

05/8**

Financial Services Authority

Suitability Standards for advice on Personal Pensions

June 2005



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 28 October 2005.

Comments may be sent by electronic submission using the form on the FSA's website at www.fsa.gov.uk/pubs/cp/cp05_08_response.html .

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It is the FSA's policy to make all responses to formal consultation available for public inspection, unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Investment advice standards of suitability

- 1.1 Where a consumer takes financial advice on an investment product, our rules require the adviser to ensure that any recommendation given is suitable for the consumer.
- 1.2 This standard is made more rigorous when the adviser wishes to recommend a packaged product¹. In that case, the adviser must select the most suitable product from within the range of products he or she is permitted to sell. The purpose of this rule is to ensure that when the adviser has to choose between several products that might be suitable for the consumer, his or her recommendation is focused on that consumer's needs and interests, rather than on any benefit that might fall to the adviser or his or her firm.
- 1.3 To reinforce this standard and to help consumers understand why a particular packaged product has been recommended, our rules require financial advisers to give the consumer a suitability letter. As its name suggests, this explains why the adviser believes that the transaction recommended is the most suitable for the consumer. The points that the letter must cover are set out in our rules.
- 1.4 The effect of the 'most suitable' rule is that an adviser offering 'whole-of-market' advice must consider the range of products generally available in the market and must select the most suitable overall. In contrast, the requirement is different for an adviser who provides advice on only a limited range of products (ie, only those from one or more providers) – what we will call a 'tied adviser' in this paper. Tied advisers are not required to take account of any potentially more suitable products outside their range when making recommendations about the products they can sell. The adviser must simply select the most suitable from within that range.

¹ Packaged products are: life policies with an investment element; personal pensions, including stakeholder pension schemes; units or shares in collective investment schemes; and investment trust savings schemes.

- 1.5 For both whole-of-market and tied advisers, the final selection might come down to value for money, rather than any more technical aspect of a product. But tied advisers do not need to consider the availability of cheaper products outside their range.
- 1.6 However, the requirement for advisers to consider only products within their range is modified when an adviser decides to recommend a personal pension or free standing additional voluntary contribution (FSAVC) plan. In this case, the adviser must explain in the suitability letter why the personal pension recommended is at least as suitable as a stakeholder pension (SHP)². This is exceptional because the requirement to consider the relative suitability of the SHP applies whether or not the range of products that the adviser can sell actually includes a SHP.
- 1.7 In this Consultation Paper, we consider the rationale behind this rule (COB 5.3.16R(3))³ and the impact the rule may have had on the market for personal pensions. We then consider the implications of our proposal to remove it.

The impact of COB 5.3.16R(3)

- 1.8 There is evidence that suggests that the introduction of this standard in 1999 alongside the SHP price cap (then 1%) contributed to a perceptible drop in personal pensions charges to the SHP level. (Charges had, however, been reducing for some time before SHPs were introduced.)
- 1.9 However, the introduction of the rule has also been associated with a contraction in the market for personal pensions over the same period. This effect is difficult to attribute conclusively to the introduction of the standard; but we know that fewer personal pensions are now being sold to individuals, and the average contract size has risen.
- 1.10 So although the rule may have been effective in limiting the charges of personal pensions, this may not have worked entirely in consumers' interests if, as the industry suggests, it has restricted the availability of advice on personal pensions. Consumers need to save for their retirement and with a personal pension (including SHPs) they obtain certain tax advantages, although for many consumers the effect of those tax advantages is no greater than if they save for retirement through an ISA.
- 1.11 For some time (most recently in response to our mention of RU64 in our consultation on the new Basic Advice regime⁴) the industry has argued that the rule interferes with market dynamics. It believes that the resultant market contraction has meant that some consumers who should be saving for their

2 A stakeholder pension must conform to the Government's criteria regarding the features of the product. An important element of the design is a cap on the annual charge that the provider can make.

3 Throughout this paper we refer to 'COB 5.3.16R(3)' as shorthand not only for that rule itself but also its associated rules and guidance in COB 5.3.28R and COB 5.3.29G (B). This paper considers the potential removal of all three rules and guidance.

4 CP04/11 *A basic advice regime for the sale of stakeholder products* FSA November 2004

retirement are now not given the advice and access to personal pension products that they need. The industry tells us that firms have difficulty in establishing the suitability of a non-SHP pension over a SHP. Furthermore, it says, the rule has embedded an implicit price control into our regulatory regime by obliging advisers to benchmark personal pensions against SHPs – and their charges – in every case. If this analysis is correct, the restriction on the distribution of personal pensions particularly affects consumers at the mid-lower end of the wealth spectrum.

