EXPLANATORY MEMORANDUM TO THE

The Financial Services and Markets Act 2000 (Regulated Activities Order) (Amendment) (No.2) Order 2004

No. 2737

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 This Order amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The amendment allows regulations to be made to give legal form to the recommendations proposed by Ron Sandler to create a suite of "stakeholder" products in his Government commissioned review to identify the competitive forces that drive the retail financial industry. In his review, *Medium and Long-Term Retail Savings in the UK* (2002), he noted how industry suffered from complexity and opacity, from problems of access to those on low to medium incomes, and from an inability of consumers to drive the market effectively. One of the review's principle recommendations was for the Government to develop specifications for a suite of simple, low cost, and risk controlled "stakeholder" products.

3. Matters of special interest to the Joint Committee on Statutory Instruments.

3.1 None

4. Legislative Background

4.1 The effect of the Order is that an activity which is not a regulated activity (within the meaning of the Financial Services and Markets Act 2000 (a)) will become a regulated activity. Regulations specify kinds of investment that can be made in a "stakeholder product" and therefore define the "stakeholder products". This Regulated Activities Order enables the regulations to be made and come into force. The order and regulations come into force on the 6th April 2005.

4.2 The definition of a relevant stakeholder pension scheme in Article 52B(3) of the Order reflects the definition of the term "lifestyling" that DWP are intending to adopt. The DWP are consulting on their legislation that will define the term "lifestyling" and the Order uses the definition that is in the DWP's consultation draft. If the DWP's definition is amended following the consultation, it is intended to amend the definition in this Order.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

Not applicable.

7. Policy background

7.1 The policy objective is to create a suite of simple, price controlled, and regulated "stakeholder products" that can be sold through a basic sales process, to help drive competition in the industry and improve access to financial services for those on moderate incomes. The instrument fulfils these objectives by allowing an activity that is not a regulated activity to become a regulated activity, and by specifying the kind of investment that can be defined as a "stakeholder product".

7.2 The policy addresses the problems highlighted in the Sandler review, *Medium and Long-Term Retail Savings in the UK*, of: complexity and opacity, problems of access to those on low to middle incomes, and weak consumers in the financial services industry.

7.3 A consultation paper, *Consultation on "stakeholder" saving and investment products regulations*, was published in June 2004. This included draft regulations and an initial Regulatory Impact Assessment and was the subject of a 3 month formal consultation period that concluded on 10 September 2004. The Treasury received 22 formal responses to the consultation from a wide variety of key interested parties.

7.4 The change imposed by the Regulated Activities Order is legally important for the implementation of "stakeholder products".

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is negligible.

9. Contact

Ted Hart at HM Treasury Tel: 020 7270 5234 or e-mail: ted.hart@hm-treasury.x.gsi.gov.uk who can answer queries regarding the instrument.

REGULATORY IMPACT ASSESSMENT
FOR THE
INTRODUCTION OF STAKEHOLDER PRODUCTS

Purpose and Intended Effect

i) Objective

The policy aims to increase access to savings and investment products for those on lower or medium incomes and to drive competition in the UK financial services market. The policy is a key plank in the Government's wider savings strategy.

ii) Background

In June 2001, the Government commissioned Ron Sandler to identify the competitive forces that drive the retail financial services industry and to suggest policy responses to ensure that consumers are well served.

The Sandler review[1] found three overriding problems in this sector:

- complexity and opacity caused by the huge range of products and product types, charging structures, complicated tax treatments, wide use of technical terms and lack of price and performance transparency;

- problems of access whereby the needs of those on lower or medium incomes are not catered for sufficiently; and

- weak consumers who are unable to drive the market effectively.

The review made a range of recommendations, including the creation of a suite of simple, low-cost, risk-controlled savings and investment products.

The design of the stakeholder products will address many of the issues identified in the Sandler report. In turn the products will help to resolve consumers' concerns that are currently discouraging them from saving, and in particular, that investments are complicated, opaque and high cost.

Furthermore, the Financial Services Authority (FSA) is developing a 'basic advice' process that will enable stakeholder products to be sold within a shorter process. This will enable providers to offer these savings and investment products at a reduced cost than is currently possible. In turn these cost savings will increase firms' ability to serve more customers viably in the low-middle income groups.

The proposals also build on the 1999 Welfare Reform & Pensions Act, which introduced the stakeholder pension. This resulted in providing good value retirement

[1] *Medium and Long-Term Retail Savings in the UK – A Review*, July 2002. A copy is available on-line at http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

savings vehicles for those who currently have limited/ no access to them, or for whom existing products and arrangements offer poor value for money.

In February 2003 the Government issued a consultation document on stakeholder products[2]. In July 2003 the Government's response to the consultation was published.[3]

The FSA will be consulting on the 'basic advice' process on the 17th June 2004 – the content of this RIA assumes that a 'basic advice' process is implemented by the FSA. The Department for Work and Pensions will be consulting specifically on the stakeholder pension shortly, and will include a separate Regulatory Impact Assessment (RIA). However, to ensure that this RIA is as comprehensive as possible, this assessment includes the most up-to-date information available on the stakeholder pension, although it is provisional and may be amended by the Department for Work and Pensions for the pension product only.

iii) Risk Assessment

In 2002, the Government's green paper on pensions made an estimate of the numbers of people undersaving for retirement. "Our estimates suggest that there are likely to be around 3 million people who are seriously under-providing for their retirement. Depending on their expectations and circumstances, a further group of between 5 and 10 million people may wish to consider saving more or working longer."[4] Furthermore, longer life expectancy means higher levels of savings are needed to support longer average retirements.

