“Safer” Products

Research for the Financial Services Consumer Panel by David Severn

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Table of Contents

1. Executive Summary

This report was commissioned by the Financial Services Consumer Panel ("the Panel"). The Panel wishes to form a view on whether or not it supports the development of so called "safer" products aimed at the retail, medium to long term savings and investments market. The report is based on a combination of desk based research and interviews with a range of firms and other bodies concerned with financial services. The research was conducted in a limited timescale, during April and May 2010, and so does not purport to give a comprehensive or in depth treatment of the issues.

It was agreed with the Panel that any meaningful consideration of the issues could not be confined to the possible design of "safer" products. It would need to look at a number of related issues, in particular the regulatory requirements that might govern the selling of "safer" products.

Industry views varied on what might be meant by "safer" products and indeed whether it would be desirable to promote products to the public on the basis that they were "safer". It is fair to say that almost all the firms with whom I spoke were against the idea of the Government or the regulator prescribing the characteristics of "safer" products, or of any voluntary system for designating some products as "safer".

Whether or not there might be a viable market for "safer" products among consumers will depend on the number of them with the capacity to save or invest and their attitude to the degree of risk, if any, they are prepared to take with their money.

A review was undertaken of various data sources on the number of consumers with the capacity to save and how much they might be able to save. Most of the independent and regulatory evidence seems to point to the market being relatively small and there being little capacity to save much among those earning £10,000 to £30,000. In contrast, some industry evidence suggests a very different picture. (For example, a recent study for the Association of British Insurers suggested there could be a potential market of over 17 million consumers with incomes over £20,000 for non-pension investments.) It is suggested an in-depth study be undertaken to try and resolve these starkly conflicting views on the extent of the potential market for medium to long-term savings and investments. Sensible policies cannot be formulated while there is such uncertainty. This is a matter of commercial concern since firms cannot make sufficient profit if the market is small. It is also one of regulatory concern because if the market is small and firms are still selling to it there may be questions over the suitability of some sales. And finally, the size of the market is relevant to this study because if there are few consumers on moderate earnings with a need for "safer" medium to long term investments then there may be no point in trying to devise such products.

The number of consumers with the potential to save in medium to long-term savings or investments products is only one criterion in judging the potential scope of any market for "safer" products. Another is consumers' attitude to risk. It seems clear on the basis of the evidence I examined that the majority of consumers are risk averse and are anxious to avoid nominal loss to their savings. However, in choosing "safer" homes for their savings, such as deposit accounts, they may be blind to the fact that over the long term they could still suffer loss through the corrosive effect of inflation. Based on these factors it would seem there could well be a demand for a "safer" medium to long-term savings or investment vehicle if the market is of sufficient size.

Product regulation of one sort or another already exists. Notwithstanding this there have been various initiatives at the UK and EU levels aimed at the creation of simpler or safer products. There may be lessons to be learned from this about the design of any "safer" products. Ron Sandler's 2002 report (*Medium and Long-Term Retail Savings in the UK: A Review)* gives some particularly useful pointers on the features that might be of interest in the context of "safer" products. In particular: the desirability of a low level of charges, that passive investment approaches are to be preferred to active management, and the importance of asset allocation and diversification. It is suggested that an in-depth study is needed of unit-linked life assurance to determine if consumers would be better served by "unbundling" of the product into separate protection and investment fund elements.

From 2012 all employers must ensure that their eligible employees are auto-enrolled into a pension scheme that satisfies certain quality requirements. The personal accounts scheme being designed by the Personal Accounts Delivery Authority (renamed NEST Corporation since the interviews for this report were carried out) will be one of the schemes to qualify and it seems probable that it will easily be the largest. A number of features proposed for personal accounts provide a model approach for a "safer" pension product. Assuming that personal accounts go ahead in the form currently envisaged this may provide a "safer" and fair value pension product for many consumers.

There are, however, issues in relation to the purchase of a lifetime annuity. This is a once in a lifetime and irrevocable transaction which can have major consequences for a consumer's income in retirement. The current arrangements to try and ensure that consumers get the best deal from their personal pension pots seem inadequate and the proposals for personal accounts do not go far enough. It is suggested that the default position be that consumers get advice on the purchase of an annuity. The Financial Services Authority (FSA) and NEST Corporation might jointly examine the feasibility of establishing a "clearing house" from which consumers could obtain advice on their annuity options.

The industry's experience to date of attempts to create simpler or safer products is almost universally negative. The example of stakeholder products, and particularly the pension, is generally reckoned to have been a "failure" with the industry pointing a finger at the charge cap, in particular, as a cause of failure while the Consumers' Association (now Which?) point to excessive shareholder demands as to the return on capital. The message from the industry is that in the absence of pro-active and willing purchasers of "safer" products there needs to be sufficient margin for distribution for firms to make a return which will satisfy shareholders. Although the general industry reaction is negative there are some limited areas, such as child trust funds, where there is some evidence of success.

Ron Sandler drew attention to the different tax treatment applied to essentially the same types of product. He also questioned whether tax incentives actually encouraged new saving. Work by the Institute of Fiscal Studies suggests that taxes penalise more those who have simple savings accounts and least those saving for a private pension. The Government has announced the abolition of a relatively modest but effective tax break for child trust funds while leaving in place substantial, and regressive, tax relief for pensions. As long as Government continues to use tax as a lever to influence savings and investments the tax position of "safer" products needs to be taken into account because among other things it can distort choices or impose restrictions as well as conferring possible benefits on consumers by sheltering their savings or investments from income or capital gains tax.

There is a growing momentum behind socially responsible investment and the provision of products which recognise the religious or ethical concerns of some investors. The importance of socially responsible investment is being factored in to personal accounts. Any "safer" products approach should do likewise.

The majority of industry participants with whom I spoke were far more concerned to discuss possible changes to simplify the current selling/advice regime for investments than to give consideration to the design of "safer" products. The standards for investment advice are simple and high-level and were originally consulted on even before the Financial Services Act 1986 came into force. The high-level standards mean that they are capable of accommodating a wide range of circumstances where investment advice is given. Despite this there have been a number of occasions when attempts have been made to "simplify" the advice process. Most recently, a stated aim of the FSA's Retail Distribution Review (RDR) was to try and simplify for consumers the advice landscape. Instead, we have a variety of new models being thrown into the debate by both regulator and industry – primary advice, assisted purchase, and simplified advice in addition to the existing Basic Advice and full advice – and I suggest this proliferation of advice models is unnecessary.

There is a clear resistance on the part of the industry to see Government or regulator become involved in the design of products. Even if the Government or regulator were prepared to become involved in product design it is difficult to see how they could force firms to market any products which the Government or regulator designed. An alternative approach might be to leave it to the industry to decide how best to design products which it thinks it can sell and for the regulator to assess whether such products can be regarded as “safer” or good value and to then to allow those products which pass such a test to have a simpler sales and advice regime. This it seems to me would be consistent with what the FSA has recently been saying about product regulation:

> *“One of the challenges for us would be to differentiate between good and bad innovation. We want to foster good innovation that brings better products to the market place.”*

It would not even be necessary for the regulator to create any new simplified advice process as it already has one to hand in Basic Advice. Although originally designed for stakeholder products Basic Advice was capable of being extended to non-stakeholder “safer” products and the FSA said that it would examine this possibility. It seems to me that the FSA has failed to honour this commitmnet but that It could now revisit the question. An issue that would need consideration here is how the distributors of such products should be remunerated, that is whether or not the proposed “adviser charging” should apply to non-stakeholder products sold through Basic Advice. Also, the FSA would need to ensure that any extension of Basic Advice was consistent with Directive obligations. However, as current Directive requirements are currently under review the FSA could seek modification of them if they pose disproportionate barriers to the selling of or advice on those products which the FSA deemed as “safer”. If the FSA developed the Basic Advice model in the way suggested I think it could make redundant the other forms of simplified advice considered as part of the RDR.

Much investment business is now transacted through so called “platforms”, a generic term covering a variety of ways of doing business over the internet. Although many households do have access to the internet access is not universal. The evidence is that where consumers use the internet for financial matters it is for relatively simple operations. It is doubtful that the majority of consumers would have either sufficient investments or sufficient inclination to make use of the tools which some platforms offer. While the internet should serve as one way in which consumers can buy “safer” products it should not be viewed as the solution to distribution for all consumers, at least in the short term.

A straw man is put up of the possible criteria the Panel might apply when looking for “safer” products. These criteria include:

- The product allows for regular savings. However, the terms of the product should not be such that a consumer is committed to making contributions each and every period. It is clear that many consumers who are in a position to save have relatively modest amounts to put aside. It might on occasion be possible to set aside a small lump sum but it seems likely that many consumers would be better suited by making regular savings.
- The threshold for regular savings should be reasonably low.
- The charges should be low.
- If the product is an investment it should be passive in its approach.
- If the product is an investment it should diversify across a number of asset classes in order to manage risk.
- The product should be eligible for inclusion in any appropriate tax wrapper.
- The product should not confuse saving or investment needs with protection needs. This is not to deny the importance for those with dependants having life cover in place but this is something that should be purchased separately from any savings or investment product.
- The product should be described in plain and clear terms. Providers simply must do better in being open and honest about the potential risks. An open and honest approach should help reduce the number of consumers who feel that they have good cause to complain to the Financial Services Ombudsman and to reduce the number of occasions on which the FSA feels it necessary to order a particular firm, or the whole industry, to review past business.
- The savings or investment vehicle should respect any ethical or other beliefs of the consumer.
- The product should be covered by the UK’s Financial Services Compensation Scheme in the event of the product failing.

A common industry reaction was that there are already "safer" products on the market without the need to create new ones. A number of the suggestions put forward are examined. At the time the research for this report was carried out this included National Savings and Investments' Index Linked Savings Certificates. It has since been announced that the Certificates can no longer be purchased (existing holders of certificates can, however, "roll over" their investment) although it appears that they may be re-introduced at a later date. If the Certificates are reintroduced in anything like their previous form I think they would be a sensible form of saving for the many consumers who are risk averse. Other examples put forward for consideration included the sort of low cost multi-asset funds offered by such as Vanguard Investments, and possible innovative approaches to the issue such as Black Rock's suggestion of creating bespoke "safer" products by packaging together a selection of exchange traded funds.

The argument that what is needed is clearer disclosure and not "safer" products is examined and rejected. Given the low level of literacy and numeracy of many consumers, and the poor financial capability of an even larger group of consumers, reliance cannot be placed on disclosure alone. Although it is important that consumers be given clear information about the products they are recommended to buy it still seems the case that some firms have difficulty producing material that is concise, clear, and above all open about risks. Consumers are not helped by the fact that neither the FSA nor the industry has yet implemented any clear means of indicating the risk of a product (something for which Parliament had called in 2002). The FSA needs to be more vigorous in ensuring that marketing hyperbole does not overcome sober facts in the Key Facts documents that firms produce and that firms do not seek to obscure Key Facts through other marketing literature.

Much of the focus of regulation is on what happens when products are sold. But the circumstances of individual consumers change, economic circumstances change, and products themselves may change. A product that starts out as "safer" may not remain so because of one or more of these changes. The FSA should look at what more might be done to support consumers over time given that the vast majority will not have an ongoing relationship with any financial adviser.

Many firms expressed concerns about the potential for problems with the Financial Services Authority (FSA) and the Financial Ombudsman Service (FOS) over any form of simplified advice or over the development of "safer" products. I am not sure I have seen evidence to support these concerns but as this issue was not central to this research I can do no more than report the concerns of some firms.

There are both potential EU and UK legislative constraints to the development of “safer” products on which the Panel might want to seek an expert view. But legislation is not immutable and barriers to “safer” products or a simplified selling regime could be removed or modified if a convincing case can be made to the competent authority. Since the research for this report was carried out the Government has published for consultation its proposals for the reform of financial services regulation. As currently formulated I do not think these proposals either add to or remove existing legislative constraints.

Much UK legislation already derives from European Directives and that trend is likely to grow. There are also proposals from some European trade bodies for standardisation of some aspects of financial services to facilitate the single market for consumers. The Panel might wish to use its influence to seek to influence European policy thinking.

2. Introduction

This report was commissioned by the Financial Services Consumer Panel ("the Panel"). The Panel wishes to form a view on whether or not it supports the development of so called "safer" products aimed at the retail, medium to long term savings and investments market. As one input to the Panel's consideration of this issue it asked that some research be carried out to gauge industry views on the appetite to develop "safer" products and what the industry see as the pros and cons of such an approach. The research was carried out by David Severn and this report presents the findings from the research.

The research consisted of two parts. One part involved taking the views of a variety of trade bodies, other organisations concerned with financial services, and regulated firms. The firms covered banking, insurance, fund management, building society, friendly society and retailers with a financial services presence. About forty bodies were contacted, listed in Annex A. The other part of the research was desk based looking, among other things, at previous and current attempts to develop "safer" or "simplified" products. Around forty documents were reviewed covering Parliamentary, Government, regulatory and industry publications, listed in Annex B.

In advance of any discussion with firms and others a background note to the research (see Annex C) and a list of issues (see Annex D) were provided. A few bodies provided a written response to these documents. In most cases, however, the list of issues provided the basis of a discussion concentrating on those matters on which the firm or other body concerned had experience or wished to express views.

The research was conducted in a limited timescale (April to May 2010). It therefore does not purport to give comprehensive coverage of industry views nor has it been possible to examine issues in great depth. The aim of this report is to give the Panel sufficient feeling for the attitudes, concerns and aspirations of the industry to enable it to decide whether or not the development of "safer" products is both feasible and in consumers' interests taking account too of the wider context (e.g. consumer needs and attitudes, the experience of similar past initiatives, legislative constraints).

3. Background

There are a number of strands to the Panel's consideration of the case for "safer" products. First, on 23 March 2010 the Retail Financial Services Forum (RFSF) published a discussion paper called "Simple Transparent Products" in which it set out the case for simpler products in the areas of credit cards and general insurance. Second, both the Chairman and the Chief Executive of the Financial Services Authority (FSA) have made recent references to the regulator's role in "product regulation". Third, the FSA's Retail Distribution Review (RDR) is generally reckoned by those in the industry with whom I spoke as part of this research as likely to result in independent and professional advice moving primarily to the wealth management end of the retail market. Below this intermediaries may find it difficult to "sell" to less affluent consumers the concept of paying adviser charges to get financial advice. This could leave many consumers having to make their arrangements without any help or advice, or only being sold deposit based products (which currently are outside the scope of the RDR), or simply failing to take any action on their financial affairs. A possibility, therefore, is that "safer" products might be developed to meet this market and such products might be subject to a less complex sales regime. Fourth, the development of the new private pension arrangements in the UK called Personal Accounts may not only meet the pension savings needs of many consumers but may also set out a possible model for the development of other low-cost and "safer" investment products outside the pensions area. And fifth there are periodic initiatives launched, both at the UK and EU levels, aimed at simplification of either financial products or the sales regime, the most recent example being a report from the European Fund and Asset Managers Association.

4. Scope of the report

In preliminary discussion with the Panel about the scope of this report it was agreed that it should cover medium to long term savings and investment products, including pensions and annuities but that some products such as equity release and long-term care should be disregarded because the markets are small. It was also agreed that consideration of the case for “safer” products could not be looked at in isolation from several other issues. In particular, it could be expected that industry participants would raise the issue of the selling regime for products. Other issues also arose during discussions with the industry and others. This section of the report outlines those other issues which the Panel might wish to take into account. The issues are then developed further in later sections of the report.

What exactly is meant by “safer” products? Does it necessarily follow that that safer products have also to be simple?

Is there a market for “safer” products and what do consumers themselves want? What are the characteristics of those consumers who might be in the target market for “safer” products?

Product regulation already exists. Is this enough on its own to provide “safer” products?

Both the UK and the EU have looked at various ways of creating simpler or safer products. What has been tried in the past and what is being planned for the future? One example is the introduction in the UK of stakeholder products. Another is the plan for the introduction of personal accounts. What useful pointers do these various attempts provide?

Have previous attempts to create “safer”, simpler or better value products been a success?

Is it enough to consider just the design of “safer” products, or does account need to be taken of the tax position of products?

Should any approach to “safer” products factor in a responsible or ethical investment approach?

What safeguards if any does the Panel think should apply to the selling of or advice on “safer” products?

An increasing volume of investment business is transacted through “platforms”. Is this appropriate to “safer” products?

Do the answers to the preceding questions provide a list of criteria against which “safer” products might be judged?

Are there products already on the market which might be said to meet the concept of a “safer” product?

Are there concerns about the potential approach of the Financial Services Authority and the Financial Services Ombudsman to “safer” products?

Is the real issue less one of product design and more one of effective disclosure of information?

What mechanism should be used to deal with changes over time? The change might be in the nature of a product so that it may cease to be regarded as “safer”, or it may be a change in the circumstances or attitude of a consumer.

What legislative barriers stand in the way to the introduction of “safer” products? Legislation is not immutable. EU Directives and UK legislation can be changed but it may take considerable time and effort to effect any change. It is necessary to be aware of the barriers that exist. But legislation is not the only way of establishing a regime for safer products. It could be achieved by a voluntary system.

Would an EU approach to the issue of “safer” products be preferable to the UK going it alone?

5. What exactly are "safer" products?

The Panel's brief for this research referred to "safer" products. The RFSF report referred to "simple, transparent products". In 2004 Charles Rivers Associates (CRA) was commissioned by the European Commission to look into simplified products in the European Union. CRA's report, which will be dealt with more fully later, made a distinction between "simple" and "simplified" products. "Simple" products were such as instant access bank accounts. In contrast, "simplified" products were those where Governments, regulatory bodies, or even the industry had sought to introduce some control to standardise products which over time had been subject to a high level of proliferation and differentiation. It is fair to say that all of the firms I surveyed expressed varying degrees of reservation over the use of any of these descriptions, although the description "safer" probably caused the most difficulty.

The term "safe" was thought to be acceptable in the context of products which gave a firm guarantee to pay back at least the initial investment. It was also considered reasonable to describe some products as "simple", mainly deposit based products. The term "safer", however, met with many objections. There were eight main points that made by industry participants.

The first was that the only product that could legitimately be regarded as "safer" was one which was guaranteed and involved no capital loss to the purchaser. But as a number of product providers noted, guarantees are capital intensive and in current market circumstances are very expensive to deliver to consumers. For example, AEGON in its comments on the investment approach for personal accounts commented on the prohibitive cost of guarantees *("The cost depends on the guarantee but is likely to be in the region 0.5% to 1% above the fund cost while greater exposure to equities increases the cost. The cost of full guarantees is likely to be prohibitive.")*

The second point was that some products offered what were described by one provider as "soft guarantees" and which might be regarded as "safer" by some. But a problem with these was explaining effectively any limitations with the product. So, for example, there might be a counterparty risk, or a guaranteed level of income might only be achieved at the expense of the erosion of capital, or the product in question might not be covered by compensation arrangements equivalent to those of the UK. Many firms, however, took a sceptical view of "soft guarantees" saying that a product "was either guaranteed or it was not". And many also referred to the events of the last two years or so and how the banking crisis has exposed risks in products which many thought were not present.

The third point was that a particular product might correctly be classed as “safer” at the time it was sold but changes in general economic circumstances over time might alter the case. So, a bond fund might be affected significantly by changes in interest rates. Similarly, an individual’s attitude to risk may not be static over time and may change with life events or age. I think this raises an important issue for the Panel. A product sold as “safer” at outset may not remain so. As few consumers have an ongoing relationship with a financial adviser it will be important that some effective means exists to alert consumers to a significant change in the risk profile of the product they own. And similarly where a product retains its original risk profile consumers may still need a prompt to check that the risk profile of the product still accords with their own attitude to risk which may also change over time.

The fourth point was that consumers are not the same in their attitudes to risk. What may be a “safer” product for one consumer may not be “safer” for another. One major financial institution commented:

> “*Although an investment product carries inherent risks, the risk to its investor is subjective and will depend on the investor's portfolio of products and how a new product is incorporated in the portfolio. Thus, a higher-risk product can actually be used to reduce risk in an investor's wider portfolio through diversification. Products are but building blocks that can be used to create many different portfolio structures.*”

This issue goes to the heart of whether or not it would be necessary to consider the personal and financial circumstances and attitude to risk of a consumer when selling a “safer” product and so is dealt with in more detail later.

The fifth point was to challenge the idea that “safer” products necessarily had also to be “simple”. Several product providers made the same analogy with buying a car. Few car purchasers have a degree in automotive engineering which would enable them to understand the detailed specifications for a particular car. But every consumer can be expected to understand that a car is designed to get them from A to B and to have a rough idea of how cheap or expensive the car will be to run. One asset management firm made similar points:

> *“Can simpler/safer products be described as such if the objective is simple and the product wrapper provides excellent levels of liquidity and minimal default risk, but the underlying investments and/or strategy are complex?”*

Industry participants said they had no objections in trying to give consumers a plain language account of how a product worked but they had doubts about how well many consumers might understand the description. What was considered far more important was that consumers were given the clearest possible description of possible outcomes from a product. So, for example, "am I guaranteed to get back my original money", "how much could I lose". These sorts of question go to the heart of consumers' understanding of "risk" and are also of relevance to the issue of disclosure of information and so both are discussed later in this report.

