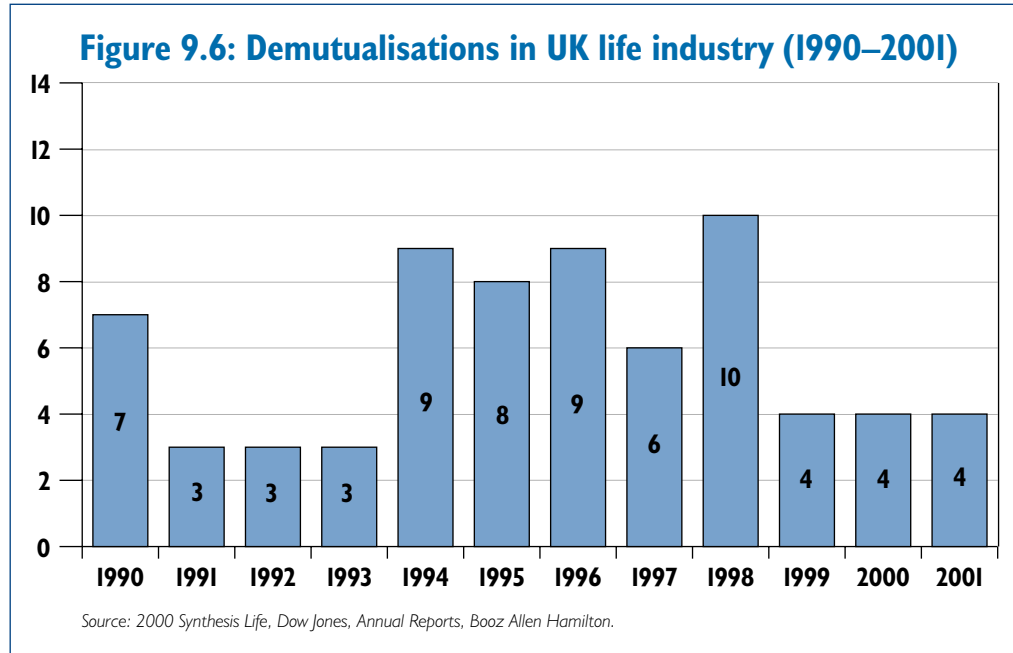
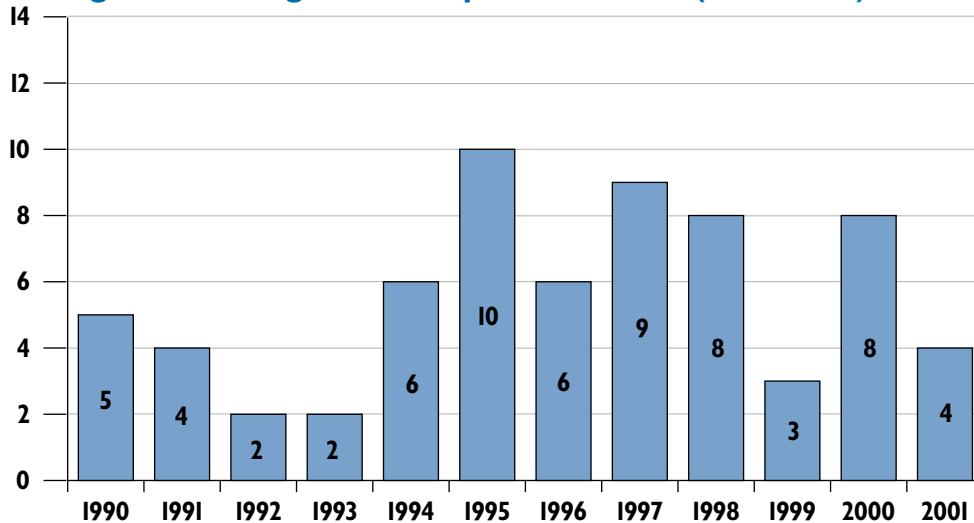


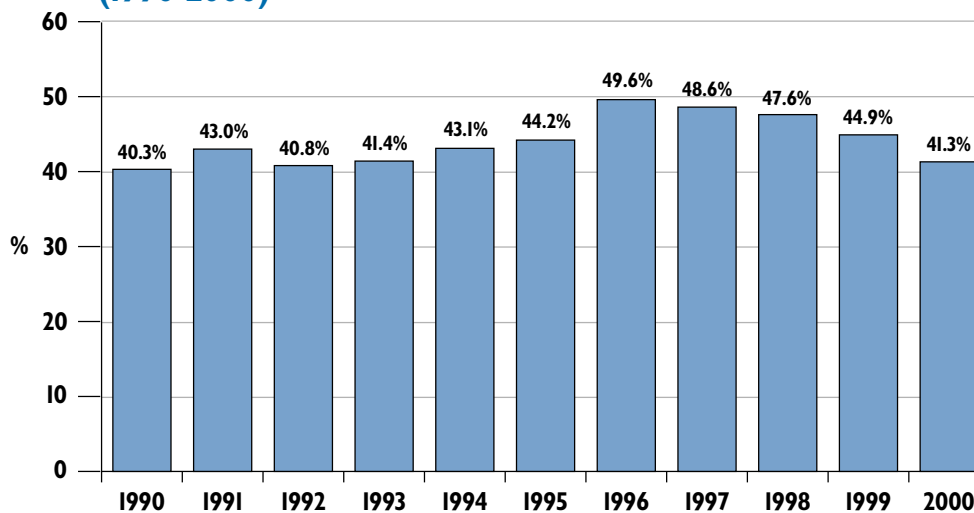
Figure 9.7: Mergers and acquisitions in UK (1990–2001)



Source: 2000 Synthesis Life, Dow Jones, Annual Reports, Booz Allen Hamilton.

9.60 But the nature of the M&A activity is also relevant. As Figure 9.8 below shows, the market share of the leading companies has not increased materially. The market share of the leading providers – including Standard Life, the Prudential, and Legal & General – has remained relatively constant. Much of the M&A activity has been undertaken by bancassurance providers, such as Lloyds TSB, Abbey National and HBOS, growing through acquisition of life businesses (e.g. Scottish Widows, Clerical Medical).

Figure 9.8: Market share of top 10 UK life companies (1990-2000)



Source: 2000 Synthesis Life, Dow Jones, Annual Reports, Booz Allen Hamilton.

9.61 Distribution of retail savings products is also highly fragmented. The market has shifted away from DSFs and towards IFAs. Whilst the top 25 IFA firms account for 70 per cent of their market, there are over 11,000 IFA firms in the UK market. Thirty seven per cent of these have a single registered

individual (RI), while the average number of RIs in a firm has been estimated at 3.7³.

9.62 The continuing fragmentation in the life industry appears to have a number of causes:

- the persistence of mutuality among life companies has enabled smaller players to survive for much longer than they might otherwise have done;
- the factors inhibiting the exercise of shareholder pressure, which are set out above, make it more difficult for the market in corporate control to function effectively;
- benefits to consolidation are counter-balanced by the difficulty and costs associated with rationalising legacy systems; and
- acquirers are inhibited by concerns that they may be assuming hidden liabilities created by past mis-selling.

9.63 These structural and environmental factors go some way to explaining the rise in industry unit costs. But that is not a sufficient explanation. There are measures which would have helped to counter these factors:

- product simplification;
- rationalisation of product portfolios;
- rationalisation of legacy IT systems; and
- standardisation of commission arrangements.

9.64 These measures have, in general, not been determinedly pursued by the industry. The reasons for this can be found in the incentives which govern industry behaviour, described earlier in the chapter and the effects of which are summarised in paragraph 9.38.

9.65 The pursuit of product simplification, portfolio rationalisation and the like has limited attractions for the industry. In contrast, producers have benefited from increasing product complexity and by innovating around product features, with new product variants generally supported by dedicated systems. It is widely recognised in the industry that this approach leads to inefficiencies, but given the opacity of charges and the system of commissions, the penalties for inefficiency are modest.

9.66 An interesting comparison can be drawn with the automotive industry, which shows many of the same features as the long-term savings industry: market pressure towards product proliferation and competition on the basis of product features; the requirement to service over many years a stock of vehicles no longer in current production; and increasingly stringent regulatory and environmental demands. Yet the automotive industry has achieved substantial efficiency gains through adopting such measures as:

³ B&W Deloitte.

- standardising components across multiple vehicle platforms;
- engineering products to ensure that feature addition does not significantly affect cost; and
- designing products to be manufactured flexibly with infrastructure and systems that are common to the entire range.

9.67 Analogous processes are available to the life industry, but consumer weakness has blunted the incentives to adopt them. The Review believes that steps can and should be taken:

- to tackle the structural factors tending to increase costs; and
- to improve the underlying incentives through measures designed to make competition work more effectively.

Summary

9.68 The Review believes that the competitive environment in the long-term savings industry has the following general characteristics:

- there are only modest incentives for distributors to offer superior advice on long-term investment, to seek out the best value products or to promote simple products. Rather, competition in distribution tends to focus on maximising sales to higher-income consumers, with products that can be differentiated by their tax benefits or because of minor additional features; and
- there are correspondingly few incentives for manufacturers to improve efficiency, simplify their products or to seek to deliver superior investment performance over an appropriate time-frame.

9.69 There are also impediments to effective shareholder pressure in the life industry because of unclear and inconsistent accounting, and the existence of inherited estate assets of uncertain value. The legacy of mutuality adds to this.

9.70 These characteristics exacerbate a situation in which products are inherently complex and opaque, and in which industry unit costs have steadily risen in both manufacturing and distribution. Various factors have contributed to this:

- the inherently long-term nature of these products;
- a shift from life to pensions;
- a shift to independent distribution;
- substantial regulatory intervention; and
- greater demands on customer service.

- 9.71 The industry's incentives to tackle these issues have tended to be weak because of the nature of the competitive process.
- 9.72 The Review has therefore sought to make recommendations to improve these incentive structures, by creating an environment in which there are greater competitive rewards for efficiency and quality. These are set out in Chapter 10.

Overall objective

- 10.1 The Review has set out how the interactions of a series of participants – consumers, product providers, distributors, Government and regulators – have led to an industry in which competitive intensity is muted. This in turn leads to concerns about:
- inefficient allocation of capital; and
 - the delivery of value for money for consumers.
- 10.2 As the analysis has also made clear, these interactions have multiple interconnections and are in many cases mutually reinforcing. It is often not possible to tackle a single issue – for example, insufficient focus on asset allocation – in isolation, with a recommendation targeted specifically at that problem. Moreover, many of the problems of the industry are never likely to be soluble through Government or regulatory intervention.
- 10.3 The Review's approach has therefore been to identify what a well-functioning market might look like, and then to develop a series of recommendations which, taken together, can move some way towards that ideal.
- 10.4 A well-functioning market for retail savings would be one in which:
- consumers have a reasonable understanding of retail savings products;
 - there is a properly functioning market for advice, with clear pressures on price and quality;
 - the incentives of advisers are aligned with those of consumers;
 - products are simple and straightforward, with differentiation occurring only when it adds value to consumers;
 - there is a strong focus on asset allocation;
 - investment performance is assessed over appropriately lengthy timescales;
 - there is strong downward pressure on price and upward pressure on quality, with more expensive products delivering demonstrable additional benefits;
 - specifically, the prices of the elements of investment, protection and advice are clearly and separately identifiable; and
 - consumers, particularly those from low/middle income groups, can reasonably easily access the markets for products or advice.

