Quality Assurance or Benchmarking? Presenting Information About Pensions

Edited by Guy Palmer
With a preface by John Greenway MP

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PREFACE

John Greenway MP

The question of whether some financial services products could be given universal approval has been on the agenda for some time. This welcome pamphlet provides a timely, in-depth appraisal of the practical issues such an innovation would raise for both product providers and consumers.

It is timely because there is a growing acceptance that the Government's ambitious plan for stakeholder pensions and Individual Savings Accounts will not succeed unless transaction costs can be greatly reduced. As those costs are primarily caused by a highly prescriptive approach to the regulation of financial service products, both regulators and product providers have questioned whether the sale of products aimed at mass markets, rather than tailored to individual needs, might be given some form of exemption from the requirement to give detailed advice in every case.

Such an exemption might take two forms. 'Quality assurance' seeks to provide comfort to investors by signalling that the product meets minimum standards and can be regarded as a 'safe' investment, though it may not be the most competitive. 'Benchmarking' aims to assist investors to make some judgement of value for money by providing a set of common criteria by which costs and benefits can be compared.

Taken together, these two initiatives might obviate the need to give advice at the point of sale, just as happens now when people invest in a bank or building society account. The risk is that is of a loss of advice about suitability which investors currently enjoy.

Arguably, the need to ensure suitability is much more important when addressing long term needs such as pensions and life assurance. The challenge for the industry, and the ongoing reform of regulation is to maintain some vestige of suitability, whilst simultaneously reducing costs.

INTRODUCTION

Guy Palmer

Problems To Be Addressed

The papers in this pamphlet discuss alternative approaches to signalling the value for money of stakeholder and other pensions. They may disagree about the precise solutions, but their diagnoses are similar.

First, they basically agree about the problem. The complex presentation of traditional financial services to consumers will not work in the mass market of stakeholder pensions: they will not allow (often unsophisticated) consumers to choose pensions with any assurance that they are reputable and cost-effective, and the current regulatory framework will be too expensive to administer given the small scale of the typical investment. In other words, the worst of all worlds: ineffective and costly.

Second, they all argue that there should be an increasing focus on the regulation of products, rather than just on the sales process and company accreditation. Such product regulation, whilst a seeming technicality, would actually be a radical shift of regulatory philosophy, designed specifically for small investments by consumers typically not well versed in financial planning.

Third, they all basically agree about the need to simplify the presentation of financial performance, such that it can be characterised by a limited number of statistics presented in a common form between competing products, rather than as a complicated story which cannot easily be compared from one offering to another.

Finally, they all agree that a key feature of pension value for money is the level of charges levied, which can have a major impact on the amounts of money received. Anyone doubting this should turn to John Chapman's paper, which demonstrates the wide variations in charges between current financial services and the effects of these differences on the yields available to the consumer.

Possible Solutions: Benchmarking And Quality assurance

In their various papers, all the authors argue for a standard benchmark presentation of product value for money, based upon reduction in yield and (perhaps) investment performance. As Garry Heath argues, "*the inclusion of a factor based upon reduction in yield (RIY), or a combined RIY/investment performance figure, would give the client an idea of relative value particularly if accompanied by an industry average for that product*." This approach is analogous to the mandatory use of APR figures for loans.

In his paper, John Chapman takes the argument one step further in his development of a more sophisticated ABC rating system which draws a distinction between reduction of yield in the short, medium and longer terms respectively. He also proposes the publication of 'league tables' which rank different firms' products according to the rating system, and provides tables ranking current firms' products. His paper includes such 1997 league tables for a variety of company's products.

The term 'benchmarking' is used to describe the approach above.

Philip Telford also argues for a benchmarking approach, along the lines of he *Which?* Best Buys, and his paper includes the results of Consumer Association research about the problems that need to be addressed from the consumers' perspective.

Adrian Boulding agrees that comparative charges are important and proposes that the maximum charges permitted should initially be set at 1.5% pa. But he also argues that other factors need to be taken into account when choosing a stakeholder pension, particularly relating to security and flexibility. His paper provides a comprehensive checklist of such factors, ranging from "*automatic procedures to 'lock in' accumulated gains as retirement nears*" to "*transfer to another scheme allowed at any time*".

Importantly, he then goes on to argue that the Government should use such a checklist to accredit particular stakeholder pension products as meeting a defined set of criteria. The term 'Quality Assurance' is used to describe such an the approach.

The Role Of Government: Government Leadership

Collectively, the papers put forward a convincing case that 'something must be done' if the stakeholder pensions initiative is to be successful, and that the focus should be on the publication of reliable, comparative and easily available information to the consumer.

But it is very difficult for any independent third party to provide such information; in contrast with (for example) Standard and Poor's debt ratings, there is no long track record and no easy way of reaching the mass audience required.

Our conclusion is simple: the Government and its regulators need to take on a leadership role, making sure that consumers have a reasonable basis for comparing pensions. The papers in this pamphlet provide a variety of ideas upon which the Government could usefully draw.

QUALITY ASSURANCE: STAKEHOLDER PENSIONS

Adrian Boulding

Synopsis

This short paper seeks to establish the case for Quality Assurance and lay the ground rules under which a regulator might award the Quality Assurance mark.

The case for product regulation through Quality Assurance, as an alternative to today's regulation through ‘best advice’ is an economic one. For a small investor, the cost of ‘best advice’ is too high a proportion of the funds invested. Meanwhile product regulation can deliver a high degree of consumer protection for very little cost, provided the product is simple.

The paper examines how the regulator would ensure that the Quality Assurance mark can verify that a stakeholder pension delivers the security, flexibility and value for money expected of it by both Government and consumers.

It goes on to examine the boundaries within which a regulator could confer a Quality Assurance mark and begins to draw a line in the sand, beyond which products would not be suitable for Quality Assurance. This does not mean that such products are not suitable for purchase by investors, rather that they require a sale with expert financial advice. Quality Assurance will be suitable for entry level products, which could form the basic building blocks of a financial portfolio. But beyond that there will be many more sophisticated products, each with its own particular niche, but all requiring an environment whereby the point of sale is closely regulated to provide consumer protection.

The paper concludes with a checklist that could be used by the regulator in assessing a Quality Assurance mark application from a stakeholder pension scheme.