The Sandler review argued that complexity and opacity of the retail savings market contributes to consumers' confusion and reluctance to save, particularly in the low-middle income segments of society. Issues included:

i) wide and inconsistent use of technical terms by the industry;
ii) products' price and performance are generally hard to compare; and
iii) complex charge structures that are opaque to consumers.

The review drew attention to the inefficient and weak competitive pressure in the retail savings market. Improving efficiency in the retail savings market would lead to better outcomes for consumers, and a more efficient allocation of capital.

The review also found that, while the significant majority of consumers find savings products confusing, it seems that greater financial sophistication is correlated with greater levels of affluence and higher socioeconomic class.

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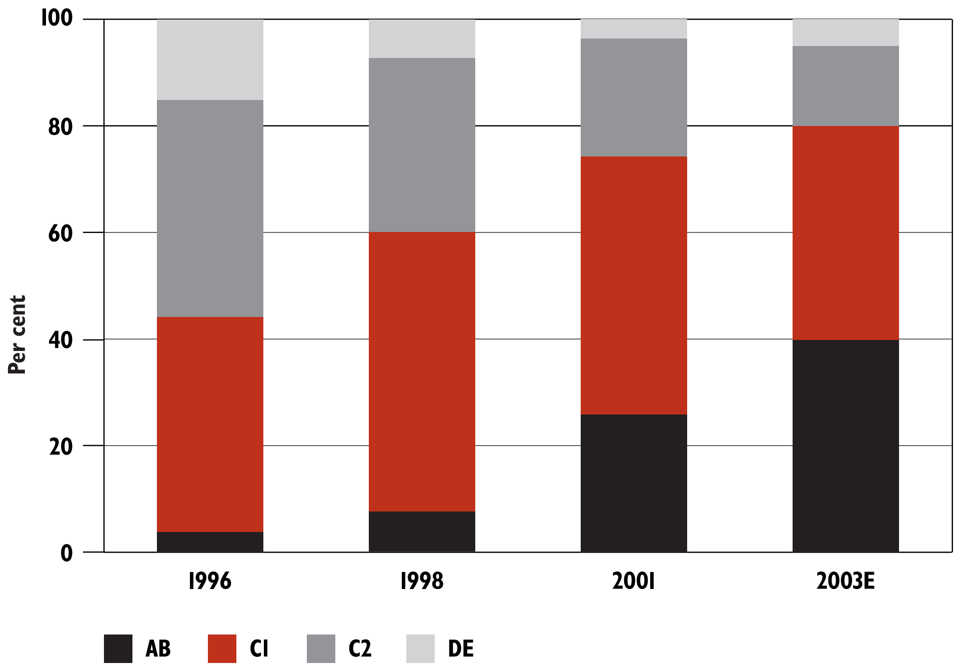
2 *Proposed product specifications for Sandler "stakeholder" products*, February 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation(240Kb).pdf

3 *Government response to the consultation on Sandler 'stakeholder' product specifications*, July 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/12836/govt_response_sandler_doc.pdf#page=1

4 *Simplicity, security and choice: Working and saving for retirement*, December 2002, Department for Work and Pensions.

Those customers on low-middle incomes cannot be advised cost effectively by the retail financial services industry. This has led to a large proportion of the population being excluded from purchasing savings and investment products through an advised sales process. Research conducted by an Independent Financial Adviser (IFA) network found that AB consumers accounted for 23 percent of the customer base of this network in 2001, with this figure projected to rise to 40 per cent by 2003[5].

Chart 1: Socio-economic breakdown of consumers purchasing through IFAs



Source: Medium and Long-Term Retail Savings in the UK - A Review, July 2002, HM Treasury

Insufficient savings will have a negative impact on any individual's quality of life throughout their life, and especially in retirement. Widespread under-saving also has serious consequences for the Government and society. Furthermore, the problem of insufficient saving is one that can be rectified more easily early on in a person's life. This policy aims to reduce the risk of insufficient savings.

The stakeholder products are designed to stimulate savings activity, especially by increasing access for lower to middle income groups, where under-saving is more acute, due to limited access to financial services, expensive advice and unsuitable savings products.

[5] *Medium and Long-Term Retail Savings in the UK – A Review*, July 2002, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/Documents/Financial_Services/Savings/fin_sav_sand.cfm

This policy seeks to redress some of these market problems by proposing a suite of products designed to:

- minimise the risk of consumer detriment caused by high charges and complex features; and
- limit the investment risk to which consumers will be exposed through product regulation.[6]

Higher levels of savings will mean that more people will be more able to meet their financial needs throughout their entire life.

Options

Option 1 - Not act in response to Sandler's recommendations, and maintain the status quo.

Option 2 - Implement Sandler's recommendation to develop specifications for a suite of simple, low-cost, risk controlled savings and investment products.

The Government outlined in July 2003 that the 'stakeholder suite' would include:[7]

a. A deposit account;
b. A medium term investment product, with a smoothed investment option.
c. A modified stakeholder pension;

The Child Trust Fund would also be available within the suite.

The deposit account will be similar to that of a CAT-Standard cash-ISA.[8] There will be a set of minimum standards for this account. The key feature is that the interest rate offered by firms cannot be lower than 1% below the Bank of England Base Rate. This will help to ensure that the consumer's return is higher than the rate of inflation.[9]

The unitised medium term product has been designed to limit the amount of risk to the investment through product regulations. The maximum amount that can be invested in equities and property is 60%, and there is a further requirement to diversify assets to spread the risk, and to help prevent the scenario whereby one equity failure will put the entire investment at risk. The remaining 40% will be invested in less volatile assets such as bonds and cash.