- 10.5 This is not a fully attainable ideal. It is not possible to turn this into an industry which functions in the way that most consumer goods industries operate, because of a number of intrinsic characteristics of the product.
- 10.6 But there is much that can be done to move towards this ideal. This will most often be achieved through an explicit aim of simplification, whether of products, processes or structures. Simplification is a strong theme of many of the Review's proposals.

“Stakeholder” products

- 10.7 The Review has sought to demonstrate that at present, competitive forces in the long-term savings industry actually drive towards greater complexity, not simplicity of products. This leads to distribution economics which make it difficult for low/middle income consumers to access products.
- 10.8 A key recommendation of the Review is therefore for a suite of simple and comprehensible products, that would be sufficiently tightly regulated to ensure that, with certain additional safeguards, these consumers could be sold such products safely without regulated advice. This recommendation would have a number of important benefits.
- 10.9 It would significantly improve outcomes for low/middle income consumers by providing them with simple, good value products, which would be more accessible because the sales process would be both cheaper and shorter.
- 10.10 This could be achieved while protecting consumers effectively from major detriment, particularly the risk of high charges, complex features and unknown levels of risk. These are problems which continue to raise concerns even under the present regulatory regime.
- 10.11 As an ancillary benefit, the Review believes that such simple and cheap products would also be attractive to consumers of all types. They would therefore introduce into the market, as a whole, strong competitive pressure towards improved price, quality and simplicity.
- 10.12 **The Review therefore recommends the introduction of a suite of simple and comprehensible products. The features of these would be sufficiently tightly regulated to ensure that, with certain additional safeguards, a consumer could be sold these products safely without regulated advice.** The remainder of this section explains how this should be done.
- 10.13 The Review has concluded that the regulations for this suite of products must have two elements:
- substituting product regulation for the current regulation of advice; and
 - prescribing a simple and clear warning process at the point of sale to allow consumer themselves to conduct some basic suitability tests.

- 10.14 The heart of the solution lies in product regulation. A system based on potentially highly complex products, sold with often equally complex advice, will inevitably exclude consumers below a certain level of income because of the fixed costs of the advice process, even if this process is unregulated. Product regulation provides an embedded means of protection that does not rely on advice and so minimises the fixed cost element of interacting with the consumer.
- 10.15 Product regulation, as envisaged by the Review, would be designed to overcome the risk to consumers of being:
- overcharged (through price-capping);
 - locked in either contractually or because of high surrender charges; or
 - exposed to inappropriately high levels of investment risk.
- 10.16 At the same time, the protection afforded by product regulation has limits. There are consumers whose specific circumstances are such that they need specific and tailored advice. For them, even heavily regulated products could be unsuitable¹.
- 10.17 Most obviously, several of the inherent characteristics of pensions present various problems, which include:
- no access to funds once these have been committed;
 - the potential for consumers to invest in a personal pension when they in fact have access to a contributory occupational pension; and
 - the potential for the State benefit system and pension income levels to interact, such that the latter reduce entitlement to the former².
- 10.18 There is also some potential for consumer detriment in purchasing medium- to long-term investment products, which needs to be addressed. Problems could arise where:
- the investor does not have a long enough time horizon; or
 - the investment is designed to achieve a specific financial outcome, and where the consequences of failing to achieve this are profound.

¹ The Review has also been conscious of the need to be compatible with the legal requirements of the Investment Services Directive (ISD), which is currently being revised: in particular, the possibility that, throughout Europe, all investment products may have to be sold with some sort of suitability test. A system of product regulation alone might also prove, in due course, inconsistent with the provisions of the ISD.

² This effect is much less widespread under the new Pensions Credit.

10.19 The Review therefore proposes an additional element of warnings given to the consumer prior to entering into the sales process³.

10.20 The Review believes that the two elements of product regulation and point-of-sale “warnings” together would provide a highly effective regime of protection.

Types of products available

10.21 The Review envisages that three products would be available within this suite:

- a mutual fund or unit-linked life fund;
- a pension; and
- a with-profits product.

10.22 The Review has not considered whether there should be any pure protection products available as part of this suite, or what form these should take if there were. Protection is outside the remit of the Review. However, given that the products listed above would essentially be investment products, there may well be such a need. **The Review recommends that consideration be given to the issue of whether a protection product should be included in the suite of products.**

10.23 These products would need to be promoted as a specific and separate set of products with an overall brand identity. The Review has used the term “stakeholder” as a working title. This has certain advantages, as the term already has recognised brand attributes which includes notions of simplicity and affordability. Equally, this may be felt to be confusing, particularly in the case of the pension product. The Review believes this should be for discussion and consultation by the Government and FSA.

Point-of-sale warning

10.24 **The Review recommends that the sales process should begin with the person selling the product giving a number of “plain English” warnings to the consumer, who would then certify that he or she had received and understood each of these.** At a minimum they would include:

- that the consumer was being offered the opportunity to buy a restricted number of simple products, and that the salesman was not in a position to provide expert advice on the appropriateness of other products owned by the consumer;
- that, of the suite of regulated products, the pension would be unlikely to be suitable for:

³ If necessary, particularly if this were required to conform to the requirements of the Investment Services Directive, this could be extended to mandating the use of some simple decision trees during the sales process, though this should be kept to a minimum.

- people on low incomes who were above a certain age;
- people who had access to an occupational scheme; and

if purchasers were in either category, they should restrict their choice to one of the non-pension “stakeholder” products, and seek advice on their pension arrangements;

- that the products being sold had an element of financial markets risk, and that therefore consumers should consider carefully before they put too much of their savings in them⁴;
- that these products were not appropriate for meeting specific future liabilities, as their future value could not be guaranteed; and
- that purchase should not be considered if the intended savings horizon was less than, say, five years.

10.25 It would be essential for these warnings to be simple and limited in number, or they would lose their effectiveness.

Product features

10.26 **The Review recommends strict limits on “stakeholder” product features, to ensure simplicity.** As a general principle, the regulations concerned would rule product features in rather than ruling them out.

10.27 **In particular, the Review recommends that the “stakeholder with-profits” product should be required to have all of the features of the model set out in paragraphs 10.125-10.147 of this chapter. These include:**

- an explicit “smoothing account” with smoothing required to be neutral over the long run;
- a “100/0” structure, with an explicit management charge to a separate management company and no shareholder participation in with-profits payouts;
- disclosure of the underlying smoothed and unsmoothed asset values; and
- standard rules for the calculation of charges for the product to ensure consistency and comparability.

10.28 The new “stakeholder” pension product could take the form of either a “stakeholder with-profits” fund or a unit-linked product, provided that they conformed to their respective product regulations.

⁴ It might even be appropriate at this point to suggest a specific quantitative limit as a proportion of the consumer’s liquid assets.

- 10.29 **The Review recommends that there should be no initial charge, and that annual charges for these products should be regulated.** The Review is aware that this is a controversial matter. It does not believe that the only important feature of a product is its price, nor that the cheapest product is necessarily always the best. But it is essential that there should be some limit on charges. No such limit would make it possible for consumers to suffer material detriment from these products, particularly in pensions where funds cannot be removed once committed, and transfer is difficult and potentially complex.
- 10.30 Clearly setting the appropriate level of such charges is a difficult issue. The economics of the product would not depend solely on the level of charges, but also on its persistency and the volumes in which it could be sold. There would therefore be some tradeoff between value for money for consumers and likely reach of the product: a more expensive product, with higher margins, would be more attractive for the industry to sell, other things being equal.
- 10.31 The Review believes that a 1 per cent cap is an appropriate starting point. For all the concerns voiced about the 1 per cent cap for stakeholder pensions as they currently exist, the fact remains that large numbers of companies have entered this market, and the Review's proposed "stakeholder" products will be considerably cheaper to sell. Examining the main drivers of compliance cost considered in Chapter 5:
- most importantly, sales times should fall. Rather than sales taking 3 or more hours, it should be possible to complete a "stakeholder" sale in a considerably shorter time because of the greatly restricted product range and removal of the COBs "know your customer" requirement;
 - in particular, the salesman would be free to focus on those types of product where a sale was most likely, without concerns about regulatory sanction for not having sought to cover all possibilities; and
 - supervision costs would be considerably less than for conventionally advised sales, because there would be very few rules to police. Training and competence would also be far less of an issue.
- 10.32 At the same time, markets evolve, and an appropriate figure today may not be so at some future point. The Review believes that a pragmatic and flexible approach to the issue of the price cap is required. **The Review therefore recommends that, given the existence of CAT ISAs and the existing stakeholder pension, a 1 per cent ceiling would be a suitable starting point, but that this should be reviewed at regular intervals to ensure that it remains appropriate.**

- 10.33 **The Review recommends that there should be strictly regulated surrender charges – ideally none at all. If consumers wished to exit the product, they should be able to do so with a limited and defined financial penalty from the provider.** This would remove an important concern about detriment. In the case of “stakeholder pensions”, the rules would govern transfer rather than outright exit, since recovering money from a pension fund before retirement age is not possible. The precise level of this regulated minimum should be a matter for consultation.
- 10.34 The consumer would, of course, still be exposed to financial markets risk, and could stand to lose financially by encashing the product because of a fall in the underlying asset values. It is important not to overstate this problem:
- the longer the period over which the product was held, the less this risk would be. This is appropriate: “stakeholder” products are specifically intended to be long-term savings products; and
 - even in the short-term, if the consumer was simply redeeming the product in order to switch the funds into a similar equity-based product, the impact of a fall in financial markets would be mitigated by the new product having a similarly depressed value.
- 10.35 It does, however, mean that it is essential that consumers understand that these products are unlikely to be suitable for short-term savings: hence the warning to this effect.
- 10.36 **The Review recommends that, through regulation, there should be limits on the investment risk of “stakeholder” products.** Clearly the products should involve some participation in equity risk. Equally, it seems sensible to attempt to put some limits on consumer exposure to such risk. However, it is essential that this should be done in a coherent way.
- 10.37 In particular, the Review believes that ruling out particular asset classes as inherently “too risky” would be a serious mistake, for several reasons. First, because this takes no account of the fundamental financial markets principle of diversification. A particular asset class might be highly volatile, i.e. “risky”. But to the extent that this volatility was uncorrelated with the rest of the investor’s portfolio, investing in that asset class could in fact reduce risk, not increase it. Second, financial markets change and develop constantly, as do the asset classes within them. An asset class that is highly volatile today may not be so in ten years time, or vice versa. So seeking to create blanket prohibitions would risk creating exactly the sort of distortion to investment decision-making that this Review and the Myners Review were established to remove.
- 10.38 Another possibility would be to set quantitative limits on the volatility of the product, as measured by the variance of its returns. But there would be problems with such an approach:
- the figure would of necessity be arbitrary; and

- the only measurable figure is the historic volatility of assets, and markets change.

10.39 Instead the Review believes that the correct approach would be for the product regulations to require a high level of diversification of risk.

10.40 Again, some caution is required. Diversification can easily be defined within a given market: maximum diversification is achieved when the only risk left in the investor's holdings is market risk, not specific risk⁵. But even in a portfolio which has achieved maximum diversification:

- the market risk may still be very great, as in the case of a fully diversified portfolio of emerging market equities, for example;
- even if the market risk is relatively modest, it is possible to construct a portfolio of especially volatile securities in such a way that it has no specific risk, but is in aggregate much riskier than the market itself; and
- mandating that portfolios should contain only market risk and no specific risk is effectively mandating passive management of the products concerned, because it is requiring people to buy the market.

10.41 It is therefore better to aim for a degree of diversification of both market risk and specific risk. This would effectively require "stakeholder" mutual funds to be managed funds. ("Stakeholder with-profits" products would, in general, already meet this requirement). There is no single optimal profile for a managed fund and the Review does not wish to be overly prescriptive. **It recommends two general rules:**

- **the fund should have a minimum component of fixed income securities; and**
- **the equity investments of the fund should be under a requirement not to invest the whole of the equity component in a single market or sector.**

The industry should be consulted as to the details of these rules.