Introduction

There are two types of pension investors. The first, the wily one, is looking to maximise every nook and cranny of the tax relief available on pensions, is keen to debate with his adviser the pros and cons of index tracking or hiring a 'superwoman' to manage his investments actively, and is looking to dovetail his pension scheme within the package of his existing financial products portfolio. The second, with whom ordinary mortals will more easily associate, just wants to set aside a little of his current income in a secure home to provide for his retirement.

Surely we should have two approaches to pension planning to meet these very different needs. I would call the first a regulated sale, the second a regulated product. Government call the first a personal pension, the second a stakeholder pension.

The difference is obvious once you have seen it, and yet it remains a revelation of damascene proportions for many. Indeed many people confuse the two, seeking to edge extra complications into stakeholder pensions, and blurring the distinction.

Existing regulation of the sales process is expensive. It was originally designed for a model of a customer in social class A/B who was willing to pay for in-depth advice. We estimate that the cost of providing two meetings with an independent financial adviser designed to deliver 'best advice' is approximately £600. Our research shows the target groups for the stakeholder pension are willing to pay about £60. This implies that the sales process will have to be much less complex than under the existing regime. In short, if stakeholder pensions are to work then it is the product rather than the sales process which needs to be regulated.

What the regulated product should bring the consumer is the opportunity to arrange a pension plan very quickly, without the need for the lengthy process of 'best advice' enshrined in the Financial Services Act, but incorporating the comfort of a Government 'Quality Assurance mark'. From this Quality Assurance mark, the purchaser can draw confidence that the product is suitable for basic pension provision and that it has attained the high standards of security, flexibility and value for money that Government have so clearly stated they want from stakeholder pensions.

It is important to understand the distinction between ‘Quality Assurance’, which this paper proposes, and ‘benchmarking’ which has been suggested by some as an alternative. Quality Assurance is the approval of a scheme by a Government appointed regulator, confirming that members joining the scheme will find it fit for purpose. Benchmarking, on the other hand, is the provision of comparable information to the consumer which would enable them to make a meaningful choice between similar products: similar to the APR figure by which consumers can compare bank accounts.

The process that we suggest the regulator will need to go through before awarding a stakeholder pension scheme the coveted Quality Assurance mark is twofold:

1. First, the regulator must verify that the scheme meets the standards of security, flexibility and value for money laid down by Government.

2. Second, and perhaps more importantly, the regulator must ensure that the proposed arrangement is suitable for the new environment of consumer protection through product regulation, and that it does not need the more traditional approach of a regulated sale through a highly trained financial adviser.

The Standards Of Security, Flexibility And Value For Money

Security

Customers need reassurance that funds invested will not go missing, and that their hopes and expectations from the pension plan will be delivered in the fullness of time.

This is partly a matter of structure and partly a matter of competence of the various professionals servicing the scheme.

A stakeholder pension scheme should be established under Trust, with the assets of the scheme held separately and independently of the finances of those running the scheme. This way, if the providers were to spend too much on marketing or administration costs, the loss will be the providers', not the members. The Quality Assurance mark regulator would ensure that the trustees appointed are independent and genuinely able to represent the members without conflicts of interest.

The appointment of service providers to the scheme should also be vetted by the regulator, as the Quality Assurance mark is effectively confirming that they will deliver to the standards reasonably expected by the consumer. The investment managers, the administrators, the marketing team and the insurers should all demonstrate professional competence to the regulator. This will usually be by reference to experience and achievements in the field of pensions with existing arrangements, but to allow new entrants to enter the marketplace, the regulator must make provision for new pension providers to persuade him of their prospective ability to deliver a stakeholder pension scheme. This system could be similar to that employed by the Bank of England in granting banking licences.

Competence needs to demonstrable not just at one point in time, but throughout time. For this reason, the regulator should look for stability of key personnel. Customer service procedures and systems must be robust to volume changes - the provider must demonstrate that he has the capacity to handle the volumes of transactions that a successful marketing campaign would bring him.

Meeting customer expectations over the long term requires the correct investment mix. For most of the time, the investment must be in 'real' assets, such as equities, in order to have the potential for significant growth relative to price and earnings inflation. A diversification of investment is necessary to prevent undue volatility that would come if all eggs were in one basket. And, as investors approach retirement, a security device is needed to lock in existing gains and protect against vagaries in the annuity market. This can be achieved by automatically switching the fund from equities into gilts over a period as retirement approaches, or through the device of with-profits insurance funds. The regulator must check that suitable long term investment policies along these lines are in place before awarding the Quality Assurance mark.

Flexibility

One of the major findings of the Government's Pension Review is expected to be that modern working lifestyles and attitudes, such as seeking security in employability for life rather than employment for life, mean that greater flexibility will be needed amongst pension schemes. For stakeholder pensions in particular, many of the target audience will be on low and possibly intermittent earnings. Members of these schemes will not be able to commit to regular premium payment over a prolonged period.

Stakeholder pensions schemes must therefore offer the facility to reduce or stop contributions without notice. Premium collection facilities must be in place to enable members to re-start contributions easily, or to make occasional or one-off contributions of small amounts. The charging structure of the stakeholder pension scheme must not penalise or discourage such variable contributions.

A key theme of Government's welfare reform programme is personal responsibility. We all have a responsibility to provide for ourselves whenever we are in a position to do so. This requires us to have an understanding of the adequacy or otherwise of the provision we are making. Stakeholder pension schemes should therefore provide ready access to straightforward illustrations, showing the contribution level required to achieve a target pension, or showing the impact on future benefits of an alteration in contribution levels.

Increasing flexibility in the labour market means that some customers will find that their circumstances change, and they will wish to move their pension to another arrangement. Stakeholder pension schemes should offer transfer values to any other approved pension arrangement, and such transfers should be at full value with no deductions for early discontinuance.

Value For Money

Above all else, the Quality Assurance mark is a reassurance to customers that they will receive a high degree of value for money. Nobody likes to see their money being used inefficiently, and especially as Government will be encouraging, or even possibly compelling, people to invest in a stakeholder pension, disaffection will quickly spread if people do not receive good value for money.

Personal pensions have offered good value for money to investors who have maintained a reasonable size of premium throughout the plan. For example, since launch in 1988, a typical personal pension has achieved an average rate of return of 5% pa in excess of the rate of inflation, leading to security and prosperity in retirement for many members. Conversely, those who have paid in only small or erratic premiums have received much lower returns, and in some cases have seen their capital seriously eroded.

