



IMA Response

HMT / DWP consultation on proposed specifications for Sandler "stakeholder " products

May 2003

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Attached are the IMA's responses to the detailed questions posed in the consultation paper. We would draw attention to the following specific points.

- **Price cap.** The IMA remains opposed in principle to the imposition of a price cap on these products. Pricing should be left to the market, and competition has led to the existence of cheap mutual fund products since the late 1980s. We append the results of an analysis of the growth of "1 per cent" fund products over the last ten years, which demonstrates that they were the result of market forces and competition, and that the introduction by the Government of "CAT standards" in 1999 had no effect.

If the Government nevertheless persists in its view that a price cap should be imposed, IMA believes that it should be imposed in a way that allows providers flexibility over whether to include an initial charge, and should be equivalent to more than 1 per cent a year.

- **Type of product.** The IMA accepts that the "stakeholder" investment product should encompass unitised life funds as well as mutual funds. But the specification of what qualifies as such a product should require a fully open-ended structure, with no lock-ins or early redemption charges. Equally the "smoothed" product type should include capital protected mutual funds alongside with-profits funds.
- **Risk control.** The IMA accepts that a limit of 60 per cent equity content is appropriate in present circumstances, and proposes that its "cautious managed" sector would provide an appropriate specification. This should however be kept under review and a shift to the "balanced managed" definition (up to 85 per cent equities) may be appropriate in due course.
- **Pensions.** The IMA argues that there should be as little change as possible to the existing stakeholder pension model, so as to avoid confusion, although relaxation of the existing 1 per cent price cap is necessary. In effect, the only other change would be that a provider wishing to take advantage of the lighter touch regulatory regime should be required to offer the "default" option only.

Responses to detailed questions

Q1: Views on the appropriate lead – in time for product development

Given an agreed specification, the normal development time for a mutual fund would be up to 6 months. (The FSA endeavours to authorise a fund within a 6 week time frame, but exceptional circumstances could extend this.) Were there to be a number of firms seeking to enter the market at the same time, there is bound to be pressure on FSA, depositary and legal resources. However, the development time would be considerably longer were the product pricing basis to change, and extensive system amendments to be required.

Q2: Views on the generic name for the product range

“Stakeholder” is a term which, because of current usage, is growing in consumer recognition and would appear to be the most viable option for the brand name of the new range. The brand name “stakeholder” would precede the product name. We can suggest nothing better. It will, however, be important for the government and the FSA to take the lead in educating consumers about the range, the products within it and the sales process.

Q4: Views on whether the government should treat collective investment schemes and life assurance products as one “stakeholder” product

Although there are material differences between the two products, we understand the desire to consider things from the consumers’ perspective. We believe that it is important to apply this principle across all the categories of stakeholder product and that they should be defined according to their characteristics rather than their underlying structure. We believe, therefore, that there should be a “smoothed product” category; an “investment product” category and a “pensions product category. We agree with the Government that a product which offers smoothed exposure to equity markets is likely to be attractive and valuable to many in the target market for “stakeholder” products but would note that that it is not only through the with profits structure that such smoothing can be produced. Capital protected funds authorised by the FSA provide a similar result and we believe it is within the logic of the Government’s thinking to include these alongside with-profits in a smoothed products category.

For both the smoothed and the unsmoothed product we believe it will be important to define carefully the criteria which a product must fulfil in order to qualify for “stakeholder” status. In particular, the Sandler Report points up the importance of simplicity and transparency as to charges and pricing. This clearly needs to be reflected in the specification of the product range. More specifically, we suggest the criteria should include the following: -

- An obligation to offer a regular savings plan since this is likely to be the most convenient and appropriate method of saving for the target market.

- Exit penalties should be prohibited, whether for selling the product before a set date or for ceasing to make regular contributions.
- The products should be "open-ended" in that savers should be able to disinvest in whole or in part at any time without penalty.
- Daily valuation (as is already the case with mutual funds) would thus be essential.

Qs 5 to 9: Views on risk control

The IMA considers that the desired degree of risk control can be achieved by use of the IMA **Cautious Managed** sector. This definition is: -

" Funds would offer investments in a range of assets, with the maximum equity exposure restricted to 60% of the Fund. There would be no specific requirement to hold a minimum % Non-UK equity. Assets must be at least 50% in Sterling/Euro and equities are deemed to include convertibles."