10.42 A possible additional feature would be a particularly long cooling-off period of, say, three months, during which the initial investment could be retrieved in full. The difficulty with this is that, over this initial period, it would either require the provider to bear the financial markets risk, or have the funds invested in cash or near-cash securities. The Review has therefore not recommended the inclusion of a lengthy cooling-off period.

⁵ Market risk being the risk of the asset class as a whole, which all securities within that class will also bear to a greater or lesser extent; while specific risk is that of the particular security.

Interaction with existing product regulation

- 10.43 The products described above share many features with both CAT-marked ISAs and existing stakeholder pensions. There are nonetheless some important differences. In particular, these products do not have any explicit controls on exposure to financial markets risk.
- 10.44 Clearly it will be important not to add to consumer confusion by creating a number of different “brands” under the general umbrella of product regulation. The Review believes it would be desirable to have the CAT regime and existing stakeholder pensions subsumed within the new “stakeholder” proposals, but it has not sought to specify how this should best be managed. This is an important issue which the Government, in consultation with the FSA, needs to consider.
- 10.45 Under any circumstances, it is envisaged that “stakeholder” products would be able to be placed within ISAs, if the purchaser so desired.

Sales of “stakeholder” products

- 10.46 The Review is confident that the features above would create a class of product which could be sold without regulated advice as safely as existing products can be sold within the present regulated advice regime. Whilst the Financial Promotions⁶ regime would still apply, and marketing material would still need to be “clear, fair and not misleading”, **provided that the warnings had been delivered and certified as understood, the Review recommends that providers should be free to market “stakeholder” products, without the bulk of the COBs regime being applied to them, specifically:**
- no requirement for those selling the products to be FPC3 (or equivalent) qualified, as financial advisers are;
 - no COBs requirement to provide “suitable advice”; and
 - no requirement to “know the customer”.
- 10.47 The Review envisages that these products would be sold through a number of channels:
- they would be attractive to high street banks, since they could use the existing branch infrastructure and staff to sell the products without incurring additional compliance and training costs;
 - they could be sold through direct promotions supported by call centres;
 - they might also prove attractive to new channels that are not themselves FSA-regulated, such as supermarkets, Post Offices or other retail outlets; and
 - they could be sold directly by employers.

⁶ The Financial Promotion regime, as set out in the COBs handbook, deals with all forms of communication that induce or invite consumers to enter into controlled activities. The regime requires that authorised firms should ensure that promotions are clear, fair and not misleading.

- 10.48 The latter two channels raise the question of how consumers would have access to the Ombudsman and to the Financial Services Compensation Scheme. The need for these should be greatly reduced, as the bulk of consumer protection is provided by the product regulations rather than by sales regulation. Nonetheless the issue arises of what would happen if, for example, the warnings were not properly delivered. The Review envisages that the basic principle would be that the product provider would be responsible for the way in which the product was sold, so whatever the distribution channel, the consumer would always have access to the Ombudsman and the Financial Services Compensation Scheme⁷.
- 10.49 Depending on the outcome of European negotiations, the revised text of the Investment Services Directive may make it necessary for the person selling any investment product to establish some sort of suitability requirement. **The Review recommends that for “stakeholder” products this be kept to an absolute minimum compatible with the legal requirements, perhaps using some sort of simple decision-tree approach.**

Implementation of the recommendation

- 10.50 This proposal covers areas which are the direct responsibility of the FSA, but also has clear connections to Government initiatives such as CATs. It is for the FSA and the Government to determine between them the appropriate division of responsibilities for taking forward the Review’s recommendations in this area. However responsibility is divided up, it is clear that there would need to be consultation on all aspects of these proposals.

Distribution

Issues of concern

- 10.51 The principal objective of the Review with regard to distribution is a better-functioning market in advice, with clearer customer pressures acting to reward advice that represents sound value for money.
- 10.52 As it currently exists, the principal basis for remunerating distribution – commission – is a barrier to the achievement of this objective. Commission is widely acknowledged to be problematic. However, it is important to be clear about where specific difficulties arise, in order to frame the remedy correctly.
- 10.53 The present commission system has three key features:
- payment to the distributor is contingent on a sale;
 - payment is typically a percentage of the value of the sale; and
 - payment is wrapped up in the product price and agreed between the provider and distributor.

⁷ In practice, the providers would almost certainly wish to protect themselves from the consequences of independent distributors’ actions and would require indemnities from the distributors for any errors and omissions by them, perhaps using the Appointed Representatives system. But this would not affect consumers’ rights.

10.54 The first two are not necessarily ideal, but they also have some advantages:

- making payment for advice contingent on a sale of some sort tends to bias the adviser against recommending that the consumer do nothing, even if that is the best advice. But by and large, consumers should be saving more, not less. Remuneration systems that create incentives to stimulate some form of savings are, in general, desirable; and
- *ad valorem* fees create incentives for the industry to focus attention upon those consumers with higher incomes. But this is not in itself problematic provided that it is still sufficiently attractive to service the less wealthy consumers.

10.55 The major problem is the third feature of commission: the fact that the cost of advice is wrapped up in product prices and takes the form of a payment from the provider to the distributor. This has two important effects, both noted by the FSA in their analysis of the market in CP121:

- it leads to different providers offering different commission levels for their products. This is what generates the problem of commission bias, which has attracted the bulk of attention in public debate; and
- there is an additional problem which is equally important, although much less debated. Consumers are largely unaware that they are purchasing advice which is distinct from the product. To the extent that they are aware, they perceive it as free. They therefore do not exert effective competitive pressure on the quality and value for money of that advice.

10.56 The Review is therefore seeking to encourage the development of a clearly identified and independent advice service which is paid for by the consumer. To this end, its recommendations aim to create:

- greater transparency about the true commercial relationships between providers, distributors and consumers, so that consumers are less likely to perceive commission-remunerated advice as free; and
- a regulatory structure that makes the provision of independent advice as attractive a proposition as possible for intermediaries.

10.57 At the same time, the Review is conscious that it must take account of consumers' general reluctance to pay upfront fees for advice. Payment by the hour for advice, for example, would deal fully with all the concerns above, but is of little practical use as a solution since it appears not to be attractive to most consumers.

10.58 The Review sets out below:

- a preferred structure for remuneration; and
- how it could be implemented.

Preferred remuneration structure

- 10.59 The traditional solution to concerns about commission has been to seek better commission disclosure. The aim is that consumers should realise that distributors are being paid to advise them, and that they should know the size of payment. But this is always an uphill struggle, because it does not impact the decision-making process: consumers have effectively no choice about the level of commission paid and it is presented to them in such a way that it generally makes little difference to them.
- 10.60 What is needed is to make the commission payment, which should be remuneration for the provision of advice, the subject of negotiation purely between the adviser and the consumer, with no provider involvement.
- 10.61 By way of illustration, a product might currently be sold with a one-off upfront charge of 6 per cent, 3.5 per cent of which is used to pay commission to the distributor, thus leaving the provider with a gross margin of 2.5 per cent. The Review envisages the following instead.
- 10.62 The provider would simply make the product available to the adviser on a basis which allows a retained margin for the provider of 2.5 per cent. This price could be thought of as the “wholesale price”⁸.
- 10.63 Advisers would receive no payment from providers for their advice. Instead, they would agree a rate for advice with the consumer at the start of the process. This could be an hourly fee or a fixed fee which was paid, regardless of whether a sale was made. But given general consumer reluctance to pay on this basis, it could also be contingent on a sale. If so, it could also be a flat rate – clearly higher than the non-contingent rate, to cover the risk that the consumer did not buy anything. Alternatively, it could be set as a percentage of the initial investment in the product, as commission is today, either on a one-off basis or an ongoing, instalment basis. The level of this percentage fee could also vary depending on the type of product, but since the fee would have to be agreed with the consumer, any differences would have to be clearly justified – for example, pensions might justifiably attract a higher percentage fee for advice because of their greater complexity.
- 10.64 At the start of a relationship, and periodically thereafter, the adviser would present the consumer with a “tariff sheet”, setting out his charges for the various services and/or transactions. Consumers would be in a position to compare these across advisers.
- 10.65 With this arrangement, the consumer might very well buy the product in the example in paragraph 10.61 and pay a 3.5 per cent upfront charge for advice. So the consumer would, as before, pay a total of 6 per cent as an upfront charge for the product and the advice accompanying it. This 6 per cent might be thought of as the “retail price”.

⁸ Providers may well offer discounts to this, depending on the volumes of business written.

- 10.66 In other words, the actual flows of income under the Review's recommendations could in many cases be identical to those in the present regime. But there would be a crucial difference. The consumer would have explicitly agreed the payment made to the adviser at an early stage in the process.
- 10.67 This would have two important benefits. First, it would make it much more difficult for commission bias to operate. If advisers had sought to charge a higher fee for selling one product rather than another, they would have had to justify it to the consumer, and the consumer's attention would be much more powerfully focused on the differential rewards to the adviser.
- 10.68 Second, this method of payment would enable the development of a properly functioning market in advice. Consumers would be much more aware that they were purchasing advice, distinct from the product, at a cost. They would have clearer incentives to focus on the cost and quality of the advice they were receiving. In addition to improving consumer outcomes, this would benefit the better advisers. Currently, an adviser's level of commission is strongly influenced by his market power vis-a-vis the provider of the product. In the model proposed by the Review, it would be his ability to add value for the consumer that was the principal determinant of success.
- 10.69 Before considering the question of how this preferred model of remuneration can be brought about, the model needs to be compared to the approach proposed by the FSA in CP121, in which a number of observations about the market echo those of the Review:
- competition in the industry centres on providers' ability to secure IFA distribution through use of the commission system. Differentials in commission levels can result in IFAs recommending unsuitable products; and
 - the bundling together of the cost of advice and the cost of the product prevents consumers gaining a proper understanding of the role of advice and its cost.
- 10.70 As a response, the FSA proposed an improved model for remuneration: firms wishing to hold themselves out as offering independent advice should be remunerated on a "defined payment basis". Like the Review's proposed remuneration system, this would permit payment on an *ad valorem* basis. However, the FSA's approach would not permit the other key element of this Review's proposed remuneration system: a sales-contingent payment for advice.
- 10.71 The FSA definition would permit independent advisers, after providing advice, to waive their fee, thus making it sales-contingent after the fact. However, advisers could not promote themselves in advance to the consumer as "no sale, no fee". The Review believes that a remuneration system which forbade such promotion in advance would be excessively strict and would therefore be unlikely to be successful in attracting large numbers of

consumers. There must also be doubts about its enforceability: if advisers were permitted to write off the fee after the advice had been given, it would be difficult to prevent them from letting consumers know that this was their policy.

Implementation of preferred structure

10.72 Given that market mechanisms have not, of themselves, led to implementation of the Review's preferred model of adviser remuneration, it is necessary to consider how it can be brought about. There needs to be a means of signalling clearly to consumers that advisers have adopted this preferred method of payment. In addition, there should be some commercial advantage to advisers who do adopt this method, since it would require, at least initially, a greater effort to persuade consumers to pay separately for advice – or at a minimum, no commercial disadvantage.

10.73 The FSA's proposal in CP121 would provide such a signal by its restriction of the term "independent" to those advisers using a defined payment system.

10.74 However, the Review believes that the preferred payment model is one which advisers could explicitly offer sales-contingent fees. CP121 would need to be modified to permit this.