We believe that the Quality Assurance mark should specify both the format of charges and a maximum level to ensure value for money. The format should be a single charge, expressed as an annual percentage of funds under management. We propose a maximum charge of 1.5% pa. Given that conservative estimates of real growth on equities over inflation suggest an average of 2% pa, then even a scheme with the maximum charge will still offer the customer the prospect of real investment growth. It is this real growth that underpins the rationale for moving to a system of funded pension provision, so it is essential to preserve it in this way.

Of course many schemes should be able to improve on this maximum charge. One of the roles of the regulator will be to review the maximum periodically, so that the benefits of further progress within the pensions industry towards reduced costs are passed through to the consumer. The maximum should be set at a challenging level, so that the wheat is sorted from the chaff amongst pension providers, but it must also be attainable for schemes where the constituency of their membership is likely to include a high proportion of small contributors, who are inevitably more expensive to service.

Suitability For Product Regulation

This is an entirely new area of thinking, and the approach adopted here will pave the way not just for stakeholder pensions, but potentially also for a whole new generation of 'entry level' financial services products.

The suggested criteria for inclusion in this new streamlined regulation, all of which must be satisfied in order to qualify to join the club are: universal customer suitability; straightforward comparability with product offerings from rival competitors; and a tightly defined specification which does not need the customer to choose between different options which will affect his financial well being.

Universal Suitability

With a little effort, Government can create an entry level pensions product that will deliver financial advantage to all consumers. We know that the population is ageing, and that demographics will make it harder for ensuing generations of workers to support the growing number of pensioners. So at a social level, pension provision is 'a good thing', and it is therefore encouraged by Government with tax relief.

At an individual level, suitability is a little trickier and will require changes to the current legislation surrounding pensions. First, stakeholder pensions need to be allowed to be held in addition to all other forms of pension scheme. So anyone with an occupational pension should not regard stakeholder pensions as an alternative, but instead as a top up vehicle.

Contracting out of SERPS will require a change to the way that the Government Actuary calculates the rebates of National Insurance available to those who elect an alternative to SERPS. Today's rebates create winners and losers, with the result that contracting out is only available to certain age groups, and sometimes to only one sex within a certain age group.

With only modest alteration to rebates, the Government Actuary could reassure all purchasers of stakeholder pensions that their private pension was a fair alternative to SERPS and so remove the uncertainty that many of them encounter today.

For those on low incomes, there is also a potential issue in the welfare benefits trap. Under the current system, there is a risk that a modest level of private saving into a pension scheme will only achieve an equivalent reduction in welfare entitlement on retirement. At its extreme, taking qualification for other state benefits into account, the lost benefits can be even greater than the value of the private saving. Such a system is both iniquitous and counter productive, and will be one of the hard issues that Government must face up to in its wider welfare reform review. The outcome must be one where all of us can feel confident that by diverting some of current income towards saving for retirement, we are improving our outlook in later life, not jeopardising our future social security rights.

Straightforward Comparability

It will not be enough for Government to confirm through a Quality Assurance mark that the product meets the required standards. By itself, that would promote adequacy, where we should always be striving for excellence through the market mechanism. To compare the relative merits of complex pension schemes, the potential consumer would need to carry a pocket actuary round with him. Instead the framework required should be one where the marketing material of rival pension providers should enable the interested but inexpert consumer to quickly see the relative strengths and weaknesses of each product. Then the market will operate efficiently and consumer choice will drive up the value of product offerings, whilst the Quality Assurance mark will provide a floor to protect anyone who chooses not to shop around. Indeed, the efficient operation of the market above the floor will allow the regulator to periodically raise the level of the floor itself, for the benefit of all consumers.

Charging will be the most important area of competition, and to ensure comparability we believe that only one charging mechanism should be allowed, a single charge expressed as an annual percentage of funds under management.

Legal & General believe that for most schemes this charge should start at around 1% of funds pa, but based on the American experience, competition could drive this down to half this level or less as stakeholder pensions mature.

Service will be the other key comparison - here there is more room for variation, but the Quality Assurance mark regulator must ensure that the marketing literature describing the range and level of service is clear and accessible.

A Well Defined Specification

This area represents a culture change, particularly for the pensions industry. Traditionally, we have often presented our customer with a wide array of choice of the investment and insurance components of a personal pension scheme. To help the exercise of this choice, we provide expert salespeople whose behaviour is highly regulated in order to provide the desired level of consumer protection.

In contrast, the proposition of the entry level pension plan to the customer is that it is a very simple way to save for retirement, and does not require complex sales advice.

So, if the stakeholder pension is to be safe to buy without needing the intervention of a financial adviser, then it must offer the customer only one choice of investment and only simple ‘yes/no’ choices of insurance. The trustees of the scheme will have already decided upon what form the investment will take, and at what level any insurance against sickness, unemployment of death would take.

The requirement for financial advice will be with the scheme trustees who will seek professional assistance in setting up the scheme. But at the point of sale, the interaction with the customer will be of a service nature, explaining the paperwork and the scheme's operation, not of a financial advice nature. By concentrating the advice, and the regulation of that advice, into a single event at the scheme's creation rather than as multiple events as members sign up, there should be the huge economies of scale that Government are looking for to extend high value pension provision down to the smallest contributors.

Conclusion

It is safe and practical to introduce product regulation as an alternative to point of sale regulation for a basic entry level product. Such Quality Assurance would deliver the economies of scale which are essential to extend value for money pension provision right down the premium curve.

This paper has set out the items that the Quality Assurance mark regulator should examine. These are essentially the variables where schemes can offer different treatments as part of the natural process of competition within a free market. In addition, there will be many other items specified for stakeholder pensions, such as disclosure of information requirements and perhaps unisex annuities, that will be contained within the statutory legislation defining a stakeholder pension and its operation, rather than within the Quality Assurance process.

Postscript - Should We Quality Assurance mark ISAs As Well?

While the Department of Social Security are busy preparing for the launch of stakeholder pensions to help more people save for their retirement, the Treasury are launching individual savings accounts to help people for save for shorter term targets. Would ISAs also be suitable for regulation through Quality Assurance?

