

HMT CONSULTATION REFORMING FINANCIAL MARKETS

Rt. Hon Alistair Darling,
HM Treasury,
1 Horse Guards Road,
London,
SW1A 2HQ

Dear Sir,

REFORMING FINANCIAL MARKETS

In addition to above consultation paper the global banking crisis of 2008 has necessitated a number of in-depth studies including those of Lord Turner and Jacques de Larosiere.

Essentially, focus has now passed to taking the macro and micro-economic measures to avoid, or at least to mitigate, any similar occurrence in the future without recourse to the tax payer. The recent G20 conference in Pittsburgh and the rulings of the Financial Stability Board together with EC plans to establish a European Systemic Risk Board (ESRB) will undoubtedly have a fundamental influence on the future of UK banking as activities and strategies are scrutinized and capital bases are significantly strengthened.

However, HM Treasury raises a number of key issues in Reforming Financial Markets which remain unanswered. In particular, annex B includes a section entitled 'Competitive markets that work for consumers' and discusses the difficulties of providing financial services in a viable regime for product provider, distributor and consumer across all income groups. On this occasion, rather than respond across all the topics highlighted in the CP text, we believe that greater value can be provided by focusing exclusively on an area of our expertise. This is section 2b regarding 'access to simple, transparent products'.

Many commentators feel that the FSA's current RDR proposals will create a regime where investment advice will only be available to the HNW and the needs of lower income groups are being overlooked. We will explore this issue in appendix A whilst our formal response to the specific questions 12 to 17 as raised in the CP are to be found in appendix B.

Please do not hesitate to contact me should clarification be required on any point.

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Appendix A

COMPETITIVE MARKETS THAT WORK FOR CONSUMERS: ACCESS TO SIMPLE, TRANSPARENT PRODUCTS

BACKGROUND: Personnel within the ea Consulting Group (eacg) have been closely involved with the ongoing Retail Distribution Review (RDR) and over many years have worked with a number of clients concerning CAT standard products and in the creation of the Stakeholder and Basic Advice regime.

Whilst the outcome of strategic reviews must remain confidential it is clear that most product providers and distributors in the marketplace are now focusing on the HNW. eacg experience has included implementing a live basic advice pilot using personnel that had previously conducted several phases of market research on behalf of the FSA using High Street bank 'non-regulated' sellers. This work resulted in the research papers CR23, 28 and 32. More latterly we have investigated the effectiveness of the 'primary advice' proposals that appeared initially in the FSA's RDR discussion paper (DP07/01) and have studied a number of distributors attempts to deliver simplified advice processes.

In a former life I was myself a member of the BBA's Sandler Committee as a nominee of the Lloyds Banking Group and also represented Scottish Widows at the ABI and HM Treasury regarding the introduction of Stakeholder products.

INTRODUCTION: Despite the reluctance of the FSA and the majority of distributors to engage on the issue, eacg firmly believes that a simplified advice process is required (linked to a limited range of priority products) especially for lower income groups to support the Money Guidance programme and moves to boost financial capability.

Any new regime must be proportionate but also seek to eliminate the possibility of consumer detriment. Any advice process should recognise that there is a fundamental difference between, say, a €100,000 lump sum investment (where full advice is advisable) and a €25 monthly regular premium where the investor essentially wants an assurance that they are doing the right thing. The RDR proposals fail to appreciate the difference.

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BASIC ADVICE: Sadly, no economically viable simplified investment advice process has evolved to date for general application although Foresters, with a limited business model, has adopted basic advice.

The FSI in general has been an outspoken critic of basic advice, steadfastly promoting full advice despite early market research using Basic Advice decision trees which showed that the percentage of 'acceptable outcomes' was higher than that achieved by formally qualified financial planning consultants. With hindsight, Stakeholder investment products with a fixed 1.5% price cap encouraged this industry response as most feared contagion. We must also recognise that financial capability continues to remain in its infancy in the UK and demand for a low cost advice route has been all but non-existent.

In essence, this means that if we are to close the savings and protection gaps today particularly for lower and middle income groups, we not only have to bring the horse to water but to make it drink without fear of financial detriment. It was, of course, a disappointment that MiFID did not create an opening for a viable simplified advice process as generic advice (lacking a personal recommendation) does not possess the catalyst that turns a consumer 'need' into a 'want'. The latter is a major reason for the poor uptake of basic advice by bancassurers who should, with higher footfall in their branch networks, have most to gain.