10.75 The Review is also concerned that the word "independent" alone may not be a sufficiently strong signal that the adviser is using such a remuneration method. Firms that did not meet this criterion, including those with a restricted number of provider links, would still be able to describe themselves as for instance:

- "unconnected with any one provider";
- "having researched the whole market to find the best product for the consumer"; or
- "regulated to exactly the same standard as other kinds of advisers".

10.76 Many consumers might find this sufficiently reassuring not to take the trouble to seek "independent" advice. The Review therefore believes that there would be merit in restricting the use of the term "adviser" as well. While "adviser" covers a wide range of relationships, it principally carries the connotation of "acting solely in the interest of the client". A term such as "financial product distributor" more accurately describes an adviser whose remuneration arrangements are negotiated with, and paid by, product providers. Restricting the use of "adviser" in this way would enhance the value of "independent" status.

10.77 **The Review therefore recommends that:**

- **the use of the word "adviser" should be restricted to those who meet the "independence" criterion; and**

- **CP121 should be amended so that “independence” is compatible with a sales-contingent fee, including one that is advertised in advance as such.**

The definition of “independent advisers” should therefore be that they are advisers who are not paid by providers.

- 10.78 The Review believes that, taken together, these two recommendations would create a clear signal to consumers that would make the status of independent adviser attractive, and would also address, where these advisers were used, the concerns raised by commission.
- 10.79 A further element is needed to make the remuneration system for independent advisers function as envisaged. There also needs to be some incentive for product providers to make their products available at “wholesale” prices to IFAs using this method of payment. The Review believes that the normal operation of competitive forces should ensure this to be the case. As the illustration above demonstrates, it is economically equivalent to selling at the retail price through commission-remunerated intermediaries.
- 10.80 However, this process would be encouraged if the FSA’s own disclosure regime in the Comparative Tables were to promote it. **The Review recommends that the Comparative Tables should publish two prices for each product: a representative wholesale price (where providers were using the independent channel) and a representative retail price, based on average commission levels.**

Referral business

- 10.81 There is a further area where there is an opportunity to make the status of independent adviser more attractive. Currently the Regulated Activities Order (2001) requires that, in order to avoid the need for authorisation under FSMA, introducers (for example, trade unions, solicitors and accountants), when referring their clients to a financial adviser, can only do so if that adviser is “independent”. For some IFAs at least, referrals such as these are an important source of business. Clearly a change in the definition of independence would require this rule to be looked at again.
- 10.82 If the wording of the Regulated Activities Order were to remain unchanged while the definition of independence in FSA regulations were changed, then this would have the effect of making the law stricter. Currently introducers can refer clients to commission-remunerated IFAs. If the definition of independence were changed, they could only refer them to advisers who were not paid by the provider, as defined above.
- 10.83 The Review believes that this is the right approach. At present, referral to commission-remunerated IFAs is the only practical option: the great majority of consumers are reluctant to pay an upfront fee. However, in the depolarised world envisaged above, there should be an alternative: the “no sale, no fee” independent adviser. The Review believes it is legitimate for the regulatory

framework to positively encourage the development of a strong independent sector, as this will benefit all consumers.

- 10.84 **The Review therefore recommends that introducers should continue to be required to make referrals to “independent” advisers in order to avoid the need for authorisation by the FSA under FSMA.**

Alternatives to independent advice

- 10.85 Existing IFAs would therefore face a choice. They could change their remuneration arrangements to conform to the new definition of independence. Alternatively, they could enter into some sort of “multi-tie” arrangement as envisaged in CP121, with close links to a restricted number of providers, perhaps with some sort of investment by the provider in their business. A third option would be for them to continue with their existing business model. They would continue to be commission-remunerated, but would have no provider links and would be able to offer consumers the full range of products across the market.

- 10.86 In this world, consumers seeking an advised sale would therefore face a choice between:

- buying products at wholesale prices from an “independent adviser”, with an additional separate charge for advice which they had explicitly consented to in advance; or
- buying products at a “retail” price from a non-independent distributor, which included commissions paid to the adviser and therefore covered the costs of advice.

- 10.87 They would also have the option of buying direct from the provider without advice (if this was on offer) or from an execution-only distributor. As a result, the Review would expect that over time, the competitive process would tend to drive the price of products available directly from the provider closer to wholesale prices than retail prices. Execution-only distributors would be under pressure to achieve discounts to the wholesale price.

Regulation

- 10.88 The Review has a number of recommendations relating to aspects of the FSA’s work.

Consumer education

- 10.89 The root cause of the problems in the retail savings industry is consumer weakness. If consumers understood retail savings products in the way that they do most consumer goods, other problematic features of the market such as commission-driven distribution would be much less prevalent and of less concern where they did exist. Many of the Review’s recommendations are therefore directed at empowering consumers.

- 10.90 Doing so through consumer education is in theory an excellent approach, since it tackles the problem directly. In practice, of course, this can have only a limited effect. It would take a considerable level of resource, applied consistently for many years, to make an appreciable improvement in standards of financial literacy across the board. In any circumstances, it would be unrealistic to expect the majority of consumers to be transformed into experts in retail savings.
- 10.91 Nonetheless, the Review is persuaded that consumer education can make a meaningful contribution to addressing the problems of retail savings. The Review supports strongly the work that the FSA has done in this area to date, and in particular, its focus on both schools and adult education initiatives. This represents an important start in this long term undertaking, with signs of improvement already visible. For example, FSA research⁹ has found that the vast majority of schools in England are now undertaking some financial literacy teaching. There are, however, broader issues about the resources available for the work, and how it should be given the profile and attention that it requires.
- 10.92 The Review has commented in Chapter 3 on the low level of resources which the FSA is currently devoting to this area. In 2001/2, the FSA's budget was £300,000 for schools and £2.7 million for adult initiatives, although this latter figure includes the provision of information and generic advice through publications, consumer help lines and web pages (excluding Comparative Tables). Taken together, this spend represented only 1.8 per cent of the total FSA budget.
- 10.93 The Review has considered whether responsibility for consumer education should be handed over to another organisation with fewer competing demands for resources. However, there is no obvious alternative organisation where this would be the case, and attempting to create one would be highly disruptive to the FSA at a very early point in its existence. The Review does not regard this as sensible. Additionally, the Review is persuaded that the quality and value of the FSA's consumer education work is enhanced because it is undertaken within the regulatory context of also ensuring appropriate consumer protection.
- 10.94 **Instead, the Review recommends that the FSA should retain its existing responsibilities for consumer education, but these should be given increased financial resources. It further recommends that the budget for consumer education within the FSA should be ring-fenced, to facilitate fund raising from the industry and elsewhere specifically for this purpose.**
- 10.95 It is not presently possible to determine the funding requirement for a meaningful consumer education initiative, although the Review considers that it will need to be considerably higher than the current spend. **Establishing the appropriate level of resourcing should follow the creation of a long-**

⁹ FSA Consumer Research paper II, "Personal finance teaching in schools", January 2002.

term plan for this activity. The Review recommends that this should be undertaken by the FSA in consultation with interested parties. The plan should be far-reaching, in terms of both its time horizon and its objectives, and should provide the benchmarks against which progress can be measured in the years ahead. The FSA should be clearly accountable for its delivery.

- 10.96 The Review recognises that delivering an effective programme of consumer education over an extended time period represents a considerable challenge for the FSA. This is partly due to the fact that, whilst the FSA may have statutory responsibilities for this activity, its implementation actually rests in large measure with other public and private bodies. In many respects, the role of the FSA is one of providing leadership and coordination. The Review welcomes the work already underway to improve coordination through the establishment of a committee bringing together the major departments involved and the FSA.
- 10.97 Consumer education is not the mainstream activity of the FSA, and measurements of progress and performance here are intrinsically difficult. The timescales involved are also extremely lengthy. There is therefore a danger that the core governance arrangements within the FSA are not well suited to overseeing the consumer education strategy and initiatives and consequently, these do not receive the attention and scrutiny they require. **The Review recommends that the FSA considers the establishment of a separate governance structure for education.** This could take the form of a sub-board, accountable to the main FSA board and with suitable co-opted external representation, responsible for all aspects of consumer education.

Key Features Documents

- 10.98 The Review has set out the concerns which many have expressed about the Key Features Document: that in seeking to meet the worthwhile objective of providing the consumer with all relevant information, it cannot simultaneously empower consumers by giving them a few simple facts about the product. At the same time, the Review recognises that consumers should also have access at the point-of-sale to a much wider range of information about the product than this. The Review believes that the solution is to develop two separate documents.
- 10.99 **The Review recommends that the Key Features Document should be substantially shortened so that it discloses only a few important features:**
- the level of charges for the fund;
 - its investment objective and investment strategy (including asset allocation); and
 - any contractual obligations to keep up payments for a certain minimum period.

Consumers should receive this at the beginning of the sales process.

10.100 **The Review recommends that a full set of product information should be prepared in a document separate from the KFD. This “reference guide” or “product features document” should be signposted in other documents and available on request, rather than being automatically distributed.**

10.101 A parallel to this dual approach can be found in markets for other complex goods. For example, in the PC market it is possible to get detailed specifications of machines, but in making purchasing decisions, consumers tend to focus on a few key aspects (hard drive size, amount of memory, modem speed, screen size, etc.) which lend themselves to easier shopping comparisons.

Regulatory clarification

10.102 As stated in Chapter 5, assessing the effectiveness of the regulatory regime is not within the remit of the Review. However, the Review is concerned with regulation to the extent that it impacts upon the competitive dynamics of the industry. The recommendation to substitute product regulation for regulation of the advice process for “stakeholder” products, as set out earlier, is one example of this.

10.103 There are two areas, relevant to the Review’s objectives, where it believes that it would be helpful for the FSA to issue clarification of its approach.

10.104 Suitability and its counterpart, mis-selling, are key factors in driving industry behaviour. These concepts are not defined in the regulations – indeed, mis-selling is arguably not a regulatory concept at all. In practice, the Pensions Review and, more generally, the pre-FSMA behaviour of supervisors have substantially shaped the industry’s views of how the suitability requirement will be enforced. A wide range of beliefs now exists in the industry as to how mis-selling may be defined. This effect is magnified by the fact that the FSA is in the process of changing its regulatory approach to one of risk-based regulation. The Review is strongly supportive of this change.

10.105 The Review believes it would be helpful if there were greater clarity about the concept of mis-selling, given its importance. **The Review therefore recommends that the FSA issues clarification of what constitutes mis-selling.** Whilst this would not provide the industry with total certainty of what is or is not acceptable practice, it would help eliminate costly unnecessary activities.

10.106 A second area where confusion arises in the industry relates to the provision of guidance to regulated firms by the FSA. In a regulatory regime in which requirements are (rightly, in the Review’s opinion) not specified in detail in writing, guidance from the regulator has an important role to play in reducing uncertainty and hence unnecessary costs. Clearly this has to have limits: businesses should not simply be able to transfer all compliance risk to the regulator. But guidance is necessary in cases of genuine uncertainty.

A likely instance is where firms wish to adopt new business practices, typically because they can take advantage of new technology. The introduction of new methods of working can often require significant investment by firms, which they will be unwilling to make if it is unclear whether the new methods will be acceptable to the regulator. It is important that the regulatory system should not serve as a barrier to innovation in this way.

10.107 The Review encountered a belief in the industry that the FSA was not always prepared to provide such guidance. The Review understands from the FSA that this is not the case. The FSA is in fact willing, where firms are introducing new methods of working, to let firms know in advance if these proposed methods of working are compatible with regulatory requirements, provided that the firm has taken reasonable steps to research and analyse a topic before requesting such guidance.

