

Proposed product specifications for Sandler “stakeholder” products

Consultation Document

February 2003



HM TREASURY

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Department for
Work and Pensions



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We invite responses to this consultation paper by **Friday 2nd May**.

Responses should be emailed to hugh.harris@hm-treasury.gov.uk or sent to Hugh Harris, Savings and Investment Products Team, HM Treasury, 1 Horse Guard's Road, London SW1A 2HQ. Tel: 020 7270 5234.

Respondents are asked to summarise the people or organisations they represent.

Responses may be made public unless confidentiality is specifically requested.

1. EXECUTIVE SUMMARY

1. In June 2001, the Government commissioned Ron Sandler to identify the competitive forces that drive the retail financial service industry and to suggest policy responses to ensure that consumers are well served.
2. His review, *Medium and Long-Term Retail Savings in the UK*, was published in July 2002. It found that the industry suffered from complexity and opacity, from problems of access for those on low to medium incomes, and from the inability of consumers to drive the market effectively.
3. One of the review's principal recommendations was for the Government to develop specifications for a suite of simple, low cost, and risk-controlled "stakeholder" products. They would help drive competition in the industry and would improve access to financial services for those on lower incomes. The review recommended that this suite should include, but not necessarily be limited to, a unitised product, a with-profits product and a pension product.
4. The features of the products would help the Financial Services Authority (FSA) to create a simpler sales regime for such products. This would result in a shift in the focus of regulation from the sales process to the products themselves, and thereby reduce the cost of selling the products.
5. This document sets out options for the specification of these products, along with a discussion of whether other products should be added to the suite. The Government welcomes comments on these proposals. They should be read in parallel with the FSA Discussion Paper 19 "*Options for regulating the sale of 'simplified investment products'*" which considers the broad options for regulating the sales regime for these products.

Unitised Product

6. From the consumer's perspective, a mutual fund and a unitised life-product are essentially the same product: an unsmoothed, medium-term savings vehicle. The Government therefore proposes to allow the unitised "stakeholder" product to take either legal form.
7. To control the degree of risk exposure in the product, the Government proposes setting a maximum level of equity exposure of 60%. There will be further requirements for the product to be diversified across a range of companies, markets and sectors. These will either take the form of additional regulations or will follow a "principles" based approach.

With-Profits Product

8. The review made a series of recommendations for the reform of with-profits policies that it recommended should be obligatory for the with-profits “stakeholder” product. The main recommendations were that they should have an explicit management charge, a fund structure of 100/0, a separate smoothing account balanced to be neutral in the long run, and full consumer disclosure.
9. The FSA will be consulting on these proposals as they relate to with-profits policies more generally in a forthcoming Discussion Paper. The Government will take into account the FSA’s findings when drawing up its final product specifications, but it is strongly attracted to the proposals in the review.
10. The Government believes that a product which offers smoothed exposure to equity markets is likely to be attractive and valuable to many in the target market for “stakeholder” products. The Government seeks views on how smoothing might work and be presented to the consumer in a way that is consistent with the review’s recommendations on transparency and ownership structure. It also seeks views on whether a smoothed product needs to have additional investment restrictions placed on the fund itself.
11. There is a strong case for believing that the term “with-profits” does not help the consumer understand the product. The Government seeks views on terminology for such a product within the “stakeholder” suite that would be a better indication of the benefits offered by the product.

Pensions Product

12. The review recommended that the pensions product should have strict limits on features to ensure simplicity, a capped annual management charge and limits on the investment risk. Stakeholder pensions, introduced in April 2001, already meet these criteria, except for the control of investment risk. The Government accordingly proposes that the current product, provided its investment content meets the proposed investment restrictions to control risk, should be the pension product within the wider “stakeholder” suite.
13. Three ways of imposing investment restrictions are considered. It could (1) be stipulated that the fund be invested in a Sandler unitised or with-profits fund, (2) have some requirement for life styling or (3) be a generalized duty on the fund manager to diversify appropriately. The Government proposes that these investment restrictions should apply to the default option of the current stakeholder pension.

Other Products

14. There is a case for including other products within the Sandler suite if this would benefit the consumer by simplifying choices and reducing the cost of bringing them to market. The main candidates are a guaranteed product, term

assurance, a deposit account, an annuity, a financial health-check and the Child Trust Fund.

15. The Government is not convinced that the benefits outweigh the problems in including term assurance or annuities within the product range. It welcomes views on whether CAT-marked cash ISAs could be rebranded in a way consistent with the Sandler suite and whether there is a case for including a standard generic advice product. There is a strong case for including the Child Trust Fund within the “stakeholder” suite.

Charging

16. The review concluded that price controls were necessary to secure price competition in the interest of the consumer. It said that 1% was a “starting point”. The Government believes that the 1% charge cap on stakeholder pensions and CAT-marked ISAs has brought considerable benefits to the consumer and has driven efficiencies in the industry. It is also a simple, comprehensible concept to grasp.
17. However, the Government also recognizes the need for efficient companies, in selling these products to lower income sectors of the market, to be able to earn reasonable returns to capital. The Government therefore welcomes views on the structure and level of a charge cap. Representations will need to demonstrate what benefits a change would bring for the consumer and for market penetration. The Government will be commissioning independent research in order to establish that the cap meets the needs of consumers, industry and Government.

Table 1 Summary of product design proposals.

	Simple	Risk-Controlled	Low Cost
Unitised	Treat unitised and life product as one	60% maximum equity exposure and diversification across firms, markets and sectors	Charge cap
With-Profits	100/0 fund structure Separate smoothing account balanced to be neutral in long run Explicit charging Full consumer disclosure Potential change of terminology	60% maximum equity exposure and diversification across firms, markets and sectors <i>or</i> no additional controls beyond smoothing	Charge cap
Pensions	Clear links with stakeholder pensions via use of default investment option	Options are: as with unitised product <i>or</i> general duty of care <i>or</i> lifestyling requirements	Charge cap

2. INTRODUCTION

18. The retail financial services industry plays a key role in the success of the UK economy. Around £1 trillion is invested in the industry, amounting to some 120% of GDP. Most people rely on the industry in some way in their daily lives and therefore have a direct, real interest in its workings.
19. The Government has a clear interest in the existence of a successful and efficient financial services sector, an interest based on:
 - the contribution the sector makes to the economy by virtue of its size, generating employment and growth;
 - its role as a transmission mechanism, allocating investment capital to help businesses grow; and
 - its role helping individuals to secure financial independence and security.
20. This interest underpins the Government's role as an "intelligent sponsor" of the financial services industry. Its interest is not in the industry for its own sake, but for what it contributes to the country's wider economic and social interest. Intelligent sponsorship means acting as advocate for the industry, arguing its corner in Whitehall, in Brussels, the WTO and across other international platforms; opening up markets; and ensuring the industry's interests are taken into account in decision making on wider economic and infrastructural issues. It means being prepared to tackle the areas where Government itself has created the obstacles, for example in reform of pensions taxation. It means recognizing where Government and industry are working in partnership to deliver public policy, for example in the recent Green Paper on pensions, and creating the conditions for this partnership to work effectively.
21. However, intelligent sponsorship also means acting as constructive critic. That is why the Government commissioned Don Cruickshank to look at competition in banking and referred the SME market to the Competition Commission; that is why the Government asked Paul Myners to look at institutional investment, and why the Government commissioned Ron Sandler to investigate the retail savings market.
22. Intelligent sponsorship is a form of partnership driven, fundamentally, by the need to create an environment in which the industry is able to deliver the very best it can, to the individual and corporate consumer of financial services, and to the economy as a whole. It ought to deliver a virtuous circle, with consumers and the economy as a whole better served, and firms able to benefit from deeper, stronger markets at home and better placed to compete abroad.

The Government's vision for retail financial services

23. The Government wants to see a competitive and innovative market for retail financial services, in which:
- consumers can easily identify the products and the help they require to meet their financial needs;
 - consumers can have confidence in the people who provide and advise on products;
 - efficient providers of good value products that meet consumer needs are able to prosper; and
 - there is better access for those on low to medium incomes
24. There is much that is working well in the UK retail financial services industry. Because of the partnership between Government and the industry, the UK has a well-developed private pensions system that means it is much better placed to meet the demographic challenges of an ageing population than other countries. Many millions of individuals in the UK have benefited from relatively easy access to savings plans, mortgages and bank accounts. In contrast to many other sectors of the economy, the industry fares reasonably well in international productivity comparisons. And the UK is a major exporter of financial services to the rest of the world.
25. But deep-seated continuing problems need to be recognised. Information asymmetries, with the provider knowing a great deal more than the consumer, are still pervasive. This means consumers find it hard to act in the market. As a result they don't send out clear signals to providers about their needs. A consequence of this is that competition in the market is often for distribution rather than consumers. The destructive legacy of mis-selling, again a consequence of a market in which the provider knows far more than the consumer, continues to impact negatively on the market. And though the sector serves those with high-income levels relatively well, the needs of those on lower incomes are less well met.
26. Since 1997, the Government and the regulator have taken a number of measures to address these problems using four tools: regulation, stimulating competition, providing information, and promoting consumer education. Its main achievements in these areas to date have been to:
- streamline the regulatory framework through the creation of the Financial Services Authority (FSA) and the Financial Ombudsman Service
 - stimulate competition and improve market access through the introduction of stakeholder pensions
 - enhance integration of financial services at the European and WTO level

- introduce the CAT benchmarks to improve consumer awareness
 - begin the process of reforming the polarisation regime in financial advice
 - give the FSA a statutory duty to promote consumer education.
 - commission the Cruickshank investigation into banking¹ and the Myners Review of institutional investment²
 - bring forward proposals to modernize the market for annuities
 - publish a Green Paper on pensions setting out a series of proposed reforms to the current pensions system
 - consult on a root and branch reform of the way pensions are taxed.
27. These initiatives have done much to improve the environment for financial services in the UK. As a result consumers are getting a better deal, and efficient providers of products that meet individual needs are better able to prosper against their competitors. But there is still more to be done.