The case for extending Quality Assurance to individual savings accounts is much weaker than it is for stakeholder pensions. This can be seen by a comparison of some of the key characteristics of these two savings vehicles :

Stakeholder pensions	**Individual savings accounts**
Uniform customer requirements	Varied customer requirements
Simple product offering	Innovations welcomed by customers
Confidence hit by past mis-selling	Customer confidence already established
Funds locked away until retirement	Instant access to funds

Quality Assurance has the ability to deliver a low cost solution to areas where the need is for a simple product, such as stakeholder pensions. But individual savings accounts cover a much wider range of needs. So whilst there would arguably be benefits from Quality Assurance an ‘entry level’ ISA, such as a simple deposit or equity index tracking vehicle, the varied uses that customers put an ISA to suggest that it would be unlikely that one product could achieve universal suitability. Furthermore there is strong evidence that customers welcome product innovation in the savings market, such as guaranteed equity funds and windfall PEPs, and Quality Assurance could stultify future innovation.

Unless Government intend to separate basic deposit type ISAs from more advanced funds, in the way that TESSAs and PEPs have been separate, it is probably better on balance not to extend Quality Assurance to ISAs.

Checklist For Awarding A Quality Assurance mark

Security

1. Scheme established under trust deed, with segregation of assets
2. Independent trustees
3. Competent servicing agents appointed for:
   - Investment Management
   - Administration
   - Marketing
   - Insurance
4. Ongoing competence measured by:
   - Investment performance relative to peer group of similar funds
   - Service complaints to scheme manager or Pensions Ombudsman
   - Periodic audit of accuracy/timeliness of contribution collection/records
5. Stability of key personnel
6. Investment in real assets, with adequate diversification
7. Automatic procedures to 'lock in' accumulated gains as retirement nears

Flexibility

1. Contributions can be reduced or stopped at any time
2. Charging structure does not penalise those reducing contributions
3. Payment methods for both regular and one-off small contributions
4. Ready availability of straightforward quotations for varying contributions
5. Transfer to another scheme allowed at any time at the full account value

Value for Money

1. Charges are expressed as a percentage of funds under management each year
2. Charges are below the permitted maximum, initially set at 1.5% pa

Checks To Ensure A Product Is Suitable For Quality Assurance

Universal Suitability

1. Promotion of product is as a basic ‘entry level’ pension plan
2. For those with access to alternative pension provision, such as an occupational scheme, promotion of the scheme is as a ‘top-up’ and not as an alternative
3. Contracting out of SERPS is available, and the National Insurance Rebates offered, when overlaid with the schemes investment profile and charges, offer at least a fair value alternative to SERPS for all ages and both sexes

Straightforward Comparability

1. Clear product literature
2. Charges prominently displayed
3. Services available prominently displayed

Well Defined Specification

1. The purchase process is straightforward, not requiring the investor to make choices that will affect his future financial well-being, and which would therefore call for investment advice
2. Scheme offers only one choice of investment profile
3. Scheme offers ‘yes/no’ choices on options for insurance against sickness, unemployment or death

QUALITY ASSURED PRODUCTS: DUMB AND DUMBER

Garry Heath

Consumer Information

If only we could invent a mechanism that would convert an inherently complicated product to something that the average financially unsophisticated member of the public could understand. The concept of Quality assurance products is certainly seductive. A mechanism which makes complicated products simple would no doubt have its advantages but only if such simplification led to the purchaser being better informed rather than rendered unaware of the nature of the contract being entered.

This is hardly the first time that such an idea has been tried. Supermarkets have been doing much the same in their wine departments for the last ten years by scoring wines' sweetness out of ten. The unsophisticated novice wine drinker purchases firstly by colour which is reasonably apparent and then by sweetness. Thus if you like a wine with sweetness factor six you can explore wines with similar scores with a reasonable confidence that you will enjoy them.

This method works well when there is only one factor to be judged. Unfortunately, purchase of a financial services product depends on a basket of factors which are far more complicated. The provider's financial strength, the charging structure, the provider's fund management history and future prospects, ability to service and product design all come into the question as do a number of bells and whistles which vary in usefulness from the vaguely useful to the downright essential. The current regulatory approach is to provide the potential consumer with enough information to make an 'informed decision'. Unfortunately this concept is proving to be far too ambitious for many consumers. Our current disclosure system was designed for university educated people who have time to invest in research and are curious about the industry and its products. The average member of the public is happy to spend the minimum amount of time looking at their financial futures, are not curious and wishes for someone to remove this burden from them.

The Danger Of Quality Assurance

The danger of the Quality Assurance approach is that the purchaser will be encouraged to believe that Quality marked products would be guaranteed firstly ‘safe’ and secondly ‘good value’.

If products are to contain an element of equity investment there is inevitably risk and therefore no product with an equity base should ever be looked upon as safe. Even the much vaunted tracker fund carries a significant risk, perhaps a higher risk in times of downward market adjustment when the need to depend on underlying value and fundamentals might swing the advantage back in favour of the professional fund manager.

If Quality Assured products are to be safe then they would need to avoid any equity content. This would mean that a great deal of the potential growth would be lost and clients attracted to Quality marked products for their simplicity would not receive a reasonable return on their investment.

As soon as one tries to define good value you inevitably need to answer: good value for whom? A product that has low charges may achieve this status by cutting down on the cost of fund management or the costs of administration. Whilst the costs may therefore be low, the overall returns and the service to the client may suffer considerably.

What Is Behind The Current Push For Quality Assurance?

The need for a value for money product is driven by the failure of the current disclosure system to allow the consumer to weed out a particular provider or product. There is an element within the providers who are selling products which are such poor value for money that the mere purchase of them would constitute misadvice if they were sold in the Independent Sector.

These direct selling organisations employ opportunist salesmen fortified by American selling techniques to sell their products. Such salesmen are unlikely to know about products outside their own range and are not really looking for an on-going relationship with the client. Clients of these firms are unlikely to compare products before purchase and therefore the current method of disclosure does not work for them.

The major thrust for Quality marked products is coming from those providers whose products are currently uncompetitive. These include the firms mentioned above, new entrants, banks and large composite insurers. It is unlikely that many of these firms could create a product with a cost structure which might be acceptable unless they were prepared to loss lead which they might be prepared to do in order to create a 'halo' effect on their other products.

The current Government is keen to introduce some form of product for the socially disadvantaged, the poor, ethnic minorities and women. Providers will be faced with collecting relatively small amounts of money, which will start and stop with fluctuations in employment. It is unlikely that any significant savings could be made in the pricing of the product without those savings being subsidised by other policyholders of the business.