10.108 **The Review, therefore, recommends that the FSA publicise its willingness to give guidance: in particular, guidance about new proposed ways of working before they are implemented.**

Quantifying the impact of the regulatory system

10.109 The Review's analysis has demonstrated the significant impact that regulation can have on the industry and its cost structures. The FSA has sought to compare the costs that its regulatory system imposes with those of other countries, but has so far not been able to do so, partly because of the difficulty of estimating the incremental costs of regulation in the UK and of obtaining comparable figures for overseas jurisdictions. The Review is aware that quantifying as complex a matter as the impact of a regulatory system for financial services is a formidable challenge. Nevertheless, it believes that it is important to do as much as possible to ensure that this crucial issue is understood, so that an appropriate balance is struck between protecting consumers and imposing cost burdens upon them. **The Review recommends that the FSA should continue to make efforts to quantify the overall cost to the industry of its regulatory system.**

With-profits

10.110 The Review has a number of concerns about the operation of with-profits policies.

10.111 Consumers cannot assess the quality or the true price of with-profits policies, since they cannot identify the effects on their payouts of:

- operating efficiency;
- investment performance; and
- smoothing policy.

10.112 Instead, competition focuses on two measures – levels of maturity payouts and crude measures of financial strength – neither of which is satisfactory.

10.113 The product also creates inherent conflict of interests, most obviously in proprietary companies. It places under the provider's control (and beneficial ownership) a pool of capital separate from that of shareholder capital, which is an alternative source of investment funding for the wider business and an alternative place to charge expenses. This problem is magnified by the historic blurring of boundaries between the with-profits fund and the shareholder-owned business through the so-called "90/10" structure, and still more by the existence of inherited estates. In mutual companies, policyholders do not know how the fund has been invested in the provider's wider business, and so are in no position to exercise any sort of effective scrutiny over its use.

10.114 The existence of inherited estates distorts competition, since certain providers, not necessarily the most efficient ones, have pools of capital which have arisen for a variety of historical reasons and which can be used to subsidise various activities.

10.115 With-profits portfolios are almost always actively managed. Yet the probability of the same provider outperforming the index through active management over the normal horizon of a policyholder is close to zero in the markets in which the majority of with-profits funds are invested: UK, US and European equities and corporate debt.

FSA proposals

10.116 As noted in Chapter 6, the FSA's investigation of with-profits has a different, although overlapping locus. The FSA has published its preliminary conclusions¹⁰ and is due to release a series of more detailed consultation documents through the second half of 2002. In summary the FSA proposals are directed towards:

- strengthening the governance framework. Firms should publish the "Principles and Practices of Financial Management" that are applied to the with-profits fund. The FSA also explores the idea that providers set up a "with-profits fund committee" to consider the interests of with-profits policyholders. This would be constituted as a committee of the board and comprised of independent members;
- improving the availability and accessibility of information on the financial condition of companies and their with-profits funds through the regulatory returns;
- improving the information given to customers and their advisers on with-profits policies, both at and after point-of-sale, to give them a better understanding of the nature of their investment and the risks attached to it; and
- developing more open and transparent processes for the handling of the re-attribution of inherited estates.

¹⁰ For details see the FSA document "Feedback statement on the with-profits review", May 2002.

10.117 The Review strongly supports these FSA proposals. Its own recommendations are designed to complement the FSA's approach, and specifically to address issues of competition and efficiency.

10.118 As well as directly addressing issues of consumer detriment, several of the FSA's proposals will also serve to improve competition and efficiency in the with-profits market. The proposals on enhanced regulatory disclosure will create better information for industry analysts to make meaningful comparisons, thus enhancing shareholder pressure on financial performance. The governance proposals, including the establishment of a with-profits committee, will also foster a more customer-focused approach. At the same time, governance changes by themselves, even if accompanied by enhanced disclosure, will not address all the Review's concerns about with-profits.

The Review's vision for with-profits

10.119 The Review's analysis has identified a number of important concerns about with-profits products. To address these, a new model of with-profits products is required.

10.120 In this model, competitive forces would need to act considerably more effectively than at present. The performance of the product needs to be open to much more effective scrutiny and competitive pressure, allowing consumers and advisers to make informed comparisons of with-profits products, both with each other and, even more significantly, with other investment alternatives. These products should compete solely on their cost-effectiveness and on the underlying investment performance they were able to deliver, rather than on payouts which may have been boosted by hidden assets of uncertain origin and which may have masked poor investment performance or operating inefficiencies.

10.121 This new type of with-profits policy would be a diversified investment vehicle that would appear to the consumer in many respects very similar to the "managed funds" offered, for instance, by unit trust providers:

- it would invest in a range of financial assets (in some cases including less liquid assets, such as property and private equity, in which managed unit trusts may not be able to invest);
- it would report the value of these assets on a regular basis to consumers; and
- as with a managed unit trust, the provider would make a single explicit management charge as a percentage of the assets. This would be clearly identified to consumers in reports on the fund's performance. There would be a small and defined list of certain types of expense that could be charged "above the line" directly to the fund (notably, dealing costs).

10.122 The essential difference between this new with-profits policy and a managed unit trust would be that, for unit trust customers, their product would be worth the value of the underlying assets, less charges, and could be sold at any point for that value. Purchasers of this with-profits policy would have a further charge made to the value of their assets: a “smoothing charge” to dampen volatility. When markets are high, this would usually be negative; when they are low, it would usually be positive. Consumers would normally (see below for the exception) be able to redeem their policies for the value of the assets less all these charges, as with a unit trust.

10.123 This would enable separate scrutiny of:

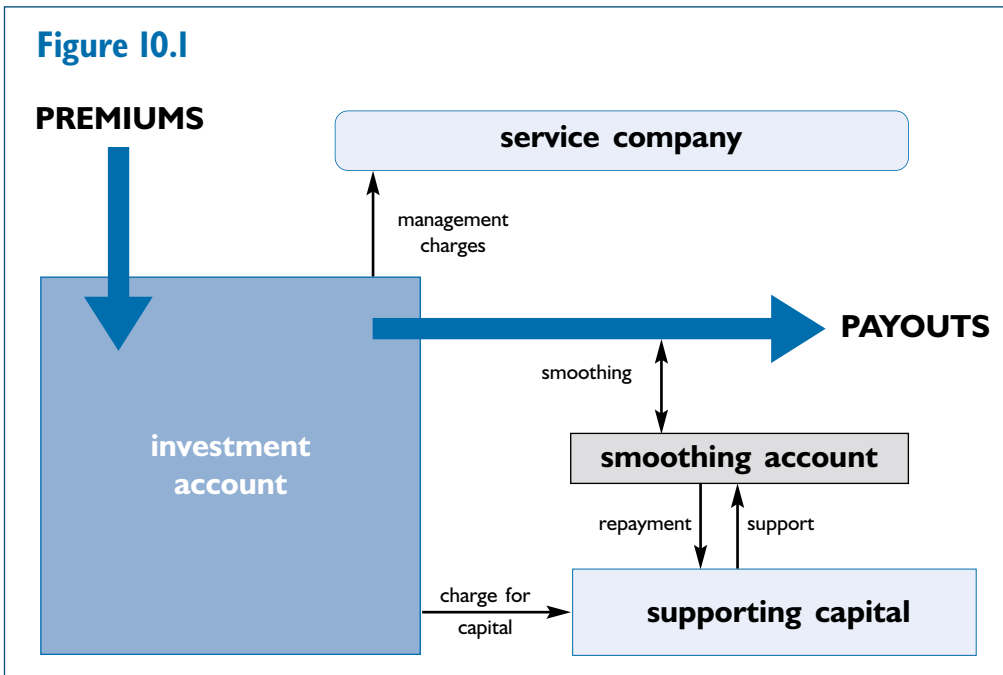
- underlying investment performance;
- management charges; and
- the application of smoothing.

10.124 A more detailed description of this new type of policy is set out below, followed by a discussion of its implementation. The Review recommends the model should be implemented in three ways:

- the with-profits product sold as part of the “stakeholder” suite would have to conform to this model in full;
- almost all of the model’s features would be mandatory for all new with-profits policies, including those sold outside the “stakeholder” regime, after some future date; and
- only the transparency and disclosure requirements, but not the structural features, of the model would apply to existing policies after that date.

Structure of the new with-profits fund

10.125 The following sets out a best practice structure for with-profits which the Review believes should ultimately be used for all with-profits business. “Stakeholder with-profits” funds would be required to conform fully with this model. The question of how, in practice, existing funds move to this model and how policies are treated in the interim is considered below.



10.126 In its most simple version, there would be three sets of assets associated with the fund:

- the investment account (which constitutes unsmoothed asset shares);
- the smoothing account; and
- the supporting capital.

Figure 10.1 above illustrates the flows of funds between the accounts.

10.127 The fund would be 100/0. Shareholders would not share directly in the returns to the fund, and policyholders would not be exposed directly to cost risk.

10.128 A separate management company (which could be owned and capitalised by the parent insurance company) would make management charges for running the fund. These would include all the operating costs – fund management, administration, and distribution.

10.129 The charges would be through regular explicit management charges to the fund and/or explicit initial/surrender charges if desired. Policyholders would be told in advance what the charges would be (the annual management charge would not have to be established for the whole life of the policy, but any changes in charges would have to be notified to the policyholder in advance). The service company would then bear the cost risk.

10.130 The fund would not be able to build up an inherited estate. Smoothing should aim to be neutral in 'the long run', with demonstration of this through the smoothing account having an average balance in 'the long run' of zero. The firm would be free to determine the time period over which it

aimed to balance the smoothing account, but would have to set this out clearly in its statement of Principles and Practice of Financial Management¹¹. The firm would then have to set out each year how the position of the smoothing account compared to expectations, and if there were to be any material difference, the reasons for this and the measures the firm intended to take to correct this.

10.131 With a long run target balance of zero, in the short run the smoothing account would vary between surplus and deficit. Where the latter occurred, capital would have to be called upon to support the smoothing of payouts. Movements of assets between the supporting capital (which would also meet any regulatory requirements) and the smoothing account would have to be clearly accounted for. These movements would be akin to a loan to the smoothing account, which would be repaid over time. There would also be an explicit charge on the policyholders for the provision of this capital, based upon an assessment of the risks to which it would be exposed.

10.132 The level of supporting capital for the fund would have to be “appropriate”. It could obviously not be too low for solvency reasons. But nor could it be excessive – owners of the capital would not be allowed to charge for its provision if it were unnecessary. The appropriate level of capital required, and the returns on it, would be dependent upon the level of risk it was supporting. Where responsibility for determining this should lie should be considered by the FSA during its review of governance arrangements¹².

10.133 The supporting capital would normally be provided by shareholders, either from their own funds, or alternatively from their share of any distributable assets from an existing inherited estate.

Disclosure requirements

10.134 These funds would have certain disclosure requirements.

10.135 Annual statements to customers should disclose four figures:

- the current redemption value of the policy;
- the proceeds on death to reflect the value of protection included in the policy;
- a projection of the maturity value of the policy; and
- the value of the underlying assets (i.e. the unsmoothed asset share).

¹¹ The Principles and Practices of Financial Management is a document proposed by the FSA as part of its review of with-profits.

¹² The FSA is conducting a review of governance arrangements for life companies. A feedback statement “Future role of actuaries in the governance of life insurers” was published in May 2002, and a consultation document on proposed changes is planned before the end of 2002.