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[7] *Government response to the consultation on Sandler 'stakeholder' product specifications*, July 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/12836/govt_response_sandler_doc.pdf#page=1

[8] CAT standards for ISA savings and investment products will be discontinued on the introduction of the *stakeholder* suite of products in April 2005.

[9] Inflation is a measure of the change in the general level of prices charged for goods and services bought for the purpose of consumption.

The stakeholder pension will require a lifestyled default fund, so investments can move into less volatile assets as retirement approaches. This means, for example, that 5 years before retirement money will gradually be transferred from equities to less volatile assets such as bonds and cash, again to reduce the risk associated with the investment. The pension specifications will be outlined fully in the Department for Work & Pensions (DWP) consultation, which will be published shortly.

Consequences of each option

Option 1 –

Maintaining the status quo has no economic costs and benefits associated with it, since it also provides the baseline against which we are measuring the policy change. However, it remains important to understand the consequences this might have.

The Government is concerned many UK individuals are potentially under saving for retirement; savings levels are especially insufficient amongst those on moderate incomes. Current estimates of the possible size is as follows:

Table 1: Government target group

Individuals who are seriously under saving	3 million
Individuals who may wish to save more for retirement	5-10 million
Possible size of target group	**8-13 million**

Note: based on DWP's estimate from "Simplicity, security and choice: working and saving for retirement", DWP, Dec 2002.

For those individuals that are served, competitive forces in the industry do not always work effectively to deliver value-for-money investment products. This is especially so in the Government's target market. Consequently, if no action is taken the current low level of savings will persist, which is undesirable for consumers, the financial services industry and Government.

Furthermore, consumers on lower or medium incomes will continue to be unable to access financial services through regulated advice, and the market will remain opaque and driven by industry.

Option 2 –

Some firms may decide not to enter the market as they may regard the cost economics as unviable for their business model, which may have an impact on the overall level of competition

Furthermore, for the intended outcome to occur it will be necessary for the following market behaviours to be realised:

- Distribution channels to emerge that embrace 'basic advice';
- Distribution channels to emerge that engage with low and moderate income consumers and others who do not currently save;
- Consumers to trust the stakeholder brand, new channels and the providers;
- Marketing effort on the part of Government, providers and distributors.

Many of these issues will be market dependent, and are impossible to predetermine. However, the Government is currently evaluating the most appropriate way to ensure that this outcome is realised. The Government is still evaluating the level of marketing that is appropriate for the product suite.

Costs and Benefits

Although firms will not be required to offer stakeholder products, it is likely that institutions that service the mass retail market will have the most positive attitude towards stakeholder products. It is also probable that larger firms who can benefit from economies of scale will offer stakeholder products.

Almost all of the adult population, many of whom need or want to save, or indeed already do save, will be eligible to purchase a stakeholder product. However, it is unlikely that all individuals will do so, as other considerations, such as their level of indebtedness and protection needs will constrain the size of the market. Furthermore, the market size will be sensitive to various factors; for example, the marketing/sales method adopted by the industry will have a significant impact on the number of polices sold.

The chart in Appendix A shows the market size that could emerge under different scenarios. Deloitte[10] assumes that the FSA's basic advice process filters out those who:

- do not have three months income in cash;
- are struggling with debt commitments;
- are aged over 70,
- those with income of less than £10,000 per annum and aged over 45, and
- those under 45 with income of less than £5,000 per annum.

This leaves a potential pool of 12.1 million consumers who might benefit from investing in stakeholder products.

Deloitte estimates that the market for stakeholder regular contribution products (the medium term and pension product) has a potential market size of £802 million in new business per annum. This would equate to approximately 13% growth on current new business levels.[11] Appendix B explains how this market estimation has been derived.

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[10] HM Treasury commissioned Deloitte to conduct research into the impact of different charge cap on consumers and the retail savings industry in March 2003. The research, *Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products* – July 2003, is available on-line at www.hm-treasury.gov.uk/stakeholder

[11] *Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products* - July 2003, Deloitte. A copy is available on-line at www.hm-treasury.gov.uk/stakeholder

Option 2 – Introduction of stakeholder products and deregulation[12]

In 2003, Deloitte was commissioned to conduct independent research into the market impact of different charge caps in the stakeholder suite. Below is a cost benefit analysis which incorporates Deloitte's work[13]. Sources of other information have been referenced accordingly.

Costs on firms of Option 2

There will be no requirement for firms to provide stakeholder products. Therefore, the firms that choose to enter the market for stakeholder products will be those who anticipate that it is profitable for them. Indeed, this is very much separate to a firm's rationale for entering the fully advised retail financial services market.

The charge cap for the medium term product has been capped at 1.5% AMC for the first 10 years of the product, then reducing to 1% AMC [14]. "The Sandler review argued that while in a fully competitive market charge caps would be neither necessary nor desirable, price control is an essential component of a regulated product in a market that is distinguished by lack of price competition and consumer weakness."[15] The charge cap for the medium term product has been set at a level that the Government believes will allow consumers to have the opportunity to purchase a transparent, low-cost investment, whilst allowing efficient firms to sell these products viably.[16]

a) Set up costs

   These represent the one-off costs of setting up the business to be able to write medium and long- term stakeholder products. They are incurred once in year 1 irrespective of the volume or variety of different products that are sold or the number of sales channels that are used.