Arguably, this definition is too low risk for a basic equity investment, and the balanced managed sector, which allows up to 85% exposure to equities, and is significantly more popular with investors, would be more appropriate. However, we accept that in present circumstances the cautious managed definition is about right. In time, when the current bear market is behind us, views may be different. We therefore suggest risk control methods should be reviewed periodically. A period of 4 years would be appropriate, in our view.

We would not accept that a lower equity exposure than that offered by the cautious managed sector would be right. If an investor is able to take on an exposure to equity risk then anything less than 60% runs the risk of not achieving an equity-related return. If an investor feels unable to take on such risk, perhaps because of insufficient cash savings to meet "rainy day" needs, that person should not be contemplating a "stakeholder" investment.

Q10: Views on the level and structure of the proposed charge cap

We believe that there should not be a charge cap. But if there is to be one all experience is that limiting charges to 1% annually leaves insufficient margin for distribution. If nevertheless the Government holds to the view that there should be a price cap, it should be set in such a way as to give firms the maximum flexibility in structuring their products and charges to take account of their distribution strategy. One possible formula might take the form "*x% over y years*" (where x is greater than y). In other words if the product were held for y years and did not change in value then the total charge paid would be x per cent. This is not to imply that the product would have to be held for a minimum of y years or that the maximum charge would be x per cent irrespective of how long it was held. The formula would be simply to

determine the range within which the balance could be set between initial and annual charges.

Evidence already exists in the mutual fund sector about the impact of government price controls, since the Government introduced in April 1999 the concept of "CAT standard" ISAs, whose charges would be limited to 1 per cent a year. The Appendix analyses experience of these funds. The conclusions are that:

- Products with a 1 percent price point were in existence well before the introduction of CAT standards.
- These products grew their market share in the 1990s, particularly as a result of growing popularity of index tracking products.
- A number of existing products adopted the CAT mark, and new funds which launched into this particular market also did so. But overall fund managers did not use CAT marks in their marketing.
- The introduction of CAT standards had no discernible impact on the market.

Qs11 to 20: Views on with – profits product

IMA members do not offer such a product, so we have no comments to offer.

Q21: Views on options for bringing stakeholder pensions into the Sandler regime

We agree that the most viable alternative would be to use the default option route applying investment restrictions to the fund which comprises that option. Clearly, it would not be acceptable, for the reasons which the discussion paper gives, to have two distinct Stakeholder Pension Schemes. Not only would this be confusing, but anything which gives investors the impression that they should switch from an old SHP to the new one is to be avoided.

If the SHP as amended is to sit comfortably within the Sandler suite then it would be important not to restrict investors to one investment choice, i.e. the investment limited default fund. We consider that investors should be free to choose from the range of funds available at point of sale, but as now, those who do not wish to choose should go into the default fund. However, only those properly qualified should be able to advise on what might be a suitable investment for a particular investor. Sales under any simplified sales process which the FSA might introduce would need to point investors to the default option .

Q22: Options for investment restrictions

We consider that the best approach would be to deliver investment restrictions through a general duty of care. The form set out in paragraph 115 of the paper is acceptable.

Q24: Views on issues unique to pensions in terms of charges

The upfront cost of acquiring pensions business is certainly more than that associated with other lump sum and regular contribution business. Distribution and advice, which needs to be taken into account individual pension circumstances and the range of pension options which might be available, is expensive. Annual maintenance costs are also higher and will continue to rise to cover statutory requirements such as statements and forecasts.

On the other hand pensions business tends to be more persistent than other types of business, accordingly there is more opportunity for funds under management to grow in value. Fund related annual charges, when taken as a percentage of fund value, can be set at a level which reflects this.

This points very firmly to the need for any charge cap not to have an annual flat limit of say, 1%. Rather, as we have said in our response to Q10, the cap should be set at $x\%$ over y years.

Q25: Views on including a guaranteed product within the " stakeholder suite"

As noted in response to question 4 we believe that capital protected funds provide a transparent smoothing mechanism which, from the consumer perspective, shows similar characteristics to a with profits product. We believe, therefore, that they should be included within a "smoothed product" category.

At present the products which are available on the market carry levels of capital protection of typically 90, 95 or 100 per cent in each one-year period. We do not think it is necessary to prescribe 100 per cent capital protection for inclusion in the Sandler suite. In principle the cost of a 100 per cent guarantee should, in a competitive market, be equal to the risk premium, so that over time such a product could be expected to deliver the same return as risk-free assets such as Treasury bills.