The Sandler Review

28. One of the recommendations of Paul Myners review, *Institutional Investment in the UK*, was to commission an equivalent review of the operation of the medium to long-term retail savings market. In June 2001 Ron Sandler was asked by the Chancellor of the Exchequer to carry out a review of this sector, with a remit to:
- “identify the competitive forces that drive the industries concerned, in particular in relation to their approaches to investment, and where necessary, to suggest policy responses to ensure that consumers are well served”.
29. The review *Medium and Long-Term Retail Savings in the UK*, was published in July 2002. It found three overriding problems:
- *Complexity and opacity* caused by the huge range of products and product types, charging structures, complicated tax treatments, wide use of technical jargon and lack of price-performance transparency.
 - *Problems of access* whereby the needs of those on low to medium income levels are not catered for sufficiently.
 - *Weak consumers* who are unable to drive the market effectively.

¹ “Competition in UK Banking- A Report to the Chancellor of Exchequer”, Don Cruickshank, March 2000.

² “Institutional Investment in the UK: A Review”, Paul Myners, March 2001

30. The review made a range of recommendations to tackle these problems. These are being taken forward by the Treasury and others. The FSA, through its Consultation Paper CP121 of January 2002, had itself opened a debate about the principle of easing the regulatory requirements bearing on sales of simplified safe-haven products.
31. The subject of this current consultation is the Sandler recommendation *for a suite of simple, price-controlled and regulated products that can be sold through a simplified sales process*. The review recognised the importance of face to face selling if low to middle income consumers were to be encouraged to save; but concluded that the complexity and opacity of the market, and concerns about ensuring compliance with sales regulation, means that face to face selling can be costly and time-consuming. As a result, low to middle income consumers are finding themselves priced out of the market for retail savings, with providers and retailers reluctant to sell to them because they did not generate sufficient remuneration.
32. The review's recommendation for a suite of simple products would address this by:
- removing unnecessary complexity in the choice between competing products;
 - controlling the degree of risk exposure in the product;
 - controlling the charges and terms surrounding entry and exit.
33. Because the choices may be made simpler and the risks controlled, the regulatory requirements surrounding the sales process should also be able to be considerably simplified. By shifting the focus of regulation from the sales process to the product, the review argued the cost of selling products could be reduced, improving access for those on low to middle incomes without sacrificing consumer protection.
34. The Sandler review recommended there should be three products available within a suite of "stakeholder" products:³ a mutual fund or unit-linked life fund; a with-profits fund; and a pension
35. The review proposed that they have the following key features:
- limits on the product features to ensure simplicity;
 - annual charge capped at 1%, no initial charge and ideally no surrender charge;

³ The FSA Discussion Papers 19 and 20 refer to "simplified" products, but for the purposes of this consultation paper we will refer to the term "stakeholder" products. The terminology is open to consultation (see Section 3).

- limits on the investment risk

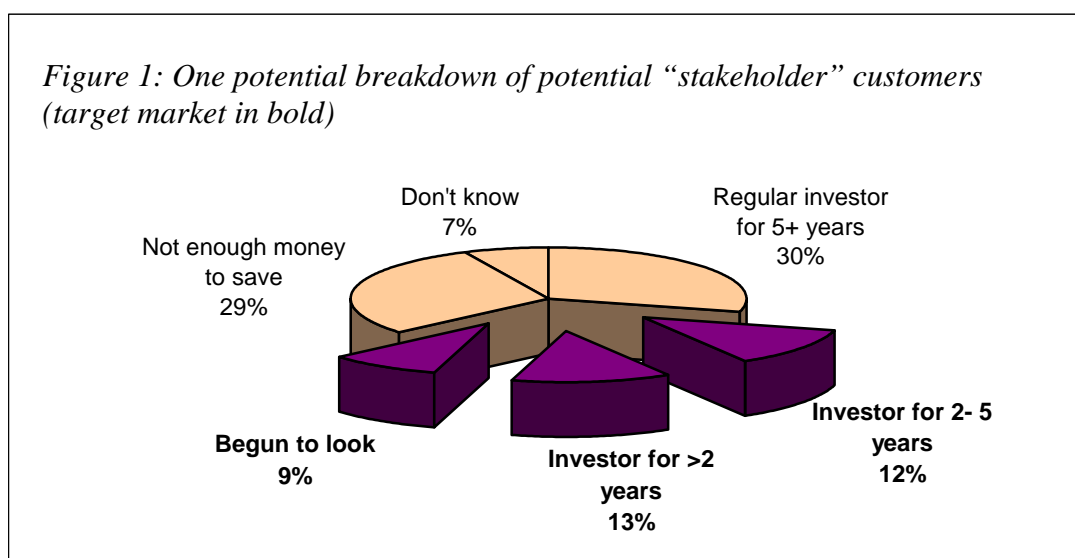
This consultation

36. This consultation document sets out the Government's proposals for the design specifications for these products. In developing these proposals the Government has been mindful of the need not to over-specify. Its aim has been to set a relatively simple framework of key requirements to secure consumer protection and to permit product innovation to meet consumer interests. It has also sought to develop simple solutions – where possible using existing products and models rather than seeking to reinvent the wheel. The document also explores the case for extending the Sandler concept to other products.
37. This document should be read alongside the FSA's Discussion Paper 19 "*Options for regulating the sale of 'simplified investment products'*", which sets out broad options for regulation of the sale of the products.
38. The proposals have been informed by a Consultation Panel set up by HM Treasury that met between October and December 2002. The Panel comprised representatives of the Association of British Insurers, Association of Friendly Societies, Association of Independent Financial Advisers, British Bankers' Association, Building Societies Association, Consumers' Association, Department for Work and Pensions, Financial Services Authority, Financial Services Consumer Panel, Financial Ombudsman Service, Investment Management Association, Inland Revenue, Institute and Faculty of Actuaries, National Consumer Council, and the Office of Fair Trading. The purpose of the panel was to allow the Government to test ideas with key stakeholders. Membership of the panel should not be taken to imply endorsement or ownership of the proposals. The terms of reference of the panel are attached at Annex A. The Government is extremely grateful to the panel members for their time and contribution, which has proved invaluable.
39. The consultation document is structured as follows. Section 3 introduces the principal features of Sandler products and explores their potential market. Sections 4, 5 and 6 set out the proposed detailed design features of each product. Section 7 explores whether any other products should be included in the suite. Section 8 provides a summary of the consultation questions. Annex B contains a draft Regulatory Impact Assessment.
40. The deadline for responses is Friday 2nd May. The Government will respond to consultation findings in the summer. The FSA will need to consult publicly on detailed proposals for the simplified sales regime, taking account of feedback to its Discussion Paper 19. Subject to responses to consultation, the products could therefore be offered to consumers from mid-2004.

Q1: The Government welcomes views on the appropriate lead-in time for product development.

3. THE TARGET MARKET

41. The review recommended the creation of a suite of regulated products in order to offer low-to-middle income groups who can find themselves priced out of the market for retail savings advice, attractive, easy to access and easy to understand products which producers and retailers would want to sell.
42. It is important to see the role these products might play in the wider context of Government savings policy. The measures to promote awareness of the need to save (especially for retirement) as set out in the Pensions Green Paper “*Simplicity, security and choice*”, and the role played by the FSA and others to promote financial awareness and education all play a part too. These products will play an important part in the success of this wider policy, by making it easier for people who perhaps have had no experience of the retail investment market, or who have previously been reluctant to engage with the market, to buy products that will help meet their needs.