   Deloitte, following consultation with the industry, suggests an average cost of £10 million per provider[17] that includes recruitment and re-training of sales staff and initial marketing, although this would be lower for some specialist

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[12] Deregulation - The time it takes to sell stakeholder products through the FSA's basic advice process is expected to be significantly shorter than the current process. In effect, providers would be subject to a streamlined sales process, which will be more cost efficient.

[13] There are many underlying assumptions to Deloitte's work, please refer to Deloitte's report – *Assessing The Likely Impacts Of Charge Caps On Retail Investment Products* - published today for full details of how the cost and benefits are derived. It copy is available on-line at www.hm-treasury.gov.uk/stakeholder

[14] Although the product is designed for a consumer investing for 5-10 years, there is no set time horizon.

[15] *Proposed product specifications for Sandler "stakeholder" products*, February 2003, HM Treasury. A copy is available on-line at http://www.hm-treasury.gov.uk/media/55586/Sandler_Consultation(240Kb).pdf

[16] This is based on the assumption that 'basic advice' is available.

[17] This is an average indicative figure, and will differ from firm to firm, and will be dependent on their current product offering. However, £10m is regarded as a realistic average, and includes the cost of systems expenditure, product development expenditure, initial marketing spend and the recruitment and/ or retraining of sales staff. The £10m figure is included as part of Deloitte's profitability analysis. The profitability analysis includes a wider range of costs, including on-going costs. A copy of Deloitte's research is available on-line at www.hm-treasury.gov.uk/stakeholder

niche providers. It is difficult to estimate how many providers will enter the market. Based on consultation with the industry and the possible sizes of the stakeholder market under different charge caps, Deloitte estimates that three providers would be a low estimate, ten a high one and six a medium figure. This would result in total set-up costs of £30 million, £100 million and £60 million respectively. All set-up costs are expected to be recouped from future profits.

Niche providers may be able to provide stakeholder products to their specified market with considerably less initial costs, but will incur significant cost to reach outside their special affinity. It is unlikely these firms will seek to provide stakeholder products to the wider market.

b) Ongoing cost

There will be initial and annual administration cost to each new contract sold. Again, firms are expected to recoup all of this cost from future profits.

c) The stakeholder deposit account replaces the current CAT-mark cash ISA. It has been decided that the interest rate offered to consumers cannot be below Bank of England base rate, minus 1%. (previously 2% under CAT). The reduced charge cap will favour consumers by reducing the potential loss they could incur. The majority of CAT-mark cash ISAs currently offered on the market all operate within 1% so we do not expect any reduction in profitability associated with this product.

Benefits to firms of Option 2.

a) Increase sales

We anticipate industry will benefit from increased sales of investment products: Deloitte estimated 458,000 new medium term and pension contracts per annum (245,000 medium term and 213, 000 contracts). This equates to £802 million of new regular contributions per annum. Appendix B explains how these figures have been derived. Providers that choose to enter the market would be those that anticipate it will be economically viable for them to do so. Profits are obviously an important benefit to firms.

b) Sales achieved through the 'basic advice' process (deregulation)

The reduction in the cost of advice benefits the industry by reducing salary, training, compliance, monitoring and supervision costs and reduced sales time per client.

Length of sales process

Sales through basic advice will be quicker, and, being less complex, require less supervision than sales through full advice. Estimates of sales time for full advice and basic advice are given in the table below.

Table 2: Estimated sales time (hours)

Task	Current DSF	Current Bancassurer	Simplified Sales
Total adviser time	6.2 hours	4.7 hours	1.2 hours

Source: FSA

Salary levels and training costs

Staff conducting only basic advice will not be required to have a specific qualification (but will need to be competent for the role that they perform). They are likely to be paid a lower salary than would be paid to a qualified adviser; and to receive less training. Estimated salary levels and training costs are given in the table below.

Table 3: Salaries and training costs

	Qualified Adviser	Basic advice Staff
Salary	£32,000	£20,000
Supervisor	£35,000	£35,000
Overhead rate	75% salary	75% salary
Training cost per sale	£50 per sale	£25 per sale

Source: FSA

Cost savings will depend on the extent to which firms use different staff for basic advice than they otherwise would use for full advice. Industry responses suggest that most firms will use existing (non-advisor) staff or recruit new staff for basic advice. As a conservative estimate, it is assumed that 25% basic advice sales are made using qualified advisors and 75% using basic advice staff.

Total benefit

The table below shows the estimated costs of full and basic advice.

Table 4: Estimated sales costs

	Estimated average costs of full advice via direct sales force (£)
DSF[18]	485
Bancassurer[19]	317
	Estimated average costs of basic advice (£)
Using qualified adviser	203
Using staff who are not qualified adviser	126

Source: FSA

Assuming a 50:50 split between DSFs and bancassurers and a 25:75 split between qualified advisers and basic advice staff, the average cost saving is (approximately) **£400 – £145 = £255**
Source: FSA

Deloitte estimates that 458,000 new regular contribution medium-term and pension contracts could be sold per annum. The cost saving, however, can only be apportioned to those customers who would have entered the savings market anyway with full advice, irrespective of stakeholder products, but would have purchased an alternative savings product. In consultation with the FSA, we estimate that 70% of the 458, 000 would fall into this category. Consequently, the average cost saving (of stakeholder products sales via simplified sales process compared to sales via the current sales process) to the industry for medium term and pension products is therefore:

320,600*£255 = **£81,753,000**

Cost to consumers of Option 2.

a) Some consumers may otherwise have bought a non-stakeholder product that could have resulted in a better outcome for them. For example, a consumer may purchase a product under streamlined advice that they would not have purchased if they had been through full advice.

b) There are also other factors. For example, a consumer may decide to purchase a medium term investment product when they could potentially have been better reducing their debt commitments. However, this would be dependent upon each individual's specific circumstances.