The current view in regulatory circles is that advice should be an integral part of the financial services selling process: matching particular products with the needs of particular clients. Over time, it is envisaged that professional advisers will retail products to the consumer and increasingly those advisers will be of degree standard. The industry is also being pushed into a more transparent mode of operation in which the costs and benefits of products are exposed to the public.

These two elements do not commend themselves to those in the industry who have benefited from selling opaque products through less than proficient salesmen. In many cases, these providers do not enjoy the confidence of the Independent Sector and find difficulty satisfying their needs for production through that sector. They have also tried to create new distribution routes and have failed in this.

The Effect Of Quality Assurance On The Financial Services Market

The creation of Quality marked products will inevitably lead to a general decline in the competitiveness of the market, a skewing in the design of products to satisfy the Quality Assurance criteria rather than the client's needs as well as a decline in the ability to innovate. Quality Assurance will make the mediocre saleable.

The idea is to create a product that is so simple that it can be sold with little to no advice. This takes us into the territory of additional benefits and whether they should be included as a matter of course.

The problem with a 'safe product' is whether you add in a number of benefits which will only be needed by some clients and will require time consuming explanation and advice. Any integral benefits will have to be explained so that the clients know how the product works and when to claim. The other option is to strip the product of all additional benefits, which may leave the client with a product that does not suit their needs.

In essence it is the difference between a rough fit and a properly tailored garment, with the difference that the client will not be able to tell the difference until something goes wrong.

What Other Solutions Are Available?

The regulator could start regulating product design and start by simplifying its details. This has been the approach of the German government since the Second World War. There are elements of this approach in the Government proposals on the stakeholder pension. Regulators would need to have the skills to do this and to communicate the fact to the public that the resulting product is cut down with only a limited number of benefits.

There are a number of inherent problems in this approach, as the Germans have discovered, not least the lack of product innovation and the temptation placed in front of government to interfere with the investment strategy.

One of the underlying benefits attributed to Quality marked products is to ensure that all clients receive value for money products. A better method to achieve this aim would be to further open the market to competition by a wider use of disclosure.

Improving Disclosure By Creating An Understandable Benchmark

The current confusing regime needs to be replaced by one that reflects the attention span and education of the most vulnerable consumers. The inclusion of a factor based upon reduction in yield (RIY), or a combined RIY/investment performance figure, would give the client an idea of relative value particularly if accompanied by an industry average for that product. The RIY figure would show consumers the effect of a company's charges on your investment: a low figure indicates low charges. Those clients currently supplied by opportunist salesmen would have a figure, broadly comparable in function to APR with which to compare the product offered with the industry average. This would give them an idea that there were other products of better value elsewhere.

Regulation must form an alliance with the consumer in order to offer real protection whilst maintaining a competitive market. The UK has most innovative and competitive market in Europe if not in the World and it could be said that if the public had wanted kite marked products the industry would have already invented them.

If Quality marked products create a 'no lose' product then it must be accepted that such a product will likely not be a winner in the UK's competitive market place. Such products are probably better created in the national savings environment or by building societies.

Conclusion

As highlighted by a recent National Consumer Council report, the professionalisation of the industry is going to cause a serious problem for those on low incomes[1]. The cost of regulation and the possible cost of litigation is causing many advisers to be far more selective in who they accept as clients. Just as in the legal and medical professions, those on low incomes may well be in the most need for detailed and complicated advice but are in the least well placed position to pay for it.

[1] NCC, *Savings and Investments for Low-income Consumers*, 1997.

Legal Aid and the National Health Service both square this circle but nothing of its like is available to the clients of financial services professionals. Government might well wish to consider some form of aid as being a cost effective way to prevent such individuals becoming a claim on the Exchequer.

Finally there is one overarching question, who will control the Quality Assurance? The European Commission refuses to accept that a regulator could do this. Self-certification would soon dissolve into porridge of self-interest and I see no other body willing to take the responsibility or the resulting claims.

Perhaps it is better to depend on the market, which can work, as long as it is given a chance. That chance could be created by more transparency, a clear form of disclosure and less proscriptive regulation.

BENCHMARKING: RATING PERSONAL PENSION PLANS

John Chapman

Buying a financial product is often like buying any other product. You look at the price and the conditions, and compare with competing products. Deposit accounts and TESSAS have interest rates, bonuses and penalties. Unit trusts and PEPs have initial charges and annual charges.

In general, it is not difficult to shop around, and financial journalists help with lists of best buys. With personal pension plans (PPPs) and endowments, however, the position is different.

Instead of playing it straight by using only two types of charge, the pension companies use over a dozen types of charge. These include initial charges, usually in the form of bid/offer spreads of around 5%, annual fund charges of around 1% pa, reduced allocation of premiums (e.g. first year premiums taken in charges), capital units (disguised reductions in allocations of premiums), capital levies of say 6% pa on capital units, policy fees of around £3 a month, introduction fees, various penalties if you stop paying premiums or transfer or take early retirement, and more novel charges. Endowments are much the same.

Pension companies have reason to make their charges confusing. As one anonymous Marketing Director put it, "*In this industry we spend half our time spending money chasing clients, and the other half trying to find ways of hiding the charges necessary to cover our costs*". Pension companies run up heavy charges in chasing clients, with some having expense ratios (acquisition expenses divided by new business) four or more times the most efficient. About two-thirds of company costs arise in selling - mostly in commissions to salesmen/advisers.

Disclosure Of The Effects Of Charges

The providers of PPPs and endowments have until recently got away with heaping up charges without showing their effects. In 1993 the Office of Fair Trading (OFT), with the help of the Treasury, forced through the principle of disclosure.

Such disclosure began in 1995, with companies showing projected transfer and maturity values after the effects of charges. It was soon apparent that the messages from this morass of figures, namely which are the low charge and which are the high charge companies, would not get through without a simpler presentation.

The ABC Rating System

Because of the different incidence of charges, the OFT stressed the need for comparisons of projected returns at the early, mid and final stages of a policy. In late 1995 I suggested a system in which products would be rated A, B or C at such three stages[2]. A product with a rating AAA would have relatively high projected returns, reflecting low charges, throughout the period of the policy. In contrast, a product with a rating CCB would have low projected returns at the early and mid-way stages, reflecting heavy charges, and a moderate return at the maturity stage. The details of the system are set out in an appendix.