The sixth point made was that there was inevitably a trade-off between the design of simple products and giving consumers better returns. So, the instant access bank account may be simple but pays very little interest. The consumer who wants more interest may have to accept that the cost of getting it is not to have instant access.

The seventh point was the general nervousness at describing any investment product as "safer". This it was thought could imply to some consumers no potential downside risk to a product.

The eighth point was, quite simply, to challenge whether "safer" products were the right way ahead. For example, one firm said that it:

> *"would argue that the key in getting more people to save is financial education and not creating simpler/safer products."*

Or again, there were several who commented on the absence of demand: thus, one major life insurer said there was an "engagement" problem and so it was usually necessary to sell products, consumers did not buy them. And some felt that the needs of customers were already met adequately by existing products. So, one firm commented:

> *"All of our current funds are low to medium risk plus we have a range of savings plans. Therefore, [we] feel that our current portfolio meets the needs of our customers."*

Or again, a major retail bank said that it transacts relatively little investment business and takes the view that the majority of its customers are risk averse and so provides them with a range of deposit and structured products which it feels meets their needs for capital secure products.

The Panel chose the term "safer" which is a relative description of the riskiness of a product. So, it is not necessarily the case that a product has to be risk-free. It might, however, need to have a limited downside. A number of firms also suggested that a better term might be "lower risk" than safer. One fund management group said:

> *"a better way to look at this matter is in terms of lower risk products and furthermore to define risks not just in terms of how a product may perform but also in terms of liquidity, default etc."*

Similarly, another major firm with a significant high street presence said that it had read "safer" as meaning:

> *"investment products with a low capital risk. Our experience shows there is an appetite amongst customers for relatively simple products, with a low capital risk, that have the ability to outperform cash over the medium to long term. We believe there is potentially a place for this type of product for all customers, not just specific segments (although our experience suggests that they will be particularly popular with first time investors, who tend to invest relatively small amounts and who are only prepared to tolerate small risk to capital)."*

6. Is there a market for “safer” products and what do consumers want?

Whether or not there is a market for “safer” products will depend, among other things, on the number of consumers who are in a position to make a medium to long term commitment to save or invest and on their attitudes to such matters as risk.

The firms spoken to as part of this research all told me that they do customer research of some kind or another to help inform product development. The extent of such research varies: sometimes it is among the existing customer base, sometimes it covers a wider population including those who might become customers for a firm’s products, sometimes firms share in syndicated research, and sometimes it is a case of intermediaries articulating what they claim their customers want. Sometimes firms’ research is published and in those cases the overall message is generally the same: consumers ought to save more. As an example, the Association of British Insurers (ABI) commissioned research from Oliver, Wyman & Company on the shortfall in UK savings and the results of which were published in 2001 as *“The Future Regulation of UK Savings and Investment: the Savings Gap”*. This claimed a £27 billion savings gap between what consumers were saving in 2000 and what they would need for a comfortable retirement. The report also claimed that the gap was most acute among low to moderate income customers, “creating a form of social exclusion”. In August 2002 the company published a follow-up report *“Strategies for Tackling the Savings Gap: The Role of the Saver Agent”* which commented on the earlier research as follows:

> *“The research concluded that the current regulatory regime fails to find a proper balance between encouraging saving and protecting consumers. Reform is needed to increase saving and it should focus on increasing the availability of face-to-face advice to those on moderate incomes, for whom help and encouragement are key to overcoming innate psychological barriers to saving.”*

The report went on to consider two scenarios: the first identifying incremental change to the regulatory regime, and the second to look at more radical moves to a different regulatory model. The effect of these two scenarios was said to reduce the savings gap by a mere £600million to £700 million in the first case, and by £4 billion to £5 billion in the second case. In other words, the industry might be right in claiming that consumers needed an extra £27 billion in order to have a comfortable retirement but even a radical reduction in regulatory protections would still have left a gap of at least £22 billion. One plausible explanation of this remaining and significant gap is that consumers simply do not have anywhere near that much disposable income that they are able to save.

It is worth recalling here what Anthony Hilton wrote in his City Comment column in the *"Evening Standard"* on 14 May 2002:

> *"The small minority who can save will. The vast majority of poor people will carry on living from hand to mouth. The bulk of people in between will use the first six months of the year to save for a summer holiday and the second half to save for Christmas. That said, it is worth considering what would happen if we all did what this savings industry trade association says is good for us." Hilton then went on to give a short but devastating critique of the possible economic consequences were the UK population to start saving on the scale suggested by the industry. He concluded "So the dishonesty of the ABI's position, and more culpably the dishonesty of Government, is in telling people that everything will be all right if they all save. In fact, saving is a passport for the relative few who are reasonably affluent. If we all save like demons, we destroy the economy."*

It is understandable that the financial services sector is keen to encourage consumers to save or to save more. Firms can't sell their products and make profits if consumers don't buy. So, on the part of the financial services industry the motivation to get consumers to save is as much to do with its own commercial survival as a profitable business as it is to do with any claims of concern for the financial wellbeing of consumers. The industry seems to continue to measure its success principally by the volume of new business which it transacts rather than by how well it does for its existing customers. Similarly, Government departments such as HM Treasury and Department of Work and Pensions are not disinterested in their efforts to get consumers to save more. If consumers save more there will be some who do not benefit from doing so because they lose some or all means-tested benefits to which they might become entitled in the future. This may be a satisfactory outcome for Government but is not so for those individual consumers whose efforts to save may leave them no better-off.

It may be that consumers should spend (or borrow) less and save more but consumers do not have an inexhaustible supply of money. Any competent financial adviser would expect a consumer to look after first such things as an "emergency fund", protection for dependants, repayment of expensive loans and other essentials such as car insurance and household insurance. The next priority would be pension saving. Meeting these sorts of needs could absorb any available income for many consumers.

A valid question to ask, therefore, is if there are objective sources of data which will give an indication of the potential size of the market for medium to long-term savings and investments. It is also important to have some objective evidence as to consumers' understanding of and attitude towards risk and also their attitude to saving.

7. Evidence on the wealth and savings of consumers and their characteristics

In sections 7.1 to 7.27 that follow there is a review of a variety of different data sources in an attempt to bring together evidence on matters such as:

- the wealth and assets of consumers (and hence their capacity to save);
- consumers' understanding of and attitude to risk;
- consumers' attitude to saving; and
- changes in consumers' circumstances that may affect the capacity to save or the attitude to risk.

7.1. Evidence on market size from the ONS report on wealth in Great Britain

In December 2009 the Office for National Statistics (ONS) published *"Wealth in Great Britain"* giving the results of a survey of wealth and assets over the period 2006/08. The results of that survey indicated some stark inequalities in the ownership of net financial wealth as the following extracts indicate.

> *"An estimated 96 per cent of households had a bank account or some kind of financial investment in 2006/08. The most common was the current account, held by 92% of households in Great Britain in 2006/08 and 50% of households had £1,000 or less in their accounts in 2006/08 if overdrafts are excluded"*
>
> *"An estimated 62% of households had a savings account in 2006/08. However, 50% of households with savings accounts had £3,500 or less in their account and 25% had £500 or less"*
>
> *"Median values of financial wealth in 2006/08 were much lower than mean values, indicating a skewed distribution. Half of all households in Britain had..net financial wealth of £7,200 or less. The analysis also shows that 25% of households had net financial wealth that was negligible, zero or negative net financial wealth."*

"The distribution of ownership of net financial wealth is more unequal than that of net property wealth and physical wealth. In 2006/08, the Gini coefficient was 0.81 for net financial wealth, indicating a relatively unequal wealth distribution. In 2006/08, half of the households in Britain owned 1% of net financial wealth, while the wealthiest 20% owned 84% of net financial wealth"

7.2. Evidence on market size from the ONS population estimates and FSA retail investment product sales data

The ONS population estimates put the total UK population at 61.4 million in mid-2008. Around one in five are aged under 16 (about 12.2 million) and therefore not in the market for savings and investments (if one excludes child trust funds). Of the remainder, about 38 million people are of working age and just over 21 million will therefore be above state pension age. Of those of pension age about 1.3 million are reported by the Poverty Site, using data from the DWP's *"Households Below Average Income"* survey, to be dependent solely on their state retirement pension and other benefits. Those consumers over pension age seem likely in the main be de-cumulating rather than putting aside money into medium to long-term investments, although of course that will not be true of all. Assume for the moment though that it is the 38 million people of working age who are potential savers for the medium to long-term. Turning now to the FSA's publication *"Retail Investments Product Sales Data Trend Report"* August 2009, this gives the number of retail investments sold in the year to end March 2009. In this period the report notes 2.8 million retail investments having been sold. So, at best, there were only about 1 in 4 consumers of working age who bought an investment product in 2008/09. In fact, the proportion of consumers of working age who bought investments is likely to be much lower than 1 in 4 because of the skewed distribution of wealth reported by the ONS *("half of all households in Britain had net financial wealth of £7,200 or less", "the wealthiest 20 % of households owned 84% of net financial wealth").*

7.3. Evidence on market size from an FSA report on asset ownership

In 2008 the FSA published *"Asset ownership, portfolios and retirement saving arrangements: past trends and prospects for the future"*. It is unfortunate that the title of this paper gives a somewhat misleading impression because the paper itself did not address the holdings of assets among the population as a whole; rather it focussed on older individuals (broadly speaking aged 50 to 64). Nonetheless for this age group the paper presents some useful information.

The paper notes first some evidence of consumers moving away from investments:

> *"Holdings of investments were most prevalent in the late 1990s and very early 2000s. However, since 2001 fewer families with members aged between 40 and 69 have held any sort of investments. Investment ownership may well have been driven up in the late 1990s by building society demutualisations, many of which happened in 1997, and events affecting the stock market in 2001 may well explain much of the decline in investment ownership after this date. There is some evidence of individuals moving away from holding investments at older ages, with the prevalence of such assets declining after about age 55 or 60."*

Although the paper was right to point to demutualisations it is surprising that no reference was made to another policy of the Conservative Government of that time (sometimes described as "selling the family silver"), the rash of privatisations of major concerns like British Telecom, British Gas, BP. It was a "no brainer" for more affluent consumers to buy shares on favourable terms and then quickly sell them for a profit to institutions.

It was also noted that:

> *"The characteristics of those holding savings and investment products are not significantly different now from what they have been over the last decade. Higher income individuals – those who are more highly educated, own their own home, have higher levels of wealth overall and /or who have a private pension – are all more likely to hold savings products and investment products".*

The paper also presents some valuable evidence on how wealth is distributed among different types of asset for those aged 52 to 64. The mean figures show that 57.3 % of wealth is accounted for by owner-occupied housing and state pensions. The paper then goes on to say:

> *"In comparison, financial (non-housing, non-pension) wealth amongst this group is much smaller. The vast majority of individuals in this age group hold at least one type of financial product – around five out of six (83.6%) hold some form of savings product, while just over half (52.2%) have some form of investment. However, for many individuals the amount of wealth held in these financial products is small relative to holdings in other assets – on average just 7.5% of total net wealth amongst this age group is held in financial products. This is a reflection of the fact that for many individuals, the value of wealth held in these types of product is small ... one in four hold less than £3,840 in savings or investment products. On the other hand the overall distribution of financial wealth is highly skewed with another one in four having at least £65,500 in such assets. The median level of gross financial wealth is £21,000. For some individuals, financial wealth will be a significant source of retirement income, but for others it is likely to make little difference. Indeed, at the median, individuals' net financial wealth holdings are equal to only just over 100% of their current income."*

7.4. Evidence on market size from the post-implementation review of basic advice

Another source of information about the potential size of any market for "safer" products comes from the FSA's report *"Basic Advice regime – a post implementation review"*. Later in this report, when I discuss possible simplifications of the sales and advice regime, I will have more to say about Basic Advice. For the present it is enough to note that Basic Advice was designed as a streamlined advice process for certain products aimed at middle income earners (£10,000 to £30,000) and as part of its post implementation review of the regime the FSA commissioned research on the size of the market from Volterra Consulting.

It is worth dwelling on the results of the research because if accepted as valid they may have important implications not only for any proposal to simplify advice (discussed later) but also on the potential among middle income earners not just for "safer" investment products but any investment product at all.

The first stage of Volterra's research was to look at the number of consumers between the ages of 18 and 64 on earnings of £10,000 to £30,000 and they put this figure at 16.5 million adults, of whom some 6.5 million were estimated to own already some type of equity or similar product. (The *Annual Survey of Hours and Earnings*" published by ONS put median average earnings for the tax year ending 2009 at £25,800.)

The second stage of the research was somewhat convoluted, its being described as " to identify people who do not own equities but who share the characteristics of those who do and identify those who share some, but not all of the characteristics of equity owners. The former group could be thought of as new to the market investors in Basic advice products and the latter group might be thought of as marginal potential investors." The outcome of this process was to identify four different groups of consumers (aged between 18 and 64 with incomes between £10,000 and £30,000) as follows:

- just under four million adults already owned some equity-based investments and were predicted to do so;
- around nine million adults did not own equities and were correctly predicted not to do so;
- around two million were identified as owning equities, even though they were not expected to do so;
- a million and a half had characteristics which made them likely to own equities, but who did not.

It was this last group that Volterra regarded as the target market for Basic Advice and on this footing the FSA concluded that the upper limit for the Basic Advice market was one and a half million people.

> *"This estimate was made up of a million customers with low to moderate incomes i.e. who could be in the government's target group for stakeholder products, and 0.5 million higher income customers. Furthermore, this was not a per annum figure, but a total given current consumer demographics and population size. In reality the actual market is likely to be even smaller, as Volterra's estimate does not take into account the effect of auto-enrolment into personal accounts, or the impact of an individual's indebtedness on their ability to save."*

Now, if the Volterra research is accepted as valid then it seems to that there is a stock, not a flow, of a mere one million customers in the income range £10,000 to £30,000 (and a further half million above £30,000) who are potentially in the market for investments. And the number could be much lower if account is taken of auto-enrolment into personal accounts. The conclusion the FSA draws from this is that there is not a big enough market to sustain Basic Advice. If Basic Advice is cheaper for firms to deliver than full advice then it must also surely follow that there is not a sustainable market for full advice or for non-Stakeholder products for those with incomes between £10,000 and £30,000. It is not clear to me from the research whether the stock is stable, increasing or decreasing (as there are inflows from people joining the labour market, and outflows from people retiring or dying). Also, it is unlikely that consumers in the income range £10,000 to £30,000 will be buying several investment products or even just one product each year – so if firms were successful in getting these one million potential customers into investments would not the market virtually disappear over time?

7.5. Evidence on market size from simplified advice

During the preparation of this report another source of industry information came to hand on the potential size of the market among middle income earners for investment products. In the time available I have not been able to study this in detail but it seems to cast more confusion on the matter of the market size. Both the ABI and the BBA are keen to advance the idea of a "simplified advice" process (described more full later in this report) and as part of their research they commissioned Charles Rivers Associates (CRA) to undertake a study which included looking at the potential size of the market. The results of this study were published in May this year in *"Cost of Providing Financial Advice"*. CRA explained that:

> *"Having identified the size of the premium for which advice can be profitably provided, we were also asked to assess the potential market size associated with these levels of premiums i.e. to consider the number of customers that might be able to make investments of the necessary level."*

For regular contribution products CRA assessed the potential market size on the basis of the number of customers whose income enable contributions to be made at the level of the minimum case size (at which firms could sell profitably). For this purpose CRA assumed individuals could save around 6% of their income in savings and investments (not pensions), this assumption being based on the results of the NS&I Quarterly Savings Survey.

CRA then first estimated the minimum annual income of a consumer that would be required in order that the relevant proportion of income (6%) is equivalent to the minimum case size. The result for regular contribution collective investments is an average income of £20,320. Using information on income distribution from HMRC, CRA then estimated the size of the population who have incomes above £20,320 and this was an average population for all distribution channels of 17 million consumers.

7.6. Conclusions on market size

Now, clearly Volterra and CRA were asked different questions and took different approaches but we still have the situation where the regulator is working on a potential market size of 1.5 million for Basic Advice mainly in the income range £10,000 to £30,000 and the industry is working on an assumption of 17 million consumers for Simplified Advice in the income range £20,000 and upwards. It seems to me that the FSA and the industry need to try and reconcile the different estimates. Sensible policies cannot be formulated if there is such uncertainty about the size of the market. This is a matter of commercial concern since firms cannot make sufficient profit if the market is small. It is also a matter of regulatory concern because if the market is small and firms are still selling to it there may be questions over the suitability of some sales. And finally, the size of the market is relevant to this study because if there are few consumers on moderate earnings with a need for "safer" medium to long term investments then there may be no point in looking to create such products.

The other data sources I have used seem to me to indicate that the majority of consumers have a limited capacity to save and to the extent that they are able to save this is more likely to be through small, regular or occasional amounts rather than by lump sums.

7.7. Understanding of and attitudes to loss and risk

The Personal Accounts Delivery Authority (PADA) – which, after the research for this report was carried out, was renamed NEST Corporation- reported the views put to it by consumer representatives about the development of a new type of pensions arrangement called "personal accounts as being that:

> *"Loss is worse than anything else, members would prefer not to lose than to make gains .. personal accounts should adopt a building society mentality with the aim to preserve capital".*

PADA, drawing on its own research, said that loss is not a fixed measure but needs to be referenced to what an individual believed they had in the first place. It identified a number of ways in which loss can be described:

- ”absolute or nominal loss” – this above all is the measure consumers can both understand and fear most (“I had £1,000 and now I have only £750”)
- ”relative loss” – this refers to underformance compared say to some benchmark. This type of loss is very difficult for most investors to try and judge. The person who starts out with a £10,000 investment and 20 years later gets back £12,000 might not feel too bad about the outcome. They would be less satisfied; however, if they were in a position to know that with almost any other provider of their investment their money could have been turned into £20,000.
- ”loss in real terms” – also difficult for consumers to assess is the loss in purchasing power of their money due to inflation. The person with a small amount in a bank account may be happy that their savings are earning a little interest but after taking account of the effects of inflation the interest rate being earned might actually be negative.

In the main regulatory requirements for financial services are directed more at dealing with proper disclosure of the risks that might cause loss rather than seeking to control those risks. One of the principal risks needing to be disclosed is volatility (“the value of investments can go down as well as up”). But, as a number of firms pointed out there is a need to consider other risks:

> *“‘Risk’ is usually taken to mean volatility of returns. But there are other risks within the product, e.g. counterparty risks etc. And one must also consider the full risk picture - simple bank deposits are (arguably) the least risky, but there's the risk of inflation. Bond portfolios might be less volatile than equity portfolios, but even then the wider economic picture is important (e.g. if you foresee a hike in interest rates, the value of the bond portfolio will fall...).”*

7.8. Evidence from the ONS on attitudes to risk

The ONS survey *“Wealth in Great Britain”* looked at peoples’ attitudes to risk. Respondents to the ONS survey were asked two questions aimed at determining their risk preference and time orientation.

ONS said that:

"The results show that people were predominantly averse to risk and had short time horizons financially. More than three-quarters (78%) of people said they would choose to receive a guaranteed payment of £1,000 rather than take a one in five chance of winning £10,000. Similarly, 80% of people said they would rather receive £1,000 today than £1,100 next year, while 20% said they would rather receive £1,000 next year"

7.9. Evidence from the FSA on attitudes to risk

In 2004 the FSA published a research paper *"Consumer understanding of financial risk"*. This commented:

"The complexity of financial products often led to confusion about characteristics and performance amongst respondents of low and medium financial sophistication. For example, ISAs were perceived as being safe because they were provided by the government and few were aware of the distinction between cash and equity ISAs."

"Capital risk was consistently the biggest concern amongst respondents and the fear of losing money entrenches consumers within savings accounts. However, there was some naivety amongst respondents of low financial sophistication as they believed the issue lacked any personal relevance and assumed that their money would always be safe".

7.10. Evidence from the Consumer Panel on attitudes to risk

In 2007 the FSCP published *"Research into Risk Ratings"* which observed:

" It is clear from the findings of the research that consumers generally do not fully appreciate what risk is; what the potential impact of it is; or how they need to factor risk in to their buying decisions. Most understand the relationship between risk and reward, but few really understand more complex aspects such as the risk to capital (whether only part or all of it), the risk to the reward or the time impact of risk."

"It is very clear from other research that consumers do not fully understand the risk they take when buying products". Drawing on FSA research, it noted that 21% of respondents who had recently purchased an Equity ISA felt there was no risk of losing some or all of the money invested; this figure was 31% for recent purchasers of an investment bond. When asked what level of risk they were prepared to take 20% of respondents who held an Equity ISA and 24% who held an investment bond said they were prepared to take no risk when investing."