[18] DSF – Direct Sales Force
[19] Bancassurer is a company or group offering a range of financial services to its customers. Usually applied to banks having subsidiary insurance companies.

Benefits to consumers of Option 2

a) The primary beneficiaries of the new products will be consumers who are currently excluded from the market but who have the potential to be saving, or indeed could enhance their current savings provision. It is estimated the stakeholder market will produce 245,000 new medium term regular contributions and 213,000 new pension contracts per annum, although not all of these will necessarily have been excluded from the market within the status quo. (Appendix B explains how these figures have been derived). This is a total market size of 458,000 new contracts, which is £802 million new regular contributions per annum in monetary terms.

   This represents a positive increase in savings activity from current levels, and will benefit consumers.

   As well as explaining the base case scenario of 458,000 contracts, Appendix B provides sensitivity analysis to show the range of business growth. Overall, the market growth of stakeholder products has also been assessed under different sensitivities, as the table below summarises.

   Table 5: Market growth range

	Market growth		
Scenario	**Number of contracts sold**	**£m New contributions pa (regular contribution business)**	**Growth in % on current new regular contribution business levels**
Base case	458, 000	802	13
50% of base case (number of contracts and average case size)	229, 000	201	3
150% of base case (number of contracts and average case size)	687, 000	1805	30

   Source: Deloitte

   The consumers of stakeholder products stand to benefit financially from the potential higher rate of return, although *some* consumers may potentially expose their capital to a higher level of risk. For example, a consumer may decide to purchase a stakeholder medium term product rather than depositing their money in a standard deposit savings account.

For the medium term product, assuming an overall return of 8.1% on equities and 4.5% on bonds, a stakeholder medium-term product, with a maximum 60% equity exposure and 40% invested in bonds, the annual expected nominal return on the investment can be estimated as 6.7%[20].

Independent of charges and inflation, there is therefore a nominal per customer benefit of 6.7% as outlined in the table below[21]:

Table 6: Nominal Average returns for the stakeholder medium term product.

Product	Average returns in %
Equities	8.1
Bonds	4.5
Stakeholder Term Medium Product (60% Equities & 40% Bonds)	6.7

Source: Deloitte

It is assumed within this figure that a consumer is not saving in an alternative medium term savings or investment vehicle. For those that do then this net benefit could be lower. However, it is complex to quantify, and would be dependent, for example, on the investment performance and charges of their existing product, and the value that they associate to other forms of advice processes they may have previously used.

b) Consumers of stakeholder medium term products, including those who choose to substitute into the market, could benefit from lower charges. A charge cap will ensure that the reduction in yield[22] (RIY) to the consumer from charges imposed by the provider is at a reasonable level, yet being consistent with allowing efficient firms to make a reasonable return on their capital.

   The average current charges for medium-term financial products are in the region of a 5% up-front charge and a 1% annual management charge (AMC). Deloitte have produced a model to analyse the impact of charge caps on the market and the associated reduction in yield for consumers. The model is used to produce the table below, which shows the benefits to consumers of having lower charges on a medium term financial product. The charge cap for the pension product will be analysed in a separate RIA by the Department for Work and Pensions.

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[20] The 8.1% and 4.5% are derived from Deloitte's proprietary economic model, The Smith Model, calibrated to market information at the time of modeling. *Assessing The Likely Impacts Of Charge Caps On Retail Investment Products* – July 2003, Deloitte. A copy is available on-line at www.hm-treasury.gov.uk/stakeholder

[21] This assumes that a customer is not saving in an alternative savings or investment vehicle.

[22] Reduction in yield occurs as a result of charges levied by the financial services provider.

Table 7: Regular contributions stakeholder medium term product

	RIY in %		
Term	5% Contribution Charge, 1% Annual Management Charge	Stakeholder - 1.5% Annual Management Charge for 10 years, followed by 1% Annual Management Charge	Difference in RIY % (= consumers' savings)
1	10.59	1.58	9.01
3	4.45	1.58	2.87
5	3.09	1.58	1.51
7	2.50	1.58	0.92
10	2.05	1.58	0.47
20[23]	1.52	1.21	0.31

Source: Deloitte

They will also benefit from the ease of access to their investments due to the presence of charge controls at the point of entry and exit. This will reduce the consumer detriment caused, for example, by lock-in periods or having to pay charges to gain access to the savings when required, that exist with some other investment products.

c) There will also be time saving benefits to consumers from the reduction in the length of the sales process. The FSA have designed and 'consumer tested' the stakeholder basic advice process. The results indicate that the basic advice process compared to current sales process takes on average 2 hours less to complete. The time saving to consumers in monetary terms is £10.50; this is quantified by taking 50% of an assumed average net wage of 10.50 an hour[24].

d) The financial services market: The introduction of the stakeholder products could have a "halo effect" on the existing products. That is, the benefit of lower charges and increased efficiency could spread across the market. This is beneficial to all consumers of financial services products.