With very limited use most commentators expected basic advice to disappear following the earlier RDR consultation proposals but, on paper at least, it is now back in favour with the FSA. Many, however, believe that this is largely a result of criticism that a full advice, fee-incurring independent regime favours wealthier market segments. The FSA is effectively promoting exclusion should basic advice be withdrawn without any alternative available.

In defence of the FSA, the Stakeholder regime as envisaged by Ron Sandler only makes sense if supported by a low cost F2F advice process taking full advantage of the products' designated risk profile. For those contemplating a simplified advice process it should not be forgotten that evidence suggests that basic advice is simply an expensive way of selling a Cash ISA.

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PRICE CAP: The price cap also limits the attractiveness of the Stakeholder medium term investment product for the FSI. Lower ticket values inevitably generate narrow margins and overall there has been little scope for volume sales. A price cap is said to stifle innovation, although complexity in itself cannot defeat a bear market and innovation in any event might prove deleterious to the consumer. There is much to be said for adopting a sliding scale for management fees where both investor and product provider can benefit from a fund performance above certain thresholds for sustained periods. The remuneration of the product provider falls or is cancelled altogether where value is not created for the investor.

RISK: Risk treatment is the major issue for any simplified advice process. This is especially so in light of the 2008 global banking crisis and work to develop a standardized approach to investor risk assessment at EU level is most welcome. The suggested basic advice decision tree uses a simple 'low' (meaning cash) and 'medium' risk categorization (for a stakeholder investment product) but customer risk profiling by regulated DIB sellers in general involves a much more complicated approach.

Conflict is likely should a distributor decide to offer basic and full advice sales forces, opening the possibility that the consumer could come into contact with both advice processes. A Stakeholder product is potentially more adventurous than, say, an investor by inclination opting for a cautious fund, although historically, over a shorter time horizon, investors might be better served by staying in a savings account than by following a cautious investment strategy. Similarly, a guaranteed product is relatively expensive and charges might negate fund growth especially after a period of inflation.

RU64: Without doubt RU64 and the price cap has impacted on pension charges to the consumers benefit. Despite the advent of SIPP, where many product providers anticipated a hike in their own remuneration, RU64 has kept charges in check and created greater interest in Stakeholder pensions. Extending RU64 to other products is an option but will devalue its pivotal purpose with pensions if applied elsewhere. It is, however, believed that the RDR's proposals for 'independent' advice and an end to commission-bias should negate the need to consider extending the scope of RU64.

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PRODUCT REGULATION: As recognised by the Sandler Report in 2002 and, earlier this year, by the Turner Report there is much to commend product regulation in protecting the consumer and in promoting value-for-money. Whilst Sandler was concerned with savings and investments and the ABI subsequently explored the role of a 'saver agent', it is clear that a wider range of products is required today to meet the essential needs of all consumers (e.g. life cover) where affordability is not an issue.

PERSONAL ACCOUNTS: Currently scheduled to be launched by PADA in April 2012, this trust-based occupational pension scheme with auto-enrolment will inevitably impact on Stakeholder pensions. We must be mindful of this development in promoting a new low cost simplified advice regime.

After due consideration of all the above factors the following proposals have evolved which we believe are worthy of further consideration:

ea CONSULTING GROUP PROPOSALS: The following outline proposals for a new simplified, advice process will cater only for the essential needs of retail consumers. As the word "simplified" implies, the MiFID/IMD full advice process will not be replicated in full to deliver a much shortened assessment and recommendation. Consumers can request that advice only be provided for a particular need or product (e.g. life cover).

It is anticipated that the Money Guidance national roll-out will stimulate demand for low cost F2F advice as volume is key to the viability of any simplified sales/ advice process. Reference to the process should be made prominent within Money Guidance materials. This type of low cost simplified advice should be suitable for all channels (e.g. F2F, internet, telephone).

Although found wanting in many areas, basic advice has already proved the viability of decision trees as a user-friendly concept both for advisers and potential investors. Consumer risk aversion should be anticipated and although longer term investments in mutual funds should provide an improved return it is very important that the consumer understands that investments can fall in value. A very limited choice of fund is desirable to reflect the consumer's risk appetite (not, of course, including any higher risk exposure!).