10.136 The provider would also produce an annual report setting out the financial condition of the fund, asset allocation, investment performance, and costs charged to the fund¹³. This report would be “signposted” on the annual policyholders’ statement, with copies available on request, and posted on the company’s website. It would include a statement of the company’s policy on smoothing and its investment strategy, consistent with the proposals of the FSA, and would set out the provider’s compliance with the Principles of Investment for retail savings products (see the Review’s recommendations on investment).

10.137 There would be clear regulatory prescription on the treatment of costs, to ensure consistency across providers and products. In principle, this should say that all costs should be shown, rather than being netted off investment return. However, it will be important to ensure consistency with unit trusts/oeics, which have certain costs which can be treated in this way.

10.138 The Review also believes a major cause of confusion in the with-profits arena is the use of technical jargon, such as “terminal” and “reversionary” bonuses. The language used should be simplified and streamlined, measures the FSA is already looking into as part of its with-profits review. Ideally the concept of a “bonus” should simply not be used. It is inconsistent with the Review’s vision of with-profits policies. The Review believes an annual return on the smoothed value of the policy should be used, again giving comparability with other investment products.

10.139 As part of this simplification, the term “with-profits” should itself be looked at. It is a historical term which conveys no useful meaning and might better be replaced by “smoothed investment funds” or something similar.

Policyholder rights

10.140 Payout rights would also be more clearly defined and set out. The policy payout value would be set annually, with the policyholder able to cash in the policy at anytime during the following year at the redemption value. This could only be varied by application of an explicit Market Value Adjustment (MVA), not by an unspecified “change in the payout policy”. Any surrender charges would have been stated at the point of sale and their effect set out in the annual statement.

10.141 An MVA could only be applied in either of two circumstances:

- a significant change in the value of the underlying assets since the setting of the redemption value; and
- a high volume of redemptions seeking to take advantage of a smoothed asset value above the unsmoothed value.

¹³ The FSA is currently reviewing what mandatory information should be provided to customers after the point-of-sale as part of its “treating customers fairly after the point-of-sale” review. The Review would expect comparable requirements for all types of investment products.

10.142 When firms wished to apply or alter an in-force MVA they would have to write to policyholders informing them (akin to the Banking Code requirement that non-branch based deposit account customers are informed personally when interest rates are altered¹⁴). MVAs would have to be applied equally to all surrendering policyholders in a policy type – case by case MVAs would not be permitted. This is important to ensure MVA policy is clear to both existing and potential future policyholders, thus aiding competition.

PROTECTION AGAINST POLICYHOLDERS SELECTING AGAINST THE FUND

Under this disclosure regime, there would be at least a theoretical arbitrage opportunity. If the redemption value of the policy was above the value of the underlying assets, consumers could benefit from redeeming the policy and immediately taking out another one (subject to the operation of up-front and surrender charges).

The Review is not persuaded that this would occur to any significant extent. It would require a degree of sophistication that the great majority of consumers do not possess. Moreover, the opportunity for such arbitrage exists to some extent today: when financial markets are down, at least some with-profits policy values can be fairly safely assumed to be higher than the value of the underlying assets.

But since the possibility exists, it is necessary to give providers the means to combat it. In the new with-profits model, companies would be permitted to apply an MVA if there were significant levels of redemption prompted by an excess of smoothed value over underlying assets, such that the viability of the fund was threatened. The Review believes the possibility of MVAs being applied should in itself act as a deterrent against selection.

Investment restrictions

10.143 In proprietary firms, the Review believes with-profits funds should not be used to finance other parts of the provider's business. This would remove a source of potential conflict of interest between shareholders and policyholders, by prohibiting investment in a business in which the shareholders of the insurer had an interest. This would include stand-alone businesses run by the provider's management team, such as banks and chains of estate agents; and the underwriting of pure protection business. The assets of the with-profits fund would also not be used as regulatory capital for the protection element of the with-profits product.

10.144 The Review is aware that requirements of the First Life Directive¹⁵ are likely to prohibit such restrictions being placed on insurers, although it is not entirely clear whether these rules, which place limits on the extent to which governments/regulators can direct life companies to invest in certain types of assets, would also apply to the rules recommended above, which relate to asset ownership. But should the First Life Directive prove to be an obstacle, an alternative approach to overcoming the conflict of interest difficulties is required.

¹⁴ See paragraph 4.6 of "The Banking Code", British Bankers' Association/The Building Societies Association/Association for Payment Clearing Services, January 2001.

¹⁵ The First Life Directive (79/267/EEC) relates to the regulation of life insurance companies. Article 21 (as amended by Council Directive 92/96/EEC) prevents governments/regulators from directing life insurance companies to invest/not to invest their free assets (i.e. the assets not required to cover their long-term liabilities) in a particular way. So, for example, member states cannot require life insurance companies to invest their free assets in government debt.

10.145 If its proposals were found to be in breach of European requirements, the Review would expect the industry to adopt voluntary rules on such investment restrictions, probably applied through the Raising Standards code. At a mandatory level, proprietary firms would instead be required to disclose details about the assets of the fund invested in other parts of the provider's business where this takes place, akin to a conventional "related parties disclosure" statement. This would set out, inter alia, the performance of the investments made in the related businesses.

10.146 Mutuals would, in any case, be subject only to the disclosure requirements. Proprietary firms are able to raise funds in the capital markets. Mutuals cannot do this: their source of capital is their own customers, including their with-profits funds. Banning mutuals from using with-profits capital to fund their operations would make it extremely difficult for them to raise any capital at all. Instead mutuals would be required to meet the disclosure requirements set out in paragraph 10.135.

Protection and guarantees

10.147 Providers will wish to add one other element, protection, and possibly another, guarantees, to the operation of their with-profits offerings:

- as insurance companies are required to do insurance business, a with-profits policy must offer a protection element, although this is typically negligible in modern policies. In the best practice model, the protection element would be separately identified, with an explicit charge to a protection company, which would supply the regulatory capital, make payouts and take on the risk relating to this activity; and
- some firms may wish to offer guaranteed payout values¹⁶, which would be met regardless of investment conditions at the time (i.e. even if the unsmoothed asset share value had fallen substantially below the guaranteed value). As set out in Chapter 6, such guarantees have costs, as capital is required to cover them. In this case there would be an operation similar to that for the protection element – explicit charges for guarantees with the risk being borne by the provider of the regulatory capital to support these.

Implementation of this model

10.148 The Review has considered how this new form of with-profits should best be implemented. First, a distinction must be drawn between "stakeholder with-profits" products and other with-profits products. The best practice model, as set out in paragraphs 10.125–10.147 above, should apply in full to "stakeholder with-profits" products. For such products, the total charge to the policyholder, including any charges for protection and guarantees, would have to be within the price cap.

¹⁶ Either at maturity, or at defined points during the lifetime of the policy.

10.149 For “non-stakeholder” products, a further distinction must then be drawn between existing policies and those to be sold in future. In practice, a date would need to be set for implementation of the model. Products sold up to that date would be classified as “existing” products. Those sold afterwards would be classified as “new” products.

10.150 For these, the Review believes that all of the features of the new model, with the exception of a mandatory 100/0 structure, should apply¹⁷.

10.151 The Review believes that the 100/0 approach is greatly preferable because of its clarity and the better incentives that it creates. At the same time, it recognises that moving to a 100/0 structure would not be straightforward. It could be achieved through a number of routes:

- one option would be to convert the existing 90/10 fund into a 100/0 structure. This would involve a reattribution of rights within the existing fund, a potentially complex and time-consuming exercise; or
- an alternative would be to close the old 90/10 fund and to create a new 100/0 fund. The old fund would go into run-off, although providers could be expected to create an explicit arrangement of linked smoothing between it and the new fund. Absent such an arrangement, the provider might need to put up additional capital to underpin the old fund to enable it to continue with its existing investment strategy. Wherever a fund is closed, the existing policyholders in the closed fund should not face any diminution of their existing rights.

10.152 Given the complexity of these processes, the Review does not believe that the 100/0 model should be a mandatory element of new policies (other than for “stakeholder”). Such a requirement would considerably delay the implementation of the new model, and the costs of so doing would outweigh the benefits. However, the Review believes that providers would have an incentive to move voluntarily to a 100/0 structure because only with-profits policies conforming in full to the structure set out above could be sold as “stakeholder with-profits”.

¹⁷ This would not necessarily entail the creation of new funds. Existing funds, with inherited estates, could become compliant with the requirements to enable new policies to be sold out of these. In this case, the new policyholders would have attribution rights to these inherited estates.

10.153 The scope for existing policies to conform with the model above would be more limited because they will have existing contractual terms, and wider considerations of policyholders' expectations will also apply. It is therefore not possible to impose requirements on these policies which go against the existing arrangements, other than to mandate the disclosure requirements of the best practice model¹⁸.

10.154 The Review's recommendations are therefore as set out below.

10.155 **The Review recommends that the best practice model, as set out in paragraphs 10.119–10.147 above, should apply in full to “stakeholder with-profits” products.** With-profits products which did not conform fully with this model could not be sold through the “stakeholder” route.

10.156 **The Review recommends that the FSA should, following appropriate consultation, set a date for implementation of the new model more broadly. Policies sold up to that date would be classified as “existing policies”. Those sold thereafter would be classified as “new policies”.**

10.157 **The Review recommends that the FSA should, following appropriate consultation and sufficient time for preparation, require new policies to adopt the best practice model in full, with the exception of the mandatory use of a 100/0 structure.**

10.158 **The Review recommends that the FSA – again following appropriate consultation and sufficient time for preparation – should require existing policies to:**

- **disclose their performance, as in paragraphs 10.135–10.136 above. Where a firm cannot provide these figures they would have to put the case to the FSA to judge, and the FSA should give an exemption only in extremis. If the firm received an exemption, it would be required to write to policyholders explaining the basis for the failure to meet the requirements; and**
- **disclose the existence and performance of any investments in businesses or assets in which the provider had an interest, as in paragraph 10.145 above.**

Inherited estates

10.159 After the implementation date of the proposed new form of with-profits policies, it is likely that there would still be a stock of inherited estates.

10.160 As noted in Chapter 6, the existence of large inherited estates creates both competition and efficiency issues. Inherited estates tend to mask both investment performance and operational efficiency. It is also the case that,

¹⁸ Even disclosure of performance is not necessarily a straightforward requirement in the case of many older policies, where data limitations make it difficult or impossible for providers to produce asset share figures. The Review believes that a firm should in these instances, have to seek explicit FSA exemption from the requirement, and communicate to policyholders that it has received this exemption.

for many providers, this capital could be deployed more productively if it could be identified and unlocked for other uses. The Review believes that this would improve the capital efficiency of the industry.

10.161 The attribution exercises that have taken place in recent years, combined with the FSA proposals to enable a value to be placed on the inherited estates, will clarify both the quantum and ownership of these assets. **The Review recommends that outstanding attribution exercises are completed as soon as possible. The Review also strongly endorses FSA plans to improve regulatory reporting so that values can be placed on inherited estates**

10.162 The effect of these changes will be to allow much greater scrutiny of inherited estates and their uses, and generate market pressure for their distribution. **The Review recommends that where distributable assets are identified, such distributions should take place¹⁹.** This should not imply any weakening in the existing regulatory safeguards, which permit distribution of assets from inherited estates only where it is prudent.

Tax

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

- increasing consumer confusion, exacerbating the problem of consumer weakness;
- increasing the 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.

10.164 The Review also identified a number of specific concerns:

- the pensions tax regime is extremely complex, and creates barriers to pension 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.

¹⁹ The effects of any inherited estate distributions to policyholders on their policy values should be explicitly shown on the annual statement.