7.11. What do savings patterns tell us about attitudes to risk?

It is instructive to look at where many consumers have chosen to put their money when they do have some to save and for which they do not need instant access. One such vehicle is the Individual Savings Account (ISA), popular because of its claimed tax advantages. HM Revenue and Customs (HMRC) publish statistics on ISAs. The statistics show that for the tax year 2008/09 2.922 million people chose a stocks and shares ISA (of which only 175 thousand took out an insurance based stocks and shares ISA) which would have exposed them to some market risk. Although those subscribing to a stocks and shares ISA could have contributed up to £7,200 in the year in fact the average subscription was only £3,230. So, even those prepared to take some risk with their money were investing a relatively modest amount. The HMRC statistics also show that 11.299 million people subscribed to a Cash ISA in the year. Although these consumers could have contributed up to £3,600 the average subscription was only £2,480. In addition to demonstrating that the majority of consumers prefer to avoid risk (and therefore forgo potential higher rewards) the HMRC figures also support what was said earlier about the capacity of consumers to save. In the case of both the cash and stocks and shares ISAs the average amount saved by consumers fell well short of the maximum they were allowed to save.

7.12. Inflation risk

It has already been noted that one aspect of risk which may be difficult for consumers to grasp is the long term effect of even low rates of inflation. For example, at 3 per cent inflation per year the value of £1,000 would be roughly halved in 20 years. As a general proposition, therefore, consumers should be seeking to get a return that at least matches inflation and preferably exceeds it. A further perspective on inflation is that it is not uniform in its impact on consumers. This has been pointed out in an Institute of Fiscal Studies study *"How does inflation affect different households?"* This study noted that published inflation rates are simply averages and that there is a variation in the effect on different households because of their different spending patterns. Thus, for the same published inflation rate, those, for example, in poorer households, or older households, or single adult households will suffer more from the effects of inflation than some other types of household. And those households, of course, are likely to be the ones with least to save.

7.13. Attitudes to saving

The ONS survey *"Wealth in Great Britain"* also looked at attitudes towards saving. Consumers were asked to report how often they had money left over at the end of the week or month over the past 12 months.

> *"This showed that 44% of individuals had money left over at least most of the time, including 28% who always had money left over".*

But there were also 17 % who said they never had money left over.

In an article in the July 2009 issue of Economic & Labour Market Review, *"Improving measurement of household savings and wealth",* described trends in household saving and wealth leading up to the current economic downturn. The article noted that:

> *" During the last decade, the UK has seen big increases in household spending relative to total resources, and the saving ratio fell to 2.2% in 2007 and 2% in 2008".*

In fact, by 2008 the savings ratio had fallen to its lowest level since 1957. Once the banking crisis hit, however, there was a change. Since the banking crisis and the onset of recession there has been a significant change in the savings ratio although it is far from clear whether this will be sustained. The ONS Quarterly Accounts for Q4 2009 show the savings ratio rising to a peak of 8.4 % by Q3 2009 and then falling away to 7% by Q4. This rise in the savings ratio might well be a panic reaction to the uncertainty which exists over the future for many employees and it seems questionable whether it can be sustained for very long.

In 2000 the FSA published one in its series of Occasional Papers, *"Cat standards and Stakeholders – their role in financial regulation".* The author, Paul Johnson, commented about savings habits:

> *"There is plenty of evidence that people with lower incomes do not save much. It is much harder to be certain that they do not save enough. The existence of state pensions, of means-tested benefits and the fact that poorer people suffer higher mortality rates than their richer counterparts all suggest that they may not currently be saving irrationally small amounts."*
>
> *"So while much of the target population of low earners is engaged in the financial services market already through pension provision, they are saving rather little in that context and are not much engaged in other saving markets. Those least likely to be engaged are, not surprisingly, those with unstable incomes."*

Johnson also noted the lack of consumer understanding and confidence:

> *"In fact the problem is not just one of understanding financial products but a general problem with numeracy. Research on adult literacy ... suggests that half the adult population in the UK cannot go beyond simple addition and subtraction and are unable to understand percentages, compound interest and other concepts fundamental to make sensible use of information provided either by providers of financial products or as a result of disclosure mandated by the PIA. This lack of basic skills translates into a lack of confidence (or unjustified confidence)"*

Mention has already been made of the FSA report *"Consumer understanding of financial risk"* and this commented on consumer attitudes to savings and investments:

> *"Those with no savings or investments often felt they had no spare cash to save (often because they were in debt already), wished to enjoy their money now and did little or no planning concerning their future. Those with savings but no investments felt that they had insufficient income to invest, wanted accessibility to their capital, and wanted control of their finances. They also had a poor awareness of the range of products available and a lack of trust in financial advisers."*

An important point made to me by one bank is that the general economic environment is an important factor in consumer decisions about savings and investments:

> *"The market is the biggest influence on customer appetite to purchase investment products. When the market is performing well customers have a high propensity to purchase products, however, when the market is performing poorly, customers want to manage their risks as best as possible.*
>
> *Our customer research tells us that in the current economic environment, customers are not simply looking for safer products in isolation. They are looking for 4 key elements:*
>
> *.A brand they trust – brand is an important customer consideration with many customers still uncertain where their money is safe*
>
> *.products that offer security - Capital security is an issue for all but the most sophisticated customers and a product which offers capital protection is a way of opening the customer's minds to considering an investment product. Customers see the risk in investing in an investment product as meaning they may not see their full capital returned to them. They do not (in general) see that the real return they are receiving on the Cash holdings may actually be falling. Cash is in their eyes a 'safe' option.*
>
> *.a trusted advisor – who they can talk through their investment needs with and who will treat them as an individual."*

7.14. Changes in circumstances

There are a variety of life events or changes in circumstances that might affect an individual consumer's wealth, or ability to save, or attitude to risk, or needs. One example is job mobility. In the November 2003 issue of Labour Market Trends there was an article on *"Job mobility and job tenure in the UK"*. This reported that in 1996 half of all employees had been working for the same firm for five years or less. By 2001 the figure had fallen to four years. In other words, for many employees job changes are common and it is reasonable to suppose that for some of them a move from one job to another will not be seamless but will be punctuated by a period of unemployment.

Another example is changes in family circumstances, and in particular divorce. According to the ONS the divorce rate in England and Wales in 2008 was 11.2 divorcing people per 1,000 married population. The 2009 edition of Social Trends reported that 51% of couples divorcing in England and Wales in 2007 had at least one child aged under 16. The report *"Asset ownership, portfolios and retirement saving arrangements"* noted that younger individuals are more likely to be divorced than older groups.

> *"Being divorced is associated with a lower probability of holding savings and investments and with a higher likelihood of being concerned about future financial security."*

It should not really surprise those who advise consumers or those who design products for them that there is a strong likelihood that an individual's circumstances may alter significantly from the point at which a financial product is sold to them. A change in an individual's circumstances is not a problem providing that the individual can maintain his or her commitment to a financial product. If, however, an individual is forced by changed circumstances to cash in a product or to cease payments into it there can be adverse financial consequences. This is particularly the case with life and pension contracts. Since the regulators started to publish information about the persistency of life and pension products some 20 years ago these have consistently shown a failure by many consumers to maintain policies even though they are often designed to be held for twenty or more years. If a policy is terminated there can be financial loss.

7.15. Pension saving

As noted above, to the extent that UK consumers do have financial wealth it is likely to be in the form of their pension saving. A pension is likely to be the most significant financial asset for most consumers and for many it may be their sole financial asset. So, for example the *"Wealth in Great Britain"* survey demonstrated the extent to which private pension wealth contributed to total wealth. An estimated 39% of total wealth in 2006/08 was said to derive from private pension wealth.

Or again, the FSA data on retail investment sales is that of the 2.8 million sales around half (1.5 million) were of pensions (unfortunately, in its consultation paper 09/31 the FSA also noted from its own persistency data for 2008 that only 41.7 % of group personal pension (GPP) business arranged by IFAs in 2003 was still in force after four years. Commenting on this the FSA said:

> *"Some lack of persistency will result from changes in individual employees' circumstances .... but the overriding conclusion is that GPP business is being moved around the market, with comparatively little true new business".)*

Although Paul Johnson's report, quoted above, found a low propensity to save among those on lower incomes he noted that coverage of pensions was quite extensive. He said:

> *"ownership of some private pension actually penetrates quite a long way down the income and wealth distributions. The DSS, for example, estimates that about half of those earning between £9,000 and £20,000 are members of an occupational pension scheme. Of the 5.3 million who are not members of an occupational scheme about 2.5 million contribute to a personal pension, with around one million being in a personal pension but contributing nothing in addition to the NI rebate. These figures chime in well with others which also indicate that, for pensions at least, the biggest problem appears to be not so much that people do not have one; rather that many of those who do are contributing rather little."*

Research by Black Rock conducted in the context of personal accounts suggests "widespread distrust and lack of understanding of pensions". The messages Black Rock was getting from its research were that pensions are:

- intangible (shrouded in mystery, no user friendly statement of holdings);
- not transparent (not easy to see where the money goes, cannot readily see the worth of the investment, may not grow/can fail, not trusted);
- locked away (30+ year investment, fear of not being able to get hold of the funds if needed);
- long tern mechanism (not worth starting for a few years contributions/short term, not seen as flexible);
- rigid (no sense of portability).

7.16. Conclusions on consumer characteristics

It seems clear on the basis of the evidence presented above that the majority of consumers are risk averse and are anxious to avoid nominal loss to their savings. However, in choosing “safer” homes for their savings, such as deposit accounts, they may be blind to the fact that over the long term they could still suffer loss through the corrosive effect of inflation. Based on these two factors it would seem there could well be a demand for a “safer” medium to long term savings or investment vehicle. It also seems clear that the vast majority of consumers have a very small amount of money set aside in savings or investments, which suggests that any form of “safer” investment vehicle should permit of regular savings rather than expect consumers to be in the position to invest lump sums. Although pension saving ought clearly to be a priority there is clearly widespread and deep mistrust of pensions. Another point which seems to stand out from the evidence is the need for flexibility in any “safer” investment vehicle because of the changes of circumstance which consumers can suffer (and in particular periods of unemployment which are likely to be much more common for those in the income range £10,000 to £30,000). What is not clear, however, is the number of consumers who might be in the market for a “safer” investment.

8. Existing product regulation

Product regulation already exists and it might be claimed that one aim behind the introduction of the present forms of product regulation is to make products safer. The two main examples of product regulation are dealt with here.

8.1. UCITS

The Investment Management Association (IMA) quite properly pointed to the fact that there is a longstanding system of product regulation in the UK governing collective investment schemes. The legal nature of the schemes may differ, some being unit trusts and others open-ended investment companies, but they are often simply referred to as "funds". The system of product regulation derives from a European Directive, Undertakings for Collective Investment in Transferable Securities – although that mouthful is usually shortened to UCITS Directive. UCITS was adopted as long ago as 1985 and although it has been subject to a number of revisions since the basic framework remains the same. A fundamental feature of the UCITS Directive is that such funds can be freely promoted to members of the general public throughout the EU. As implemented into UK law, through rules of the FSA, the Directive provides among other things for:

- how funds may be legally constituted
- investor relations
- the investment and borrowing powers of schemes
- the valuation of and pricing of units in a fund
- the responsibilities of the manager of a fund and the depositary

There has been no instance in which a unit trust has been declared in default which would have necessitated consumers making a claim on the Financial Services Compensation Scheme (FSCS). Also, in the year to end March 2009 there were just 191 complaints to the Financial Ombudsman Service (FOS) in respect of unit trusts out of a total of 127,471 complaints and the comparable figures for the year ended March 2008 were 114 complaints out of 123,089. So, it was not surprising that some in the fund management industry put to me the question why further regulation was needed to create "safer" products when UCITS already provided product regulation.

Although UK funds offer diversification and safeguards it is quite another matter to regard them all, or even most of them, as necessarily falling in to the description “safer”. Above all else, funds do carry a variety of risks and some funds are “riskier” then others. The Charles Rivers Associates report, already referred to, commented:

> *“Indeed, some argue that the UCITS Directives are unique in leading to the only financial product defined by European legislation and this has resulted in a de facto simple product. However, in practice the UCITS Directives place relatively few constraints on products, indeed the most recent version UCITSIII, has relaxed many of the previous requirements and has therefore included funds that were historically excluded from UCITS.”*

The liberalisation of the market has now gone so far that the European Commission is currently giving active consideration as to whether UCITS should now be classed as “complex” and “non-complex” schemes with possible differentiation in how they are then sold.

8.2. Unit-linked life assurance

It may not be appreciated by some consumers that if they hold “life assurance” what they actually have is two things bundled together. One part of the product is straightforward life cover which they could have bought separately. The other part is an investment and usually these days that means a unit-linked fund rather than a with-profits fund.(In 2009 Nottingham University’s Centre for Risk and Insurance Studies published a report *“The UK with-profits life insurance industry: a market review”* which noted a “dramatic” fall in with-profits new business from 42.6% of all new business in 1985 to just 3.7% of total new business in 2007.) Unit-linked funds are actually subject to some degree of product regulation although not to the same extent as UCITS. The FSA sets what are called “permitted link rules”. These rules determine the assets which life companies are allowed to use to support the promises they give consumers under life and pension unit-linked policies. The rules are set at a high level. What may also not be apparent is that in some cases unit-linked funds do no more than invest in authorised unit trusts often with both the unit-linked fund and the unit trust managed by separate companies within the same corporate group). Like unit trusts, unit-linked funds carry a variety of risks.

9. UK attempts to create safer or simpler products

Although two of the principal products within the UK retail investment market are therefore already subject to varying degrees of product regulation this has not stopped attempts at introducing additional layers of control with the aim of making the products concerned "simpler" or "safer" or offering fairer value. It is therefore worth considering what has gone before to see if there are any lessons that can be learned. As with this research, previous proposals aimed at product regulation have found it impossible to exclude consideration of issues relating to the distribution of such products. So, for example the introduction of stakeholder products in the UK was accompanied by the development of what was called a "Basic Advice" regime. It is convenient to deal here with developments relating to product design and to leave until later discussion of those proposals aimed at simplifying the sales and advice regime either as an accompaniment to product regulation or instead of it.

9.1. The Personal investment Authority

In 1996 the Personal Investment Authority (PIA) published a discussion paper called *"Evolution Project"* which looked at a wide range of areas of potential regulatory reform one of which was product design. It said:

> *"A thought which was discussed at a number of meetings with firms was the relationship between the extent of PIA's standards of advice and the nature and design of products. The suggestion put to us was that the PIA might consider a lighter regulatory touch, or indeed that it would not be necessary to apply any 'know your customer' or standard of advice requirements, where the products being sold had a number of virtuous features. Such features might include:*
>
> - *readily realisable; and*
> - *no penalty for early termination; and a transparent charging structure; and*
> - *the extent of the investment risk was plain (and quite possibly the risk would be low).*
>
> *There is a similarity here with the recently published proposals of the Consumers' Association which suggests that certain 'safe haven' products could be designated by the regulator and by which consumers would know that these products were suitable for certain core needs."*

The PIA said that it thought that the concept of such 'safe haven' or 'kitemarked' products was worth exploring further and sought views on the idea, despite what it described as some obvious potential drawbacks:

- *"that it smacks to some extent of product approval (which could involve conflicts with EU and UK law);*
- *the scope for dispute with firms over whether or not a particular product contains the virtuous features necessary to passport it to a lighter regulatory regime;*
- *precisely what regulatory exemptions might be granted to such a product (for example, could one rely entirely on disclosure)."*

In "*PIA's Evolution Project: The Next Steps*" published in 1997 the PIA reported on the views which had been put to it on the subject of product design and on the basis of which it had decided not to proceed with attempting to designate any products as "safe haven":

> *"The majority of respondents were against any involvement by the PIA in awarding kitemarks to products or designating them as safe haven products. This was for a whole host of reasons:*
>
> - *that it might mislead consumers into purchasing products which were not suitable for their circumstances;*
> - *that it might give purchasers of safe haven products a false sense of security, or alternatively that those who had purchased non-kitemarked products might be unnecessarily concerned about the safety of their investment;*
> - *the whole process of kitemarking or designation has the potential to be bureaucratic, costly and open to considerable dispute between firms and PIA;*
> - *there are potential concerns about the possible restriction of competition or possible conflict with EU legislation;*
> - *some thought that the designation of a product could not be a one-off event and that it would be necessary for PIA to track subsequent changes to the product to ensure that it still met the necessary standards;*
> - *some thought that it would be a risk for PIA itself in lending this form of regulatory support to a product in circumstance where it subsequently 'went sour' on a particular consumer;*
> - *some respondents thought it inappropriate to have a different standard of regulation simply because a product was kitemarked."*

9.2. Consumers' Association

The Consumers' Association (now known as "Which?") published in June 1998 a policy paper called "*Financial Products Regulation*". In the paper the Association said:

> *"Currently, when buying many financial products, the consumer cannot be sure of a minimum level of safety (unlike other sectors such as electronic goods). We have to rely on our own judgement or that of those selling the products. However, the number and sheer complexity of the products, make it impossible to make informed decision; the concept of choice is illusory. On the other hand, events such as the pensions mis-selling scandal have shown what can happen when the industry is left to its own devices.*
>
> *To date these problems have primarily been dealt with through process regulation, ensuring that certain procedures are followed during the selling process. But as our research has shown, this has not worked.*
>
> *We'd like to see a new approach taken, based on the levels of risk involved and using minimum standards to force really poor, high risk, products out of the market. "*

9.3. CAT standards

In fact, at the time the Consumers' Association paper was published, HM Treasury had already been working on a form of product regulation but based on a voluntary footing. This initiative was announced by the Economic Secretary to the Treasury on 1 October 1998 and was known as "CAT standards", the "CAT" standing for charges, access and terms. CAT standards were developed for the Individual Savings Account (ISA) market and there were different standards depending on whether the ISA concerned was cash, insurance or stocks and shares. The stated aim of CAT standards was to help inexperienced savers recognise products which they will find easy to understand and which should give them a fair deal. (So, note that it was not an aim of CAT standards to necessarily make products "safer".) The standards developed for each type of ISA were therefore designed to ensure reasonable charges, easy access and fair terms. CAT standards were entirely voluntary so product providers who decided to launch such products were effectively self certifying that their products met the CAT standards, and there appears to be no evidence that any provider made false claims to an ISA being CAT standard when in fact it was not. The marketing material produced by providers was, of course, subject to regulatory oversight by the FSA. In addition, HM Treasury specified that when marketing CAT ISAs providers should not imply that they were always suitable for savers, that the performance was guaranteed, or that the products were Government approved.

9.4. The Sandler Report

On 18 June 2001 the Government announced a review of retail savings to be led by Ron Sandler. This review led to the publication in July 2002 of Ron Sandler's report "*Medium and Long-Term Savings in the UK: A Review*" ("the Sandler report"). The analysis presented in the Sandler report has relevance to a number of aspects of the issue of "safer" products and so frequent reference is made to Sandler throughout this report. The main conclusion of the report was as follows:

> *"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.*
>
> *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...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 consumers.*
>
> *The Review therefore recommends 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"*

The phrase "certain additional safeguards" should be noted as it is a point to which I return when discussing the selling regime for products.

The conclusions Sandler reached were built up through a detailed analysis of various aspects of the market. The analysis is still relevant today. It is worth considering the analysis in some depth because it supports the case for "safer" products and gives some pointers to some of the possible characteristics of "safer" products. The following sections therefore consider four areas covered by Sandler supplemented by other evidence. The four areas are:

- product proliferation;
- charges:
- passive versus active management; and
- asset allocation.

9.5. Product proliferation

The Sandler report drew attention to the proliferation of products in the retail savings industry "some of which are fundamentally the same but are marketed as being different". If anything the Sandler report underestimated the number of products. According to the latest FSA Annual Report the number of authorised and recognised collective investments schemes is 1,811 (compared with the 1,600 different schemes quoted by Sandler). But the number of authorised schemes does not give the full picture. There has been an increasing trend for a single authorised or recognised scheme to be structured to consist of several sub-funds in which consumers can separately buy units or shares. If sub-funds are looked at the choice facing consumers rises to 7,042 different sub-funds. Then there are unit-linked life assurance and pension funds and with-profit funds. The Association of British Insurers was not able to give figures for the number of unit-linked funds in existence but on the basis of performance data for funds published in the magazine "Money Management" it would seem that there may be well over 4,500 thousand unit-linked life and pension funds. In addition to these there are also several hundred investment trusts and a growing population of exchange traded funds.

Since the Sandler report was published there has if anything been a worsening in the position regarding the diversity in the market. In June 2009 Lipper published *"Profiting from Proliferation"*. This report was looking solely at the fund management industry in Europe. It commented:

> *"New launches drive a significant proportion of mutual fund sales: the number of funds has increased by 70% over the past ten years; percentage management fees do not fall as assets rise"*
>
> *"Launching new funds has been a significant feature of the European industry for the last decade, with over 2,500 mutual funds launched each year"*
>
> *"There is around one mutual fund for every 1,000 active investors. The resulting emphasis placed on distribution (the ability to reach the investors) has been inevitable".*

9.6. Charges matter

There is a wealth of evidence that charges have a major effect on the returns which consumers can obtain from an investment.