Source: Adapted from FSCP (MORI data)

43. The products will be of value to all those who have sufficient savings to consider investing in equity-based products, and who wish to purchase good value, simple investment products. The sales regime on which the FSA is separately consulting will help people identify whether the products are right for them, or whether other products or actions (for example, paying off debts or making cash savings) might be more appropriate, or whether they would be better off seeking financial advice.
44. Though anyone with sufficient savings may choose to buy a “stakeholder” product, they are particularly aimed at those on low to medium incomes. There are many ways of segmenting this target market, in terms of age, financial sophistication, wealth, income and savings habits. And ultimately it will be the responsibility of those delivering the products to determine how

best to target them. But over-lapping segments we need to consider as possible consumers for these products are:

- around 15 million “novice” consumers who are either considering entering the market or have entered it only recently;⁴
 - 22% of households earning between £15,000 and £30,000⁵;
 - 30% of households who have savings between £1,500 and £16,000⁶
 - 3 million consumers who are currently seriously under-saving for retirement and a further 5-10 million who may also be under-saving⁷
45. The potential market therefore encompasses a large section of the adult population. It covers those who are single or in couples, are employed or self-employed, in part-time work or fulltime work and who are spread across the age spectrum. It is unlikely to include substantial numbers of people who are unemployed, due to their lack of savings potential.
46. The sheer size of this potential market poses a challenge for designing products. Clearly, there will be a range of differing needs within the market, and a “one-size-fits-all” approach would not satisfy every market segment. There is a danger that in over-specifying what products should look like, the Government produces something that doesn’t appeal to anyone. For this reason, the Government’s approach will be to set *minimum* standards which the products must meet. This approach can help secure consumer protection and competitive pressures in a market where the consumer is weak, while at the same time creating a space in which the industry can innovate to meet the needs of particular sectors of the market.
47. The “stakeholder” product features will have a broad appeal across the segments identified above:
- *Lower risk products.* People on low to medium incomes are more likely to be risk-averse than those on higher incomes, in part as they can ill-afford to lose a substantial proportion of their savings in the stock market. A recent survey, for example, found that 51% of those with £13,500-£24,999 said that they definitely wouldn’t invest their money in anything risky⁸, with the fear of losing their investment being the principal risk concern. As many in the target market will have under £8,000 in savings, the need to limit this “downside” risk through appropriate investment restrictions is very real. So “stakeholder” products will provide this.

⁴ Adapted from *Consumers in the Financial Market*, Financial Service Consumer Panel 1999, p 81; the chart references to saving and investment products include those with simple saving accounts.

⁵ Family Expenditure Survey 2001

⁶ Family Resources Survey, 2001

⁷ Government estimates as outlined in the Pensions Green Paper p30 and Annex 4

⁸ *Consumers in the Financial Market*, Financial Service Consumer Panel 2000 p 59

- *Simplicity.* Few in the target market will have significant knowledge or understanding of financial products. There is widespread evidence of consumers not knowing what products are available, of not understanding advice received, and of not reading the small print on products that they buy. Simple “stakeholder” products will therefore appeal to this target market.
 - *Comprehensible charging structures.* This target market will have very little understanding of the nature and level of charges that are currently applied, with many not even realising that they pay charges. A simple charge cap set at a level that ensures the needs of both industry and consumers are met will therefore appeal to this market.
48. The Government is therefore confident that appropriately designed regulated products will be attractive to a substantial proportion of the target population. Of course, the existence of these products alone won’t result in everyone who might benefit from them investing in them. This is why the proposal needs to be seen in the context of the Government’s overall strategy for encouraging savings. But with the appropriate branding strategy they have the potential to gain significant market share, though there should and will remain a significant market for more complex products.
49. In order to ensure these products are appropriately branded to meet the needs of this market, it will be necessary to create an appropriate name for the suite of products. The Sandler review recommended the title “stakeholder products”, and it is the working title for the purposes of this consultation document. It has an inherent appeal in that the stakeholder brand is already established in the market as offering low-cost, simple investment products.

Q2: The Government welcomes views on the generic name for the product range.

Q3: The Government welcomes views on the likely size and nature of the target market providers envisage for these products.

4. UNITISED PRODUCT

50. The “stakeholder” unitised product, as with the other products, will have three features under which the specific design proposals need to be considered:

- simplicity
- risk-control; and
- charge controls

Simplicity

51. In many ways unitised products are already simple. This is one of their principal attractions. There is, however, a potential complexity in the differences between a unit trust or oeic and a unitised life insurance product.

52. From the point of view of the investor, there is little initial apparent difference between the two. The economic form is very similar. It involves an investor paying for asset management services within a transparent wrapper, with the ability to acquire or dispose of the investment at will. The value of the investment is related directly to the underlying assets.

53. However, there are differences in legal form which impact upon the investor in that they feed through to the segregation of assets and the regulation of the fund structure. There are also differences in tax treatment.

Tax Issues

54. There are a number of differences between the taxation of authorised collective investment schemes and life insurance companies which in turn impact upon the taxation of the investor. Details of these are set out in Annex C. It has been argued that these differences provide a complicating factor. But it is not clear to what extent consumers are likely to understand them, or to what extent any lack of understanding is likely to have a material impact on the appropriateness of product choices.

55. From the point of view of consumers, another relevant consideration is the treatment of this (and the other “stakeholder” products) in the ISA regime. The Inland Revenue will be considering this later in the year.

Legal form

56. The legal form of a life insurance product is a contract between the investor and the life insurance company. As such, the investment will be successful only in so far as the company (and the investor) are able to honour the contract. There is therefore some counterparty risk for a retail investor

buying an investment product from a life insurance company. This is, of course, very largely mitigated by the FSA's prudential regulatory regime. In mutual funds, on the other hand, the investor has a beneficial interest in the underlying assets of the unit trust or oeic. The assets of the fund are segregated, and the investor is, in effect, exposed only to the risk of fraud (in addition to the underlying investment risk).

57. On balance, although there are differences between collective investment schemes and life insurance products, the Government considers that these do not, in practice, create significant issues for consumers. The Government therefore proposes not to treat these differences as a barrier to provision through both collective investment schemes and life insurance.

Q4: The Government welcomes views on whether to treat collective investment schemes and life insurance products as one “stakeholder” product

Risk-Control

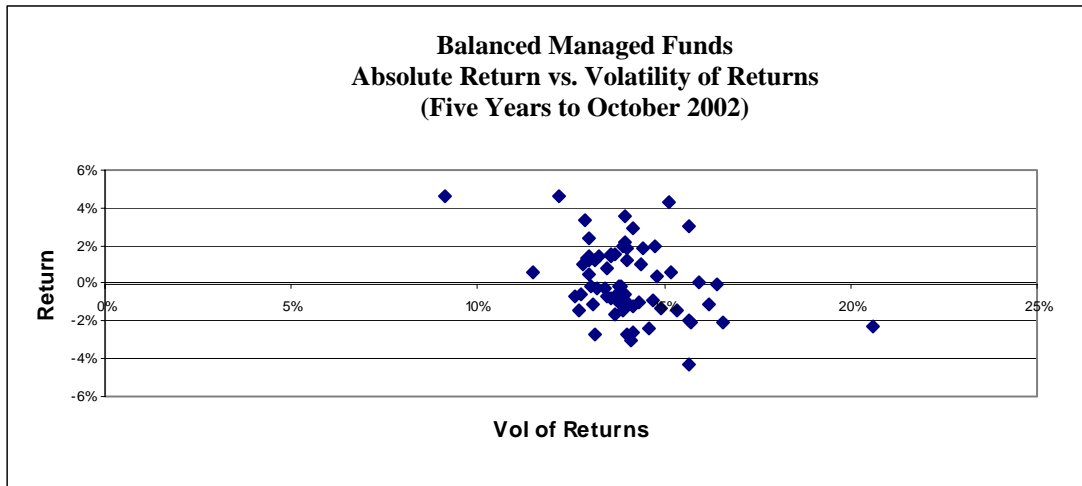
58. The Government proposes that investment restrictions in the unitised product meet two principles. They must (1) protect investors from excessive risk, (2) be sufficiently flexible to allow for industry innovation.
59. Trackers are the obvious candidates for delivering low-cost basic investment. But most popular kinds - straightforward equity index trackers - do not provide a high level of risk protection in the event of significant market movement. Not only do they not have exposure to fixed interest securities, but also the index in question may not have appropriate levels of diversification.

Diversification of asset classes

60. Asset allocation is generally agreed to be the most critical element in determining long-run investment performance. The primary means of limiting risk should therefore be to set appropriate diversification regulations for asset allocation. In practice, this means setting a maximum level of equity exposure.
61. There are existing industry classifications in this area, provided by the Investment Management Association (IMA) and the Association of British Insurers (ABI). The “balanced managed” sector has a maximum equity exposure of 85%, and the “cautious managed” sector has maximum of 60%. The ABI also has a “defensive managed” sector with a maximum equity exposure of 35%.
62. The balanced managed level would allow for a wider product range and would probably provide higher returns - over the past 100 years equities have averaged 7.8% real returns against 2.4% for bonds. But it would also expose the consumer to a fairly high degree of risk. Over the past century the average annual volatility of equities is 20.1% against 14.6% for bonds. And in the past five years the absolute volatility of returns for the IMA balanced

managed sector has a mean of 14.04% (Figure 2) compared to the cautious managed mean of 9.34%. And almost 50% of balanced managed funds have lost money during this period, against only two cautious managed funds.