Such a rating system is very relevant because of the high lapse rates of PPPs and endowments. Figures from the Personal Investment Authority (PIA) indicate that about 20% of PPPs lapse by the second year, and nearly 30% by the third year[3]. This in part reflects people switching or losing jobs. With some companies as many as 45% of plan-holders stop paying premiums by the third year, so poor selling is also a factor.

A Fresh Look At Disclosure

Disclosure currently focuses on transfer values (invested premiums less charges) and maturity values (what you get if you keep paying premiums to the end of your policy). But most people may not transfer to another PPP or occupational scheme; nor do they keep paying premiums to maturity. It seems that many stop paying premiums early, and leave their accumulated premiums less charges with the same company. The company accords them a 'paid up value', which grows with that company's investments, less charges, to give some maturity value at the end of the plan period.

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[2] Office of Fair Trading, *Discussion paper*, November 1995.

[3] PIA *Survey of the Persistency of Life and Pensions Policies*, November 1997. Assuming one third of sales were through IFAs.

If many if not most people ‘go paid up’, then surely the projected paid up values, and the maturity values arising from them, are disclosed? But this is not the case, and the little that is known about them has largely come through a survey in Money Management[4]. This indicated that returns from paid up values could be significantly reduced by charges like policy fees and capital levies. In the latest disclosure report, the PIA Chairman refers to secret profit-making through charges on paid up values, and suggests that disclosure should be extended to cover them[5].

But if ‘going paid up’ is so common, perhaps disclosure should actually focus on the projected maturity values arising from paid up values?

Rating By Projected Maturity Values From Paid Up Values

The table below shows the maturity values and returns from paid up values if premiums are stopped at certain stages of pension plans. I have also shown the ABC ratings of each plan, and ordered the plans according to such ratings. [6]

Company	Maturity Values if premiums stopped after:-			Net returns if premiums stopped after:-			ABC rating
	2 yrs(£)	5 yrs(£)	20 yrs(£)	2 yrs	5 yrs	20 yrs	
Equitable Life	49,566	110,283	264,841	8.4%	8.4%	8.3%	A+A+A+
Marks & Spencer	44,500	103,000	257,000	8.0%	8.1%	8.2%	AA+A+
Nationwide	41,103	101,671	259,209	7.7%	8.0%	8.2%	AA+A+
Scottish Widows	42,405	97,488	238,382	7.8%	7.9%	7.8%	AAA
Virgin	42,833	96,072	237,828	7.8%	7.8%	7.8%	AAA
Alliance & Leicester	40,708	98,559	242,244	7.6%	7.9%	7.9%	AAA
Legal & General	41,086	94,308	243,628	7.7%	7.7%	7.9%	AAA
Woolwich	37,908	92,810	237,362	7.4%	7.7%	7.8%	AAA

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[4] *Money Management*, October 1997

[5] PIA, *Life Assurance Disclosure: Three Years On*, November 1997

[6] Based on 30 year pension plans, premiums £200 pm, projected growth 9% pa. Sources: *Money Management,* October and November 1997 & January 1998.

Company	Maturity Values if premiums stopped after:-			Net returns if premiums stopped after:-			ABC rating
	2 yrs(£)	5 yrs(£)	20 yrs(£)	2 yrs	5 yrs	20 yrs	
Royal & Sun Alliance	36,229	92,390	235,802	7.2%	7.7%	7.8%	AAA
N.P.I.	24,792	89,755	251,363	5.8%	7.6%	8.1%	BAA+
Standard Life	37,162	91,504	231,580	7.3%	7.7%	7.7%	AAB
Friends Provident	25,730	88,007	245,582	6.0%	7.5%	8.0%	BAA
Commercial Union	34,703	81,503	227,275	7.1%	7.2%	7.6%	ABB
Abbey National	26,027	83,405	234,206	6.0%	7.3%	7.8%	BBA
Clerical Medical	25,326	78,889	249,056	5.9%	6.7%	8.1%	BBA
National Mutual	25,308	88,365	240,624	5.9%	7.4%	7.9%	BBA
Norwich Union	24,703	84,589	245,311	5.8%	7.3%	8.0%	BBA
Scottish Mutual	26,392	82,102	235,317	6.0%	7.2%	7.8%	BBA
AXA Equity & Law	20,907	82,999	241,541	5.2%	7.2%	7.9%	BBA
General Accident	21,083	81,065	238,603	5.2%	7.2%	7.8%	BBA
Scottish Life	19,778	77,991	237,330	5.0%	7.0%	7.8%	BBA
NatWest	22,516	79,507	227,815	5.5%	7.1%	7.6%	BBB
Britannia Life	22,866	78,433	233,492	5.5%	7.0%	7.7%	BBB
Eagle Star	20,177	75,740	231,539	5.1%	6.9%	7.7%	BBB
Midland	27,715	79,411	214,825	6.2%	7.1%	7.3%	BBC
Barclays	23,711	75,477	213,683	5.6%	6.9%	7.3%	BBC
Tunbridge Wells	24,408	76,550	215,841	5.7%	6.9%	7.4%	BBC
Scottish Amicable	19,911	78,186	216,354	5.0%	7.0%	7.4%	BBC
Sun Life	12,024	79,815	247,927	3.2%	7.1%	8.0%	C-BA
Britannic Assurance	21,850	73,629	214,726	5.4%	6.8%	7.3%	BCC
Black Horse	17,619	72,769	221,928	4.6%	6.7%	7.5%	CCB
Scottish Equitable	17,918	67,843	219,525	4.6%	6.5%	7.4%	CCB
J Rothschild	13,826	67,829	230,568	3.7%	6.5%	7.5%	CCB
Colonial	12,759	70,644	221,252	3.4%	6.6%	7.5%	CCB
Allied Dunbar	7,348	69,058	242,174	1.5%	6.5%	7.9%	C-CA
TSB	17,098	70,800	217,139	4.5%	6.6%	7.4%	CCC
Guardian	15,922	69,825	216,878	4.2%	6.6%	7.4%	CCC
Skandia	14,984	56,901	202,017	4.0%	5.8%	7.0%	CCC-
Canada Life	10,488	61,599	207,939	2.7%	6.1%	7.2%	C-CC
Lincoln	8,127	60,673	199,582	1.9%	6.1%	7.0%	C-CC-

Company	Maturity Values if premiums stopped after:-			Net returns if premiums stopped after:-			ABC rating
	2 yrs(£)	5 yrs(£)	20 yrs(£)	2 yrs	5 yrs	20 yrs	
Benchmark (5% initial, 1% pa)				7.7	7.7	7.7	AAB
Mean/Standard Deviation				5.7/1.6	7.1/0.5	7.6/0.3	

There are striking differences in the projected maturity values - from £7,348 (Allied Dunbar) to £49,566 (Equitable Life) if premiums stopped after two years, from £56,901 to £110,283 after five years, and from £199,582 to £264,841 after twenty years.