Sandler drew attention to the lack of competitive pressure on price. He said this was:

> *"evidenced by the persistence of wide variations in fund charges. This is most striking for passively managed funds, where annual charges vary from 0.3% to more than 2% across providers of broadly similar products. Variations in quality between passive funds are not such as to justify such wide variations in price".*

It is significant that many of the UK's professional financial planning firms draw attention to the importance of charges. Gareth Marr of The Red House Consultancy (and also the current Deputy Chairman of the Financial Services Skills Council and a former Deputy Chairman of FIMBRA) commented:

> *"Like inflation, costs are insidious – a percentage here or there does not sound very much but it is. Small differences in return compound into large differences over extended periods of time."*

Evolve Financial Planners give a clear illustration of how charges can eat into returns over the long term. On an investment of £250,000 growing at 7% a year for 20 years there would be a return to the investor at the end of the period of £791,260 if charges were only 1% per annum. But if the charge is increased to 2% the return is reduced to £645,858, the investor has lost over £140,000 in extra charges.

In 2000 the FSA published one of its Occasional Papers on *"The Price of Investing in the UK"* by Kevin James. In his paper James established a new measure MP1 to represent the cost to consumers of investing in an investment fund (whether unit trust or life office unit-linked fund). If consumers incurred no costs whatsoever when investing in the stock market they would get back the total return in the market and MP1 would be measured as 1. Obviously it would never be possible for consumers to invest in the stock market without incurring costs and so one would expect the MP1 for a fund to exceed 1. So as to provide a benchmark against which to assess the costs being borne by consumers when investing in funds James calculated the MP1 of investing though a notional "Minimum Cost Efficient Markets" (MCEM) fund. The MP1 of an MCEM fund is just enough to provide retail investors with the core portfolio management services they require and to pay for a degree of active management sufficient to bring about efficient markets. The MP1 of the MCEM fund was estimated as 1.15. James found that consumers were incurring an MP1 of 1.5 on average in an actively managed unit trust or life office unit-linked fund. The difference was accounted for by a combination of direct charges and costs arising from dealing and not all these charges are apparent at the time of investing. For index-tracker funds the cost of investing was lower, with James estimating the MP1 as 1.2.

Another very important aspect of the James report and one which tended to get overlooked at the time is what he had to say about the price of investing through life offices. James said:

> *"Life offices offer highly mediated investments characterised by complicated charging structures and significant amounts of investor pooling. A given investor's return is thus highly dependent upon his or her exact policy and circumstances. It follows that performance data comparable to those one finds when examining unit trusts and mutual funds are simply not available."*

"Furthermore, while regulations require that each life office files an annual statement of its financial, position; single economic entities sometimes find it convenient to divide themselves into numerous legal entities for reporting purposes. Allocating joint costs across these entities is no doubt influenced by accounting convenience as well as economic fundamentals."

"Calculating the average price of investing through a life office on an investor by investor basis is therefore impossible and even doing so on an office by office basis is difficult."

The approach that James took to try and deal with this "fog" surrounding the cost of investing through life offices was to combine all life offices together and then treat the combined single entity as a single "unit trust". As James observed about his approach:

"By approaching the price of investing through life offices in this way, I am treating life offices as pure investment funds. In doing so, I am ignoring two key aspects of their business, namely pure insurance and risk reduction (this latter point though was made in relation to with-profits business which was an important source of new business at the time of the report but is no longer so). If these aspects of the business add significant amounts of value to the policies investors purchase, then by ignoring them my approach will overstate the true price of investing through life offices (or underestimate the services which are purchased for this price)."

So as to assess the potential magnitude of each of these factors James considered each in turn. On the pure insurance aspect of life office business he noted that:

"total claims arising from death, 'other insurable events' and permanent health policies accounted for less than 9 per cent of total claims paid out by life offices in 1997. Even this 9 per cent figure overstates the claims that fall under 'insurance' properly considered, for in many cases if claims due to death (the principal source of 'insurance 'claims) the claim paid out is worth no more than the invested value of the premiums paid in (a unit trust would provide the same benefit to one's heirs). Thus, life offices can be thought of as essentially running investment funds with a small pure insurance element. Ignoring the value an investor may assign to the insurance element should not therefore greatly distort my analysis."

The thrust of the conclusions in the report was that investors were making their decision about investment funds on imperfect information principally because of the high dealing costs associated with actively managed funds which were either not disclosed or not disclosed clearly enough. James estimated that if management charges for funds could be brought down by as little as 10p it could add an extra £4 billion per year to the investment income of consumers.

9.7. Passive versus active management

An issue that has been hotly debated over the years is the respective merits of passive versus active management of investments. Sandler commented on this to the effect that investment-decision making does not appear to function effectively. Sandler said:

> *"Recent research showed that the average UK unit trust underperformed the market by 2.5% per year due to a combination of higher charges and unsuccessful asset management"*
>
> *"Correlation between higher charges for unit trusts and superior investment performance is at best weak. Consumers who pay more usually receive no additional benefit."*
>
> *"A greater percentage of products are actively managed than in the institutional market, despite the fact that institutional investors generally are better equipped to identify superior investment managers".*

In "*The Arithmetic of Active Management*" William F.Sharpe said that the criticisms of active managers on the passive approach to investment management:

> *"can only be justified by assuming that the laws of arithmetic have been suspended for the convenience of those who choose to pursue careers as active managers. If 'active' and 'passive' management styles are defined in sensible ways, it must be the case that:*
>
> *1. before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and*
>
> *2. after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.*
>
> *These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required."*

Again, many professional financial planning firms eschew active management. Gareth Marr of The Red House said:

> *"There is a very simple truth to the active management game – for every investor who beats the market, there has to be an investor who loses against it".*

Evolve Financial Planners say:

> *"Active fund management is based on two main beliefs. Firstly, that markets are priced inefficiently so that good fund managers can pick stocks that are undervalued. Secondly, that these same individuals have the ability to time investment decisions, in other words know when is a good time to buy and when is a good time to sell. There is ample evidence to suggest that neither of these claims is correct."*

In April 2003 the FSA published a report *"Performance Persistence in Mutual Funds"*. The report was commissioned because of the ongoing debate between the regulator and the fund management industry on the validity of publishing past performance data when promoting funds. The report disagreed with the approach taken by Charles Rivers Associates in the studies which it had carried out for the Investment Management Association on the issue. The FSA commissioned report said:

> *"We do not think that the publication of persistence measures that induce investors to seek more risk are in the best interests of investors. No skill is needed on the part of a fund manager is required to select a high-risk strategy. To the extent that superior performance in raw returns merely reflects higher levels of risk, it can be replicated at lower cost (since active fund management fees can be avoided) by using geared or leveraged investment strategy based on tracker funds. If the purpose of performance league tables is to enable investors to select the most skilfully run mutual funds, performance should therefore be measured and reported on a risk-adjusted basis."*

The report therefore concluded that:

> *"there is a reasonable case for arguing that risk-adjusted past performance data should be included in the FSA's Comparative tables. This is not because of the traditional argument over whether superior performance might or might not persist, which we regard as inconclusive, but rather because of the evidence that inferior performance seems to persist."*

Frontier Capital Management in an article published in 2007 titled *"When is a Total Expense ratio not a Total Expense ratio"* observed that active funds incur greater transaction costs than passive funds.

> *"Very simply put, the more often a fund buys and sells securities the greater the level of costs incurred."*

Frontier, using data from the FSA and Lipper Fitzrovia, observe that the FSA estimated:

"the average transaction costs of trading for UK large cap active funds at 1.8% (based on 100% asset turnover)" but that costs could be even greater because "for some equity funds as almost a quarter have a turnover greater than 100%. In contrast the median UK index tracking fund has a turnover of only 13% and investors in these funds will pay much lower ... costs as a result".

The firm Dimensional Fund Advisers in a comment piece ("*Managers vs. Markets*", May 2010) said:

"Proponents of active management believe that skilled managers can outperform the financial markets through security selection, market timing, and other efforts based on prediction. While the promise of above-market returns is alluring, investors must face the reality that as a group, US-based active managers do not consistently deliver on this promise, according to research provided by Standard& Poor's. Over the last five years, about 60% of actively managed large cap US equity funds have failed to beat the S&P 500; 77% of mid cap funds have failed to beat the S&P 400; and two-thirds of the small cap manager universe have failed to outperform the S&P Small Cap 600 Index. Furthermore, across the thirteen fixed income fund categories, all but one experienced at least a 70% rate of underperformance over five years. Of course, the results of these studies will fluctuate over time, and a majority of funds in a given category might outperform over the short term. But the message is clear: As a group, actively managed funds often struggle to add value relative to an appropriate benchmark—and the longer the time horizon, the greater the challenge for active managers to maintain a winning track record."

9.8. Asset allocation

A frequent comment made by firms was the importance of asset allocation or, quite simply, "not putting all your eggs in one basket". Sandler commented:

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

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

A widespread consensus exists among investment theorists that, in most circumstances, the asset allocation choice is far more important in determining overall investment performance than is the set of security selection decisions"

In general terms, the aim should be to spread investments across different asset classes and in different proportions according to the individual's attitude to risk, their time horizon, and whether or not they are aiming to reach a certain target return.

Combining asset classes can actually help to reduce risk as Black Rock comment:

"Combining low-correlating assets can help to diversify portfolio risk. Ideally, if an investor holds assets that are negatively correlated (when one goes up the other goes down) the overall volatility of the portfolio would be minimised"

Gareth Marr commented:

"From an investing perspective, asset classes that do not perform in the same way can help to make the investment journey smoother without giving up return when combined together. Combining two asset classes together whose return patterns are independent of one another can reduce the risk of a portfolio by a quarter. If you can find four such asset classes, the risk can be halved without giving up return."

Another noted financial planner John Lang of Tower Hill Associates sets out the investment policy of his firm as:

"built on evidence from academics at the leading edge of financial science. At its heart is the empirical study by Brinson, Hood and Beebower which concluded that over 90 per cent of the variation in investment returns was determined by Strategic Asset Allocation (the high level mix between equities, bonds, property and cash)."

9.9. Sandler's conclusions from the market analysis

Sandler concluded from his analysis that a well-functioning market would be one which included the following features:

- products are simple and straightforward, with differentiation occurring only when it adds value to consumers;
- there is a strong focus on asset allocation;
- there is a 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.

As noted, Sandler's proposal for delivering this well functioning market was the introduction of a suite of simple and comprehensible products to be called "stakeholder products". Leaving aside with-profits products, for which Sandler found it necessary to specify a special set of conditions, it was proposed that mutual funds and unit-linked funds should have the following features:

- There should be no initial charge, and annual charges for stakeholder products should be regulated. Sandler said that he was aware that setting charges was controversial. He suggested that given the existence of CAT ISAs and the existing stakeholder pension, a 1% ceiling would be a suitable starting point for the annual charge.

- There should be strictly regulated surrender charges –ideally none at all.

- Through regulation, there should be limits on the investment risk of the stakeholder product.

9.10. Stakeholder pensions

In fact, before Sandler's report was published the Government had already taken steps to introduce Stakeholder pensions from 6th April 2001. Their aim was to encourage more long term saving for retirement, particularly among those on low to moderate earnings. Stakeholder pensions were required to meet a number of conditions set out in legislation. These conditions included a cap on charges, low minimum contributions, and flexibility in relation to stopping and starting contributions. Originally, the maximum annual charge was 1% of the fund value each year but from 2005 this was increased to 1.5% of the fund value for each year until the 10th year and 1% thereafter.

9.11. Other stakeholder products

In 2003 the Government decided to act on the rest of the Sandler recommendations and in February 2003 HM Treasury published a consultation paper on the proposed standards for the design of stakeholder products.

The Treasury said that key features of the products would be:

- simplicity – the products would have strict limits on their features in order to ensure that they are easy to understand
- risk controlled – each of the products would have investment restrictions in order to limit the potential loss to the consumer
- low cost – the products would be charge capped in order to ensure that they are good value for money.

In July 2003 the Treasury announced decisions on the features of stakeholder products following its consultation. It said:

> *"These products, to be known as 'stakeholder' products, will address the basic needs of savers and are particularly aimed at those on lower incomes. They will go on sale in 2005."*
>
> *"A suite of three products will be introduced:*
>
> *A short-term investment product. The existing CAT standard cash ISA will become part of the stakeholder suite.*
>
> *A medium-term investment product. There will be two investment options, both with a maximum equity exposure of 60% of the fund's value: a pooled investment product; and an investment product with smoothed returns based on Ron Sandler's proposed ideal model for with-profits.*
>
> *A long-term investment product. The existing stakeholder pension will become part of the suite. There will be a requirement for the default fund to be life styled."*

In addition, the Government made clear that when it gave details later in the year of Child Trust Funds these too would be available within the stakeholder suite.

The Government deferred a decision on the precise level of the charge cap so that it could take account, among other things, of the work which the FSA was doing on the sales regime for stakeholder products (of which more later). In June 2004 the Treasury was finally in a position to announce the caps. It said:

> *"Cash deposit account: the rate of interest payable must be within 1% of the Bank of England Base Rate. This is a reduction from the current 2% margin allowed in cash ISAs."*

"Medium term investment product and pension product: there will be an annual management charge capped at 1.5% for the first 10 years that the product is held and 1% thereafter."

9.12. Personal Accounts

Stakeholder pensions have not been the success that Government had hoped, as we shall hear later. This has led to another attempt to solve the problem of lack of pension saving and that is the introduction, among other things, of so called "personal accounts" which are being designed by the Personal Accounts Delivery Authority (PADA), (which from July 2010 became the NEST Corporation).

According to PADA there are around seven million people in the UK who are not currently saving enough to generate the pension income they are likely to want, or expect, in retirement. Against that background the Pensions Act 2008 has introduced further reform of workplace pension arrangements. Starting form 2012 employers will have to automatically enrol all their eligible employees into a pension scheme that meets or exceeds certain legal standards (one of which is to set a minimum contribution that employers have to contribute to their employees' pension funds). Automatic enrolment should overcome one of the problems with stakeholder pensions: the inertia of many employees needing to be persuaded to enrol in a stakeholder pension; but that persuasion was often lacking because many in the industry did not feel there was sufficient margin in stakeholder pensions to market them successfully.

A key part of the reforms is the introduction of personal accounts which will be a national, low charge, workplace pension scheme which any employer can use to meet their obligations to enrol employees in a pension scheme. One of the objectives is to help those –typically on low-to-moderate incomes- who currently don't have access to a workplace pension. In the context of this report the key features of personal accounts are that it will be low charging and will adopt an investment approach designed specifically for low-to-moderate earners and so it may provide some useful pointers to the construction of "safer" non-pension investment products.

In 2009 PADA published *Building personal accounts: designing an investment approach*" which set out its conclusions from the consultation on how it should approach the issue of investment. There seemed to be a general consensus that because the target group for personal accounts is those on low-to-moderate incomes they will have less money to save or invest. It is therefore likely that such consumers will be less exposed to financial products and less inclined to take risk with what little savings they have. There was also a general view that consumers saving into personal accounts are likely to find making financial decisions difficult and for that reason it was expected that the majority of them would be in the default fund, not necessarily because it suits their personal circumstances but because they do not feel comfortable making their own choice about which fund to choose for their investment.

Respondents to the PADA consultation also considered that personal accounts would be the only long term savings vehicle of members and their main source of income, other than the State Pension. This last is an important conclusion for this present report. The target population for personal accounts will include many consumers who are also among those at whom “safer” savings and investments might primarily be targeted. But such consumers simply would not have the wherewithal to save for both a personal account and a “safer” investment and between the two priority should probably be given to personal accounts. This analysis raises a further question over the potential size of the market for non-pension “safer” products, or indeed any other investment product.

It is interesting to note that PADA was also told that given that its members would have low-to-moderate earnings and breaks in employment would be typical for them it was thought that the members would only be able to save small amounts and will be unable to contribute continuously for 30 to 40 years. This chimes in with what was said earlier in this report about the target market for “safer” investments being more likely to consist of regular savers than lump sum investors, and that because they are likely to suffer a variety of changes in circumstances they are unlikely to be regular savers on an uninterrupted basis.

A key decision for PADA has been choosing the investment objective for the default fund, in which the vast majority of its members are likely to be invested, taking account of such factors as the attitude to risk of its members (who are risk averse) and that for many their personal account is likely to be their only source of saving for the future. An interesting aspect of PADA’s report on its consultation about the investment objective is the divergence of view between those who thought the investment objective should be based on what members need and those who thought it should be based on what members want. Apparently the majority of respondents to PADA thought the objective should be based on what members need based on their economic circumstances, an approach which might not match the risk tolerance of members. A minority of respondents, particularly consumer representative groups, argued that the investment objective of the default fund should instead be “broadly consistent with the risk tolerance of members”. They felt that it was necessary “to preserve members’ capital both in the short term and the long term, otherwise any reductions in members’ savings are likely to discourage them from making regular contributions into personal accounts”. The outcome of PADA’s consultation is that it has decided to adopt an investment objective for the default fund of personal accounts that seeks returns in excess of inflation after management charges. PADA is currently still examining the extent of the excess return which should be set for the default fund. At this stage it is probably fair to say though that PADA has chosen an objective which is essentially cautious and the intention appears to be to be especially cautious in the early years of the scheme so as to build the confidence of members.

The way in which the default fund will be managed to meet the objective is also interesting. PADA will seek to have the default fund invested across a broad range of the traditional asset classes such as equities, bonds and cash. It will also, however, invest in what are termed “alternative assets”, that is assets such as commodities and private equity funds. Altogether this could mean the default fund investing in up to 13 different types of asset, the aim being to achieve a very broad diversification and consequent risk reduction. The management of the assets in the default fund will be largely passive in its approach mainly because of the low charges attached to such an approach, but also because of doubts about the sustainability of an active approach over the long term. However, PADA is going to allow active management in some limited areas where it could add value, such as in emerging markets. This was not, however supported by all respondents to PADA who considered there were other ways of accessing alternative asset classes without the need for active management.

There are a variety of ways in which the investment approach of the default fund could be tailored to fit the needs of members over their working life and as they reach retirement. PADA has decided to go for what are called “target-date funds”, already popular in the USA, because they are easier to explain to members and they have advantages in flexibility and cost. In essence, members are invested in a fund that corresponds to their expected retirement date and the assets of the whole fund are move towards a lower risk profile as the fund reaches the target date.

Although it seems likely that the vast majority of the members of personal accounts will end up in the default fund, PADA will be offering a choice of other funds for those who want a different approach. This will include various risk-graded funds, but more importantly will include funds which are religious-compliant, or ethical in their approaches.

9.13. Annuities

One issue that PADA is currently tackling is how members of NEST will secure their income in retirement. This, however, is not a new issue as it faces almost every consumer coming up to retirement and wishing to take an income from their pension pot. There is also an ongoing debate about whether or not annuities are always the best option for providing a retirement income. For example, the IMA published in 2008 *“Enabling Choice for Retirement”,* a discussion paper which looked at various innovative alternatives to the lifetime annuity. There has not been time in the scope of this report to consider the complex issues around the design of annuity products and possible alternatives. So instead I have accepted the fact that the vast majority of consumers will still buy a lifetime annuity and focused on how annuities are bought.

I have heard a few in the industry describes annuities as “simple”, that seems to me nonsense. Buying an annuity is a once in a lifetime and irrevocable decision. Once purchased a lifetime annuity will govern not only the income of the annuitant but also that of any dependants. There are many annuities to choose; single life or joint life; level or inflation linked; investment-linked or not; impaired life and so on. Even if a consumer is clear what type of annuity to buy the actual level of income they will get may vary considerably from one provider to another. But many consumers simply buy the annuity offered by the provider with which they built up their pension pot even though it may be the wrong annuity for their circumstances or may offer a much lower level of income than they could obtain elsewhere. Consumers do have what is called the “Open Market Option” (OMO) and if they exercise this then they may take their pension pot to see if they can get a better annuity deal elsewhere.

Although the FSA has made efforts over the years to try and encourage greater use of OMO the measures have generally been pretty ineffectual. Both The Pensions Advisory Service (TPAS) and the FSA have on their websites decision type trees which should be of some help to consumers who have the confidence (whether well founded or not) to choose the type of annuity that best fits their circumstances, but then the consumer is on his or her own in trying to arrange the annuity. It is also the case that the ABI is, as part of its plans for “Simplified Advice” (dealt with below) looking at how to help consumers with their annuity choices. Although this is commendable I cannot envisage individual insurers being happy to see large chunks of money (because although individual pension pots might be small collectively they can amount to a tidy sum) moving out of their management to that of a competitor. It does not need the insurer to act in any way that is unfair, they simply need to rely on customer inertia (“stay with us for your annuity and we’ll help you sort it all out, but if you want to go elsewhere you will have to fix it yourself”).

Research only just published by the ABI *“Pension annuities and the Open Market Option”*, and which I have therefore not had the time to consider in detail, seeks to put a positive slant on the annuities market. It points to the fact that two-thirds of annuitants arranged their annuity “internally” that is through the provider of their pension rather than going to other providers through the open market option. The ABI then goes on to summarise its research as follows:

- *”The majority of providers (17 out of 23) offer ‘internal’ annuity rates on the most popular product (a single-life level annuity) that are at least 95% of the highest rate available externally”*
- *“Eighty-five per cent of customers purchase a single-life level annuity at a rate of at least 95% of the highest external rate.”*
- *”The lifetime gain from buying the highest paying annuity available externally compared to the average internal annuity is £530 for a pension fund of £10,000”.*

There are a number of comments I would make on the ABI's research:

- It is still the case that by failing to shop around two-thirds of consumers buying annuities may not be getting the best deal.