Figure 2: Performance of Mutual Fund Balanced Managed Sector 1997-2002



Source: Threadneedle

63. Even allowing for the unusually high levels of volatility in the markets in recent years, it could be argued that even the long-term level of volatility in balanced managed funds is too high for products aimed at investors who are less able to bear significant losses. But the defensive managed maximum of 35% equities might conversely be too low. This would limit the market to a relatively small number of providers, even allowing for the fact that the “stakeholder” products are aimed at a risk-averse target market not currently being catered for (Figure 3, overleaf). It would also not allow consumers to take sufficient advantage of exposure to equities. On the assumption that most “stakeholder” investors will be investing in the medium to long term, and will therefore not be enforced sellers, the annual volatility of a higher equity exposure should be less of a concern. The Government is therefore minded to set the maximum level of exposure between the defensive and balanced funds, at the level of the cautious fund level of 60% maximum equities.

Q5: The Government welcomes views on whether a 60% maximum equity exposure provides an appropriate level of risk-control for unitised products.

64. There is a related issue of whether there should be a minimum level of equity exposure. The case for this would be to ensure consumers generate adequate returns, and to ensure that the product range for “stakeholder” products is not so broad that the range of choice confuses consumers. However, the rationale for the product design is that they should set maximum not minimum thresholds for risk. The Government therefore does not propose to set a minimum level of equity exposure.

Q6: The Government welcomes views on whether there should be a minimum level of equity exposure alongside the proposed maximum.

Figure 3: Fund Value by Sector

	Mutual Fund (£bn)	Life Fund (£bn)	Total (£bn)
Balanced Managed	4.97	37.9	42.9
Cautious Managed	0.96	5.33	6.29
Defensive Managed	N/A	0.32	0.32

Source: ABI, IMA (November 2002)

65. The Government has considered whether there should be additional restrictions placed on the fixed-income security component of the product. The main options are to limit them to (1) gilts, (2) investment grade bonds or (3) sterling-based securities. In the interests of being non-prescriptive, and on the understanding that high-risk assets such as junk bonds can in fact help lower the overall portfolio risk if they are negatively correlated with other securities, there is a case for not placing additional restrictions on these assets. But without additional restrictions there is the danger that this part of the portfolio could be invested in, for example, highly correlated Eastern European junk bonds.

Q7: The Government welcomes views on whether there should there be additional constraints in terms of the permissible portfolio of fixed-income securities.

Additional diversification requirements

66. Imposing a maximum exposure to equities may not be a sufficient guarantee against risk. A company could, for example, offer a product with highly correlated junk bonds, and place the entire equity component of the fund in a small number of technology shares. Clearly such a product would not be low risk.
67. It could be argued that a firm would not choose to do this, given its desire to protect its reputation. And the relatively low-risk investment choices made by firms currently offering balanced and cautious managed funds under the ABI and IMA guidelines gives grounds for optimism that the majority of providers will operate within the spirit as well as the letter of the specifications. Against this, it may be that additional diversification regulations across markets and sectors may be needed to ensure adequate consumer protection.
68. There are two ways of setting out extra diversification requirements:
- *Principles-based approach.* A principles-based approach would state that the fund must be diversified across sectors, geographical markets and across a wide range of funds, but not set quantitative limits. Individual fund managers would then determine how this could best be done for the

individual product in question, though guidelines could be set. It would operate on the understanding that there was a duty of care on the fund manager to make appropriate investment decisions.

- *Regulations-based approach.* The second approach would spell out more explicitly what would be required in terms of additional diversification requirements, in the form of additional regulations. The following regulations could meet this objective: 90% minimum developed country exposure, 20% maximum exposure per sector, 5% maximum exposure to each company, and 50% maximum exposure to non-UK markets.

69. The regulations-based approach has the advantage of regulatory certainty, and provides greater clarity for providers. But the principles-based approach is less prescriptive and so would allow for more industry innovation and flexibility.

Q8: The Government welcomes views on whether additional diversification requirements are necessary, and if so the form and content they should have.

Other approaches

70. Alternative models for controlling risk in these products would involve setting absolute or relative quantitative limits to the degree of permitted volatility of the product. This could be achieved by requiring the fund to have a beta value of around 0.6-0.8 or by setting limits for the tracking error of the fund or by fixing the permitted standard deviation of the fund at less than 8%.
71. The appeal of these measures is that they capture directly what the diversity approach tries to do indirectly. But they may be less transparent to the consumer and ensuring funds stay within parameters would add costs to firms. Volatility limits are also - as the Sandler report made clear - both arbitrary and based on historical models. The Government therefore does not propose to set quantitative risk-control measures in place of diversification requirements.

Q9: The Government welcomes views on the potential of these alternative means for controlling risk.

Charge controls

72. The Sandler review argued that while in a fully competitive market charge caps would be neither necessary nor desirable, price control is an essential component of a regulated product in a market that is distinguished by lack of price competition and consumer weakness. It recommended a 1% ceiling as a suitable starting point with no initial charge and strictly regulated or non-existent exit charges.

73. The Government agrees that a price cap is an appropriate design feature for these products. The Government believes that the 1% charge cap on stakeholder pensions and CAT-marked ISAs has brought considerable benefits to the consumer and has driven efficiencies in the industry. Further, it is a simple, easily comprehensible concept to grasp.
74. The stakeholder pension experience has been that over 1.2 million products have been sold, and there are over 40 registered providers currently in the market. This experience, combined with the factors outlined above, mean the Government has a high threshold for persuasion for moving from a flat 1% charge.
75. The Government is, however, aware of a number of concerns relating to the proposed charge. Firms have made representations to the effect that the 1% charge does not allow a sufficient return on capital, and that the payback period is too long on smaller funds to justify selling to the smaller investor. The amounts invested will depend on the exact make up of the target market, and are difficult to quantify with precision, but may well be £50 per month or less. The economics of the cap must reflect the economics of selling to this target market for the different products in the suite.
76. While the Government remains to be persuaded to move from 1%, it is prepared to listen to arguments that a different cap or structure might deliver a fair outcome for consumers and the industry. It would therefore like to encourage representations of this subject. Representations will need to set out any benefit to the consumer in terms of better service and greater market penetration among those with less to invest than any change would deliver.
77. In view of the importance of setting the correct charge level, in addition to this consultation the Government will be commissioning some independent research to ensure the cap delivers benefits to consumers, greater market penetration and a reasonable return on capital for efficient firms.

Q10: The Government welcomes views on both the level and the structure of the proposed charge cap.

5. WITH-PROFITS PRODUCT

78. The second product that Sandler recommended to be included in the suite of regulated products was a with-profits fund.
79. With-profits provide the benefits of reducing risk by pooling between different generations of policyholders. They are therefore an attractive proposition to those wanting exposure to the equity market but nervous of the higher volatility involved in unitised products. They also allow small investors to access a professional asset allocation and invest in a diversified way across a range of asset classes. But it is also important that the risks of the product are clear to consumers - it is not a product that is risk free, and consumers should be able to understand the essential nature of the proposition and not take it on trust.
80. The majority of with-profits products available on the market generally have three elements: returns are smoothed to protect the investor from the volatility of the stock market; the value of the policy is guaranteed either at a particular point in time or after a particular time period; and the consumer is effectively “locked in” to the product for a specified period. The investor is therefore buying a bundle of services: asset management, capital guarantee and smoothing of investment returns (but in a highly discretionary manner).
81. As with the unitised product, the design features for this product will be explored under the three generic features of “stakeholder” products:
 - simplicity
 - risk-control; and
 - charge controls

Simplicity

82. With-profits have provided a useful entry-level investment product. However, in order to meet the basic criteria of the “stakeholder” suite, changes are necessary to improve clarity and transparency. Historically they have been opaque, with structures that are difficult for consumers to understand - FSA consumer research has revealed that many customers had no idea that with-profits were invested in equities. The products also often have complex charge structures, which make it difficult for consumers to see exactly what they are paying. In order to increase the transparency of the product, the Sandler review therefore proposed requiring four additional “ideal model” features (Figure 4, overleaf).
83. The FSA is issuing a Discussion Paper covering the implications for with-profits policies in general of the Sandler proposals, and the Government will want to take the FSA’s findings into account before making final decisions

on product design, not least to avoid creating consumer confusion and unnecessary costs or logistical problems for producers. But the Government is in principle attracted to the clarity of the Sandler model for the with-profits “stakeholder” product. A number of providers have already moved in this direction.

Figure 4: Sandler’s With-Profits Proposals

The Sandler review proposed a radical reform of with-profits in order to ensure that they meet new high standards of simplicity and transparency. The review recommended that all with-profits funds be altered to reflect four main features:

1. A fund structure of 100/0 (though this is not mandatory)
2. Explicit management charging
3. A separate smoothing account, balanced to be neutral in the long run;
4. Full consumer disclosure, with the ability to impose a market value adjuster (MVA) to prevent arbitrage.

100/0 fund structure

84. Sandler recommends with-profits funds should adopt the 100/0 structure, whereby 100% of the declared surplus is distributed to policyholders and shareholder returns are funded by an explicit charge to the fund. Shareholders do not share directly in the returns to the fund and policyholders would not be exposed directly to cost risk. The Government recognises that in many cases this would require new funds to be established. However, there is already evidence that this approach is being adopted by an increasing number of providers and there are clear benefits in the transparency offered by this approach.

Q11: The Government proposes to require a 100/0 fund structure for the “stakeholder” with-profits product and welcomes views.