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In terms of risk, the consumer will be protected largely by product regulation, although empirically both need and appropriateness should be established and affordability confirmed. Product regulation will limit investment risk and promote economies of scale to providers and distributors. Fundamentally, the advice process will offer value for money products with a far lower charge than that incurred for full advice under the RDR proposals. Any individual whose circumstances do not fit the use of decision trees must always be referred to a firm offering a full advice service.

Although the experience of “lifestyling” has proved mixed in the USA it is an approach that does offer simplicity and focuses the consumer on a date for retirement with a commitment to a longer term investment. Earmarking invested monies into an appropriate fund should also be simplified with a greater cash element as retirement nears. Pension calculators should be employed by advisers. Such pension treatment can continue from April 2012 alongside the new Personal Accounts although a review should follow after 12 months to see the impact of the one on the other.

It is suggested that the Stakeholder brand name be changed to ‘People’s Products’ or similar as the former name has little relevance to the typical investor. Such ‘People’s Product’s will be awarded a FSA kite mark to this effect and should also be available through the fully advised route to boost sales and the economic viability of the regime. Whilst public authorities are in general not thought good at designing products, we are here looking at basic products with long established features and benefits. No innovation is required beyond ruling on a cost structure.

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THE MAIN PROPOSALS ARE AS FOLLOWS:-

- Use of decision trees
- Applicable for new or novice investors only
- An upfront charge to cover the true cost of the advice
- Applicable to lump sum investments up to €25,000 and regular premium business
- Consumer can opt for a restricted decision tree approach focused on pre-selected specific needs
- No assessment of existing holdings/policies with preferred referral to a full advice process
- Extension of existing Stakeholder products to include protection (life-cover/MDTA & IPP)
- FSA to introduce detailed product regulation for all products within the scheme
- New FSA kite mark to aid consumer trust in selected products (features/costs/benefits)
- FSA to decide a range of acceptable management charges and kite mark confirms 'value-for-money'
- Ideally, re-branding of Stakeholder products to 'People's products'
- All products must be appropriate to the priority needs of unsophisticated investors/consumers
- Suitability and Affordability (or Over-indebtedness) must be empirically tested by decision tree and/or by use of distributor's own internal indices if available.
- Promotion of the ISA as a quasi-pension product (but offering immediate access etc).
- 'Lifestyling' for pension investments to simplify risk treatment – specify year aiming to retire + a preferred risk strategy to identify appropriate fund (cash/cautious/balanced)
- 'Advisers' using this process must complete a suitable T&C scheme to prove competency
- It is appropriate that the 'advisers' be formally called 'sellers' so that the consumer is fully aware of their role and relationship.
- Non-pension investment products (>5 years term) can be offered offering a choice of cash/ cautious/ balanced funds. Risk is reduced by product regulation.
- An Article 4 MiFID exemption will be required.

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Appendix B

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Q12: Would simplified labelling help consumer understanding of financial products? What lessons can be learned from the traffic light system of food labelling and how can these be applied to financial products? Should such labelling be compulsory? It is difficult to establish whether the use of a traffic light system for financial products will aid or confuse the consumer. If adopted it would certainly have to be compulsory. This will ensure that the consumer is always exposed to its existence and reference can be made to the traffic light colours awarded during the sales process. For comparison purposes, the consumer may also have some confidence that the traffic light treatment is consistent amongst all product providers/distributors.

That being said, whilst food labelling can easily focus on a few key constituents, it should be noted that cost is not amongst them nor the complexity of the food mix. The consumer in general has a far greater knowledge of food than of financial products but often cost will override any dietary or health considerations. The target market most likely to benefit from traffic lights with financial products is likely to display similar characteristics, either ignoring warnings or, as now, simply avoiding purchase altogether. Adopting different colours for different products will also complicate a world where everyone understands the meaning of red/amber/green but would certainly be confused if faced by, say, purple/white/blue. Red is universal currency for danger.