- The ABI refers to the single-life level annuity as the "most popular" product. I am not sure this gives an entirely fair picture. When a provider sends a quote to a customer stating how much their pension pot can buy the provider cannot, quite reasonably, give a quote for every conceivable type of annuity the customer might wish to choose. The quote that is sent is for a single-life level annuity, I suspect customer inertia or ignorance then sets in and that is the type of annuity the customer accepts (rather than it being a popular "choice"). But a single-life level annuity simply may not be suitable for many customers. A customer with a dependant partner, for example, should surely be thinking about a joint-life annuity. A customer retiring at 60 might have another 30 years to live and surely ought to be thinking about an index-linked annuity.

- Because it is the single-life level annuity which all providers seem to quote it does not surprise me that there is some convergence in the rates they offer. In that way any customer who takes a brief look at what can be obtained from different providers may well conclude that it is simply not worth the time and effort of going down the open market option route if the rates on offer from different providers are not that different. What I would be interested to know is if the same convergence exists in the rates on offer for the types of annuity for which providers do not provide an automatic quote. I suspect that the differences in rate for other types of annuity are far more pronounced than for a single-life level annuity.

- Even for the single-life level annuity the ABI quotes it is still the case that 15% of customers get an annuity that is less than 95% of the best rate available. Over the many years during which these customers get paid their annuities they could be losing substantial sums of money.

Research by PADA found that among consumers:

> *"there was lack of awareness about the issue of securing an income in retirement. Most people were unaware of the choices that had to be made, and the options that were available to them."*

Although in other respects PADA has set out admirable proposals for personal accounts it seems to me that those it has put forward for choosing and buying an annuity simply do not go far enough. PADA says:

> *"We sought views on a proposed structured choice approach which would help to guide members through the process of choosing an annuity type, followed by a focused choice, which would enable them to buy an annuity from a limited range. This would largely be a self-service method, automated as much as possible to keep costs to members low. While generic information on the types of annuity would be available to members, we would not provide the member with any regulated financial advice."*

The Consumer Panel itself, in its response to PADA, thought that the proposals did not go far enough and suggested that there might be a greater role for Money Guidance and The Pensions Advisory Service, or that PADA should explore options for paying for advice. Although both PADA's proposal and those of the Panel represent a significant advance from the position today I think that they are not radical enough. Even for personal accounts it would still be the case of a consumer having to take the initiative and seek advice. And it would do nothing for those with a personal pension who face the same annuity choices.

I think it is worth the FSA and PADA giving joint consideration to making it the default position that all consumers reaching their retirement date should not only be offered the Open Market Option but more importantly should take advice on the issue of what type of annuity they need. Something like an "annuities clearing house" could be created to which consumers would be referred to get regulated advice and for which they could pay through adviser charges. Such a clearing house would be dealing with very high volumes of business, and it would be a specialist, and so it ought to be possible to provide advice at low cost (indeed I would suggest that the FSA and PADA set an acceptable level of fee). Although such a clearing house would be the default option it would still be open to an individual to opt out and to either choose and arrange the annuity themselves or to go to their own financial adviser.

9.14. FSA and product regulation

As noted above the FSA does already have a role in relation to product regulation: it gives effect to the UCITS Directives through its rules and it then authorises or recognises schemes; and it also sets out some high-level standards for unit-linked funds. But in a speech in September 2009 one of the FSA's managing directors, Jon Pain, seemed to indicate that there might be a sea change in the FSA's approach to product regulation.

Pain said:

"The events of the last two years invite us to question some of the assumptions we have held in the past. The Turner Review particularly challenged the idea that the FSA should avoid regulating financial products – an idea that has been part of our regulatory philosophy until now.

In the past some markets have failed to work well for consumers, and financial innovation has in some cases delivered little benefit. Problems with mortgage endowments, bank charges, pension products and payment protection insurance mean we have to explore alternative approaches to ensure that products and services sold in the retail market are designed to meet the needs of consumers and are targeted accordingly.

Consequently we will approach product regulation with an open mind in future. We would see the term 'Product regulation' as encompassing a whole spectrum of possible measures. It can be about pre-approving and banning products or alternatively setting parameters or constraints around certain design features.

So why might we consider introducing a form of product regulation? The reasons for introducing product regulation are based on the limits of the other tools we currently use. In our experience, we have seen the limits of what can be achieved with tools such as disclosure of product details and charges. In the past, we have attached great importance to ensuring that consumers were given the right information in order to enable them to make the right choices.

However, experience has shown that although this might be necessary, it is not a panacea to enable consumers to deal with product complexity and make informed choices. The consumer must be able to understand the nature of the products they are actually buying and how it meets their needs, which is why of course financial capability is so important. The number and complexity of financial products needs to reflect the needs of consumers, not merely the needs of product providers.

Product regulation could potentially not only improve consumer outcomes but also change competition dynamics within the market place. Arguably, product regulation could lead to more standardised products which could incentivise firms to offer better value rather than compete on extraneous bells and whistles. This could also bring economies of scale

However we recognise that product regulation may be too blunt a tool to achieve all the outcomes that we desire and that it poses considerable challenges. We will have to be sensitive to the economic effects of regulating product design. We would need to ensure that intervention does not introduce more problems than it solves.

We are also aware that the public authorities are not generally good at designing products and that financial firms should be better placed to do this. From a firm cost perspective, product regulation could also encourage firms to focus exclusively on high income consumers and exclude others. Some argue that product regulation would limit consumer choice and stifle innovation in a competitive environment. One of the challenges for us would be to differentiate between good and bad innovation. We want to foster good innovation that brings better products to the market place. At the same time, we realise that some 'innovative' products may contain exploitative features or unnecessary complexities.

So, when considering product regulation, we must also ensure we do not see it as a panacea or a substitute for other tools, such as regulation of financial advice. Surely a vanilla product can still be 'mis-sold' if a consumer does not actually need it."

However, by November the FSA seemed to be back tracking somewhat on how far it would move towards production regulation when one of its directors said in a speech in November 2009 ("*Annual Conference Conducting Business with Consumers – Delivering the Best outcomes"):*

"Finally, I would like touch on product regulation .. there have also been some misunderstandings about this and I wanted to clarify what is in our minds when we talk about product regulation. One form is familiar to many in the audience today – that is the authorisation of a product, like a regulated collective investment scheme, allied with a ban or restriction on marketing products which do not meet the criteria for authorisation.

But the term encompasses a much wider range of potential interventions than that. (It includes) looking at firms' business models, as we are increasingly doing, both at the point of authorisation and on an ongoing basis, involves considering the products they are offering and who they are offering them to. As Hector Sants said earlier this month, we are now firmly into the realm of making judgements about judgements taken by firms and how they affect consumers. This does not just cover business models and incentives, but also the products that they sell."

10. European attempts to create safer or simpler products

We have already noted that the UCITS Directive has provided a long-standing framework for the regulation of mutual funds, but there have been other moves to reach pan Europe solutions in other areas and particularly pensions.

10.1. Charles Rivers

In 2004 Charles Rivers Associates (CRA) was commissioned by the European Commission to carry out a study of the potential for simplified products in Europe. CRA's report was published as *"An assessment of the extent of an identified need for simplified, standardised financial service products"*, (the CRA report). CRA considered from a theoretical perspective why a simplified product might be beneficial to help establish:

- *"the types of market conditions where benefits may arise from the development of simplified products and whether they are not likely to be useful;*
- *where alternative forms of regulation might be substitutes for simplifying products and where different forms of regulation would be complementary; and*
- *the questions and data required to understand where these benefits might be greatest."*

CRA went on to observe that:

> *"The major reason put forward in the literature for the regulation of financial products is the existence of asymmetric information i.e. when consumers know less about the market than the providers. There are several different aspects of the nature of financial products that lead to this information asymmetry, namely that:*
>
> - *they are complex, and consumers have limited understanding of them,*
> - *their quality can be hard to ascertain before acquisition (with some elements of quality not even being revealed after a long period of time), and*
> - *they are infrequently purchased by retail customers."*

CRA provides a lot more theoretical analysis but it concludes that, from a theoretical perspective, the implications of the literature are:

> *"Simplified products are most likely to be valuable where:*
>
> - *the product has many characteristics that need to be taken into account to determine whether the product is suitable; but*
> - *there is little differentiation that it is valued by consumers i.e. a simplified product meets the needs of the significant group of consumers."*

Moving on to what CRA found in practice among the Member States, it said:

> *"We found that in eleven of the other fourteen Member States there were products that could be described as simplified which have been developed. Compared to the seven simplified products that have been launched in the UK, we have only identified nineteen products that we have categorised as simplified in the other fourteen Member States. However, we found that these were predominantly focused in two products areas: bank accounts and private pensions."*

CRA also noted that:

> *"There is considerable concern regarding the complexity of life products in a wide number of Member States. In many countries, the products are seen as opaque and difficult to compare. Indeed, in many countries there is a concern regarding the value of the product if products are held only for a short period of time and consumers are not able to switch between providers."*

In spite of this concern CRA said:

> *"However, we have not found any simplified life products (other than in the UK) or strong direct support for such a product to be developed."*

CRA described as "surprising" the failure to develop simplified life assurance products, except in the UK:

> *"when the underlying issues around life contracts appear to be very similar to those of pensions. It is possible that the lack of enthusiasm ... reflects the history of deregulation. In particular, there is a concern that liberalisation of insurance products was largely driven by European legislation. Many countries claimed that prior to the Third Life Directive product design of life insurance was much more closely regulated than it is*

today; and this involved product design and charging structures being presented to the regulator before the product is authorised."

"It was noted in a number of countries that investment based life insurance products involve bundling together an insurance contract with an investment fund. However, the value of the whole -of –life component of the contract and the value of the investment part of the contract are not separated. Hence it is impossible for the consumer to compare this bundled product to the cost of separately purchasing a whole-of-life policy and an investment fund. In some countries, there have therefore been calls for these two components to be separated in order that consumers can assess the value of the bundled product in comparison to the cost of the separate products. It has also led some regulators to suggest that consumers should insure their lives in a traditional life contract and invest in a pure savings instrument separately. Finally, the complexity regarding the relationship between the return on product and underlying investment is seen as an important argument for standardisation or simplification. It has often been almost impossible for the consumer to understand the relationship between the returns on underlying assets and the resulting returns to them. This is particularly the case for non-unit-linked life insurance, but even with unit-linked life insurance there are concerns that charges have been very opaque in the past implying that consumers struggle to understand the returns that they should expect."

It seems to me that the CRA report and the Kevin James report covered earlier point to the possible need for the FSA to undertake a study to determine whether or not consumers would be better served by the "unbundling" of unit-linked life assurance. Such a study might look at:

- consumer understanding of the product they hold, that is whether they understand they have principally an investment fund with some protection;
- whether those consumers whose principal need is for protection understand that they might do better to take out a pure protection product rather than a unit-linked investment one;
- whether those consumers who have taken out a unit-linked contract for investment purposes actually need the life cover that comes with the contract, and whether they understand how the contract is invested (for example, that in some cases it will simply be investing in a unit trust).

10.2. European Financial Services Round Table

In 2007 the European Financial Services Round Table published *"Pan-European Pension Plans- From Concept to Action"*. This proposed the introduction of pan European Pension Plans which would allow financial service providers anywhere in the EU to set up and sell the plans in all member states (just as now mutual fund providers can market UCITS throughout the EU). Among the features proposed for such plans was that the products they contained would be flexible, and portable, and offer the opportunity of asset pooling and diversification.

10.3. European Fund and Asset Management Association

This year the European Fund and Asset Management Association (EFAMA) has published a report *"Revisiting the landscape of European long-term savings"* which contains eight recommendations for improving long-term savings in Europe, but particularly in the pensions field. The EFAMA proposal is for an "Officially Certified European Retirement Plan" (OCERPs) which would:

> *"create a new market segment for which a level playing field is needed to ensure fair competition for the best personal retirement plans. Therefore, a unified certification standard should be introduced".*

The plan would be a pension wrapper within which products are held and here EFAMA is proposing certain aspects of product regulation. For example:

> *"Individual choice allows people to structure their retirement investments according to their own needs and preferences. There are valid concerns about individuals' ability to make the right decisions when it comes to planning for their retirement, hence the need for the regulator to support this individual choice. In this context, the following should be required:*
>
> - *OCERPs should limit the range of underlying products in which individuals can invest, and put in place mechanisms to help individuals make well-informed choices;*
> - *OCERPs should offer a default investment option to help individuals who are unable or unwilling to make investment choices;*
> - *OCERPs should provide solutions for dealing with investment risk during the accumulation and pay-out phases. This requirement would seek to ensure adequate investment returns over the long term, while seeking to avoid individual exposure at the point of retirement to unnecessary market risk."*

11. Have previous attempts to create “safer”, simpler or better value products been a success?

It should be clear from the preceding sections that both at the UK and EU levels consideration has been given to ways in which an element of product control might be introduced with the aim of making products simpler, or safer, or to improve access to them. But it is only in the UK that these attempts have been so extensive. The questions is, have the UK’s efforts met with success? And if the efforts have been unsuccessful to what causes can the failings be attributed?

It will be seen from what follows that to date the industry’s view is overwhelmingly that attempts at product regulation to produce simpler or safer products have failed. Although the general view on the stakeholder product range are negative it is not universal. For example, Forester Life told me that once they had a quite restricted product range and actually saw the introduction of stakeholder products as the opportunity to change their business model. They now offer a pension plan, child trust fund, and savings and investment products including a stocks and shares ISA all of which meet the stakeholder standards and are making a success of their particular proposition to customers. And later we shall see that the Child Trust Fund is regarded as a success by some.

Most of the evidence that is available comes from the experience of the Stakeholder pension. According to HMRC statistics (Table 7.5, *“Stakeholder pension for individuals: annual contributions)* the number of members in stakeholder pension schemes in 2008/09 was 1.86 million and altogether a modest £3.84million was paid into the stakeholder schemes (of which only £1.9million were contributions by the individual members). This certainly does not read like a success story. It is worth considering the different views of the ABI and the Consumers’ Association in the evidence they gave to the Treasury Select Committee on the factors which militated against Stakeholder Pensions being a success and what conclusions the Committee reached on the evidence presented to it

In its evidence in March 2006 the ABI gave its views as follows:

> *“Stakeholder pensions have not led to the hoped-for increase in saving. More than 80% of Stakeholder schemes set up by employers have no participating employees. There are three main reasons:*
>
> - *the absence of mandatory employer contributions mean low incentives to save;*
> - *pension providers and financial advisers are often unable to recommend Stakeholder pensions to low and moderate earners because the means-tested*

Pensions Credit makes it hard to satisfy the 'suitability' requirements of the FSA's current regulatory regime;

- *the charge cap is set at a level making it difficult to reach out to the target group of savers.*

In addition, high regulatory capital requirements, especially with regard to sterling reserves for future expenses, also make Stakeholder pensions less economic. The fear, possibly misplaced, of retrospective Financial Ombudsman Service intervention has also made providers and advisers cautious in promoting Stakeholder pensions."

But the Consumers' Association put a different interpretation on the price cap argument at the time when the industry was putting pressure on Government for an increase in the cap. In its evidence to the Committee in 2004 it said that it had commissioned Watson Wyatt to look at the economics of access to pensions in the UK and a number of other countries for consumers who could afford only low to moderate contributions. On the basis of this research the Consumers' Association told the Committee:

"We take the view that there is no objective economic justification for raising the price cap on stakeholder pensions, and that the industry's arguments that the price cap should be raised to allow it to sell pensions to consumers who can afford to make lower-medium contributions is disingenuous. Despite its protestations to the contrary, the industry generally has never been interested in or been able to sell to successfully to mass market consumers who can afford to make relatively small contributions each month. In the past, the industry cost base and commercial model meant that consumers who were investing £50 per month in insurance company personal pensions and endowments were taking 10 years to break even at a time when stock markets were booming. This was primarily down to the industry's need to levy high front end loaded charges to support its distribution models.

CA's analysis suggests that even today the industry would need to at least double or treble charges from the current 1% stakeholder level to make a return sufficient to satisfy shareholder demands. "

The Treasury Select Committee itself summed up the experience of Stakeholder Pensions as follows in its Fifth Report in 2006:

> *"The failings of the private pension system in recent years are exemplified by the experience of Stakeholder pensions, which were introduced in 2001. One of the central founding principles of the Stakeholder pension was that there would be a limit on the Annual Management Charge (AMC) that could be levied, alongside prohibitions on certain other charges. The cap on the AMC was initially set at 1%, which providers claimed prevented effective promotion and distribution of Stakeholder pensions. In 2004, the Treasury announced that, for people joining a Stakeholder scheme on or after 6 April 2005, the cap would be 1.5% for the first ten years, reducing to 1% for subsequent years for those remaining in the scheme. The then Financial Secretary to the Treasury told our predecessors in 2004 that the increase of 50 basis points was a 'charge explicitly for advice'."*

> *"Mr Cazalet suggested that the increase in the charge cap was actually used to pay more commission to intermediaries. This view appears to be supported by Standard Life, who observed that "providers rationally offered intermediaries as much commission as they could afford within the confines of the charge cap". Standard Life also backed up Mr. Cazalet's contention that Stakeholder pensions remain an uneconomic proposition for providers. Mr Mick McAteer, Policy Adviser at Which?, contended that the industry had wished to see the price cap increased to make money at the higher end of the market, not in order to extend reach among those on average earnings or below."*

> *"In the early stages of the life of the Stakeholder pensions there were some signs of success in reaching the target market of middle earners. However, in 2003 the Department for Work and Pensions provided little evidence of take-up or interest in Stakeholder pensions among middle earners who did not have an existing private pension. Although the number of holders of Stakeholder pensions exceeded 1 million by late-2002, many of these new pension arrangements seem to have arisen from individuals switching from other schemes (notably personal pensions) and from existing Group Personal Pensions being reconstituted as Stakeholder pensions. Since 2002, the number of new contracts has declined year on year. "*

Malcolm Small (Director of Policy at The Tax Incentivised Savings Association –TISA- and through the Lyncombe Consultancy produces the annual “Pensions Report”) said:

> *“In this case, the government specified the charging structure and pretty well everything else flowed from that. The problem with controlling price is that typically, it’s hard to justify market entry because of political risk and operational risk, usually on account of the aspirational rate at which the price is typically set – almost every Stakeholder book in the country is losing money and will continue to do so. Just because you make a product cheap does not mean that people will beat a path to its door.”*

A number of firms made a similar point that it is no good having simplified products:

> *“if they sit on the shelf. Consumers don’t think when they wake up in the morning that ‘I’ll buy an investment’”.*

Even among those firms that decided to participate in the Stakeholder pension market and devoted effort to try to make them a success some told me that they now viewed the results as very disappointing.

Another example is that of the child trust fund (CTF), introduced in 2002. The aim of CTFs was to encourage the savings habit for children by opening a long-term savings and investments account where the child and no one else could withdraw money from age 18. Both income and any capital gains within the account are tax free. There is a maximum of £1,200 each year that can be put into an account by parents, family or friends. A novel feature of CTFs (until the new Government announced their abolition) was the provision for each child born of a £250 voucher with which the parents could open a CTF for their child. Moreover, in another new development, if the parents did not open a CTF for their child within a specified time HMRC would do so automatically using the £250 voucher to open a so called “Revenue Allocated Account” (RAA). There is a choice of funds with a CTF but the default fund (and the fund in which all RAAs are opened) is a stakeholder fund.

According to HMRC statistics between September 2002 and April 2008 some 3.959 million CTFs were opened. Of these 2.963 million were opened in the Stakeholder default fund (this includes the 911 thousand RAAs). It may be of course that some parents actively chose the Stakeholder fund but it seems more probable that most simply went with the default fund, possibly because this was the one that some firms actively marketed. Of the 996 thousand CTFs opened that were non-Stakeholder only 284 thousand were opened in a shares fund, the other 712 thousand being put into a cash CTF. So, where choice is being exercised by parents it is generally in favour of the low risk option.

One measure of success for CTFs is whether having opened an account using the voucher further savings are then made into the account. The HMRC statistics seem to accord with what one would intuitively expect. It might be thought that those who chose a non-Stakeholder CTF are more financially sophisticated (or believe themselves to be so) or engaged and would be more likely to make further contributions. In fact, 278 thousand non-Stakeholder accounts got further contributions (or around 28% of such accounts). Those going with the default Stakeholder fund where it was the parents who opened the CTF there were 664 thousand (32%) of such accounts which got further contributions. The RRA CTFs, automatically opened in a Stakeholder fund, one would expect to involve parents who are least engaged with financial services, and indeed only 20 thousand (2%) got further contributions.

Another interesting aspect is the amount of the additional contributions made into CTFs. As noted above, there is a maximum of £1,200 a year but in fact for the tax year 2008/09 the average contribution across all types of CTF accounts was only £279, perhaps reinforcing the point that there is a significant proportion of the population that has very little to save. Moreover, there were not too significant differences in the average amount contributed for different types of CTF; so, the RAA Stakeholder funds (which one would expect to get the smallest contribution) had an average of £232 contributed whereas the non-Stakeholder shares funds (which one would expect to attract a much higher contribution) still only had an average of £336 contributed. This again seems to reinforce earlier evidence that many households simply do not have large amounts to save.