Explicit management charging

85. Sandler discussed the establishment of a separate management company (owned and capitalised by the parent company) to provide management for the fund. The fund would be charged explicitly for this management. As a result, policyholders will know the level of charges in advance and risk will be on management company. Charges will not have to be set for the whole life of the policy at the point of sale. Separate companies would also be established to provide any guarantees and the protection elements of the product.

86. This structure is similar to that of unit-linked products. This structure would allow for specific management charges to be made and for the investment return to be allocated to policyholders on a 100/0 basis without the need to set up what could be a complex structure with a number of separate companies providing different elements of the product. The main difference between such a with-profits fund and existing unit-linked policies would be the smoothing of returns and the way in which the effect of smoothing is shown (for example, it might not be in the form of additional units.)
87. It is also worth considering whether the with-profits model used currently in stakeholder pensions would provide the desired clarity and transparency of fund structure. Under the stakeholder with-profits structure, the 1% charge cap applies. The charge has to be calculated by reference to the member's *rights* in the fund, not by reference to the value of the total fund. There are also provisions to ensure there is no leakage from the stakeholder part of the fund into any other part e.g. the stakeholder must not contribute to any general reserve held for smoothing. A small number of providers are operating funds under this structure. The Government is interested in views on the practicalities of operating this structure and whether it delivers the aims of clarity and transparency.

Q12: The Government welcomes views on these options for establishing an explicit management charge

Separate smoothing account

88. Sandler recommended that a separate smoothing account be maintained, the balance of which should be zero in the long run, although the firm would be able to determine the time period over which it aimed to balance the smoothing account. The firm should set out its aims in its statement of the Principles and Practices of Financial Management. In the short run the smoothing account would vary between surplus and deficit. When in deficit, capital would have to be called upon to support the smoothing of payments.
89. The Government will examine feedback from the FSA's discussion paper on with-profits in order to determine whether this is a viable proposition. But there is a clear advantage to this approach in that it prevents any build up of excess assets. And the fact that some providers already operate a separate smoothing account, funded by a deduction from premiums paid by investors, indicates there is no generalised difficulty with moving towards such a system. The Government is therefore attracted to this proposition.

Q13: The Government welcomes views on requiring the maintenance of a separate smoothing account.

90. A further issue is whether this smoothing account should have specified rules. Under the Raising Standards initiative, providers are required to set out their approach to smoothing in a "with-profits guide". The FSA proposal for

a requirement for providers to produce a statement of the Principles and Practices of Financial Management, which would include the approach to smoothing, builds on this requirement. Examples of the approach providers take to smoothing currently include:

- smoothing performance to 50% of the difference between an expected growth rate (set by the provider) and the underlying fund performance
- smoothing the difference between a specified growth rate and the actual performance of the assets for a period of time and, after that time, calculating the value of the policy as the difference between the underlying assets and the average growth of the fund since the policy was started.

91. These requirements will ensure that consumers are informed of what the smoothing approach is. However, if the approach to smoothing is complex, it is unlikely to be easily understood by the consumer. For the stakeholder with-profits product, it would be possible to specify in the design specification the parameters within which the smoothing could take place. For example, we could take one of the above examples as a starting point and specify that, as a minimum, returns should be smoothed to 50% of the difference between an expected growth rate (set in the product design and subject to regular review) and the underlying performance of the assets in the fund.

Q14: The Government welcomes views of whether it is desirable to specify parameters within which smoothing can take place, and whether this should be done by specifying a single smoothing model or through higher level guiding principles.

92. An additional issue relating to smoothing in the with-profits product concerns the use of guarantees. Currently, the smoothing of returns can be used as a way to ensure a contractual guarantee on a policy is met. One approach could be to smooth on a cautious basis and distribute remaining returns in the form of bonuses to ensure guaranteed values are met.
93. The difficulty of this from the perspective of a “stakeholder” product is that guarantees imply lock-in: returns will be guaranteed in some way provided the policy is maintained for a particular period of time. Some of these product features are driven by the tax rules governing qualifying policies but there are also other drivers that lead to lock-ins being applied.
94. It is clear that some consumers value the guaranteed features of with-profits policies. But these lock-ins militate against ease of exit, and are also costly to run, both of which make them undesirable for inclusion as “stakeholder” products. If it is not viable to offer a guarantee on the stakeholder with-profits policy, it may therefore be better to offer a simple guaranteed product (either guaranteed money back or guaranteed return at a moment in time) as the low impact alternative to direct equity exposure (this is covered in Section 7).

Q15: The Government welcomes views on the relationship between smoothing and guarantees, and in particular whether smoothing is viable in the absence of guarantees and whether guarantees are likely to be viable within a stakeholder with-profits product.

Market Value Adjusters

95. Market value adjusters (MVAs) are used typically to ensure that those leaving at a particular time do not take more than a fair share of the assets of the fund, to the detriment of those remaining in the fund. MVAs allow providers to adjust redemption payments, particularly those taken before maturity, to take account of changing market conditions and the general outflow of funds. Sandler recommends that MVAs should continue to be allowed in limited circumstances only, that is where there is:
- a significant change in the value of underlying assets since the setting of the redemption value; or
 - a high volume of redemptions (seeking to take advantage of a smoothed asset value above the unsmoothed value).
96. It has been suggested that as MVAs can be applied to any guarantees associated with a policy, if MVAs continue to be permitted, there will little or no value to consumers from the smoothing aspect of the policy. As the smoothing will be associated with additional cost to the consumer, this could represent a poor deal. However, the Government is aware that some new products being offered do not offer guarantees.
97. Sandler recommends that the redemption value of a policy should be set annually and disclosed in the annual statement provided to policyholders. The policyholder should be able to cash in the policy at any time during the following year at the quoted redemption value. Sandler notes concerns that this may give rise to an opportunity for arbitrage; if the redemption value of the policy is above the value of the underlying assets, consumers could benefit from redeeming the policy and immediately taking out another policy. The opportunity for such arbitrage exists in the current regime, particularly in times of falling stock markets and for sophisticated investors. As a deterrent against such arbitrage, Sandler recommends providers be permitted to apply MVAs in limited circumstances.
98. It is not clear the extent to which individual policyholders would be sufficiently financially aware to be able to take advantage of the redemption value of a policy being greater than unsmoothed asset share. However, concerns have been expressed that larger and more sophisticated investors would be in a position to take advantage of such transparency to the detriment of the fund and other policyholders.

Q16: The Government is interested in views on the implications for funds of disclosing unsmoothed asset share, particularly on the scope of arbitrage.

Q17: The Government would welcome views on how effective MVAs could be in protecting both funds and remaining policyholders from the effect of selection against the fund.

Charging

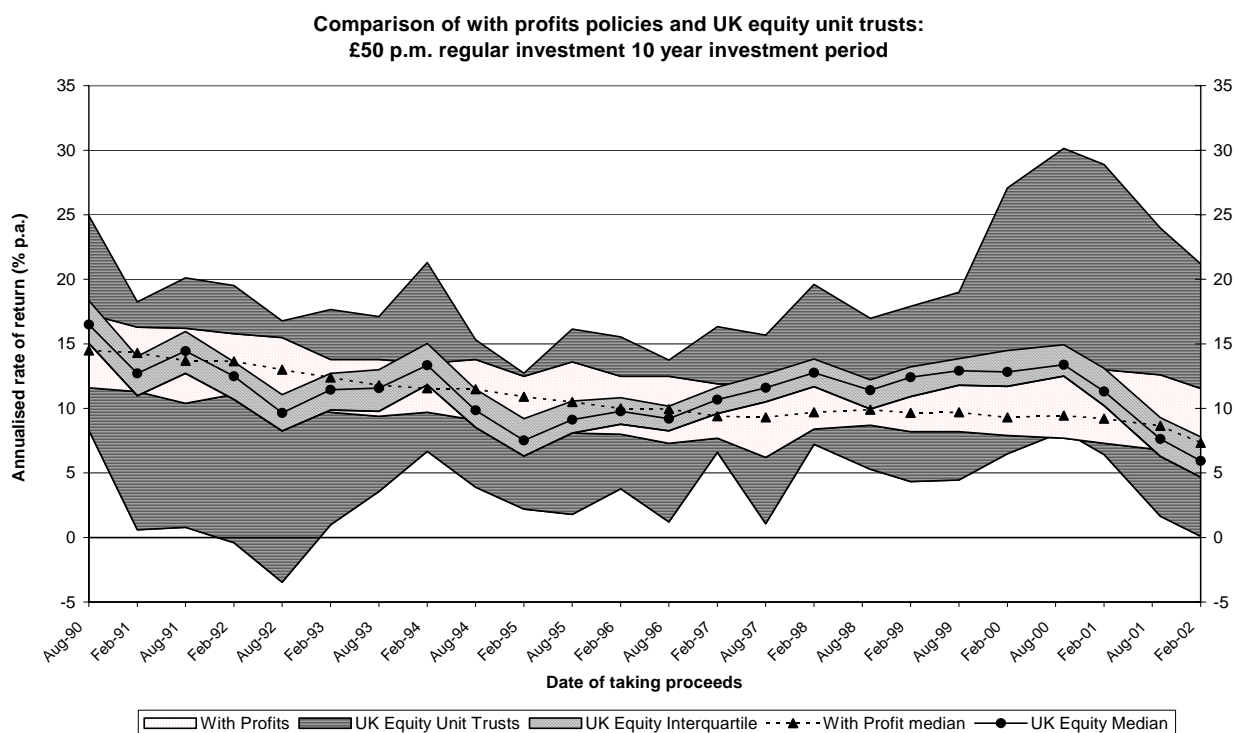
99. The assumption is that the costs associated with the underlying fund are largely the same as for the unitised product and as such the charging structure should be the same as that set out in Section 4.
100. The provision of smoothing and/or guarantees is the source of additional costs for the provider, justified in this context in the interest of providing less variation in returns. Sandler recommended explicit charging for smoothing and guarantees. In addition to seeking views on the annual management charge, the Government is therefore also interested in views on separate charging structures and levels for smoothing and guarantees. It will also be commissioning independent research on this particular issue as part of the research referred to in Section 4.