Ideally, financial products should be like Ronseal products and do what they say on the tin with a simple, easily understood description of structure and purpose. Rather than adopt the traffic light system the FSA should award a specific 'kite mark' for specific mainstream products meeting standard conditions including an acceptable cost structure. The FSA kite mark should in itself be sufficient to give consumers confidence in a product or to question why one has not been awarded. A RU64-style rule can also be introduced and apply where an adviser is not recommending a kite mark product.

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Q13: Which products would – and would not – be suitable for simplified labelling? Is it possible to establish a single system of disclosure for a diverse range of products? In promoting a FSA-driven kite mark it is our considered opinion that meaningful labelling has major drawbacks for all financial products although simplified labelling might be applied to term cover, mortgage protection assurance, medium term investments and ISA's in general. A single system of disclosure should not be attempted – investment products are fundamentally different to insurance policies.

Q14: Should price be benchmarked? Should there be disclosure to help people identify products which are relatively expensive?

Although price caps are believed by many to be 'anti-innovation' on the grounds of consumer protection, some indication should be provided that a product offers value for money.

The FSA's latest RDR proposals on investments will outlaw commission payments but highlight a fee for the provision of advice. The cost of advice will vary between advisors and the type of service provided but will be highlighted early in the advice/sales process to the investor.

With regard to fund management fees and insurance policy premiums a kite mark should be adopted as discussed in our response to Q12, and will be awarded to those products broadly offering (and of course those bettering) normal market rates. Although underwriting risk may create difficulties in making cost comparisons it should be possible to do so if based on the product provider's 'standard terms'. The kite mark should not be awarded to those, say, in the upper quartile cost distribution or where the majority of business is not undertaken on standard terms.

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Q15: Why do some existing simple products not sell well?

Fundamentally, simple products have been designed for a market sector that is very reluctant to purchase them irrespective of their purpose and value. Whilst governments have concerned themselves with the savings gap in lower and middle income groups there is also a larger protection gap. Financial capability is, of course, an issue and is likely to continue for a generation.

We should, however, not forget the importance of a stimulus to convert that 'need' into a 'want'. Tax relief undoubtedly boosts the sale of pensions and ISAs, with higher tax rate investors/HNW particularly favoured. The Savings Gateway experiment has had limited success but clearly underlines the need for a sizeable incentive if we are to influence behaviour.

Average UK earnings are approximately €25,000pa and young families will normally focus on day-to-day survival and holidays rather than on longer term savings and protection cover. High house prices and mortgage commitments plus many now with Student Loans will only accentuate the problem. Unsurprisingly, there has been suspicion and a lack of trust in the FSI fuelled of late by unacceptable IPP abuses and the 2008 banking crisis which highlighted the risk and complexity of many investment products.

The Stakeholder regime was doomed to failure largely as product providers feared contagion with a universal 1.5% price cap and looked to develop new products elsewhere. Many focused on creating 'guaranteed' investment products for the mass market with a complicated and more opaque charging structure.

The Cash ISA remains, however, very attractive to all those saving for a rainy day as it permits ready access in times of need. Despite RU64 the Stakeholder pension will not gain universal support unless an element of the funds invested can be accessed in case of need. Few on lower incomes will wish to invest in a non-occupational pension fund if monies must await retirement age before any pay-out can be considered.

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Q16: Should the Government extend the concept underlying RU64 to other products – i.e. require firms to demonstrate why a complex or expensive product is better than a simpler or cheaper alternative?

NO.

In light of the new RDR proposals with detailed rules defining 'independent' advice, any changes to RU64 will be a further and unnecessary complication. A prominent FSA-sponsored kite mark is a far simpler solution providing an assurance to the consumer that the product is fit for purpose and cost effective. Consumers will expect to see the kite mark and advisers must explain if the product has not been awarded such an accreditation and why not. Sufficient information should always be made available so that the consumer can make an 'informed choice' on whether to proceed with the purchase.

Simplified advice processes must only be permitted to offer products bearing the FSA's kite mark.

It should always be remembered that low cost does not guarantee a better customer service or an improved fund performance. A consistently top performing fund or fund manager may well justify a higher charges regime.

Q17: Who should set benchmark standards for products?

Overall responsibility should rest with one body – the FSA. Reference should, of course, be made to the leading FSI professional organizations (eg ABI, BBA) for input to ensure that any benchmark standards adopted are accurate, consistent &, if appropriate, proportionate.