Pros and cons of revoking COB 5.3.16R(3)

- 1.12 The Government has recently raised the SHP charge cap and we might expect the average charges of personal pensions to follow suit and increase alongside it, especially for smaller premium policies. So we may see an increased scope in the pensions market that would deliver, at least in part, some of the benefits that the industry expects would occur by removing the rule. It is important to note that we take no view on the level of the cap, which is a matter for government. However, if (despite the increase in the SHP cap) the impact of our rule means that personal pension charges are still being kept artificially low, firms may yet have insufficient incentives to devote more resources to developing and distributing pensions to a wider range of consumers. Removing the rule might help to allow the market to meet that demand.
- 1.13 But there would also be costs to consumers associated with removing this rule. The most significant risk is that, in a market where competitive forces are weak, pension providers might increase their charges beyond the level for an efficient market. It is also possible that the range of SHPs offered – and the number of advisers offering them – would be reduced in favour of personal pensions, and that charges on personal pensions could become more opaque.
- 1.14 To decide how to proceed, we have sought to weigh up the likelihood of pension charges rising against the possibility for greater access to personal pensions. We have explored various sources of market data to develop our plausible scenarios. But accurate forecasting is problematic since there are a number of new factors that will affect the market, including the impact of the recent increase in the SHP charge cap. Some of these may help to mitigate the risk of prices rising or becoming more opaque, and are discussed in more detail in Chapter 3. Our detailed cost benefit analysis is set out in Annex 1. In summary, however, the evidence we have gathered does not allow us to predict the future outcome with certainty.
- 1.15 In the absence of a clear cost benefit case for or against removal, we have taken account of several policy considerations to determine an appropriate course of action.

- 1.16 In the interests of facilitating access to advised sales of pensions, we believe that it is now right to remove the rule and return the standards governing the sale of personal pensions into line with all other packaged products.
- 1.17 We are concerned that if the rule has genuinely contributed substantively to a contraction in the market and caused a group of consumers to be effectively excluded from saving for their retirement in a tax-efficient way, this would be a serious regulatory failure that we should address.
- 1.18 We recognise that there will be a cost to allowing more freedom in the way personal pensions are sold, and that even if consumers buying pensions are content to pay higher prices, their returns (and ultimately their retirement income) will be reduced by the charges they will have paid. And we recognise that as pensions are typically held for longer than other investments, they are particularly sensitive to the cumulative effect of charges.
- 1.19 But we are concerned that our rule appears to have had the unintended consequence of influencing prices in this market. This would not be consistent with our regulatory approach – we prefer to rely on market forces, together with our other regulatory interventions, to redress any market failures such as excessive pricing. If, as we propose here, the rule is deleted, we will monitor the market to assess the impact this change has had and will take action if we see significant consumer detriment arising.

Next steps

- 1.20 The closing date for comments on this consultation is 28 October 2005. We would particularly welcome your responses to the questions we have included in the paper. Details of how to send in responses are given at the start of this paper.
- 1.21 Subject to the outcome of this consultation, we expect to make the relevant changes to our rules and bring them into force in January 2006.

Structure of this paper

- 1.22 In Chapter 2, we explain the background to COB 5.3.16R(3) and consider the impact the rule has had on the market. In Chapter 3, we examine how the market might develop if we retained, or if, as proposed, we remove the standard.
- 1.23 The paper also has a number of annexes:

Annex 1: our cost-benefit analysis of the proposals

Annex 2: a statement of why we consider our proposals to be compatible with our general duties under the Financial Services and Markets Act 2000

Annex 2: a list of the questions in this CP

Appendix 1: the proposed rule changes

Consumers

This paper will be of interest to consumers who are interested in buying a personal pension and to groups that represent the interests of such consumers.

COB 5.3.16R(3) is a rule in the FSA Handbook which requires financial advisers to explain in writing why the particular personal pension or FSAVC contract they have recommended is at least as suitable for the customer as a stakeholder pension.

Consumers will be particularly interested in the possible effects which lifting this rule may have on prices of pension contracts and the availability of advice (Chapter 3).