Allowing capital protected stakeholder products with less than 100 per cent capital protection opens the investor to the possibility of loss, especially in the sort of markets experienced in the last three years. But neither have investors in "with profits" products over the same period been immune from the risk of loss, through the application of MVAs. So it is reasonable to treat them on the same footing within the "smoothed" category.

The question then arises what should be the qualifying criteria for a capital protected collective investment scheme to be part of the "smoothed" stakeholder range. We suggest it would be sufficient to rely upon the existing criteria applied by the FSA in allowing a fund to use a name implies some degree of capital security. Such funds are authorised on a case by case basis with the following basic requirements:

- the policy and objective of the fund must provide a material degree of security in respect of the total amount paid for a unit;

- the protection must not cause the possibility of conflicts of interest between holders and the manager or depositary.

In addition, there are certain disclosure requirements in the prospectus and the Key Features Document as to:

- details of the protection;
- description of risks that could affect achievement of the protection including details of what happens when an investment is encashed before the expiry of any guarantee or protection.

We consider therefore that FSA authorisation should be a sufficient criterion as to suitability of the fund for inclusion in the suite (apart from other rules which may be imposed, e.g. on pricing).

Q26: No case for a protection product within the " stakeholder suite"

We agree that the variables described would not permit such a product within the "stakeholder" suite. However, the suite of products will not solve every financial need. Consumers must still ensure that their needs are prioritised. For many, family protection or debt rescheduling will be of paramount importance. Investors, especially those buying through the simplified sales process envisaged by the FSA in its discussion paper 19, must have these needs properly dealt with.

Q27: Views on the advantages and disadvantages of rebranding the CAT standard cash ISA to make it consistent with the wider " stakeholder suite" and on how this might best be done

The opinion of the IMA is that all CAT standards (not just that in respect of the cash ISA) should be abolished on the basis that they are subsumed into the new suite. All "stakeholder funds" should automatically qualify for inclusion in the equity component of an ISA. Otherwise we will have non – ISA "stakeholder" funds as well as funds which, because of their investment objectives, will not qualify for inclusion in the "stakeholder" range, even though they are acceptable as ISA investments. This would be a recipe for confusion.

Q28: Annuity product

We agree with the decision not to include an annuity product within the "stakeholder" suite.

Q29: Views on whether an advice service could have a place in the "stakeholder" suite, and the form it might take

The difficulty with providing a generic service of the type envisaged is answering the question "who pays?" Firms will normally offer an advisory service where the investor agrees to pay a fee for that service or commission can be earned from the sale of a product. Not all advice processes result in a sale, so the cost of the adviser's time is not

covered and the investor effectively receives free advice. However, this is seen as an acceptable commercial risk.

A generic advice service would not result in a product sale so there is no chance of cost recovery. Depending on the status of the firm or individual giving generic advice, there is even a risk that the investor would use the advice to make a purchase from a competitor. So setting up a generic advisory service is not normally seen as an acceptable commercial risk. Certainly not by those who have the capability to provide standard qualified advice.

It would be preferable for the shape of the product cost structure to be such that there would be sufficient upfront margin to pay for advice from a qualified person.

Q30: Views on whether explicitly linking the CTF to the " stakeholder" product would be helpful.

We consider that it would be of benefit. There would have to be "stakeholder" and "non-stakeholder" versions to give investors flexible choice of investment. But, as with the proposed revised stakeholder pension product the "stakeholder" version of the CTF might be the fund used for the default option with its investment restriction, and possible lighter touch sales regime.

Issues concerning the sales regime

Finally it will be very important for government and the FSA to be very clear about the relationship between the stakeholder range of products, and other investment products which sit outside the range. Providers and advisers must be under no obligation to sell or recommend a "stakeholder" product simply because it might be cheaper than another investment product which has been recommended as suitable for an investors financial needs. A more expensive product might offer more flexibility and features than the "stakeholder" product. Provided the product is suitable, cost should not be a factor on which the recommendation is judged.

Further, provided the terms of the contract have been delivered, there should be no recourse to compensation for investors who have decided to buy a "stakeholder" product through the simplified sales process envisaged by the FSA in DP 19, and who subsequently decide that it is not suitable for their needs.