One advantage of rating by these maturity values is that projected net returns can be derived (whereas they cannot be with transfer values when they are below the premiums paid). Thus the £49,566 Equitable Life figure indicates a return of 8.4%, with only a 0.6% reduction in yield as a result of charges. In contrast, the £7,348 Allied Dunbar figure reveals a return of only 1.5%, with an extraordinary 7.5% reduction in yield.

The ‘front-end loading’ of charges is shown by the mean or average returns rising from 5.7% if premiums stopped after two years, to 7.1% after five years, and 7.6% after twenty years.

Comparisons may be easiest by reference to the ABC ratings. The top ten companies, with ratings from A+A+A+ to AAB, all have projected returns of over 7% at all three stages. In contrast, the bottom ten companies, with ratings from CCB to C-CC-, have poor or very poor returns at the first stage, poor returns at the second stage, and returns of over 7% only at the third stage - which the majority of their plan-holders are unlikely to reach.

The need for more effective publication of the messages from disclosure is indicated by the make-up of the five top-selling pension companies in 1996 (excluding Prudential, which was not in the survey). Equitable Life (A+A+A+) does top sales with new income of £300m, with Standard Life (AAB) next with £123m. But the strong roles of Scottish Equitable (CCB), Sun Life (C-BA) and Allied Dunbar (C-CA), with new income of £118m, £97m and £94m respectively, suggest that hundreds of thousands of plan-holders are unaware of the pitfalls of heavy early charges and high lapse rates.

Even a CCC rated product can bring new income of over £20m a year, through some twenty thousand new policies.

Performance In Perspective

Actual returns will also depend on investment performance. But claims like "It's performance that counts" help little. In the short term higher performance will affect transfer values only marginally. In the longer term, higher performance will not eliminate the larger differences in returns arising from charges.

Moreover, no-one can tell which pension companies will perform best over periods as long as fifteen or thirty years. As the OFT commented in its July 1997 Pensions report, selecting a fund is something of a lottery, and past performance is an "insubstantial and illusory" basis for choice[7].

An Alternative Approach

Another approach to improving the quality of products would be to require or recommend that they meet certain criteria, in particular that their charges should not exceed certain levels.

Most PPPs and endowments, and nearly all unit trusts, have 'basic' charges of an initial charge of around 5% and a fund charge of around 1% pa. PPPs and endowments may then have an array of apparently secondary charges.

An appropriate 'benchmark' product might then have only a 5% initial charge and a fund charge of 1% pa, or the equivalent to allow for innovations. There would be no other charges or penalties, i.e. no reduced allocation, capital units, etc.

The projected rates of return and ABC ratings of such a benchmark product are also shown in the earlier table. Six of the products shown have charges lower than or in line with the benchmark product at all stages. In practice, other products shown with higher charges are being sold with only benchmark level charges, where IFAs are prepared to take lower commissions.

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[7] OFT, *Report of the Director General's Inquiry into Pensions*, July 1997. Section 4.3.2

Using Ratings And Benchmarks

Given the enormous importance of the personal pensions and endowment markets, and the substantial proportions of policyholders who achieve losses or poor returns, a priority task in personal savings must be to make people aware of the merits of low charge products, and warn them about the pitfalls of high charge products.

A rating system, on the lines of the ABC system, could well be the best way of getting across the charges message.

In addition, consumers could be recommended to look for products with only benchmark or lower charges.

Appendix - The ABC Rating System

The purpose of this rating system is to simplify comparisons of the features of financial products. Instead of having to make comparisons of projected returns from fifty or more personal pension plans or endowments, it is possible to compare simple ratings accorded to each product.

Given the different incidence of particular charges, it is important to have ratings at the various stages of products. The OFT have advocated comparisons at the early, mid and final stages of life insurance products and pension plans.

ABC ratings are not based on numerical orders of returns, or on groupings like quartiles, but instead a standard deviation approach is used. This enables account to be taken of whether the values in question are very spread out or very bunched together.

The system involves finding the mean or average of a group of returns. The central B band includes returns close to that mean. The A band covers returns well above the mean, and the A+ band even higher returns. The C band is for returns well below the mean, and the C- band for even lower returns. The precise bandings are as follows:-

Bands	Ratings
More than 1.5 standard deviations above the mean	A+
Between 0.5 and 1.5 standard deviations above the mean	A
Within 0.5 standard deviations of the mean	B
Between 1.5 and 0.5 standard deviations below the mean	C
More than 1.5 standard deviations below the mean	C-

Standard deviations reflect how closely returns are grouped. They are calculated by squaring the difference between each return and the mean, finding the sum of such squares, dividing that sum by the number of returns in the survey, and taking the square root of the result after dividing to give the standard deviation.

Thus in the table in the paper the mean of the returns when premiums are stopped after 2 years is 5.7%. The standard deviation is 1.6%. The B band returns are those within the range 4.9% and 6.5%. The A band returns are those within the range 6.5% to 8.1%, and so on.

Carrying out ratings at three stages enables overall AAA, BBC or CCC type ratings to be given to each product. Advisers and consumers can then see at a glance how a product compares with all others at three key stages.

THE CONSUMERS' PERSPECTIVE

Philip Telford

Introduction

Regulation can address three areas: processes, people or products. From its inception, the financial services regulatory system in the UK has focused on a process-driven approach. Only more recently has it begun to deal with the people, through training and competence requirements, and to date it has shied away from product regulation altogether.

But process-based regulation has failed. It has been reactive, confusing to the consumer, and has not prevented poor quality products getting onto the market. Essentially, it has focused too much on the input of the sales process and not enough on the output, that is, has the customer been provided with a good quality product?

Anything To Disclose?

In markets where informed consumers can make genuine choices between products, competition should provide the motor to drive out poor quality products. In an attempt to inform consumers about financial services products, the regulators introduced the 'hard disclosure' regime in January 1995. But this has failed.