2 The introduction of RU64 and its COB successor

- 2.1 In 1999, the Government introduced the price-capped SHP to encourage all who can save for retirement to do so. At that time, the insurance market generally was selling personal pension contracts with relatively high, often loaded up-front, charges. The SHP price restrictions meant that providers could levy only a flat charge of no more than 1% per annum⁵ and could not impose switching costs.
- 2.2 In March 1999, the Personal Investment Authority (PIA) issued RU64 to guide firms in the lead-up to the introduction of SHPs. PIA's concern was that firms would continue to sell personal pension contracts with high charges and poor early surrender or transfer values that effectively locked consumers in or attracted high penalties if they wanted to switch into the lower-charging SHPs.
- 2.3 RU64 reminded firms that they must take account of the advantageous terms available under the new product when making recommendations about personal pensions to consumers. So RU64 advised firms that consumers they had sold personal pensions to should be able to convert their contracts when SHPs became available, without the transfer giving rise to a material disadvantage. Firms would also have to record their discussion about SHPs with customers to help demonstrate the suitability of the product recommended.

The temporary nature of RU64

- 2.4 Once SHPs became available in April 2001, RU64 had served its primary purpose. It had created an environment where the SHP, even before its introduction, was the benchmark personal pension product. This probably began immediately to exert downward pressure on product charges and commissions for personal pensions.
- 2.5 RU64 no longer has any regulatory status. However, the requirement to take account of SHPs when selling a personal pension became an established standard and was carried forward into the PIA's rules (and those of the other

⁵ The charge cap was raised in April 2005 to 1.5% for the first ten years of the contract, falling to 1% after that.

pre-FSA regulators) from November 2000. It was subsequently included in the FSA's Handbook as COB 5.3.16R(3), COB 5.3.28R and COB 5.3.29G(B).

Market consequences

- 2.6 The industry has argued for some time that this rule has distorted the market to the detriment of consumers. We outline below some of the consequences of the rule, as reported by the industry, along with the evidence cited. Most of this analysis relates specifically to the market for personal pensions, although COB 5.3.16R(3) also refers to the sale of FSAVCs. We note that the market for new FSAVCs has shrunk over recent years⁶ and is likely to shrink further from April 2006 when 'concurrency' restrictions fall away⁷.
- 2.7 The industry believes that COB 5.3.16R(3) has the effect of extending the price cap applying to stakeholder products to personal pensions as well. This is because firms find it difficult to show that other pensions are at least as suitable as SHPs if their charges are higher than SHPs'.
- 2.8 This difficulty is not, in itself, unreasonable, as charges are an important aspect in the choice of a personal pension. This is particularly true since a pension is expected to be a long-term contract and the cumulative impact on returns of even apparently low charges over time can be quite significant. But there are other features that might affect suitability – such as the range of funds on offer, the product's flexibility, and the strength or the service levels of the product provider. It is simply harder to establish the value of these features against higher charges.
- 2.9 Historical information about personal pension charging shows that for some time even before SHPs were introduced, a downward trend in charges was evident. This is attributable to increased disclosure and competition. However, the introduction of RU64 and the announcement of the price cap can be associated with a significant further drop in personal pension charges towards the SHP cap of 1% annual management charge. Average Reduction in Yield figures (RIYs)⁸ fell from 1.9% in 1995 to 1.1%, where they have remained since 2001⁹.

6 Association of British Insurers (ABI) statistics show the FSAVC regular premium market falling to £10m in 2004 from £106m in 1998.

7 The current rules allow only individuals who earn less than £30,000 a year and are not controlling directors to contribute to a SHP when their earnings are being pensioned through a company pension scheme. From April 2006 this restriction will fall away, allowing everyone, including controlling directors and high earners, to contribute to any registered pension schemes simultaneously.

8 RIY is a method of expressing charges that takes into account all of the product charges and expresses them as a reduction in the growth of an investment

9 Average RIYs for personal pensions, in common with other life products, showed a small but steady drop from 1.9% in 1995, to 1.7% in 1998, following the start of the PIA's annual published review of RIYs. But the average RIYs for pensions then dropped more sharply than those of other products around the introduction of SHPs in 1998/9 (to 1.5% in 1999 and down to a steady 1.1% from 2001 onwards).

- 2.10 It can be argued that COB 5.3.16R(3) has caused product providers not only to standardise the features of their personal pension products into ‘stakeholder-friendly’ versions to make them more obviously comparable with SHPs, but also to limit the charges to bring them closer to those chargeable for SHPs. But this effect does not mean that all pension products ought necessarily to look the same, as consumer needs can vary widely. It is desirable that the market should be able to meet those needs appropriately.
- 2.11 The industry has also argued that at 1%, the SHP level of charge has been insufficient to fund the costs of advice and administration for new contracts on low premiums. This is because it does not cover the up-front cost of setting up contracts and providing advice (especially for lower value transactions). Consumers’ financial circumstances, and the fact that they are not locked-in, can mean that they are more likely to switch pensions or stop contributing before the initial costs are recovered. The industry argues that this financial constraint has led to a reduction in the sales effort and, hence, to reduced sales of personal pensions. This case was supported by the independent view of Deloitte, which advised the Treasury that 1% would not support large-scale sales of stakeholder products¹⁰.