Although some of the firms I spoke with were lukewarm about the success of CTFs a notable but not surprising exception was The Children's Mutual (TCM) which is probably the only specialist firm dedicated to the long-term savings market for children. TCM effects the lion's share of CTF business in the UK. It told me that, like other providers, it has around 75% of CTFs being opened with it within a child's first year. Moreover, around 60% also open a direct debit at the same time so as to put more into their child's (or grandchild's) account, which is a higher proportion than the industry average. In addition, TCM has found that those parents who do make additional contributions to their child's CTF are putting in on average £24 per month compared with only £15 a month which parents used to contribute to TCM's "Baby Bond" (the product TCM marketed before child trust funds were introduced).

Although not all in the industry regard CTFs as a success I think it has to be counted as a reasonable success that around a third of the parents who open a CTF for their child not only go on to voluntarily put more into their child's account but also seem to be saving more than they did in products available in the past. Even those parents who fail to open an account themselves (and who are probably among the least financially capable) at least a few go on to save more into their child's account.

Although the majority of CTFs in force are Stakeholder ones it is not clear that it is the creation of a “safer” Stakeholder fund which has been the critical success factor; rather it seems to be the combination of providing an incentive via a voucher and a form “auto-enrolment” if parents fail to open an account within a specified time.

One of the first acts of the new Government has been to announce that after December 2010 children will no longer be eligible for a CTF.

Although past history with CAT-standard and Stakeholder products has generally been quite disappointing it would be wrong to think that personal accounts are necessarily going to suffer the same experience. The important difference is that auto enrolment will tackle one of the key problems with Stakeholder products, overcoming the inertia of consumers to save. Add to that the employer contribution and a wise choice of default fund and I think there is cause for some optimism about personal accounts. If personal accounts go ahead in the form currently envisaged then it seems to me that they will provide a fair value, widely diversified and risk controlled form of pension for many consumers. At the time of writing, however, the Government is conducting a review of the proposed personal accounts regime. The outcome of the review will clearly have an important bearing on whether or not consumers can look to personal accounts as a trustworthy and good value vehicle for their pension savings.

12. Tax

Although the principal focus of the Panel's interest is in the scope for designing a "safer" product it is also necessary to think about any tax wrapper in which the product may be contained. Tax incentives potentially may motivate consumers to save, or to save more, they may influence the choice of one savings or investment vehicle over another, they may impose restraints such as they do in the case of pensions, there may be charges attached to providing the tax wrapper (e.g self-select ISA) which may reduce the value of any tax benefits, they may be regressive or progressive, or they may simply be ineffective.

Sandler commented as follows:

> *"Historic tax structures continue to have a powerful, and often unintended, influence on savings products flows. Many products are sold on the basis of tax advantages, rather than on the underlying investment benefit, and the sheer complexity of the tax regime for savings products, as it has evolved over decades, adds greatly to the need for consumers to seek expensive advice ..... looking forward, I am also sceptical of the effectiveness of tax incentives as a means of promoting overall saving."*

He also criticised taxation differences for their capacity:

> *"to distract attention away from the more fundamental features of charges and investment performance"*

The Sandler report recommended that, in future, governments should avoid introducing new tax-based savings incentives if their aim is to increase aggregate savings levels. It suggested that the core objective of policy in this area should be simplification. It also said that there was some evidence that matching schemes are a more effective means of affecting savings behaviours than ordinary tax relief.

A useful analysis of the way in which taxation affects the returns on various forms of savings and investments is given in the Institute of Fiscal (IFS) studies paper *"How Much Do Tax The Return To Saving?"* published in 2009. The conclusions of this report may, of course, be affected by any changes to taxation made by the new Government. But as matters stood in 2009 the IFS concluded that:

> *" UK households hold their assets in a range of forms that face different tax treatments;*
>
> *These differences in tax treatment can equate to quite big differences in the level of the tax on the return to these assets;*

Differences in tax treatment can be due to the tax rates that an individual faces, as well as to the types of asset in which he or she chooses to save;

Tax rates on the return to assets have generally converged over the past 30 years."

In spite of the convergence noted by the IFS it still notes quite a range on the effective tax rates for a range of different assets with the most favourable applying to savings in private pensions and the least favourable to savings in cash deposit accounts (which, of course, are the type of asset most likely to be held by poorer consumers)

HMRC commissioned Opinion Leader to carry out some research into attitudes to pensions, with particular reference to the so called A-day changes (which among other things involved some "simplification" of tax arrangements). Opinion Leader concluded that:

"People were generally aware of the need to save for their retirement but differed in the priority they placed on this and whether they thought they could afford to do so. Pension provision was driven by the interplay between attitudes to pensions, financial resources and other priorities. These personal factors had more of a bearing on whether someone saves than factors such as tax relief. Tax relief could move pensions up the list of priorities, but was not able to overcome entrenched mistrust of pension schemes or free up the resources for people to invest."

Malcolm Small was plainer speaking about tax and pensions:

"from my work on The Pensions Reports 2006 and 2007, it's pretty clear that consumers don't understand tax relief on pension contributions and don't get very excited about it when they do, which is why we've got a tax relief bill heavily skewed towards higher earners. Contrast this with the situation in Australia when the system of "matching" for personal contributions to a "Super" came in a few years ago and the aggregated contribution rate shot up from 11% to 16% of pay virtually overnight."

Industry views on Individual Savings Accounts (ISAs) for investments tend to be more positive. Malcolm Small believes that they:

> *"have been a success story of major proportions and it's hard to see much potential for consumer detriment in either their structure or charges, and they are in essence a government-led product. It must be good to save; the ISA is simple, flexible, with easily understood tax breaks. Consumers can easily understand it and engage with it and are saving ever more money into it, including for retirement. In fact, I would argue that, as things stand, saving into a pension structure is potentially unsuitable for many people, because of the adverse interaction between pensions saving and the means tested retirement benefit regime, pointing up that product regulation can't happen in isolation from other salient matters."*

But if evidence were needed that tax wrappers can cause problems in relation to the most simple of products one need look no further than Cash ISAs. Here Consumer Focus has made a super complaint which is currently under consideration by the Office of Fair Trading. Among other things this super complaint alleges many providers of Cash ISAs are guilty of delay or obstruction when consumers want to move their ISA, and that many providers are soliciting business using high headline rates of interest which they then rapidly cut when consumers have bought in to an ISA.

The relevance of both the tax and benefits regime is that "safer" products cannot be viewed in isolation from the environment in which they sit. The more complex the interaction with the tax and benefits regimes the more difficult it becomes for consumers to make choices and the more a need is created for advice.

13. Socially responsible and ethical investment

In many areas of daily life we are encouraged to have regard to the environment, to sustainability, and to fair trade. Some consumers have explicit ethical or religious concerns. The retail financial services industry is possibly somewhat lagging behind in the attention which it gives in offering to consumers' savings and investments that are socially responsible or ethical. Nevertheless, this is an area that is gaining greater attention. The UKSIF (he sustainable investment and finance association) has been prominent in promoting "investment and other forms of finance that support sustainable economic development enhance quality of life and safeguard the environment." It also seeks to ensure that "individual or institutional investors can reflect their values in their investments" (such as through religious or ethical funds). In its general approach PADA will, like many leading pension funds across Europe, be supporting the role of responsible investment in its approach. More specifically, PADA will be providing religious and ethical fund choices to the members of personal accounts. If "safer" investments were to be developed it seems to me that among other things there should be a sufficient fund choice that would allow consumers to reflect any ethical or religious views they have.

14. What safeguards if any does the Panel think should apply to the selling of or advice on “safer” products?

It is fair to say that in discussion with industry participants there has been as much if not more focus on what conduct of business requirements would apply to the selling of “safer” products than to the possible design of a “safer” product. This actually resolves itself into two separate points. Would there need to be proactive and willing purchasers of “safer” products or would the products still need to be sold. And secondly, if the products do need active selling what safeguards, if any, should attach to the way in which they are sold. On the first issue one fund management group, for example, said that it:

> *“was not convinced the introduction of simpler/safer products will mean that they will be bought and particularly by those who currently do not save. There are plenty of examples of arguably similar initiatives which have not proved to be successful (stakeholder pensions, child trust funds, CAT marked ISAs)”.*

On the second issue one bank said:

> *“Product regulation will not result in safer products – and there is a real danger that attempting to introduce the regulation of ‘safe’ products will result in increased cost and reduced choice for consumers. A safer products regime must focus on ensuring that the customer is matched to an appropriate product in terms of the customer’s attitude to risk, objectives, etc. In deciding what constitutes ‘safe’, it is necessary to recognise that consumers’ ability to handle risk varies considerably, meaning that a product that will be absolutely ‘safe’ for one consumer will be absolutely unsuitable for another”.*

Earlier in this report I dealt with the proposals in the Sandler report for a suite of stakeholder products that “with certain additional safeguards” could be purchased safely without regulated advice. In fact, Sandler did not go so far as to suggest that stakeholder products be sold without any safeguards. His suggestion was 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 had received and understood each of these. Sandler said that at the minimum these would include warnings that:

- the consumer was being offered 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;

- the pension would be unlikely to be suitable for people on low incomes who were above a certain age; and people who had access to an occupational pension scheme;

- the products being sold had an element of financial markets risk, and that therefore consumers should consider carefully before putting too much of their savings in them;

- the products were not appropriate for meeting specific future liabilities as their future value could not be guaranteed; and

- purchase should not be considered if the intended savings horizon was less than, say, five years.

14.1. Basic Advice

Although the responsibility for deciding whether or not stakeholder products should be introduced was a matter for Government the question of what sort of selling regime should apply to the products was the responsibility of the FSA. At the same time as the Government consulted on the design of stakeholder products the FSA published in 2003 Discussion Paper 19, *"Options for regulating the sale of 'simplified products'"* which considered the broad options for how to regulate the way in which stakeholder products would be sold.

This was followed in 2004 by the FSA's Consultation Paper 04/11 *"A Basic Advice Regime for the Sale of Stakeholder Products"*. In this the FSA explained that although (at the time) Stakeholder products could be sold through either direct offer financial promotions or through full advice the FSA took the view that these did not offer sufficient choice for consumers, particularly the less affluent. It therefore set about testing a "Basic Advice" model. The FSA said:

> *"Our aim in carrying out this work .. has been to determine whether a simpler, lower-cost regime could be developed that still delivered an appropriate level of consumer protection"*

The FSA described the characteristics of the Basic Advice process as follows:

> *"The Service provides limited, basic advice. It is limited to a specific range of products (currently the Government's stakeholder suite). And the extent to which the firm must satisfy itself that those products are suitable for a consumers' needs is limited to establishing the consumer's position on broad issues such as risk, savings objectives, significant financial priorities and obvious counter-indications. Only information provided during the basic advice process will fall to be considered by the firm in their suitability assessment. But because the purchase of a specific product may be recommended, the salesperson provides 'advice' under the FSMA"*
>
> *"Salespeople providing basic advice are not required to hold formal financial planning qualifications. But firms are required to ensure that their salespeople are competent to administer basic advice, through a combination of training and supervision."*
>
> *"The sales interviews are pre-scripted by the firm, and the salesperson has clear limits as to the issues on which he/she may advise. We will require the process to deliver warnings about the need to address financial priorities such as debt, and to end if the firm has reason to believe that the customer will not be able to afford any product. The customer is given a record of the interview and of the response he or she has given on which advice has relied"*

In November 2004 the FSA published its feedback on the basic advice consultation in Policy Statement PS04/22, *"Advice on sale of stakeholder products"*. In this the FSA noted that some respondents had called for the scope of the basic advice regime to be widened to more than stakeholder products on the grounds of increased competition. It said that:

> *"Although respondents understood the decision to develop the regime for stakeholder products, some urged us to look at how the range of products could be increased. They argued that this regime could be applied to a wider range of products while affording the same degree of consumer protection".*

In responding to the comments which had been made about the scope of basic advice the FSA said:

> *"We agree that maintaining standards of consumer protection is central to any decision on extending the regime. But we must also recognise the competitive pressure to extend the regime where this can be done within those standards. We intend to conduct a full post-implementation review of the regime ... When we have completed this we will consider the possibility of extending the regime."*

There was, therefore, an unambiguous undertaking from the FSA to consider the extension of basic advice to non-stakeholder products once the post-implementation review had been carried out.

Also in its feedback statement the FSA responded to queries which had been put to it about whether non-investments could be sold as part of the Basic Advice regime. The FSA said:

> *"We have clarified in our rules and guidance that firms can cross-sell non-investment products , as long as they give the consumer a clear explanation and warning at the points where any advice given is no longer subject to the standards that apply to, for example, deposits, mortgages or general insurance".*

It was therefore open to firms to design a sales process that enabled them to sell not only stakeholder products but also products such as protection insurance or cash ISAs.

In November 2008 the FSA published the results of its post-implementation review *"Basic Advice regime – a post implementation review"*. As noted earlier, this paper reported research commissioned from consultants on the size of the market for Basic Advice. Also as part of its post-implementation review the FSA sought views on how Basic Advice would need to change for firms to make more use of it. The common suggestions put to the FSA were very similar to the views put to me by firms as part of this project:

> *"either raise or scrap the stakeholder charge cap;*
>
> *limit firms' liability from the FSA and the FOS; and*
>
> *widen the scope of products available, by including protection products as an example."*

(The last item mentioned shows just how industry myth can gain credence over facts. But it seems even more surprising that the FSA accepted this statement without commenting that its feedback statement on Basic Advice made clear that products like protection could be cross sold alongside Basic Advice.)

One bank commented:

> *"Basic Advice failed since it sought to regulate both the distribution process and the product, had extremely tight margins for providers and distributors and firms remained concerned that the hindsight risk was too great. It is extremely unlikely that prescription of both product and distribution process will be attractive for providers, distributors or consumers."*

Although the overall reaction to Basic Advice (including from the FSA itself) seems negative it is not universal. Forester Life was again refreshing in its positive approach as it was about stakeholder products. Foresters adapted its business model to deliver Basic Advice to its customers and is operating it successfully and as well as selling investments by this method it also sells protection insurance. It has had no problem with the FSA over Basic Advice, despite the fact that it was studied as part of the post-implementation review as well as being subject to normal supervision visits, nor with the FOS.

The one element from the FSA's post-implementation review that appears to be missing is any consideration of whether or not the process might be extended to non-stakeholder products.

14.2. Assisted purchase

In 2008 ORC International was commissioned by the ABI and the BBA to undertake research to evaluate consumer reactions to a prototype of a new "Assisted Purchase" model for the distribution of products. Among other things the research was designed to assess whether the model could produce outcomes that benefit consumers, whether or not consumers would use such a process were it introduced, and the extent to which consumers understood the limitations of the model. In effect, the prototype was an attempt to sell products "without advice" so as to avoid the regulatory problems that attend sales made with advice (cost and time of qualified advisers, possible complaints to the Ombudsman etc).

From the industry's point of view the results, published in 2009, were disappointing. Only 44 per cent of respondents were offered an investment product as an outcome. There were about two-thirds of respondents who thought that they were given a "personalised recommendation based on their needs and circumstances" (i.e. advice), but at the same time an almost equal proportion thought they had been given "guidance and information to allow them to make their own decision", so there were clearly some consumers who were completely foxed as to what service they had been given. A quarter of those interviewed were concerned that they were given no formal confirmation that the options they were given were indeed suitable for them.

Worryingly, the report concluded:

> *"There does appear to be some evidence that the process is better suited to consumers who are currently less engaged with the financial services industry, and who are less well-off or financially sophisticated" (but many would argue that those are precisely the consumers who would benefit most from advice).*

14.3. Primary Advice

Another proposal for simplifying the advice regime emerged as part of the FSA's Retail Distribution Review (RDR) and this was so called "Primary Advice". In 2008 the FSA published *"Primary Advice – Consumer Perceptions of the Primary Advice concept"*. In the research there were in depth interviews with a small sample of generally less financially sophisticated consumers with incomes of less than £30,000 a year. All of the consumers had purchased a product through the basic advice process and in addition to testing their views on that process the research asked about their reactions to the concept of Primary Advice.

> *"The main initial reaction to the Primary Advice description was that of confusion. In particular, a number were keen to clarify and understand how Primary Advice differed from Basic Advice. In fact, after reading the description, many thought it described the Basic Advice process they had experienced. Primary Advice and Basic advice were seen to be similar as they both offered a broad rather than a detailed level of advice. After hearing and digesting the description of Primary Advice, the greater range of simple financial products was seen as the key benefit of the process ... the link between the removal of price-capping leading to greater profitability for firms and potentially resulting in an increased range of products was only made by a handful of those interviewed."*

14.4. Simplified Advice

Yet another candidate for simplification has now emerged, and that is the suggestion from the ABI and BBA of "simplified advice".

One firm said:

> *"we do not see Simplified Advice as requiring a new set of products – the stakeholder experience has surely shown that the market is the best place to determine product structures and charges. Rather, we see that Simplified Advice may be a more efficient/quick sales process that enables the mass market to gain access to long term saving, investment and pension products."*

In March 2010 one of the FSA's directors said:

> *"There has been some discussion about what the effect of the RDR will be on the market overall. We accept that the number of individual independent financial advisers may reduce, but we do not necessarily believe that this will reduce the availability of advice.*

We are conscious, however, of suggestions that advice may be driven 'up market'. We are also aware that, in light of this, the industry has been considering that it might be able to provide a 'simplified advice' offering. This would be a simple way for people whose needs were relatively straightforward to access the market for investment products. It would involve some form of focused advice process, possibly making use of modern technology, which delivered advice on a narrow range of straightforward products. It would take less time than the full advice process and would be cheaper to deliver and cheaper for the consumer to access.

We have looked carefully at the issue and recognise that there may be room for such a service. We believe, however, it is for the industry rather than the regulator to develop appropriate solutions which comply with existing EU obligations. Regulators are not the experts in product design.

We have discussed a range of options, at different stages of development, and we think that there is a genuine interest in this area, not just from the industry, but from some consumer groups too. However, we and the industry recognise the challenges in delivering an advice service of this type, where the risks to consumers are appropriately mitigated. Some of the big challenges to consider are:

- *how is the process delivered – is it face-to-face, by telephone or screen driven? Do differences arise depending on the delivery channel?*
- *what is the right portfolio of products that should be included in a Simplified Advice process? .what safeguards – such as screening questions – are there to ensure that only those people for whom this is right go into this service?*
- *are there safeguards for people where it becomes clear that the Simplified Advice service is not appropriate?*
- *what level of skills and competence does an adviser delivering this process need?*
- *how big is the market for this process and how do we avoid creating barriers to entry?*

Overall, we recognise that any such process must deliver good value products for consumers, in a way which is profitable for product providers. We want to continue working with the industry to support their efforts in this area."

14.5. Conclusions on advice

The standards for investment advice are simple and high-level and were originally consulted on even before the Financial Services Act 1986 came into force. The high-level standards mean that they are capable of accommodating a wide range of circumstances where investment advice is given. Indeed, around 2004 there was debate about whether or not the FSA needed to create specific rules for a Basic Advice regime. The fact that it did create such rules has less to do with legal necessity as the desire to give comfort to the industry by pinning down the steps that firms would be expected to take when advising on stakeholder products and that if they followed those steps they would have a safe haven from regulatory action by the FSA or having complaints found against them by the FOS.

A stated aim of the FSA's current Retail Distribution Review was to try and simplify for consumers the advice landscape. Instead, we have a variety of new models being thrown into the debate by both regulator and industry – primary advice, assisted purchase, and simplified advice. It appears to me that the FSA failed to deliver on its commitment to consider extending Basic Advice to "safer" non-stakeholder products. It could now revisit the issue. This it seems to me would be consistent with what the FSA had recently been saying about product regulation:

> *"One of the challenges for us would be to differentiate between good and bad innovation. We want to foster good innovation that brings better products to the market place."*

There is a clear resistance on the part of the industry to see Government or regulator become involved in the design of products. Even if the Government or regulator were prepared to become involved in product design it is difficult to see how they could force firms to become involved in the market for any products which the Government or regulator designed. An alternative approach might be to leave it to the industry to decide how best to design products which it thinks it can sell and for the regulator to assess whether products can be regarded as "safer" or good value and to then allow those products which pass such a test access to Basic Advice. An issue that would need consideration here is how the distributors of such products should be remunerated, that is should "adviser charging" apply.

15. “Platforms”

A growing volume of intermediated investment business is now transacted through what are called ‘platforms’, or let’s just say that the business is done over the internet. The FSA is currently examining the role of platforms as part of its Review of Retail Distribution.

Although transacting business over the internet must be the way ahead there are a number of issues with the internet as a distribution channel for consumers who have modest amounts to save or invest. Those issues are:

- access to the internet
- competence in using the internet
- concerns over security
- costs

The ONS, in *“Internet Access Households and Individuals”,* reported that in 2009 18.31 million UK households had internet access (90% of these having broadband access). This represented 70% of households. Stating the obvious, this means that there are still around 30% of households without internet access at home.