Summary of Benefits to the Consumer of the Medium Term Product

Expected Number of products Purchased Per Annum	**245 000**
Average Consumer Contribution	**£120**
Nominal Average Expected Return Per Annum (net of maximum management charge) until year 10[25]	**5.12%**

[23] Although the product is designed for a consumer investing for 5-10 years, there is no set time horizon.
[24] This is based on the mean gross earnings from the 2002 New Earnings Survey, adjusted for real earnings growth to 2004 and tax/ national insurance. The consumer saving also assumes that an individual values basic and full advice equally - if they do not then the benefit to the consumer will alter.
[25] The nominal average expected return will be higher after year 10 as the charge cap reduces from 1.5% AMC to 1% AMC.

The Government

The gains to the Government will come from enhancing the ability and flexibility for all to save for their future needs, and certainly for those on low-middle incomes. Increasing efficiencies in the retail financial service market will occur by tackling information asymmetries and enhancing competition. There will also be a long run fiscal policy gain through a higher level of savings amongst the UK population.

Small Firms' Impact Test

The Small Business Service (SBS) and HM Treasury are currently working together and will monitor the situation as it develops. Based on the information presented in this RIA and the consultation that has already taken place, the SBS is content that there appears to be no significant or complex impact on small firms in general.

Competition assessment

The Office of Fair Trading requires a competition assessment to be carried out on all policies that impact on competition in a given market in order to determine that the policy does not work to the detriment of competitive markets. The proposals will impact upon the retail financial services industry. The proposals may generate changes in the industry but firms are not required to offer stakeholder products and the proposals are explicitly aimed at increasing rather than reducing competition. As a result we do not anticipate that these changes will have a significant negative impact on competition.

The retail financial services industry includes a wide range of companies (e.g. banks, building societies and life insurance companies). Not all companies will decide to offer stakeholder products but of those who do, we anticipate that while a number of companies may offer the full range of stakeholder products others may only offer some of the products. Some companies (e.g. life insurance companies) *may* also sell products through intermediaries (e.g. banks, supermarkets). Consequently some banks may therefore distribute, but not manufacture, certain stakeholder products.

With regard to the supply of stakeholder products, it may be possible for some of the larger firms in this industry to establish a significant market share of sales (e.g. 20% or more) of one particular product. In particular, the larger companies may be able to benefit from economies of scale. If we consider the whole stakeholder product range, however, we expect that the market shares of stakeholder product sales for any one company would be less. With regards to demand for stakeholder products, consumers will have different needs so that while some may make comparisons with a limited range of alternative savings products, others (e.g. those with higher incomes) may compare them with a broad range of financial products currently on offer. It is also important to remember that the sale of stakeholder products is voluntary, and takes place under a different selling environment from the status quo.

Thus, while some companies may face high set-up costs, these will be incurred after an assessment that a suitable return can be made over the costs involved. In this regard, the introduction of stakeholder products alone should not force any companies out of the retail financial services industry nor should stakeholder products (which will be just one part of the wide range of financial products already on offer) be enough on their own to prevent entry to the retail financial services industry.

It is intended that stakeholder products will be regulated by a charge cap. In the context of these proposals, the charge cap will be a key consideration in whether a firm decides to enter the market, and will help to determine the number of firms who do so. If the charge cap is set too low this may result in firms deciding not to offer stakeholder products, which may subdue competition between providers for customers. If fewer companies enter the market, those that do will be able to establish larger shares of stakeholder sales; costs may therefore fall as these firms benefit from economies of scale. The consultation will allow representations on the stakeholder policy. The Government envisages a review of the short term and medium term products, including the charge cap, three years after the policy comes into force in April 2005, to see if the policy intent has been met.

We would welcome views from interested parties on this assessment.

Enforcement and sanction

The existing level of enforcement and sanction that already exists for deposit accounts, stakeholder pensions and medium term investment products will apply to the new suite of stakeholder products as well. There will be a variety of different bodies undertaking the enforcement of different parts of the policy. In practice this means that the enforcement bodies for specific elements of the products will be the Financial Services Authority, the Occupational Pensions Regulatory Authority, the Financial Ombudsman Service, the Pensions Ombudsman, the Inland Revenue or the Banking Code Standards Board, as well as self-regulation and whistle-blowing undertaken by the retail financial services industry.

Consultation

The Government consulted on stakeholder products in the February 2003 consultation document entitled *Proposed product specifications for Sandler "stakeholder" products*, and the Government responded in July 2003 in the *Government response to the consultation on Sandler "stakeholder" product specifications*.

The consultation proposals took forward one of the main recommendations of the Sandler Review of Medium and Long Term Savings in the UK, which called for the creation of a new suite of simple, investment-restricted, low cost, investment products to be sold via a simplified sales process.

The Government consulted widely on its proposals. In addition to the formal consultation, meetings were held with over 40 fund management and life insurance firms, banks and building societies, consumer groups and others to discuss the issues raised. The Financial Secretary also held a seminar for key stakeholders and officials spoke at a number of conferences.

The majority of respondents to the consultation came from providers and distributors. In determining the appropriate way forward, the Government has sought to balance these views with those of the other major stakeholders, including consumer representatives.

The consultation process has been extremely helpful in developing the policy in terms of the product specifications to ensure that the proposals meet the needs of the consumer, yet are able to be implemented as simply as possible by industry.

Monitoring and review

The Financial Secretary will review the policy for the short and medium term products to ensure that the policy intent has been achieved. In particular, the level of the charge cap will be reviewed to ensure that the market is working as intended.