- 10.165 The Review believes there is considerable scope for simplification of these tax treatments.
- 10.166 The first recommendation is one of broad principle. The analysis showed that tax-based savings incentives affect composition of saving more than they do overall savings levels. Indeed, there is little evidence to suggest that tax incentives have a significant impact on overall savings levels, especially amongst the lower-income groups for whom increasing saving should be a priority. What is more, it is evident that such incentives generally increase the complexity of the regime as a whole, and that this complexity leads to higher costs. **The Review therefore recommends that, in future, governments should avoid introducing new tax-based savings incentives if their aim is to increase aggregate savings levels. The core objective of policy in this area should be simplification.** There is some evidence that matching schemes are a more effective means of affecting savings behaviour than ordinary tax relief.
- 10.167 Pensions taxation is extremely complex and this has a number of effects. For instance, the fact that there are eight tax regimes for pensions, each of which is complicated, leads to confusion both for the public and professionals; this is a disincentive for saving, especially amongst the more modest income groups. Simplification of the pensions taxation regime is therefore a high priority.
- 10.168 The number of pensions tax regimes could be reduced. There would be benefit even if the simplification were limited to ensuring there was just one regime for occupational pensions. However, a more radical simplification, whereby there was a single regime for all pensions, both occupational and personal, would be desirable.
- 10.169 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 are in themselves simple. Current limits on contributions and (especially) benefits are complicated functions of salaries. Of course, limits of some kind are essential. But there is no need for them to be complicated.
- 10.170 It was announced last year that the Inland Revenue was initiating an examination of aspects of pensions taxation, which the Review welcomes. The Review has not carried out detailed work in this area. **However, the Review recommends that the Government should seek to take a radical approach to this work. It would be desirable to:**
- **reduce the number of different regimes for pensions tax to the fewest possible; and**
 - **minimise the number of different variables that the tax system sought to control. In particular, it should seek to limit either contributions to pensions or the benefits paid out, but not both.**

- 10.171 It was also noted in the analysis that the tax rules create artificial barriers to the provision of pensions by non-life companies. Individual Pension Accounts (IPAs) were launched in April 2001 to address this. Unfortunately, the regulations at least appear to require IPAs to sit within a pension set up under the normal rules, thus seeming to require IPA providers to set up traditional pension structures. This aspect of the rules has made IPAs unattractive to non-life companies; indeed, mutual fund companies are still setting up life companies in order to provide pensions. The Government is currently working with the industry to make IPAs workable. **The Review recommends that the Government considers changing the IPA rules, if changes are necessary, to allow non-life companies to compete in the pensions market.**
- 10.172 The Review acknowledges that fixing a technical aspect of the rules is unlikely to be sufficient to level the playing field for IPAs. There are other respects in which the pensions provision field is not level. For instance, the manner in which tax relief is administered is more burdensome for IPAs than it is for normal life pensions. There is also a VAT exemption for management fees charged by life insurers for managing pension funds that does not currently apply to such charges levied by non-life companies. There is no clear justification for this difference in treatment. **The Review therefore recommends that the Government should thoroughly consider all the differences in treatment between pensions provided through life companies and non-life pensions (and in particular the difference between insurers and others for the VAT treatment of pension fund management). The Review recommends that the Government considers making the playing field level wherever possible by, for example, extending the VAT exemption for pension fund management fees to include those levied by non-life companies.**
- 10.173 The Review also has a number of recommendations within the area of life policy taxation.
- 10.174 The qualifying regime for life savings policies, as it has historically developed, ties in with no apparent policy objective; there is no reason for savings involving a life insurance element to be advantaged over other forms of saving. Further, the qualifying regime is regressive in that its advantages are focused on higher-rate taxpayers. For these reasons (among others), the qualifying regime is an unjustified addition to distortion and complexity. **The Review therefore recommends that the concept of the qualifying life savings policy should be abolished for new business: all new life savings policies should be taxed in the same way (though pure protection policies would still enjoy special tax treatment).**

- 10.175 The 5 per cent withdrawal rule for life policies distorts the market because it is a feature that does not apply to non-life policies, and can distract attention away from charges and investment performance. Like the qualifying regime, it is also regressive, in that its benefits are focused on higher-rate taxpayers. What is more, it is evident from the fact that the rule was introduced for administrative reasons, that these consequences were entirely unintended. **The Review recommends that the 5 per cent tax-deferred withdrawal rule for life policies should be abolished for new business, and replaced with a rule (modelled on the previous partial disposal rule) that reflected the economic reality of the withdrawal.**
- 10.176 Even after these changes, life taxation would still be a source of complexity. In particular, the treatment of unit-linked life policies would remain very different from the tax treatment of mutual funds, even though these are virtually identical products in other respects. The difference in treatment, which is related to the special way in which life companies are taxed, makes it difficult to make comparisons between the performance of life policies and other competing investment vehicles, and therefore reduces competitive intensity. The Review has only considered life company taxation to the extent that it bears directly on the specific proposals made on life policy taxation above, and so has not attempted to address these issues. However, in relation to the taxation of life companies – a major issue in its own right – the Government should keep in mind the Review’s broader analysis of the competitive dynamics of the industry.
- 10.177 The Review also has two recommendations to help remove competitive distortions between different types of mutual funds. The Review acknowledges that there are a number of important differences between investment trusts on the one hand and unit trusts and oeics on the other. However, it does not accept that these justify all of the differences in tax treatment.
- 10.178 Stamp duty reserve tax (SDRT) within IPAs is one such instance. Authorised unit trusts and oeics enjoy an exemption from SDRT for certain kinds of transactions within an IPA. This exemption is designed to enable them to compete with life companies. Investment trusts, though they are allowable IPA investments, do not enjoy the exemption. The Review accepts that, because unit trusts have a stand-alone SDRT treatment that differs fundamentally from the treatment that applies to trade in shares, it is impossible to have an SDRT rule that treats both unit trusts and investment trusts in precisely the same way within IPAs. However, the current rules only give equivalent SDRT treatment within IPAs to unit trusts and investment trusts when the transfer of units into a unit trust directly cause the need for a purchase of underlying assets that turn out to be shares in UK-registered companies; in all other cases, the investment trust pays more SDRT than the unit trust when carrying out effectively the same transaction.

10.179 Given that the overall aim of the IPA regime is to allow non-life companies to compete for the provision of pensions, the Review believes that it would be desirable to enable investment trusts, and not just unit trusts, to compete with life companies. **The Review therefore recommends that the Government should introduce an SDRT-exemption for investment trust companies within IPAs which replicates, as far as possible, the present exemption for unit trusts/oeics.**

10.180 Consideration also needs to be given to the VAT treatment of investment trust management. The argument for excluding investment trusts from the VAT exemption given to unit trusts/oeics is less than compelling. Investment trusts are in direct competition with unit trusts/oeics. Also, the refusal of exemption has been based on the fact that investment trusts are closed-ended and are not required to separate the management function; as European comparisons suggest, it is not clear why these features should drive a different VAT treatment. **The Review therefore recommends that this inconsistency should be removed.**

10.181 The Review has a final tax-related recommendation on ISAs. The Review believes that the ISA regime should continue. It is an established feature of the savings landscape, and removing it would cause considerable confusion and cost. However, it is complicated by the maxi/mini structure, the rationale for which lies in polarised distribution, and which is less relevant in a depolarised world. **The Review recommends that once the likely impact of depolarisation on distribution is clear, the Government should revisit the maxi/mini distinction, with a view to its removal.**

Investment

Impact of Review's wider proposals

10.182 Investment decision-making in this industry is characterised by:

- generally low levels of investment expertise among consumers and, more worryingly, among advisers;
- insufficient attention paid to asset allocation;
- excessive focus on short-term past performance;
- insufficient attention paid to costs and charges; and
- a lack of clarity about the choice between active and passive investing.

10.183 Features of the wider market identified elsewhere in the analysis are important causes of these problems:

- consumer weakness and lack of understanding of the products;
- a product-focused culture in the industry, partly driven by the tax system and by the adviser qualification regime; and
- opacity in products and charging structures.

10.184 The Review therefore believes that the most important contribution to improving investment decision-making is through its wider effort to create a market of simpler products with better alignment of incentives and stronger competitive pressures on price and quality. The creation of such a market will help focus both consumer attention and adviser effort better on investment issues.

10.185 Nevertheless, the Review does believe that there are some investment-specific proposals that will bring progress over and above the broader impetus for change that will flow from a better-functioning market. These proposals are aimed at providers, advisers and consumers. They reinforce the Review's broader drive for greater clarity and competitive intensity in the market for long-term retail savings.

Qualifications

10.186 The FSA is currently reviewing the qualification regime for financial advisers. **The Review recommends that a new regime should have:**

- **a much greater focus on investment issues: in particular, the importance and process of asset allocation; and**
- **a syllabus which is organised around investment issues (investment performance, manager selection, regulatory framework and so on) rather than products.**

Buyers' Guide

10.187 In addition, more could be done to empower consumers in this area. As long as consumers have a limited understanding of financial services, they will not be able to identify good value in their purchases. This in turn creates a lack of competitive pressure on advisers to make sound investment recommendations, and on providers to compete on quality and price. Whilst increasing levels of financial understanding amongst consumers could ultimately rectify these problems, there are clearly limits as to what this could achieve in the foreseeable future.

10.188 A measure with potential for more immediate impact is a short and simple "Buyers' Guide", including a prominent list of questions for the consumer to ask his adviser, and which he would receive at the beginning of the advice process. The questions would have to meet the tests of being meaningful to IFAs as well as comprehensible to consumers.

10.189 The FSA already produces a "Guide to Financial Advice" which helps consumers to decide whether they need advice, how to go about getting it and how to help ensure they "get the right advice". While having been designed with wider policy objectives in mind, it shares many of the characteristics of the proposed "Buyers' Guide", including a list of questions to be put to the adviser to help the consumer establish whether good value has been pursued on his behalf. These questions, however, are not a prominent feature of the publication.

10.190 Currently, hard copies of the “Guide to Financial Advice” are available free from the FSA and it is also available on its website. However, there is no requirement for advisers to distribute the guide to their customers. As would be expected for a document which consumers must seek out, it only reaches a small minority of individuals making advised purchases (in 2001, the FSA distributed 45,000 copies). Moreover, the Review believes that the Guide is currently seeking to do two jobs: one, to communicate important background information, such as how to find an IFA or how to contact the Ombudsman; and the other, to suggest questions for customers at the point of choosing a product. While the Review understands the importance of the first task, it believes that separating the two objectives would allow the creation of a considerably shorter “Buyers’ Guide” which would stand a better chance of being used by consumers at point-of-sale.

10.191 The FSA’s guide will need to be rewritten in response to any changes made to the depolarisation regime. The Review believes that this presents an opportunity to either issue a new concise “Buyers’ Guide”, or to amend the existing guide in two ways:

- by concentrating on highlighting for consumers the key issues on which they should be focusing; and
- by removing some of the factual material provided as background.

10.192 As part of this process, the Review believes that the questions should be amended to focus on two key issues of costs and fund selection. The main topics about which the consumer should be encouraged to ask questions are:

- the level of charges for the product, including surrender charges;
- the level of commission being paid to the intermediary²⁰;
- the tradeoff between risk and return underlying the adviser’s recommendations;
- the asset allocation recommendations of the adviser;
- the level of diversification in the portfolio; and
- the split between active and passive management in the portfolio.

The Review therefore recommends that either the “Guide to Financial Advice” should be amended, or a new product issued to the following specification:

- **less factual information;**
- **greater prominence to the questions which consumers should ask of their advisers; and**
- **a requirement that its provision be a compulsory part of the sales process.**

²⁰ Where remuneration is being paid by the provider, rather than by the consumer, as under the Review’s proposed remuneration mechanism for independent advisers.