Q18: The Government welcomes views on the level and structure of a charge cap for smoothing and guarantees

Risk control

101. The Sandler stakeholder products are intended to have controls on investment risks to prevent investors being exposed to an unduly risky investment strategy and thereby suffering financial loss they cannot easily afford. The issue in relation to smoothed products is how much smoothing already cushions investors from volatile equity markets and whether further limits to investment risk are required in addition to smoothing.
102. According to ABI data from the last 10 years, with-profits policies show substantially less year-on-year volatility than unit trusts (Figure 6). Average unit trust returns varied between -0.4% and 28.9%, whereas with-profits policies varied between 7.3% and 16.3%. Unit trust performance is also more variable for any given year in the past decade than with-profits policies.
103. However, it is possible to smooth almost any kind of fund, and a smoothed fund that invests in volatile assets could be more risky than an unsmoothed fund that invests in more stable assets. For this reason, there is a case for introducing the same risk controls as those set out for the unitised product in Section 4: 60% maximum equity exposure and additional diversification requirements across firms, sectors and industries, whether in the form of rules or principles. If in practice providers are not likely to smooth highly volatile assets due to the costs of so doing, these rules may, however, not be necessary. Instead the market could be left to determine the appropriate investment strategy.

Figure 6: Risk within With-Profits



Source: ABI

Q19: The Government welcomes views on whether the underlying investment fund of the “stakeholder” with-profits product should have the same risk-controls as the “stakeholder” unitised product.

Terminology

104. The Sandler review notes that the name “with-profits” can in itself be misleading implying higher returns than might be the case, particularly at times when equity markets are not performing well, and creating unrealistic expectations among policyholders. The introduction of a smoothed stakeholder product taken together with the FSA’s review of with-profits provides an opportunity to change the terminology.

Q20: The Government welcomes views on alternative names for investment products with smoothed returns.

6. PENSION PRODUCT

105. The third and final product that the Sandler review recommended be included in the “stakeholder” suite was a pension product. As with the other products, the review proposed the product should have strict limits on features (to ensure simplicity), a 1% annual management charge, and limits on the investment risk. With the exception of controlling for risk, the existing stakeholder pension meets these requirements. The principal issue for the design of this product is therefore the relationship between the existing stakeholder pension and the new Sandler “stakeholder” product. The Government has twin objectives:

- to build on the existing stakeholder pension causing minimum disruption to providers and existing consumers
- to produce a simple, workable regime for providers and consumers going forward.

Simplicity

106. The Government is not attracted to options that would lead to two products, i.e. keeping the current stakeholder pension unchanged whilst introducing a separate new product. This would be unnecessarily complicated. It would create two Government-regulated pension products. It would be hard for consumers to understand the difference between them, and for advisers and sales-forces to explain it. Existing consumers might also question whether their stakeholder was in some way inferior to the "new" product and whether they should switch.

107. Two alternative proposals which are considered below may be workable, and which could satisfy the proposal of the Sandler review that the Sandler “stakeholder” product regime subsume the regime for stakeholder pensions:

Requiring stakeholder pensions to offer a single ‘Sandler’ investment restricted fund.

108. This would be the most simple and easily comprehensible approach. It would, however, require the most change to existing stakeholder pensions. Providers would in effect need to launch a new stakeholder product, rebadging their previous stakeholder pensions as traditional personal pensions. Investors who had been sold an existing stakeholder pension would need to have explained to them why a ‘mark 2’ version had been created. And, it would mean explaining to existing investors who wanted to continue with investments in other types of funds that stakeholder protections no longer applied.

Bring stakeholder pensions within the Sandler “stakeholder” product regime using the already existing default investment option.

109. This is the Government's preferred alternative. Limits on investment would be applied to the default option, with the result that the modified stakeholder pension could be sold within the new Sandler sales regime. This approach would require changes to current default investment options (where they do not meet the new requirements) but would still allow a wider choice of investment options.
110. A further issue would be the relationship between this investment restricted default fund and the wider range of investment funds in the stakeholder pension. An argument could clearly be made for limiting any sales through the sales process currently being consulted on in the FSA Discussion Paper 19 to the default fund. Any switching into other funds would then be made under the existing execution only or fully advised sales regimes. On the other hand, this would potentially complicate the sales process for the industry and consumers alike. An alternative might be for all consumers to choose between the various funds at point of sale but, as now, those who do not wish to make a choice would go into the default fund.

Q21: The Government would welcome views on options for bringing stakeholder pensions into the Sandler regime.

Risk-Control

111. Stakeholder pensions are currently required to have a default investment option, but providers are free to set the default option as they wish. The default option may provide a suitable means of accommodating an investment restriction. There are three ways this could be delivered:

Requiring the pension product default option to be invested in a Sandler unitised or with-profits product.

112. Allowing only one investment choice in this way has the benefit of extreme simplicity. However, the long time horizon for pension investment may take either of these Sandler investment products too far towards the low risk / low return end of the investment spectrum.

Requiring use of lifestyling

113. Lifestyling is the name for the mechanism whereby the assets of pension funds are gradually moved from equities towards fixed income as the investor nears retirement. There are a number of ways this operates in practice, with most firms beginning to move funds between 5-10 years prior to retirement. It has therefore been suggested that lifestyle investment approaches work best with a considerable degree of flexibility for the investment manager, and would not lend themselves to tight prescriptions on investment strategy, though it would be possible to specify some minimum requirements, for example a maximum of 60% equity exposure 5 years prior to retirement.

114. Pension products traditionally have more predictable investment horizons than other investments, making it arguably more appropriate to manage investment risk at maturity through shifts in asset allocation, allowing a higher proportion of equities in the earlier years of the investment, with a shift into fixed interest as the investor nears retirement. However, retirement ages may be becoming increasingly variable and the Government has an objective to extend opportunities for older workers, as set out in the recent Green Paper on pensions. Retirement may become more of a process and less of an event, and this has implications for the feasibility of strict controls of investment strategy.

Requiring a general duty of care

115. With this in mind, it has been suggested that an alternative way to deliver investment restrictions might be to have a more general duty on the manager of the funds to manage the funds appropriately, within more widely drawn discretion. Such a duty might take the following form:

‘diversify assets between stocks and asset classes to balance risk and return throughout the expected duration of the investment’

116. This would have attractions. It would be flexible and un-prescriptive. However, while the Government’s clear presumption would be that in most cases it would produce a suitable outcome, it might not do so in all cases.

Q22: The Government would welcome views on these three options for investment restrictions and on how a general duty might best be framed, if respondents support it.

Charge Controls

117. Section 4 discusses the generalities of charging structures and levels at some length. But there may be additional charging issues unique to pensions. Pensions products typically have higher persistency than other investment products (with the exception of endowments) and preliminary analysis suggests that this may have remained the case for stakeholder pensions. This may lower costs relative to other “stakeholder” products. On the other hand, pensions products have traditionally had rather higher administrative costs, not least due to the new statutory money purchase illustration and the complexities of the pensions tax system, though the proposed Inland Revenue changes may impact on this latter point.

Q23: The Government would welcome views on previous and anticipated persistency in pension products relative to unitised and with-profit products.

Q24: The Government would welcome views on whether there are issues unique to pensions in terms of charges.

7. OTHER PRODUCTS

118. The Government can see three main advantages to including other products in the “stakeholder” product suite, in addition to the products outlined above:

- it could provide an opportunity to set a benchmark for consumers, which would simplify choices between products
- it could, where appropriate, allow a simplified sales regime that would reduce the costs of bringing products to market
- it could provide a ‘one-stop-shop’ allowing customers to buy a full range of products in one go from a single sale.

119. In reality, the first two of these potential benefits are likely to be the most significant. The Government does not plan to require providers to offer the full range of “stakeholder” products (it would be odd, for instance, to require a unit trust provider to offer a with-profits product). Yet without this requirement the one-stop-shop benefits of a wider-product range are necessarily limited. In practice, for any particular further product, the benefit will instead result if the advent of a lighter touch sales regime allows products to be offered by the same salesperson and through the same sales process.