Summary

The Government is concerned a significant proportion of the UK population could be under-saving due to, for example, a lack of access to financial products; the cost of which can be high for individuals. Indeed, the current UK financial services market cannot service the low-middle income segments of society cost effectively. The services and products it currently offers the public are inadequate to meet some consumers' needs. Tackling these problems will bring substantial benefit to consumers, the Government and industry. Implementing Ron Sandler's recommendations is a key step.

The benefits from the introduction of stakeholder products are substantial but not all are easily quantifiable. A summary table of costs and benefits of the two options is shown below. There are also many positive externalities to wider participation in savings schemes and in higher levels of savings.

The Government recommends the introduction of stakeholder products.

Option 1 – Not to act in response to Sandler's recommendations
The current status quo would remain. In summary this would mean: • Inefficiency and weak competitive pressures in the retail savings market would continue. • Complexity and opacity would continue to contribute to consumer reluctance to save, and would continue to exacerbate the problem of under-saving. • Continued limited access for those on low-middle income, potentially exacerbating problems of under saving in these segments. • Potential for under saving is likely to persist.

Option 2 – Introduction of stakeholder products and deregulation	
Cost	Firms o Set up costs – estimated at £60m, but recouped in future profits. o Ongoing costs – recouped in future profits Consumers o Some customers may have bought an alterative product to stakeholder that may have had a different offering that could have created a preferred outcome for them.
Benefits	Firms o Stakeholder market – potential increased sales, estimated 458,000 new contracts per annum. o Basic advice process – reduced cost of sales process, estimated cost savings of £81,753,000 when compared to full advice. o Increased profit created by an increased number of customers under the new product regime.
	Consumers o Choice of simple, low-cost, risk controlled savings and investment products. o Investment returns earned by consumers. o Charge cap – potentially increased investment returns to consumers for the medium term and deposit account products owing to the RiY being capped. o Basic advice process – time saving to the consumer of 2 hours (£10.50) per sale process. o Possible halo effect – benefit of lower charges and increased efficiency spread across market.

	Government o Reduce risk of insufficient savings. o Positive externality of individuals having the necessary savings to meet their short, medium and long term financial needs.

We would welcome views from interested parties on this assessment.

Ministerial declaration -

I have read this regulatory impact assessment and am satisfied that the benefits justify the costs.

STEPHEN TIMMS MP

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Appendix A

Number of Individuals (million)	Low Income	Moderate Income	High Income	Low/High Income	Total GB Adult Population	% Population
Single Filters						
Total Population with no filters	15.44	13.53	8.42	7.03	**44.43**	100%
Total Population with at least 3 months savings	6.35	5.22	3.66	4.59	**19.82**	45%
Total Population with at least 6 months savings	5.00	3.84	2.35	2.77	**13.95**	31%
Total Population with at least 12 months savings	3.46	2.35	1.03	1.84	**8.68**	20%
Total Population with cost of debt including mortgage <40% income	13.19	11.79	7.92	6.46	**39.36**	89%
Total Population with cost of debt including mortgage <20% income	11.29	10.07	5.85	4.71	**31.93**	72%
Total Population with no debt	7.37	6.91	.81	1.18	**16.28**	37%
Total Population prepared to take risks with savings	5.20	4.47	5.53	3.77	**18.97**	43%
Combined Filters						
1. Total Population with at least 3 months savings excluding those with > 40% debt and not in difficulty with repayments	6.27	5.21	3.66	3.76	**18.91**	43%
2. As 1. but excluding those aged over 70, those with income of less than £10000 pa and aged over 45 and those under 45 with income of less than £5000pa	***1.78***	***3.31***	***3.48***	***3.55***	***12.13***	***27%***
3. As 2. but excluding those unwilling to take risks	.83	1.64	2.57	2.12	**7.16**	16%

Source: Assessing The Likely Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003

Appendix B

The stakeholder market

The size of the **stakeholder** market is difficult to estimate precisely and depends on a large number of variables. One of the critical factors would be the design of the filter in the FSA sales process. FSA's work on a basic advice process is published today.

Deloitte assumes that the sales process filters out those who do not have three months cash, are struggling with debt commitments, are aged over 70, those with income of less then £10,000 per annum and aged over 45, and those under 45 with income of less then £5,000 per annum. This leaves a potential pool of 12.1 million consumers who may have the potential to buy stakeholder products, although it is recognized that other filters may also be applied (for example, inadequate life cover or a consumers resistance to risk)

Of the pool of 12.1 million -

- Group A - 4.2 million are saving less than 5% of their income;
- Group B - 7.9 million are already saving in excess of 5% of their income.

Medium-term products (i.e. regular contributions savings)

By looking at:

- past sales figures for savings endowments;
- the savings activity and potential of the pool of 12.1 million.

An assumption of 3% of those who currently save very little or nothing and 1.5% of the larger group who already save would appear to be a prudent starting point for sizing the supplementary stakeholder market.

If these numbers can be persuaded to buy a stakeholder savings plan each year, this will yield a total new market of approximately **245,000 new contracts.** This is without any business being generated from the remainder of the population.

If spread evenly across the four segments of the Market considered by Deloitte (in practice, increasing the savings activity of the lower income segments more than the higher income segments who already save), the 245,000 contracts would be distributed as follows:

Table 1 – Mix of possible savings plan buyers

Low income	Moderate income	High Income	Low/High Income
42,000	**70,000**	**64,000**	**69,000**
17%	**29%**	**26%**	**28%**

Note: Low/high income group - Individuals with total gross income from earnings, investment income, benefits and pensions less than £22,000 and with household income of £25,000 or more. Also included in this group are a small number of individuals who have recorded high personal incomes but low household incomes in the research.