The ONS also found that:

> *“Almost all adults (95%) aged under 70 who had a degree or equivalent qualification were estimated to live in a household with internet access. Those who had no formal qualifications were least likely to have an internet connection, at 52%”.*

An argument I heard is that “of course” those who do not have access to the internet at home can access it at work. The first objection to this is that some major employers have in place a policy prohibiting or restricting the use of computers for personal use so as to safeguard the security of their systems. The second and more important objection is that it seems to me a plausible hypothesis that the roughly half of the population with no formal qualifications who do not have the internet are likely to be in occupations where they do not have access to the internet at work either – road and building construction, shop workers, transport drivers etc.

In the longer term there will no doubt be inclusion of those currently without access to the internet but for the present it seems questionable to build distribution and management of savings and investment products on the assumption that the target population necessarily has access to the internet.

In 2003 *"The Skills for Life Survey"* looked at awareness and practical skills in information technology. It found that while many in the Survey had an awareness of IT:

> *"a good level of awareness was not always accompanied by good practical skills. Fifteen per cent had never used a computer and slightly fewer than half (47%) achieved Level 1 or above in the practical assessment."*

The Survey also noted that for those employed in occupations where a computer was used:

> *"The connection between frequency of use and ability was weakest among those employed in more routine occupations. The majority of frequent users in these occupations had Entry or lower level practical skills, suggesting that they either:*
>
> - *use the computer for a very limited range of tasks, or*
> - *make a lot of mistakes when they use computers."*

It is clear that the use of the internet is growing for some financial transactions. According to UK Payments:

> *"in the first half of 2009, 22 million adults used internet banking on their main current account. This means that for the first time ever more than 50% of regular internet users are banking online. The most popular tasks that people who bank online carry out on their main current account are checking account balances and checking statements, used by 95% and 83% of users respectively".*

Although these figures are impressive, it still leaves many millions who do not use the internet for their banking and even those who do use it carry out very basic functions on their account. It is also not clear how many consumers are currently using the internet to buy and manage investments.

Even among those using the internet there is a continuing concern about security. The Unisys Security Index reports that in the UK 87% of internet users are concerned that they may fall victim to ID theft. NS & I also told me that security is an ongoing concern among its customers partly because there is a basic mistrust of transacting business on-line but also a fear of making wrong entries and sending funds to the "wrong account". NS&I also noted that it is difficult to get the right balance in dealing with consumers' concerns over security:

> *"On the one hand people do not like the more sophisticated security measures –e.g. multiple questions-but on the other hand do want security assurances".*

The final issue with platforms is costs. In the present context the target population under consideration is not likely to have many savings and investments. In most cases it they may have just a single product. Moreover, it also seems highly unlikely that the target population will be “active” in managing their savings or investment product. Against this background it seems unreasonable that such consumers should bear any cost for having their product sitting on a platform with the extra cost acting as a drag on the return from their product. Yet the platforms currently in use do “cost” consumers in one way or another although currently these costs are usually hidden to consumers.

Of course, in some cases firms simply offer the internet as one way of executing business and there are not the issues which the FSA is currently addressing with regard to “platforms” So, for example National Savings and Investments and Marks and Spencer Financial Services just offer a simple service on the internet for those consumers who want to purchase products in that way.

More generally on the internet, it has long seemed to me that the FSA could do more to support the internet as a low cost channel for providing advice by being prepared to give accreditation to advice software, in the same way it sanctions accreditation in relation to examinations and will in future be giving accreditation to professional bodies.

16. Possible criteria for “safer” products?

Although it is possible that a “safer” product might well form part of the overall portfolio for wealthier consumers the assumption I make is that the Panel is more likely to be concerned with savers and investors of more modest means who are basic rate taxpayers and for whom a “safer” product might be the principal or only medium to long-term savings or investment product. On this basis the evidence presented in this report suggests that there are a number of criteria which it is desirable a “safer” product should meet. However, some of these criteria are less about the design of the product itself than about ease of access (e.g. a “safer” product may not be much use if the minimum investment allowed is £10,000). On that basis, the criteria are:

- The product allows for regular savings. However, the terms of the product should not be such that a consumer is committed to making contributions each and every period. As discussed above, it is clear that many consumers who are in a position to save have relatively modest amounts to put aside. It might on occasion be possible for consumers to set aside a small lump sum but it seems likely that many would be better suited by making regular savings. However, changes in circumstances can have an impact, temporary or otherwise, on an individual’s capacity to save so there should be flexibility allowing contributions to stop, restart or vary without the consumer suffering detriment. There is the advantage to be gained from regular saving that one gets pound cost averaging, that is paying less on average for an investment than one might do by investing a lump sum. Regular saving also helps in avoiding the irrational optimism or gloom that many investors of a lump sum seem to suffer; that is, either buying into a market when the bubble is about to burst (as happened with the dot.com boom) or else panic selling in a downturn (when more rational behaviour might be to hold tight, or use it as an opportunity for selective buying, or at least be selective in what is sold).

- The threshold for regular savings should be reasonably low. This ought not to be a problem for product providers. Several investment trusts, which perhaps do not immediately spring to mind as an investment vehicle for the mass market, offer regular savings schemes for as little as £50 a month and a consumer can stop and re-start contributions into such a scheme without penalty. Similarly there are unit trust managers that operate savings plans with a similarly low level of contribution.

- The charges should be low.

- If the product is an investment it should be passive in its approach.

- If the product is an investment it should diversify across a number of asset classes in order to manage risk.

- The product should be eligible for inclusion in any appropriate tax wrapper.

- The product should not confuse saving or investment needs with protection needs. This is not to deny the importance for those with dependants having life cover in place but this is something that should be purchased separately from any savings or investment product.

- The product should be described in plain and clear terms. Providers simply must do better in being open and honest about the potential risks.

- One objective ought clearly to be to reduce significantly the number of consumers who feel that they have good cause to complain to the Financial Services Ombudsman about their investment and another to reduce the occasions on which the FSA feels it necessary to order a particular firm, or the whole industry to review past business. The development of “safer” products might make a contribution to these objectives and so too would much clearer information for consumers about not only the benefits of the products they buy but also the commitment and risks. However, the vast majority of complaints made to the FOS are not about the design of a financial product, the complaints are usually that consumers have been wrongly advised, and in some cases misled by marketing material. And in the case of complaints about poor advice the root cause can usually be traced to one or possibly two factors: a failure to assess or to take proper account of a consumer’s attitude to risk; and affordability.

- The savings or investment vehicle should respect any ethical or other beliefs of the consumer.

- The product should be covered by the UK’s Financial Services Compensation Scheme in the event of the product failing.

17. Are there products already on the market that meet the Panel's conception of "safer" products?

A valid question is whether or not there are already products on the market which might be said to meet the idea of "safer" products. During the course of this study I have had suggested to me many possible candidates to be considered as "safer" (or lower risk) products. I do not have the expertise, and I certainly did not have the time within the confines of this report, to attempt an exhaustive examination of the validity of the claims of different types of product. I simply offer a few observations on some of the candidates which have been mentioned to me.

If the FSA sticks to its pledge "to foster good innovation that brings better products to the market place" then it seems to me the regulator could play a key role in carrying out detailed scrutiny of products and finding some mechanism (e.g. best buy tables, differentiated sales regime) to flag the "safer" products to consumers.

At the time this report was prepared I said that first and foremost it was appropriate to mention the product range of National Savings and Investments (NS&I). NS&I has 12 products, all capital secure and essentially savings products. In my view the one product that stood out in the context of this report is index-linked savings certificates for basic (and higher rate) taxpayers. For those consumers who do not need to take risks or who are risk averse, as very many are, it is difficult to think of a safer home for their savings. Not only is the consumer guaranteed to get their initial capital back but it will be protected against inflation and on top of that there will be a small amount of interest which is tax free and does not have to be declared on a tax return (the interest is currently worth 1.25% to the basic rate taxpayer).

In other words a consumer is guaranteed to get back £+ at the end of a certificate's term, in contrast to almost any other of the savings or investments mentioned in this report where the consumer is taking a chance that at the end of the savings/investment period they may end up with a £-, or even if it is a £+ it might not be enough to offset the combined effect of inflation and charges on the product concerned. At the time this report was prepared index-linked certificates came in two issues, one held for a period of three years and the other for five years. They were easy to purchase, either on-line or for those without access to the internet (or who have security worries) over the counter at UK Post Offices. A purchase could be made for as little as £100 so they could be used as a vehicle to make regular or occasional savings.

It is true there was a limit of £15,000 in each issue of the certificates but from what was said earlier in this report about the distribution of wealth in the UK it is clear that this limit is an irrelevance for the vast majority of savers (and in any event NS&I used periodically to introduce new issues of the certificates and investors can also "roll over" investments in previous issues).

Obviously to get the full value from the certificates they need to be held for the full term of either 3 or 5 years but even if there is forced encashment before the full term (which I understand is not very frequent) a consumer would never get back less than the amount they had invested and might get more than that depending when the encashment is made. Encashment of certificates at the end of their term is easy, NS&I writes to holders to inform them how much the certificate is worth and enclosing a form for encashment (although there are other options like re-investing the certificate). At present encashment is by post but NS&I told me that they are working on full online servicing for their products and hope to have this in place by 2012.

Index-linked savings certificates were not just for those on low earnings or who are risk averse. Gareth Marr of The Red House Consulting has a small number of very high net wealth clients and he told me that whenever NS&I came out with a new issue of certificates he used to contact clients to encourage them to put in the maximum amount to each issue.

It is a matter of regret that it has since been announced that index-linked certificates are being withdrawn from sale (although existing holders of certificates are allowed to "roll over" their investment when a certificate matures). As the Daily Mail commented on 21 July "Savers suffered a hammer blow this week when National Savings & Investments smashed their only chance of beating inflation." The glimmer of hope for savers is that the certificates may be re-introduced for sale at some later date. Providing that the terms on which the certificates are offered in future are the same as when they were withdrawn from sale the certificates remain a sensible option for small and cautious savers.

Leaving index-linked savings certificates on one side almost all other products on the market provide the opportunity but not the guarantee of delivering returns in excess of inflation, or cash, after charges. In other words risk attaches to them all, but some are perhaps more deserving of the description "safer" than others.

Structured products are one type mentioned to me as offering a safer choice for investors. Structured products can be deposit or investment based and the typical proposition which they offer consumers is that they offer some exposure to gains by being linked to a benchmark such as a stock market index while at the same time limiting the downside by protecting some or all of the original capital invested. But Which? has listed structured products as being among its top 10 "most useless financial products", so how has the disparity in views come about?

Well first there is the fact that precipice bonds were structured products and they resulted in major losses for many investors because in certain market conditions there was little in the way of a “floor” to the losses which investors could suffer. Next is the problem of counterparty risk for other structured products. This problem was exposed by the failure of Lehman Brothers which acted as counterparty for some structured products. The problems for investors here were made worse by the fact that as it was the counterparty which failed losses were not covered by the Financial Services Compensation Scheme.

Then there is the question of the extent to which a structured product protects the initial capital, if it less than 100% then the product surely begins to lose any attraction it might have for many investors. On the other side of the coin, to what extent does the product allow investors to share in any rise in the index to which the product is linked? Remember too, that with structured products investors do not get the dividend income which they might enjoy with other forms of investment. So, even when structured products give back more than the initial investment there is still a question about whether or not they are reasonable value for money. Then again structured products often have a minimum level of investment which although low may still be too high for some savers. And finally structured products are for a fixed term, anyone who needs to get their money out early may find they lose anyway.

It might be thought that anything with the description “guaranteed” would get an automatic passport to being regarded as “safer” but I think a better attitude to take is to regard use of the word “guaranteed” to act as a trigger to ask some searching questions. Is it just capital which is guaranteed, or income or both? If it is guaranteed income is the promised level of income being achieved by putting the capital at risk? Is the guarantor to be trusted? What are the compensation arrangements if things go wrong? Investors in failed Icelandic banks know to their cost that the nature of the compensation arrangements matter. Also, a guaranteed product is likely to have a minimum level of investment which may be beyond the threshold of some consumers and it will certainly be a fixed term product meaning that should a consumer have to withdraw their money early they could lose out.

I heard some advance the claims of Absolute Return funds as a possible “safer” investment. The claim of these funds is that they provide the potential to achieve a return even when markets are down. This is possible because such funds not only permit the buying of shares in companies that are expected to rise but also “going short” on shares that are expected to fall (in other words the funds are “hedging”). Absolute Return funds have been created following the introduction of UCITS III and the proponents of the funds claim that this sets the funds apart from hedge funds because UCITS III subjects them to “detailed regulations” which are designed to protect retail investors. But is the “potential” to deliver a return in a falling market always achieved? There are a limited number of funds available at present and while some have yielded positive returns there are equally others that have managed negative returns, which is hardly a recommendation.

Another aspect of these funds is that investors are basically being invited to believe that the manager of the fund has the skill – denied to other investment managers and the rest of us - to read the markets and make profits even when times are bad and to do so on a consistent basis.

It must be clear from earlier sections of this report that many experts believe that passive investment approaches to investment are preferable to active ones. There are two main ways in which retail investors can access passive investment – through collective investments that track an index or though exchange traded funds which do likewise. Both approaches have been mentioned to me a number of times during this research. Both approaches generally have very low costs and neither approach makes claim to being able to “beat the market”.

William F.Sharpe in *“Indexed Investing: A Prosaic Way to Beat the Average Investor”* asked the question in which markets should one invest. The ideal answer was that financial economic theory:

> *“suggests that the average investor should hold everything available, in market proportions, and arithmetic shows that this must be true.”*

The message is really that even with index investing it is best to try and diversify as much as possible across different asset classes or markets. Even when investing in something that looks as straightforward as a UK index tracking fund it is still worth looking at the spread. Some funds, for example, only track the top shares in the UK index and so may be more exposed to some economic sectors or particular companies than a fund that tracks the whole index. And funds that track only the top shares periodically have to incur dealing costs as some companies shares fall out of the top rank of the index and others are promoted.

Also, and as Ron Sandler pointed out, it is still vital to look at what is being charged for index investing. For example, Vanguard is a long-standing and prominent name in the USA famed for its very low charge, multi asset and risk rated funds. Vanguard has now established a presence in the UK but initially this has been via financial advisers rather than its approach in the USA where it deals to a very great extent direct with its customers. Vanguard has a FTSE UK Equity Index Tracker for which the Total Expense Ratio is just 0.15. In time it is possible that Vanguard may become more accessible to ordinary consumers, as it is already in the USA where large numbers deal direct with the company, these days mainly over the internet. But many other firms also have similarly low charge funds. Fidelity, for example has a range of Money Builder funds. One of these is the Money Builder UK Index fund which has an annual management charge of 0.1 per cent and when other fund expenses are brought into account it brings the Total Expense Ratio to 0.27. Moreover, this fund is accessible to ordinary consumers as regular savings can be made from as little as £50 per month. Although funds such as those of Vanguard and Fidelity do have very low management charges and expense ratios this is where such firms deal direct with their customers. From the consumer’s perspective the costs may be higher where they find it necessary to use an intermediary to whom they pay a fee or agree to adviser charges.

Exchange traded funds (ETFs) are another exceptionally low cost investment vehicle. There are already a large number of funds offering exposure to a wide variety of indexes and asset classes (equities, bonds, commodities etc). ETFs can be bought and sold on stock exchanges so in terms of access for ordinary consumers they are currently only sensible for those with a lot more to invest (because dealing costs need to be taken into account for transactions in small amounts) who also have an account with a broker. But top financial adviser firms are increasingly using ETFs to build very low cost portfolios for their clients and it is this type of approach that might potentially be capable of being translated to the mass market. Black Rock point to the fact that it would be possible for a firm to construct packages of ETFs and create a range of low cost “safer” or ethical investments, but of course it is likely to be the case that any firm that packaged together a number of ETFs and then sold them to the retail market would add a layer of costs of its own and this might reduce the attraction of this approach. Also there is a need to be careful about the precise nature of indvidual ETFs as some may not be funds but derivative instruments or structured notes so scrutiny is needed of the counterparties and risks involved.

18. Is the issue more one of clearer disclosure rather than a need for "safer" products?

Mention has already been made of *"The Skills for Life Survey"* ("Survey") and before considering the extent to which consumers might be assisted by clearer disclosure about the features of products it is worth thinking first about the level of literacy and numeracy among the population as a whole. The Survey found that around 17.8 million adults had literacy skills at Entry Level 1 or below. Among this group, around 5.2 million adults had Entry level 3 or lower literacy skills. In respect of numeracy, the Survey found that around 23.8 million adults had numeracy skills at Level 1 or below. And among this group, 15 million adults had Entry level 3 or below numeracy skills and that 6.8 million of these were classified at Entry level 2 or below.

In 2006 the Leitch Review of Skills commented on the findings from the Survey in *"Prosperity for all in the global economy –world class skills"* as follows:

> *"The UK uses five levels to measure literacy and numeracy skills: Entry Levels 1, 2 and 3, Level 1 and Level 2. The Moser Report identified Level 1 literacy and Entry Level 3 numeracy as the standards necessary to function at work and society in general. An example of an Entry Level 3 numeracy skill is being able to add or subtract money using decimal notation, or being able to work with fractions.*
>
> *"Surveys, like the Skills for Life Survey ..... assess people's basic skill levels using a variety of literacy and numeracy problems. In 2003, 16% of the working age population in England, over five million people, lacked Level 1 literacy skills and 21% (6.8 million) lacked Entry Level 3 numeracy skills."*

In addition to the widespread lack of skills in basic literacy and numeracy many consumers also lack financial capability. It is well to bear these limitations in mind when thinking about whether or not better disclosure is the answer to consumers' needs.

In fact, the quest for "better disclosure" is long-standing. In 1994 the FSA's predecessor established a "task force" of regulators which was charged with tackling a number of thorny issues which had been under dispute since the 1986 Financial Services Act was implemented. One of the results of the work of the "task force" was the design of Key Features (later to be renamed Key Facts by the FSA) documents. In 1994 the Securities and Investments Board published the proposals of the "task force" and this included specimens of how Key Features might look for some products. So, for example there was an example of Key Features for a low-cost with profits mortgage endowment. The first page was devoted to describing in plain language the aims, risks and commitments of the product. So, for example under "Risk Factors" the example said:

"The proceeds will depend on investment performance. The amount you get back may not necessarily cover the mortgage.

- *Your circumstances may change, forcing you to cash in early.*
- *Our deductions may turn out to be higher than expected."*

Then inside the Key Features there was a question and answer format which included "Is repayment of your mortgage guaranteed?" with the answers "We do not guarantee to repay it at the end of its term. But it would be repaid if we were able to earn 55 or more on your contributions.

Key Features documents (KFDs) were implemented by the PIA in 1994 which gave additional guidance to the effect that the documents should be produced to the same standard as other marketing material and firms should not seek to "hide" the documents. It has been a regulatory requirement since that Key Features be provided to consumers purchasing a range of financial products. In 2003 the FSA reviewed the Key Features disclosure regime to see if there were any ways in which it might be improved but the outcome of that work indicated that the costs of making changes would be disproportionate to any marginal benefits in clarity which might result (*"Informing consumers: product disclosure at the point of sale")*.

One of the problems with Key Features seems to be the shoddy way in which some firms implement the regulatory requirements. In 2007 the FSA carried out some thematic work and published the results in *"Good and poor practices in Key Features documents"*. This research found that only 15% of Key Features met the tests of both being compliant with the rules and also consistent with the spirit of Principle 7 (that a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is fair and not misleading). There were a further 35% of documents which were described as "poor or ineffective" which were "often difficult to understand with a wide range of deficiencies and few, if any, positive attributes".

The remaining 50% of documents failed to meet the standards of Principle 7 and the FSA said:

> *"Only a very well informed consumer would be able to understand the important features of a product by reading the KFD."*

The FSA described the main areas of concern as:

> *"explanations of risk, charges and more general information about the product itself and its aims. Jargon is also a significant problem."*

One interpretation might be that firms simply do not have people with the right skills to write concise and simple documents. But that does not seem to be borne out by the FSA's report which says:

> *"We have also observed a marked contrast with some of the accompanying promotional literature that we have seen. Firms often seem to pay more attention to making other documents consumer friendly, clear and engaging, rather than the KFD."*

Key Features were originally implemented in 1995, the fact that almost 15 years later the regulator is still finding such widespread failings suggest that there are many marketing and sales functions in firms that are simply laughing at the regulatory requirements and they are not being kept in check either by the compliance function in firms nor by the FSA itself.