120. It would be possible to consider including any number of other products within the suite. Six candidates are considered here:

- a guaranteed investment product
- term assurance
- deposits
- annuities
- a financial health-check
- the Child Trust Fund

A Guaranteed product

121. There are two forms of guaranteed product that could be placed within the suite in order to provide absolute risk assurance to investors:

- *A Guaranteed Fund* has a third party providing a guarantee (not an absolute one - its strength depends on the credit quality of the

guarantor) to indemnify the fund in the event of an investment shortfall at a given date.

- A “*Capital Protected*” Fund is one where the protection of capital forms an integral part of the scheme’s objectives to be delivered through derivatives or otherwise.

122. Capital protection and guarantees are often what consumers say they want, as they directly reduce the downside risk of the investment. As such, they fulfill one of the main Sandler principles of risk control. They have seen considerable growth in Europe and appeal to first time buyers. And if it is not viable to offer a guarantee within a with-profits “stakeholder” (see Section 5), the case for offering a guaranteed product as a separate product within the suite is stronger.

123. This would not be without its problems, however. Guarantees come at a price, and at the expense of simplicity and flexibility. Many of the products on the market require high minimum investments (e.g. £500) and an inability to redeem for 3-5 years. Many are not simple to explain to novice investors. And the guarantee is often circumscribed in some way (as in the so-called “precipice bonds” that have caused problems for investors in recent years). Hidden charges also increase complexity.

124. Despite their inherent appeal, there is therefore a question of whether guarantees fit within the principles of the Sandler review and whether they represent value for money when compared with a bank deposit (which offers flexibility and certainty) or a smoothed product (which controls volatility).

Q25: The Government welcomes views on including a guaranteed product within the “stakeholder” suite.

Term assurance

125. Term assurance is a key component of sensible financial planning, and therefore fits well with the concept of the “stakeholder” suite. However, it is a relatively simple product. It is therefore not obvious that benefits would result from a benchmarking approach. Given the wide variation in pricing between the highest and lowest premiums, one could benchmark an indicative range of the acceptable level of premium for every £1000 of cover for a typical person aged, say, 30. However, it is not clear how much useful information this would give to those – obviously the majority – whose circumstances differed from the typical 30 year old.

126. Currently the sales regime for firms selling protection products is not onerous, although in future, it is likely to need to change to meet the requirements of the Insurance Mediation Directive. Therefore it is not clear at the moment that there is any need for term assurance products, or a subset of them, to benefit from a light touch sales regime.

Q26: The Government does not therefore consider there is a good case for including a protection product in the suite of “stakeholder” products.

Deposits

127. A cash saving vehicle is generally regarded as a sensible component of personal financial planning and is the first step on the savings ladder. There may therefore be a case for having such a product in the “stakeholder” suite.
128. Deposit products currently have the lightest touch regulation of all medium and long-term savings products. It is therefore not clear how they would benefit from a lighter sales regime. However, the Government currently provides a benchmark for deposit products, in the form of the CAT-mark for cash ISAs. There might be some advantage in rebranding this in a consistent way with the products of the “stakeholder” suite.

Q27: The Government welcomes views on the advantages and disadvantages of rebranding the CAT-standard cash ISA to make it consistent with the wider “stakeholder” suite and on how this might best be done.

Annuities

129. It is not clear that a simple benchmark approach would be appropriate for an annuity. Annuity rates are strongly sensitive to individual circumstances. It is the Government’s view that the annuity market has suffered from too little product differentiation and too few consumers shopping around to meet their own specific needs. This has been addressed by, for instance, the FSA’s work on the Open Market Option.
130. Currently advised sales of annuities are subject to the full COBs regime. There would clearly be cost reductions if some annuity sales could be brought into a lighter touch sales regime. But it is not clear that introducing a standard product specification is appropriate. Purchasing an annuity is a once and for all decision, typically involving a large proportion of an individual’s lifetime savings and it is important that an individual buys a product to meet their own individual needs.

Q28: The Government therefore proposes that an annuity should not form part of the “stakeholder” suite of products.

Financial Health Check

131. The Government has long had an objective of increasing access to financial advice. One means of doing this would be to benchmark an advice service for inclusion within the “stakeholder” suite. This could usefully help dispel the notion that advice is necessarily the exclusive domain of the rich. It could

also help alleviate distrust and encourage take-up by demystifying financial advice by clarifying just what the advice is intended to cover.

132. The option of a more extended, open-ended discussion could complement the changes that the Sandler review has ushered in. A separate advisory service or financial “make-over” service could reinforce the point that product sales and advice are separate functions, and that either might usefully be obtained without the other.

133. Any standard for an advice service would probably need to cover⁹:

- the scope of the service (what level of analysis and prognosis it should cover)
- the objectivity of the advice, which would not be linked to the need to buy other products or services
- any charge or price restrictions, or similar requirements
- the need for the customer to be given an appropriate written record of the facts recorded and advice given.

Q29: The Government welcomes views on whether an advice service could have a place in the “stakeholder” suite and the form that it might take.

Child Trust Fund

134. The Pre-Budget Report 2002 announced that the Government would be consulting further on the Child Trust Fund (CTF). Its main features are likely to be:

- a universal account, opened for all children at birth (eligibility linked to the Child Benefit system)
- a progressive Government endowment at birth, with possible additional Government top-ups at later ages
- additional contributions up to an annual limit, payable by parents, other family and friends and children. It is envisaged that the growth of the fund will be exempt from tax – in a similar way to an ISA- but alternative incentives are also being considered
- a range of investment choices including equities

⁹ This idea was first floated in “Standards for retail financial products”, HMT, February 2001, paragraph 85-87

- no access to assets, including additional contributions, until account maturity at age eighteen
- no restriction on use of assets at maturity
- provision of the CTF would be by open market competition, any authorized providers would be able to enter the market, subject to meeting the conditions of the CTF, in a similar way to ISAs
- a default investment for those not choosing to “buy” the services of one of the open market providers
- financial education to be integrated into the CTF through the school curriculum, other Government and voluntary sector channels, and on a voluntary basis through financial services providers (who will be required to provide certain minimum information, such as annual statements)

135. The Government believes there are strong attractions to providing a benchmark approach for the CTF. Through time, all consumers with children, down to the least financially sophisticated, will be ‘buying’ this product (in terms of choosing a provider and making an investment choice). There would therefore be arguments for limiting charges for both annual management and for switching providers.

136. There would also be arguments for limiting the scope of investment choices, although it would be important to provide a range as all consumers will be involved and some – particularly those from very low income families – might be particularly risk averse, while others may favour higher risk products. With this in mind, there might be arguments for allowing both “stakeholder” and ‘non-stakeholder” CTFs, with the stakeholder version being the default option and having appropriate investment restrictions (thereby benefiting from a lighter touch sales regime).

137. As an alternative it would be possible to support a benchmarked CTF, sold through a Sandler-type sales regime, without any connection being drawn by the Government with the other Sandler suite products.

Q30: The Government would be interested in views on whether explicitly linking the CTF to the other “stakeholder” products would be helpful.

8. SUMMARY OF QUESTIONS

Generic

1. The Government welcomes views on the appropriate lead-in time for product development.
2. The Government welcomes views on the generic name for the product range.
3. The Government welcomes views on the likely size and nature of the target market providers envisage for these products.

Unitised Product

4. The Government welcomes views on whether we should treat collective investment schemes and life insurance products as one “stakeholder” product
5. The Government welcomes views on whether a 60% maximum equity exposure provides an appropriate level of risk-control for unitized products.
6. The Government welcomes views on whether there should be a minimum level of equity exposure alongside the proposed maximum.
7. The Government welcomes views on whether there should there be additional constraints in terms of the permissible portfolio of fixed-income securities.
8. The Government welcomes views on whether additional diversification requirements are necessary and if so the form and content they should have.
9. The Government welcomes views on the potential of these alternative means for controlling risk.
10. The Government welcomes views on both the level and the structure of the proposed charge cap.

With-Profits Product

11. The Government proposes to require a 100/0 fund structure for the with-profits product and welcomes views.
12. The Government welcomes views on these options for establishing an explicit management charge
13. The Government welcomes views on requiring the maintenance of a separate smoothing account.

14. The Government welcomes views of whether it is desirable to specify parameters within which smoothing can take place and whether this should be done by specifying a single smoothing model or through guiding principles.
15. The Government welcomes views on the relationship between smoothing and guarantees, and in particular whether smoothing is viable in the absence of guarantees and whether guarantees are likely to be viable within a stakeholder with-profits product.
16. The Government is interested in views on the implications for funds of disclosing unsmoothed asset share, particularly on the scope of arbitrage.
17. The Government welcomes views on how effective MVAs could be in protecting both funds and remaining policyholders from the effect of selection against the fund.
18. The Government welcomes views on the level and structure of a charge cap for smoothing and guarantees.
19. The Government welcomes views on whether the underlying investment fund of the “stakeholder” with-profits product should have the same risk-controls as the “stakeholder” unitised product.
20. The Government welcomes views on alternative names for investment products with smoothed returns.