It is important to stress that this number is drawn from an analysis of what might be reasonably achievable rather than an assessment of what any given charging level might achieve. Inherent in the analysis is an assumption that the charging level for stakeholder products is sufficiently attractive to the industry to begin targeting those with low to moderate incomes and those who do not currently save.

Analysis of current average contributions to savings endowments, current average contributions to equity ISAs, and average total savings for the 12.1 million across four income groups - Low income, Moderate income, High Income and Low/High Income – suggests that the likely average contributions is £120pm.

If on average, the 245,000 new savers can be persuaded to save on average £120pm (on average 7% of their incomes and the weighted average of the monthly contributions shown immediately above), this would generate a market value (measured in new contributions pa) of **£355million**.

Pension products

In addition to the savings activity outlined above, analysis of data relating to pensions – sale of pension contracts activity per year, and proportion of the four income groups in pension schemes – and employment rate amongst the 12.1 million suggests that with the support of new distribution and active marketing, it may be possible to attract 3% of those with no pension and 1.5% of those with existing pensions to buy a new stakeholder pension each year (the retired were excluded from this calculation). This will yield a total market of approximately **213,000 new contracts**.

If the same penetration rates are applied to all four segments (in practice, increasing the savings activity of the lower income segments more than the higher income segments who already save), the 213,000 contracts would be distributed as follows:

Table 2 – Mix of possible pension buyers

Low income	Moderate income	High Income	Low/High Income
46,000	**48,000**	58,000	61,000
22%	**23%**	27%	29%

Note: Low/high income group - Individuals with total gross income from earnings, investment income, benefits and pensions less than £22,000 and with household income of £25,000 or more. Also included in this group are a small number of individuals who have recorded high personal incomes but low household incomes in the research.

Combining the current averages for the four income groups, allowing for those employers who do contribute to match the individual contribution (and then rounding), leads to average contribution of £175pm. If new savers can be persuaded on average to save £175 per month, this will generate a market value (measured in new contributions pa) of **£447million**.

Total market size

	Average contribution pm	Number of new contracts pa	Total business value pa
Medium term	£120	245,000	£355m
Pension	£175	213,000	£447m
Total market size		**458,000**	**£802m**

This compares to current market sizes of in excess of £4.3bn of new regular contribution life and pension business[26] and an estimated £2bn of regular savings ISAs[27] in 2002.

£802million of new regular contributions implies market growth of approximately 13% on current new business levels.

For these base case results to emerge, it will be necessary for the following market behaviors to be realised:

- Distribution channels to emerge that embrace DP19[28] regulation;
- Distribution channels to emerge that engage with low and moderate income consumers and others who do not currently save;
- Consumers to trust the stakeholder brand, new channels and the providers;
- Marketing effort on the part of Government, providers and distributors.

In turn for much of this to emerge, the profitability of the products must be such to attract capital to the market and the potential size of the market must be sufficient to warrant investment and be seen to be capable of supporting competition.

Summary source: Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003

[26] ABI Statistics
[27] IMA Statistics
[28] Discussion Paper 19, FSA,

Appendix C

Market size sensitivities

The following table shows how different market sizes and values could emerge under different results to those described above.

Table 1 – Market size sensitivities

	Number of contracts 000 pa	£m New Contributions pa (regular contribution business)	Average Contributions £pm
Base Case	458	802	146
50% of (base case) number saving	229	401	146
150% of (base case) number saving	687	1203	146
50% of average contributions	458	401	73
150% of average contributions	458	1203	219
Worst of both (50% of base case number saving and 50% of average contributions)	229	201	73
Best of both (150% of base case number saving and 150% of average contributions)	687	1805	219

The worst case described above implies only 3% market growth with few new customers and low average contributions. Any or all of the following could result in this scenario occurring:

- The existing industry lacks confidence in the FSA's DP19 rules and new players are nervous of entering the market;
- Media discourage consumers from buying and industry analysts discourage capital investment;
- The stakeholder brand lacks punch with consumers;
- The economy becomes more uncertain;
- Employers lack confidence in allowing worksite marketing;
- The price cap is set at a level that discourages investment in distribution to the mass market;
- Few new sales channels developed or those that do are not trusted by the consumer;
  - Banks do not embrace change
  - No new sales forces emerge
  - Worksite marketing fails under DP19
  - Retailers lack punch
  - Direct offers not persuasive.

By contrast the best case results in almost 30% market growth. For this to be realised, all or most of the following will be necessary:

- DP19 option 2 is endorsed and clarity emerges from the Financial Ombudsman Service regarding the potential for future misselling;
- The media is convinced of and promotes the consumer benefit;
- Industry analysts are convinced of the potential profitability of the contracts and encourage capital investment;
- Consumers are attracted by the simplicity and transparency of the contracts and are encouraged to increase their level of saving;
- Economic stability and an improvement in stock market returns;
- Pensions simplified;
- Focus on regular savings;
- Channels emerge quickly and target a wide range of consumers;
  - New ‘home service’ style
  - Employers support worksite
  - Banks embrace
  - Retailers support
  - Direct offers attract the top end of the market.

Summary source: Assessing The Likely Market Impacts Of Charge Caps On Retail Investment Products, Deloitte, July 2003