The Consumers' Association undertook some qualitative research with NOP in 1997 to examine whether the only tool that consumers have to compare products - *Key Features* - actually works at the point of sale. Some of the key findings were that:

- Few people were aware of the charges imposed.
- There was a general mistrust of the sales process.
- Few considered the products of more than one provider. They were simply put off by the complexity of the decision process and by the sheer number of financial products on the market.
- The majority hadn't even read the key features documents.

- Respondents were put off by the sheer amount of documentation provided and by the jargon used.
- Verbal advice had more impact than written communication.
- Financial services companies were seen as necessary evils.

We see two fundamental weaknesses in the current system of regulation. The first is that the information is not clear. For example, projections are not of great use, when they show a charging structure across the whole term, but where the effect of charges is very different when considered in the light of early encashment, suspended contributions or transfer. John Chapman argues for disclosure information to be based on the reality of consumer behaviour. Current disclosure is information heavy. The challenge is to include only relevant information, and to make it understandable.

The second, and perhaps the most worrying concern is the lack of comparative data for consumers. An illustration shows a consumer a reduction in yield figure, but even assuming the potential purchaser understands this concept, there is no benchmark to compare this figure against. The consumer does not know if the figure is high, low or average. There is a clear requirement for comparative information to be available, perhaps in the form of league tables. In the same way, illustrations could be required to show industry averages, as well as own charges.

However, disclosure by itself can never be enough because the financial services market is unique:

- Products are bought infrequently.
- There is a steep learning curve.
- There is a powerful imbalance between the consumer and the individual consumer.
- Consumers are generally ill-educated about products and nervous of purchase.
- Inappropriate or poor value products may only become apparent years later.

- Choosing the wrong product is not an inconvenience, it can be a financial disaster affecting an individuals quality of life.

As a result, the concept of choice in financial services is illusory. New products proliferate and there are now thousands available. But there is a woeful lack of transparency, which means that consumers have been unable to compare products, shop around and exert competitive pressure. The time is right to look for an alternative approach.

What Is The Purpose Of A Move Towards Product Regulation?

It is perhaps worth emphasising that the aim of product regulation is to deliver good quality products into the hands of consumers and drive the 'long-tail' of poor products from the marketplace.

However, it is important to distinguish between Quality Assurance and benchmarking. Adrian Boulding draws a distinction between Quality Assurance, where approval is given to a particular scheme by a Government appointed regulator, and benchmarking, where products are required to meet one or more threshold criteria. He identifies these as security, flexibility and value for money. At the Consumers' Association, our feeling is much more for a benchmarking system incorporating similar features.

Benchmarking

We would like to see the introduction of a rating system based on the model we use in *Which?* magazine for Best Buys. Information on charges is meaningless without a benchmark to compare charges. There is no reason why the regulator cannot provide benchmark figures using a similar methodology. Information about charges, transfer values and so forth is already being collected, it is simply not being disseminated to consumers.

Rating products in this way would allow for the quick introduction of a benchmarking system for products which meet basic financial needs.

This would eventually lead to a continuous monitoring of products and the application of minimum standards. This will become critical as new/hybrid products are developed. Rating existing products should allow regulators to apply a similar approach to new products as they come on stream.

Information Versus Advice

Can benchmarking replace advice, and should it? Garry Heath argues that advice is essential in the process of obtaining financial services. Our aim is not replace the advice process, or to suggest that principles of 'suitability' or 'best advice' should be swept away. But we agree with the proposition that some providers are delivering products that are such poor value for money that the mere purchase of them would constitute misadvice. Benchmarking will assist in removing these 'pitfall products' and ensuring that there are minimum standards.

Conclusion

We are seeking a fundamental change in the nature of regulation, to concentrate on the product/outcome, not just the sales process. Attempts to regulate by overseeing the sales process have been an expensive failure. The time is right to look at the products being delivered to consumers. Poor quality products must be driven from the marketplace, and consumers given the ability to make effective choices from a range of good value, benchmarked products.

ENDPIECE

Digby Jacks

The government provides consumers with a lot of information about various goods and services in order that they can make meaningful choices when deciding which product to buy. For example, cigarette packets say that smoking seriously endangers your health. I believe that the state, via the Financial Services Authority, should extend this practice, *caveat emptor*, to pensions.

The problem with the personal pensions regime which was put in place by the Financial Services Act 1986 is that it was designed for the middle class by the middle class. Practitioners and customers equally benefited from highly technical advice about financial services. But this regime was quite inappropriate for people who had small amounts of money to save and invest.

We are now in a different situation. There needs to be a new settlement between the citizens, the providers and the state. This settlement should be flexible enough to enable individuals living on a low income to save whenever possible and to allow the breaks in contributions which flexible working patterns now demand. The costly 'tailor made' financial advice envisaged under the 1986 Act is quite unsuitable for the target market of stakeholder pensions. To reduce these regulatory costs, we need to Quality Assurance mark or benchmark 'off the peg' products such as stakeholder pensions.

The increased public confidence in the financial services industry that such a regime will create will create an increased volume of business. There will also be opportunities for financial advisers to up sell and cross-sell. This will benefit both the providers and their staff, something which, writing as a trade union officer, I can only be welcome.

ABOUT THE AUTHORS

Adrian Boulding is Pensions Strategy Director at Legal and General plc. Most recently he co-authored *Simply Secure* with Eamonn Butler and Matthew Young (Adam Smith Institute, 1998).

John Chapman, formerly of the Office of Fair Trading where he was closely involved in efforts to improve disclosure in financial services markets. He is currently a freelance writer and consultant.

John Greenway is Conservative MP for Ryedale. He is Chair of the all party Insurance and Financial Services Group.

Gary Heath. Chief Executive at the IFA Association. He has recently written *Financial Services Regulation: Defining The Problem* for the Consumer Policy Review (Jan/Feb 1998).

Digby Jacks is Sector Secretary - financial services at the Manufacturing Science and Finance Union.

Guy Palmer. Non-executive director of the New Policy Institute. He is co-author of *Housing Risks and Opportunities: Reforming Mortgage Finance* (New Policy Institute, 1997) and *Beyond Privatisation: Government Strategies For Influencing Outcomes* (New Policy Institute, 1998).

Philip Telford is a senior researcher at the Consumers' Association. He has written on *Creating 'Safe Haven' Financial Products* in the Consumer Policy Review (Sept/Oct 1997).