FSA publication of data gathered from providers

10.193 The FSA is currently reviewing its data collection from providers and the publication of such material, such as the PIA Persistency Survey and Disclosure Report. While welcoming the Comparative Tables, the Review believes that it would be a mistake if these were to become the FSA's sole publication based on information it gathers from providers. The FSA's provision of this sort of information permits the scrutiny by informed observers that is critical to fostering a competitive retail savings market.

The Review therefore recommends that the FSA should extend its publishing of relevant data gathered from providers in order to promote competition, and thus serve consumer interests.

Applicability of Myners principles

10.194 The Myners Review of institutional investment put forward a set of principles setting out a best practice model for investment decision-making by institutional investors. The Review was asked to consider the applicability of these principles to retail savings products. The Myners principles were developed for the institutional market, and clearly cannot be directly carried over into the retail arena. But the basic notion – that funds should communicate their thinking on investment issues to their customers – is a sound one.

10.195 In particular, the Review believes that retail savings product providers should communicate to consumers their:

- overall investment objective;
- approach to asset allocation strategy;
- strategy for stock selection;
- process for minimising transaction costs; and
- position on shareholder activism.

Detail on these is set out below.

PRINCIPLES OF INVESTMENT FOR RETAIL SAVINGS PRODUCTS

Overall investment objective

1. The provider should set out the fund's investment objective. The objective should be sufficiently specific to enable assessment of whether or not the fund is meeting it. For example "to achieve good returns with a moderate degree of risk" would not meet this criterion. A preferred wording would be "To achieve returns of 2 per cent above the risk-free rate with average volatility of 10 per cent over a period of five years", for example.

Asset allocation

2. The provider should set out the thinking behind its asset allocation strategy for the fund, explaining the level of investment in each asset class, including alternative assets such as private equity. The balance between domestic and overseas investments and decisions not to invest in particular asset classes should also be explained.

Stock selection

3. The provider should set out its strategy for stock selection for the fund. This would explain, on a market by market basis:
 - where the provider has chosen to bear the additional costs of active management, the reason for doing so;
 - the provider's choice of benchmarks and tracking error limits, and the reasons for their selection; and
 - the timescales it is using to assess performance internally and why these are consistent with the fund's overall investment strategy.

Transaction costs

4. The provider should set out its strategy for minimising the fund's transaction costs, including both explicit dealing charges and broader costs such as the market impact of transactions.

Activism

5. The provider should set out its strategy on activism, elucidating the circumstances in which it will intervene in an investee company; the approach it will use in doing so; and how it measures the effectiveness of this strategy.

10.196 The Review believes that all retail savings product providers should disclose this information. With-profits providers generally do not presently do so. At the same time, many authorised unit trusts/oeics providers already communicate much of this to their customers as part of their marketing strategy. The Review does not wish to interfere with those existing arrangements.

10.197 The Review therefore recommends that:

- with-profits providers should be required to disclose in line with the principles above, as part of the Statement of Principles and Practices proposed by the FSA in its with-profits review;
- providers of other products should voluntarily ensure that their normal communication with their customers includes the relevant information;
- in addition, the ABI should make such disclosure part of the Raising Standards regime; and
- if the industry fails to disclose voluntarily, the Government should consider requiring it to do so.

Insured pension schemes

10.198 Insured pension schemes raise somewhat different issues. For these, the employer is effectively the consumer, but is likely in most cases to be insufficiently active in pursuing good value and in maintaining scrutiny of the provider after the initial purchase of the scheme. Clearly it is unrealistic to expect too much of employers in this regard, as they are typically small companies. However, the Review believes that there is merit in short guidance being given to trustees of insured pension schemes – in practice, the employer, in the case of defined contribution schemes. Compliance with this would be voluntary, but it would encourage employers to extract better value from their providers.

10.199 An appropriate means of distribution for this guidance might be to require providers of insured pension schemes to give a copy of it to potential customers at the start of the sales process.

10.200 The Review recommends that guidance should be made available to the trustees of insured pension schemes, as set out below.

GUIDANCE FOR INSURED PENSION SCHEMES

1. When setting up a contract for such a scheme, the trustees should require the provider to state an overall quantified investment objective for the fund or funds offered. The trustees should, in conjunction with their advisers, consider whether this adequately meets the needs of the scheme's beneficiaries. The investment objectives should be communicated to the members of the scheme.
2. The trustees should arrange for measurement of the fund's performance and for this to be reported to them at regular intervals.
3. The trustees should ensure that the contract is structured to enable them to exit the contract at certain fixed regular points. Before reaching one of these points, they should review the contract to ensure that it is still delivering value for money to its employees. Comparisons should be made with alternative providers.

Implications for the industry

10.201 The Review's recommendations have concentrated on policy action by the FSA or the Government to stimulate and improve the competitive workings of the savings industry. But its analysis has also identified areas where action by the industry is the appropriate response. In some cases this can be taken at the level of the individual company. Other issues require industry-wide initiatives, and the relevant trade associations will have a key part to play as initiators and co-ordinators in these areas.

10.202 The key challenges for the industry are:

- to make end-to-end electronic processing of transactions the norm in the industry – in particular, fully electronic interfaces between advisers and providers; and
- to engage in large-scale product rationalisation and simplification.

10.203 Part of this will require collective action. For end-to-end electronic processing to be effective, common standards and platforms across the industry are essential. This is a major task of co-ordination. Moreover, given the significant effort involved in developing such platforms, success will necessitate very broad take-up, which increases the importance of co-ordination.

10.204 But much will also depend on action by individual firms. In general, they will need to make simplicity, transferability and standardisation key requirements in their design of products, and the systems to support these. This is very different from the way that the bulk of the industry has operated to date. In particular:

- providers need to find ways of introducing product features while retaining a common underlying template, rather than allowing these to lead to entirely new product generations;
- concerted efforts to overcome the challenges of portfolio rationalisation need to be made (and industry bodies have a role to play here in providing guidance as regards legal and regulatory obstacles);
- greater progress needs to be made in tackling the problems of legacy systems, which act as an inhibitor to successful consolidation of the industry; and
- there needs to be greater investment in automating processes in distribution at the point of sale, particularly through standardisation of templates for customer information and for recommendation letters.

Conclusion

10.205 The Review believes that these recommendations, together with the work being undertaken by the FSA and the industry, will help move the market for retail savings closer to one in which:

- consumers have a reasonable understanding of retail savings products;
- there is a properly functioning market for advice, with clearer pressures on price and quality;
- the incentives of advisers are aligned with those of consumers;
- products are simple and straightforward, with differentiation occurring only when it adds value for consumers;
- there is a strong focus on asset allocation;
- investment performance is assessed over appropriate timescales;
- there is strong downward pressure on price and upward pressure on quality, with more expensive products delivering demonstrable additional benefits;
- specifically, the prices of the elements of investment, protection and advice are clearly and separately identifiable; and
- consumers, particularly those from low/middle income groups, can reasonably easily access the markets for products or advice.

10.206 The Review would not wish to claim that its recommendations will cause the concerns identified in this report to disappear entirely. In particular, while the Review believes that its proposals will make it easier for people to save, they cannot remove the problem of insufficient saving entirely.

10.207 The traditional policy response to this has been changes to the tax system. An alternative which has been adopted in some other countries – Australia and Singapore being the most notable – is compulsory saving: in particular compulsory saving for retirement. Not surprisingly, the issue has begun to be debated in the UK, and was frequently raised with the Review by the industry.

10.208 There are good arguments on both sides of this question. Compulsion has an obvious and strong appeal in that it deals directly with the problem of insufficient saving, rather than trying to tackle it at second hand. On the other hand, it raises issues of political acceptability and enforcement costs, as well as a concern that, by giving people greater certainty about their retirement income, it may have the effect of encouraging them to borrow more or reduce other forms of saving.

10.209 If the savings level is to be raised, it may be necessary to confront difficult issues such as this one. Compulsion is an important question which deserves serious and wide-ranging debate. However, it is not the role of this Review to make recommendations in this area.

Content of the most commonly held IFA qualification, the Financial Planning Certificate

The FPC examination covers the following syllabus:

Paper 1 (Multiple Choice)

Financial services and their regulation

- Unit A: Regulation and compliance
 - The statutory framework for the regulation of the financial services sector
 - The regulatory framework within the financial services sector
 - “Statements of principle” and “Conduct of Business Sourcebook”
 - Regulators’ compliance rules
 - Compliance and training
- Unit B: Financial services background
 - Legal requirements and economic conditions
 - The different taxes, their effect on individuals and their impact on financial planning
 - National Insurance contributions and social security benefits
 - Financial needs analysis
 - Gathering and analysing customer information
- Unit C: Financial services providers and products
 - The financial services sector and services provided
 - Protection products in the market which are suitable for satisfying the financial needs of customers
 - Pensions products in the market which are suitable for satisfying the financial needs of customers
 - Mortgage products in the market which are suitable for satisfying the financial needs of customers
 - Savings and investment products in the market which are suitable for satisfying the financial needs of customers

Paper 2 (Multiple Choice)

Protection, savings and investment products

- Unit A: Protection
 - Protection in the financial planning context
 - Knowledge of the range of protection products

- Use of protection products
- Knowledge of factors to be considered when comparing products and providers
- Unit B: Savings and Investment
 - Savings and investment in the financial planning context
 - Knowledge of the range of savings and investment products
 - Use of savings and investment products
 - Knowledge of factors to be considered when comparing products and providers
- Unit C: Pensions
 - Pensions in the financial planning context
 - Knowledge of the range of pension products
 - Use of pension products
 - Knowledge of factors to be considered when comparing products and providers
- Unit D: Mortgages
 - Arranging a mortgage
 - Knowledge of the range of mortgage products
 - Use of mortgage products
 - Knowledge of factors to be considered when comparing products and providers

Paper 3 (Written answers to case studies)

- Unit A: Conducting a fact-find
- Unit B: Assessing the client's needs and devising a financial package to satisfy those needs

GLOSSARY

ABI	The Association of British Insurers
AUTIF	Association of Unit Trusts and Investment Funds
CAT	Charges Access and Terms
CII	Chartered Institute of Insurance
COBs	Conduct of Business regulation
CWP	Conventional With-Profits
DB	Defined Benefit
DC	Defined Contribution
DSF	Direct Sales Force
DWP	Department for Work and Pensions
EBC	Employee Benefit Consultant
FAR	Free Asset Ratio
FPC	Financial Planning Certificate
FoA	Faculty of Actuaries
FOS	Financial Ombudsman Scheme
FSA	The Financial Services Authority
FS-CP	Financial Services Consumer Panel
FSMA	Financial Services and Markets Act 2000
GAD	Government Actuary's Department
GPP	Group Personal Pension
IFA	Independent Financial Adviser
IMA	Investment Management Association
IoA	Institute of Actuaries
IPA	Individual Pension Account
ISA	Individual Savings Account
KFD	Key Features Document

MVR (MVA)	Market Value Reduction (Market Value Adjuster)
NAPF	National Association of Pension Funds
OEIC	Open Ended Investment Company
OFT	Office of Fair Trading
ONS	Office for National Statistics
PEP	Personal Equity Plan
pfeg	Personal Finance Education Group
PIA	Personal Investment Authority
RIY	Reduction in Yield
SDRT	Stamp Duty Reserve Tax
SIB	Securities and Investment Board
SRO	Self-Regulatory Organisations
TEP	Traded Endowment Policy
TER	Total Expense Ratio
TESSA	Tax Exempt Special Saving Account
UWP	Unitised With-Profits