In 2004 the Treasury Select Committee (TSC), in its Eighth Report, called on the FSA to improve product information. It said that:

> *"It became clear in the course of our inquiry that the current information on savings products provided to savers is sometimes not effective in allowing them to make informed judgement as to the suitability a product. One of the best ways of minimising mis-selling is to provide savers with clear, accessible and succinct information on the product so that they can judge its suitability for themselves. We challenge the industry and regulators to develop over the next six months a simple standardised Summary Box, brief enough to be displayed prominently in most marketing material. The Summary Box might show: whether the client is guaranteed to get his money back, any other guarantees attached to the product, the risk rating of the product, what the investment is linked to, what are the charges and if there are any penalties for early withdrawals." The TSC though that developing a simple system of signalling the inherent risk level of a savings product "would both inform the consumer and ensure that the product provider had thought seriously about the risk inherent in the product".*

The FSA failed to deliver the kind of system sought by the TSC, claiming that:

> *"other approaches are more effective at enabling consumers to take informed decisions on risk than the mandatory disclosure of a simplified risk rating system".*

Instead the FSA suggested that the financial services industry:

> *"may have greater freedom ... in which to explore innovative solutions or initiatives, such as the development of common risk rating measures, the harmonisation of classifications and the fostering of a single language."*

Although some of the financial services trade bodies did devote effort to the risk disclosure issue they have so far failed to come up with a solution. Now the focus has shifted to Europe, where the Committee of European Securities Regulators (CESR) has put recommendations to the European Commission on a methodology to create a synthetic risk reward indicator for UCITS (although it might also have a read across to unit linked funds) which would aim to rate the riskiness of funds on a scale of 1 to 7.

Unfortunately this proposal is already subject to criticism by the industry. In a joint ABI/IMA Research Brief the two trade bodies say:

> *"Using CESR's recommended category boundaries produces excessive bunching, with one third of asset classes and one half of authorised funds having category 6 as their model risk category, and no asset class has either category 1 or 7 as its modal rank. This will make it harder for consumers to differentiate between funds in order to make better decisions."*

It is not clear to what extent consumers would actually welcome the proposed synthetic risk reward indicator as it does not appear to have been consumer tested to see if it does enhance consumer understanding of the degree of risk attached to funds. Also, in *"Consumer understanding of financial risk"* it was found that:

> *"There were mixed reactions to the proposal of a risk rating system among respondents, with the low to medium financially sophisticated feeling that it would be of use while the high financially sophisticated felt that it wasn't tailored enough for their use. Others did not understand the system, or felt that it lacked relevance to their needs."*

It is also not clear when, or even if, the European Commission will implement the proposed risk reward indicator. Meanwhile, consumers will have to continue to rely primarily on the narrative description of "risk factors" contained in Key Features documents and to the extent that firms are honest and open in the description of risks which they give.

But some thought that disclosure was important. One major insurer was critical of "industry jargon" and thought that if more was done by firms to explain what they are trying to achieve with consumers' money this would be better than attempting to design any new, "safer" products.

19. What mechanisms could be used to deal with changes over time?

I commented earlier in this report that much of the financial services industry seems to measure its success on the extent of new business which it sells rather than on whether it is doing a good job for its existing customers. Very few consumers have an ongoing relationship with a financial adviser and in many cases consumers need to look to any institution with which they have a product for any support. One major insurer, for example, told me that it has around over 4 million retail customers of whom 2 million are without any adviser and it is expected that this number will grow significantly after the implementation of the RDR. It already has a process which aims to try and support existing customers and it will be expanding this capacity. There are, however, limits to which customers can be supported, both because of the need to avoid giving regulated advice and because the service does come at a cost. But existing customers of other financial service providers often do not have even the limited form of help which this particular insurer has decided to provide; instead they may have to rely on whatever communications issue periodically from their product provider.

A point made earlier in this report is that a “safer” product may not remain so: either because the characteristics of the product change in some way, or general economic conditions change, or most likely the circumstance so an individual investor change. It has not been possible in the time available to examine all possible ways in which consumers that once having bought a financial product are kept informed about its progress or are prompted to think about its continuing suitability to their needs. What I would suggest is that this issue might be a suitable area for future Thematic work by the FSA to try and assess:

- the frequency and adequacy of information provided to consumers about their investments and whether or not the consumer is also given a prompt to think about the continuing suitability of their investment;
- whether or not there is anything the FSA could do to help support and encourage initiatives like those of the insurer mentioned above to provide on-going support to its customers;
- whether or not there might be a case to standardise some elements of ongoing information provided to consumers as has been the case for Key Facts provided when a product is sold.

20. Concerns over the FSA and the FOS

A frequent concern I heard from many of those in the industry to whom I spoke was over the risk of regulatory action by the FSA or of the FOS finding cases in favour of consumers as respects processes like basic advice, or were it to be introduced simplified advice. In some cases this was advanced as an important factor in deciding not to offer basic advice aside from the more obvious one of the charge cap on stakeholder products.

As regards the FOS, I find it difficult to reconcile the industry's concern with the facts. In respect of basic advice the FOS set out its approach quite clearly:

> *"We will assess the complaint on the understanding that the consumer received 'basic advice'. We will not, for instance, expect a factfind to have been completed, nor for the adviser to have made detailed enquiries to 'know' the customer. We are already used to dealing with many products where there is no requirement as regards 'suitability' or 'know your customer'. In such cases – so long as consumers are not misled – we expect them to be responsible for their own choice."*

It is true that there have been few firms which have decided to offer basic advice but on asking the FOS how many complaints it has had about the process I was told that in the last year it had just five "complaints" but as they all involved simple administrative errors they were sorted out quickly and without the need for any of the cases to be referred to an ombudsman.

The FOS also gave some helpful views in commenting on the RDR, and identified key issues with any advice or sales process as including:

> *"the extent to which the processes encourage consumers to invest;*
>
> *whether the processes include what a court would consider to be advice;*
>
> *how far financial businesses can ensure their staff keep to the designed processes."*

The FOS also observed:

> *We have no reason to doubt the view, expressed by many industry players, that there is unlikely to be significant take-up in the consumer mass-market unless the sales processes involve, at the very least, some degree of legitimate encouragement. And banks and insurers do not appear to have found it easy to devise potential sales processes which provide sufficient legitimate encouragement for the consumer without also involving, at least, an implicit personal recommendation, - triggering the suitability requirement. At an earlier stage in the RDR, the FSA indicated that it was prepared to consider the possibility of a modified regulatory regime, within the constraints of MiFID and UK law. But, as*

indicated in its November 2008 feedback statement, the FSA has not yet been persuaded that a special regime is necessary."

"It may be that this arises, at least in part, because some of the work by banks and insurers appears to have concentrated primarily on trying to devise processes that seek to exclude regulated advice and a personal recommendation. As one industry member conceded in private, it might perhaps have been more fruitful if these banks and insurers had focused first on devising processes which worked well for customers and potential customers and then considered how the rules applied (or might need to be changed). Some of the prototype models devised by the industry, although intended to avoid regulated advice, were considered by the FSA to involve regulated advice – and were considered by us to involve what is legally advice, whether regulated or not. As indicated in the FSA's November 2008 feedback statement, the legal concept of what constitutes advice is broader than the definition of regulated advice. So a process which avoids regulated advice will not automatically avoid what a court would consider to be advice. A financial business which aims to encourage consumers in the mass-market to buy investments may find it difficult to restrain its staff from providing what will be interpreted as advice. So it might be safer for financial businesses to accept that and to develop the concept of what has been called in the past 'focused advice'".

When I conducted research for the FOS on its handling of mortgage endowments complaints (*"The Financial Ombudsman Service and mortgage endowment complaints")* I also encountered similar concerns on the part of the industry but again could not find evidence to indicate that the concern was a valid one.

I can only report the industry's concern over the regulatory risk from the FSA, it was not central to this report to examine any evidence on the validity of the claim nor did I have the time to look at such evidence. I can only observe that it is the FSA's role to ask challenging questions of firms. Indeed, the FSA has been criticised for not being challenging enough in the past. It seems to me that the industry cannot complain if it is simply being "found out" by the FSA in devising products or adopting selling practices which cannot be reconciled with treating customers fairly (precipice bonds, payment protection insurance etc).

21. What are the possible legislative barriers?

It would be necessary for the Panel to seek professional legal advice for a statement of the legal position regarding any barriers that may exist in respect of product regulation. Nonetheless, anyone who has been concerned with the development of financial services policy needs to have an awareness of the potential constraints that may apply when developing policy and be able to frame specific questions to legal advisers. It is with that background that I offer what are no more than pointers to the Panel on the legal measures that may be at issue.

The Treaty of Rome would prohibit rules which would have a direct or indirect discriminatory effect on EU products being sold in the UK.

There is a framework of Directives for financial services. In the case of the UCITS Directive, already discussed, it provides for a system of "product regulation". Other Directives govern either particular types of product (such as life assurance), or services (such as the Markets in Financial Investments Directive – MiFID). In the case of the Directive covering insurance there is actually a prohibition on member states requiring systematic prior notification of contract terms.

When implementing Directives in the UK it is not open to the Government or the FSA to set standards that are below the minimum provided for in the relevant Directive. It may be possible to set standards that are in excess of a Directive's requirements but in that event the UK needs to justify such standards as being in the "general good". It appears that the EU is less willing than it has been in the past to accept claims from member states on "general good" grounds. Similarly, the UK appears to have been less willing to propose rules that go beyond the minimum standards set in a Directive as that would mean notifying the EU and possibly having such rules challenged in the European Court.

The Financial Services and Markets Act 2000 (FSMA) gives the FSA power to make rules. In proposing new rules the FSA must have regard to a number of considerations set out in FSMA. Among these considerations the FSA must have regard to the desirability of facilitating innovation and the need not to unnecessarily impede competition. Like any public body that makes rules the FSA may in exercising its rule making function be open to challenge in the courts through judicial review. Also, rules made by the FSA are subject to scrutiny by the Office of Fair Trading (OFT). The OFT may find that the rules of the FSA have a significant anti-competitive effect that is more than necessary to protect consumers, maintain confidence in the financial system, or to implement international obligations. Outside of those rules necessary to implement the provisions of the UCITS Directive the FSMA does not provide for any power for the FSA to make rules to regulate products.

It does, however, seem to be open to the FSA to make rules that:

- set voluntary benchmarks for savings or investments in the same way that HM Treasury did for CAT-standard products
- impose controls on the sale of particular savings or investments incorporating particular terms (for example unfair contract terms)
- limit or ban particular charging structures, including controls on commissions
- prevent the sale of particular products to members of the general public.

In addition to the specific Directives dealing with types of product (UCITS and the Insurance Directives) it is also necessary to have regard to Directives which govern the selling of products. In this regard the most important to mention is the Markets in Financial Instruments Directive (MiFID). This Directive caused the FSA to modify its rules on Basic Advice. The effect of the changes was to allow only firs not subject to MiFID (or non-MiFID subsidiaries of MiFID firms) to sell stakeholder products using Basic Advice. Currently the European Commission is engaged in a review of certain aspects of MiFID. Alongside this review the Commission is also conducting a so called Packaged Retail Investment Products Review (PRIPs). The outcome of these reviews is expected around the turn of 2010. Therefore, if the Panel wished to suggest any changes to facilitate the sale of "safer" products it could do so to the Commission.

Since this report was prepared the Government has published its proposals for reforming the regulatory regime. These proposals include abolition of the FSA with its functions being split between a Prudential Regulation Authority and a Consumer Protection and Markets Authority. As the proposals stand at present it does not appear to me that they either add to or remove any of the constraints which currently apply to the FSA as regards product regulation.

22. Would an EU approach be preferable to the UK going it alone?

Much of UK financial services regulation already derives from European Directives. And even where Europe does not set out specific legislative measures it may still act as a constraint on the UK's ability to make domestic rules (for example, the "general good" factor). Also, as has been briefly mentioned in this report there are proposals emerging in Europe for products meeting the needs of the single market beyond the scope of UCITS schemes. The Panel might therefore wish to use its influence to help shape the direction of European policy if the Panel sees the merit in either "safer" products, or simplified selling, or both.

ANNEX A –Firms and other bodies contacted

AEGON

Artemis

Association of British Insurers

Association of Financial Mutuals

Association of Investment Companies

Aviva

AXA

Beacon Strategic

Black Rock

British Bankers Association

Department of Work and Pensions

European Financial Services Roundtable

Fidelity

Financial Services Ombudsman Scheme

Foresters Friendly Society

HSBC

Investment Management Association

JPMorgan

Lanson Communications

Legal and General

LV

Lloyds TSB

Lyncombe Consultancy

Mandatory Provident Fund Authority, Hong Kong

Marks and Spencer Financial Services

Nationwide Building Society

National Savings and Investments

Personal Accounts Delivery Authority

Prudential

Santander

Schroders

Scottish Widows

Standard Life

Tax Incentivised Savings Association

The Childrens' Mutual

Tesco Bank

The Red House

Tower Hill Associates

UKSIF – the sustainable investment and finance association

Vanguard Investments

(The following were invited to provide input but failed to do so)

Barclays

Co-Operative Financial Services

Royal London

Institute of Actuaries

Sainsbury Bank

Australian Securities and Investments Commission

ANNEX B – Desk based research

Association of British Insurers

"Cost of Providing Financial Advice", Research paper No22, 2010

"Pension annuities and the Open Market Option", Research Paper No8, 2010

Charles Rivers Associates

"An assessment of the extent of an identified need for simplified, standardised financial service products" December 2004

Consumers' Association

"Financial Products Regulation" Policy Paper, June 1998

Department for Education and Skills

"The Skills for Life Survey" 2003

Department of Work and Pensions

"Households Below Average Income" 2010

European Fund and Asset Management Association

"Revisiting the landscape of European long-term savings: A call for action from the asset management industry" March 2010

European Financial Services Roundtable

"Pan-European Pension Plans – From Concept to Action" 2007

Financial Services Authority

"The Price of Retail Investing in the UK", Occasional Paper by Kevin James, 2000

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"A Basic Advice Regime on the Sale of Stakeholder Products: Feedback on CP04/11", Policy *Statement 04/22, 2004*

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"Primary Advice: Consumer Perceptions of the Primary Advice concept", Consumer Research 71, 2008

"Asset ownership, portfolios and retirement saving arrangements: past trends and prospects for the future", Consumer Research 74, 2008

"Basic Advice – a post-implementation review" 2008

The impact of life events on financial capability", Consumer Research 79, 2009

"Retail Investments Product Sales Data Trend Report" August 2009

"Restoring Confidence & Trust", speech, 19 September 2009

"Annual Conference Conducting Business with Consumers – Delivering the Best Outcomes", speech, November 2009

"Delivering the right regulatory framework", speech, March 2010

Financial Services Consumer Panel

"Research into Risk Ratings" 2007

"Building Personal Accounts –securing a retirement income", consultation response 2009

Financial Services Ombudsman Service

"How we handle cases: stakeholder products and basic advice", FAQs on website

"The Financial Ombudsman Service and mortgage endowment complaints", Report by David Severn, 2008

Frontier Capital Management

"When is a Total Expense Ratio not a Total Expense Ratio?", April 2007

HM Treasury

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"Charge caps for new stakeholder products", Press Notice 57/04, June 2004

"Stakeholder suite providers", Press Notice 42/05, April 2005

"Prosperity for all in the global economy – world class skills", Leitch Review of Skills, 2006

"Simple Transparent Products Discussion Paper", Retail Financial Services Forum, March 2010

"Simple Transparent Financial Products Research", Report by Gfk, March 2010

Institute for Fiscal Studies

"How does inflation affect different households?" 2009

"How Much Do We Tax The Return to Saving?" 2009

Investment Management Association

"Asset Management in the UK 2008", July 2009

"Note on CESR's recommendations for the calculation of a synthetic risk reward indicator", Research Brief 2010

Lipper

"Profiting from Proliferation", June 2009

Nottingham University Business School

"The UK with-profits life insurance industry a market review", Centre for Risk and Insurance *Studies, 2009*

Office for National Statistics

"Job mobility and job tenure in the UK", Labour Market Trends November 2003

"Population estimates"

"Annual Survey of Hours and Earnings" 2009

"Wealth in Great Britain" 2009

Oliver, Wyman & Company

"The Future Regulation of UK Saving and Investment: Targeting the Savings Gap" 2001

"Strategies for Tackling the Savings Gap: The Role of the Saver Agent" August 2002

Opinion Leader

"HM Revenue and Customs Pensions Taxation reform: a baseline study of individuals" 2008

ORC International

“Assisted Purchase”, Report jointly commissioned by ABI and BBA, October 2009

Pensions Institute

“ Performance Persistence in Mutual Funds: An Independent Assessment of Studies Prepared by Charles Rivers Associates for the Investment Management Association”, Report prepared for the FSA, April 2003

Personal Accounts Delivery Authority

“Building personal accounts: designing an investment approach”, November 2009

Personal Investment Authority

“Evolution Project”, Discussion Paper, 1996

“PIA’s Evolution Project: The Next Steps”, Consultative Paper 23, 1997

Securities and Investments Board

“Life Assurance: disclosure of commission and other matters”, Consultative Paper 77

Treasury Select Committee

“The Economics of Pensions”, Written Evidence by the Consumers’ Association, July 2004

“Memorandum submitted by the Association of British Insurers”, May 2006

William F.Sharpe

“The Arithmetic of Active Management”, The Financial Analysts Journal, 1991

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Annex C - Research for the Consumer Panel: background note

1. On 23 March the Retail Financial Services Forum published a discussion paper called "Simple Transparent Products". In the context of the Retail Distribution Review the FSA says it is looking to the industry to come forward with proposals on simplified advice. And more generally the FSA has given indications that it will be taking a much closer interest in product design. Against this background the Financial Services Consumer Panel (FSCP) wants to be in a position by about July 2010 to take a view on whether or not it supports the development of what it is calling "safer products" and if so what sort of selling regime should apply to them. To that end the FSCP has commissioned David Severn to conduct some research to gather evidence from the financial services industry and to prepare a report. The focus of the Panel's interest is in medium to long-term savings and investment products and in annuities. On the basis of the report and other evidence available to it the FSCP will then form its own view on the merits or otherwise of developing simpler/safer products. The FSCP wishes to hear the views of the industry on, among other things:

. The feasibility of introducing a set of simpler/safer products

. The type of products to which such an approach might apply

. What the industry sees as the risks and benefits of such an approach and how it might be applied in practice

. Any ideas the industry might have about new ways of distributing such products, in particular to reach those consumers who currently could save but do not.

2. The information gathering stage of this project needs to be completed by about mid-June. In the time available it may not be possible to see too many individual firms. The product provider trade associations therefore probably have a key role to play in ensuring that a representative view emerges from each sector. To that end I would be grateful if associations would consider ways in which to get involvement by their members.

3. I will be contacting as many individual firms as I can in the time available. But given the time constraint it may not be possible to see each firm face to face and so I would be grateful if firms would be prepared to deal with this matter by telephone conference call or email if need be.

4. I am enclosing with this background note a list of the possible areas to be covered in discussion with trade associations and firms.

Annex D - Issues to discuss with the industry

Firms' experience of product regulation

1. If firms have sold in the past CAT-standard or stakeholder products it would be helpful to hear their experiences.

What issues did firms have over the design of the products or over their distribution?

Which products did the firm sell?

Were there any notable successes in selling such products and to what does the firm attribute the success?

If there were failures to what does the firm attribute the cause?

2. Collective investment schemes have long been subject to product regulation but firms would probably agree that existing requirements would probably not qualify all CIS as being "safer products".

What could be learned from CIS product regulation about how safer products might be developed?

What might be done to UCITS legislation to enable a type of "safer" scheme to be introduced?

Firms' customer research

3. What does the firm's own customer research tell it about customers' desire for "safer products"?

What sort of products if any has the firm launched to try and meet the needs of customers?

What might be learned from the firm's experience that might be of general applicability to this issue?

Does the firm think that "safer products" are really only needed for a particular segment of the customer base or are they suitable for all consumers?

How should a "safer products" regime be governed?

4. There is a variety of ways in which "safer products" might be governed and the following ideas are not mutually exclusive. Which do firms think will work best?

Legislation at the EU level such as exists with the UCITS Directive?

Legislation at the UK level such as we have with stakeholder pensions?

Voluntary standards set by the Government such as happened with CAT-standards?

Voluntary standards set by the industry?

Self-certification by firms that their products meet a particular standard?

Pre-notification to the FSA (subject to EU/UK legal constraints)?

What changes might be needed to distribution arrangements?

5. Different regulatory requirements obtain to the selling of products depending on the product at issue. How would firms like to see these modified if "safer products" were introduced?

Has the firm used a basic advice process and if so what can be learned from it?

Is the firm looking at a simplified advice process?

Would the firm see "safer" products as suitable for non-advised distribution (subject to any current

Mifid constraints)?

Should “safer” products be excluded from the adviser charging regime?

The Mifid Directive is to be reviewed, are there any changes which might go on the UK shopping list to facilitate sales of “safer” products?

Should the normal redress and compensation arrangements apply?

6. If a set of “safer products” is designed should the existing arrangements for handling consumer complaints apply to those products? If not, what modifications would firms suggest?

Should the existing compensation arrangements apply?

Is this less an issue of product design and more one of clearer labeling?

7. The RFSF has asked if the issue of simpler and transparent products is less one of product design and more one of better labeling. What do firms think?

Annex E - About the author

David Severn was a financial services regulator from 1988 to 2004. In 1988 he was the first Secretary to the Building Societies Commission. In 1989 he moved to the Securities and Investments Board, then in 1994 to the Personal Investment Authority, and finally to the Financial Services Authority which he left in 2004. In 2005 he was Director General of the Association of Independent Financial Advisers. Since 2006 he has undertaken occasional regulatory consultancy and journalism. He is a Governor of the Pensions Policy Institute.