Pensions Product

21. The Government welcomes views on options for bringing stakeholder pensions into the Sandler regime.
22. The Government welcomes views on these three options for investment restrictions and on how a general duty might best be framed, if respondents support it.
23. The Government welcomes views on providers’ experience with previous and anticipated persistency in pension products.
24. The Government welcomes views on whether there are issues unique to pensions in terms of charges.

Other Products

25. The Government welcomes views on including a guaranteed product within the “stakeholder” suite.
26. The Government does not therefore consider there is a good case for including a protection product in the suite of “stakeholder” products.

27. The Government welcomes views on the advantages and disadvantages of rebranding the CAT-standard cash ISA to make it consistent with the wider “stakeholder” suite and on how this might best be done.
28. The Government therefore proposes that an annuity should not form part of the “stakeholder” suite of products.
29. The Government welcomes views on whether an advice service could have a place in the “stakeholder” suite and the form that it might take.
30. The Government would be interested in views on whether explicitly linking the CTF to the other “stakeholder” products would be helpful.

Annex A: Terms of Reference of Sandler Suite Consultation Panel

Ron Sandler's review, "*Medium and Long-Term Retail Savings in the UK*" recommended: "the introduction of a suite of simple and comprehensible products, the features of which would be sufficiently tightly regulated to ensure that, with certain additional safeguards, these could be purchased safely without regulated advice" (Chapter 1, paragraph 128).

The Treasury intends to issue a consultation paper about how the suite of products recommended by Sandler might look in practice. This will form the basis for FSA work on the sales regime that would provide the "additional safeguards" mentioned in the report, and the consultation paper will seek views on marketing and distributional implications.

A panel, made up of representatives of consumer and industry bodies, the regulator and Government Departments, is being created to assist officials in the work on product design, and in particular to:

- offer suggestions for product design features;
- assist officials in assessing the practical implications of design proposals;
- consider whether the products the Sandler review suggests should form part of the suite should be supplemented by other products that were not part of his remit (for example, term insurance);
- help ensure the overall package is coherent, does not have adverse unintended consequences, and meets the Sandler review remit.

The panel's discussions will be confidential. Where it would help the panel's work to discuss proposals with others this will also be done on a confidential basis. But the organisations represented on the panel will of course be free to offer their own views on the Treasury's consultation exercise once the paper is issued.

Annex B: Partial Regulatory Impact Assessment

Purpose and Intended Effect

The product specifications contained in this consultation document are aimed at increasing access to investment products for those on low to medium incomes and driving competition in the UK retail financial market.

Risks

The risks that the proposals seek to minimise are:

- the risk of consumer detriment caused by high charges and complex features
- the public policy risk of insufficient savings for retirement.

The specifications are also designed to limit the investment risk to which consumers will be exposed through product regulation.

Benefits

The primary beneficiaries of the new products will be consumers who are currently excluded from the market but who have the potential to invest/invest more. The numbers of potential beneficiaries depends upon the precise segmentation, but are potentially a large number. While it is very unlikely that all of these groups would make use of these products, there are 10 million people who earn £15,000-£30,000 who may be considered as among the target market.

There are five primary benefits that will accrue to this group:

- (1) They stand to benefit financially from the prospect of a higher rate of return from any savings than they would have relative to a savings account (though they will also expose themselves to a greater risk that their savings loses value). Deposit account real returns are in the region of 1.5%, whereas equities have averaged a real return of 7% over the past century. The precise gain here will depend upon the decisions relating to investment restrictions- a product with greater bond exposure will bring less gain on average.
- (2) They will benefit from lower charges. The Sandler review suggests that there is little effective price competition in the retail savings market. A charge cap will ensure that the reduction in yield to the consumer from charges imposed by the provider is at a reasonable level, consistent with allowing efficient firms to make a reasonable return on their capital. The benefits of this charge reduction will be received not just by those in the target market, but also by those who chose to substitute into the market.

- (3) They will benefit from any efficiency gains that are made on a wider industry basis that are driven through the consumer expectation and understanding of charges. This is difficult to estimate quantitatively, but the stakeholder pension experience indicates that the presence of some form of “halo effect” can be expected.
- (4) They will benefit from ease of access to their investments due to the presence of charge controls at the point of entry and exit. This will reduce the consumer detriment caused by lock-ins and having to pay charges to gain access to savings in emergencies.
- (5) There is the potential for opportunity cost benefits from any reduction in the length of the sales process that might be introduced to accompany these measures. Consumers, producers and distributors will all benefit from this.

In addition to consumer benefits, there will also be industry gains. The reduction in the regulation of the sales process will (1) lead to substantially lower up-front marketing and distribution costs (currently individual delivery to customers via the full Conduct of Business Regime has been estimated at over £420 for Individual Financial Advisers¹⁰) and will (2) lead to increased sales for investment products. The size of this likely volumes increase is dependent on a large number of variables, but with the size of the target market it is realistic to assume that it may be substantial.

The gains to the Government will be in the form of reducing financial exclusion through the promotion of low-cost, easy-access investment products, and of increasing efficiencies in the retail financial service market through tackling information asymmetries and stimulating competition. There will also be a long-run fiscal policy gain through a reduction in the current 3 million people who are seriously under-investing for their retirement.

Costs

There will be no requirement for firms to provide “stakeholder” products. The firms that chose to enter the market will therefore be those who anticipate that they will generate sufficient returns to income in a reasonable pay back period and anticipate a net profit from so doing. However, the proposal for a charge cap will reduce the potential revenue firms will be able to generate from entering this market.

From the point of view of industry the consumer “halo effect” – that the benefit of lower charges and increased efficiency spreads across the market – has the risk of being a provider “contagion effect”. That is why we are commissioning independent research into the level and structure of the price cap, to ensure the cap delivers consumer and efficiency benefits while at the same time enabling efficient providers to earn a reasonable return on their capital.

¹⁰ Oliver Wyman & Co.

Competition Assessment

The Office of Fair Trading requires a competition assessment to be carried out on all policies that impact on competition in a given market in order to determine that the policy does not work to the detriment of competitive markets. Of the nine filter questions (Table 3) the regulations must elicit positive responses to more than half for a full assessment of the competitive impact to be undertaken. This is not the case with the current proposals. Indeed they are explicitly aimed at increasing rather than reducing competition within the retail financial service industry.

Table 3: Competition Filter

1	In the markets affected by the new regulation, does any firm have more than 10% market share	Yes
2	In the markets affected by the new regulation, does any firm have more than 20% market share	No
3	In the markets affected by the new regulation, do the largest three firms together have at least 50% market share?	No
4	Would the costs of the regulation affect some firms substantially more than others?	No
5	Is the regulation likely to affect the market structure, changing the number or size of firms?	Yes
6	Would the regulation lead to higher set-up costs for new or potential firms that existing firms do not have to meet?	No
7	Would the regulation lead to higher ongoing costs for new or potential firms that existing firms do not have to meet?	No
8	Is the market characterised by rapid technological change?	Yes
9	Would the regulation restrict the ability of firms to choose the price, quality, range or location of their products?	No

ANNEX C: TAXATION OF COLLECTIVE INVESTMENT SCHEMES & LIFE INSURANCE PRODUCTS

Collective investment schemes

- I. Authorised Unit Trusts and OEICs are subject to corporation tax at 20% on their taxable income, but are exempt on their capital gains. In practice, they pay little or no tax, the principle being that income and gains “pass through” to the investor. The intention is, as far as possible, to achieve the same tax result as if the investor had invested direct in the underlying equities of the fund. Income available for distribution is taxed as company dividends on investors, whether it is physically distributed or accumulated within the fund. So, taking account of the tax credit, only higher rate taxpayers have any additional tax to pay. Investors are also subject to capital gains tax on disposals of units or shares in the usual way.
- II. UK bond funds have a slightly different treatment. The “pass through” principle is the same. However, the difference is that bond funds can elect to make “interest distributions” instead of paying a dividend, where, throughout the whole of the distribution period, more than 60% of their assets are interest-bearing. So, in such cases, investors receive, or are deemed to receive, interest under deduction of tax at the savings rate.

Life insurance policies

- III. The income and capital gains arising on funds held by UK life insurance companies to back payments to holders of life policies are, under the I-E rules which tax the net profits after expenses, subject to corporation tax at special rates equivalent to the basic and lower rates of income tax. (Pension policies are not relevant to this note and are ignored.) For various reasons the corporation tax paid by a life company on a capital gain can be significantly different from the capital gains tax an individual would have paid on an equivalent gain. Nevertheless, the corporation tax paid by the company is treated as discharging the policyholder’s liability to basic and lower rate tax. In the case of “qualifying policies” - regular premium policies lasting ten years or more - there is no liability to higher rate tax. In the case of other policies, higher rate taxpayers pay tax on their gains when they cash in their policies on the difference between the higher and basic rates of income tax. So, in effect, tax other than higher rate tax is paid by the company annually (on income as it arises and on gains as they are realised) with any higher rate tax being paid on gains that arise when withdrawals are made. However, investors can also defer tax on withdrawals, provided they do not take out more than the equivalent of 5% each year of the premiums paid.