APPENDIX

THE IMPACT OF CAT STANDARD ISA FUNDS

There are currently 50 funds on the market which are, or have until recently been, CAT-marked. They account for £11.6 billion funds under management at the end of February 2003, just over 6 per cent of the total (or about 11 per cent of funds held by retail investors). For the purposes of this paper we have included the certain funds which are no longer formally CAT-marked, since it is important to consider the market for 1 per cent funds as whole.

The sector breakdown of these funds is as follows:

	No. funds	FUM <i>February 2003</i>	% of total sector FUM
UK All Companies	29	£6.54 bn	12.6%
UK Corporate bond	8	£2.47 bn	13.5%
UK Other Bond	3	£1.1 bn	16.0%
Balanced Managed	3	£0.63 bn	13.9%
Europe Excluding UK	3	£0.51 bn	2.9%
Other	4	£0.38 bn	N/a

52 per cent of these assets are in tracker funds. 27 per cent are income funds (49 per cent of gross retail sales in the year to February 2003). Four per cent are in actively managed equity funds.

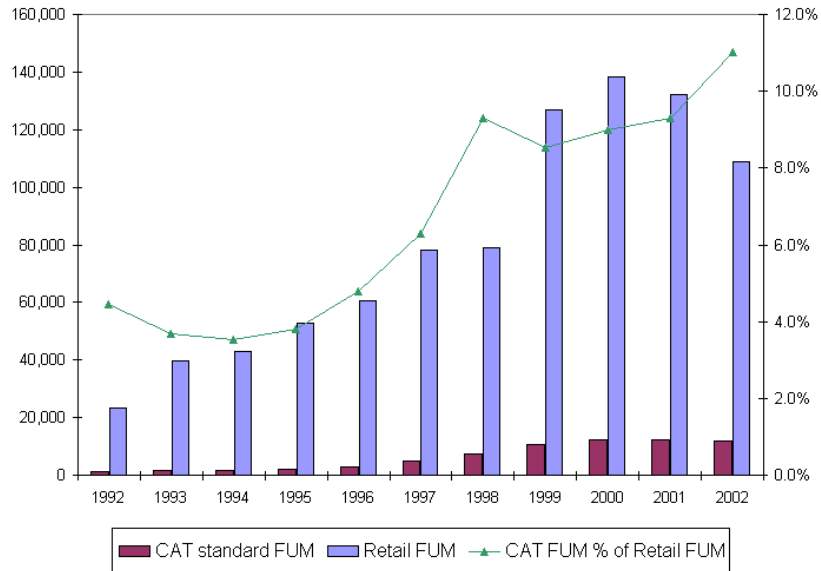
There is a high degree of concentration among these funds. The top ten funds account for 58% of funds under management, and 70% of gross retail sales in 2002.

These ten funds involve seven management companies, which between them account for 64% of 1 per cent funds under management. Five of the top ten largest funds are managed by only two companies, Legal & General Investment Management and Morley, although the latter group have recently dropped CAT marking from most of their funds. All but two of the top ten funds are distributed through sales forces.

What influence have CAT standards had?

Most of the 50 funds were already established, with their existing price structures, well before the introduction of CAT standards. Nine of the top ten were launched between 1988 and 1996. The following chart shows the growth of these funds in aggregate over the last ten years. Broadly speaking, they initially accounted for rather less than 5 per cent of the retail funds under management but began to grow their market share in the mid 1990s, levelling off at around 10 per cent by 1998.

CAT Standard FUM and Retail FUM



From this chart, it is evident that the main growth in market share occurred before the introduction of CAT standards in April 1999. The growth was largely the result of increased market share secured by existing funds, not the result of new fund launches. Since the CAT standard did not feature in the marketing of these funds, it cannot have been a factor in their growth. It follows that the existence of CAT standards was not the cause of the increase in market share over the period 1994-98.

In IMA's view, the fundamental cause of the increase was the growth of index trackers, a product for which this period was one of growing interest. Many of the funds which showed the most rapid growth over the period were trackers: between 1994 and 1998, the market share of the index trackers in this group grew from 1.1% to 5.5%, a five-fold increase. Over the same period, the market share of non-tracker 1 per cent funds also grew, but much less rapidly – from 2.4% to 3.8%. In other words, the increased market share of 1 per cent funds over the 1990s resulted from the growing popularity of index tracking products and not from the introduction of CAT standards.

The detailed fund level data underpinning this analysis is set out in the attached spreadsheet.