The contraction in the personal pension market

- 2.12 Market data shows that fewer personal pensions are now being sold via advice to individuals, and that the average contract size has risen. Association of British Insurers (ABI) statistics report that the number of new regular premium contracts has fallen by 61% since 1998 while the average regular premium paid to new contracts has increased by 54%.
- 2.13 Advisers do not always find it economic to advise consumers who want to make low value transactions within the stakeholder charge cap. The low levels of commission payable mean that some transactions may never offer a break-even on the costs of the adviser’s consultation and administration time. A recently published report¹¹ on adviser commission suggests that the average commission on regular premium personal pension plans has fallen to around half the level seen before RU64 was introduced. But consumers are generally not willing to pay a fee for advice on pensions. So low product margins, and the absence of penalties for switching, do not encourage firms to provide a full advice service in the complex area of pensions. But at the same time, many consumers are not confident, and in many cases not competent, to buy a pension without some advice.

10 *Assessing the likely market impacts of charge caps on retail investment products*; report prepared for the Treasury by Deloitte, July 2003.

11 *Study of Intermediary Commission*; a report for the ABI by Charles River Associates, Feb 2005.

2.14 Of course, there are many influences on consumer behaviour. The observed shift away from investment in pensions and life insurance products towards property, currency and deposits also reflects the poor returns that equity-based products offered over this period. Changes to the benefits system may also have reduced the incentive for low earners to save through pensions. Nevertheless, it is likely that part of the decline in personal pensions can be explained by a reduction in sales effort by providers and advisers, and this can be attributed to the impact of COB 5.3.16R(3) and the SHP charge cap.

Impact on consumers

2.15 If the rule has played a major part in the contraction in the market, there will have been mixed effects on consumer welfare. Those consumers who purchased pensions with charges lower than they would have otherwise faced will clearly have benefited. However, there may be other consumers who would have benefited from purchasing pensions even at a higher, non-COB 5.3.16R(3) influenced, price. A higher-charging pension might still have been the best choice for this group, but they did not make a purchase because of the reduced sales effort by providers and advisers. But it has not been possible to construct estimates of the sizes of these different groups due to a lack of relevant data.

Q1: Do you agree with our analysis of the consequences which COB 5.3.16R(3) may have had on the market?

3 COB 5.3.16R(3) and the future of the UK pensions market

The consequences of no change to the rule

- 3.1 The 1% cap on SHPs has recently been raised to 1.5% for the first ten years of the contract. So even if the rule remains in place, this may increase the scope of pension provision as firms take advantage of the increased revenues to fund greater sales effort.
- 3.2 Also, reducing the charge to 1% after ten years creates an incentive for consumers to stay with the product they bought rather than switch to a new one charging the higher initial rate. It is also possible that the new depolarisation regime, allowing multi-tied agents, will reduce the cost of advice¹², making it possible to fund a greater volume of sales within the level of the cap.
- 3.3 But the scale of these benefits is unclear, since there is also a possibility that firms might still have insufficient incentives to devote more resources towards developing and distributing pensions to a wider range of consumers¹³. The industry claims that although the increase may support the sale of products through Basic Advice, it will still be insufficient to fund a full advice service for policies of all sizes. Basic Advice offers consumers wanting to make lower value transactions a form of low-cost advice; but our research has shown that in order to achieve 'safe' sales of pensions, it cannot serve all consumers. Those consumers who cannot be served by Basic Advice, and potentially many other individuals, may still need full advice because their circumstances are more complicated. And if that advice is not made available, some consumers may simply not be encouraged to buy pensions.

12 See the CBA in CP04/166 *Reforming polarisation: removing the barriers to choice* FSA, January 2003.

13 A recent study on adviser commission – *Study of Intermediary Commission*; a report for the ABI by Charles River Associates, Feb 2005 – suggested that the market participants interviewed doubted whether adviser remuneration would increase significantly following the increase in the SHP charge cap, as the new limit still represented a significant restraint for firms.

- 3.4 There is some evidence which suggest that even at these charges (around 1.5%), fully advised pension sales are profitable only at higher levels of premiums¹⁴. So it is still possible that if COB 5.3.16R(3) were retained, even though most personal pension charges might rise to around the new cap, firms offering advice would continue to focus on higher income consumers. There may be only limited new incentive for advisers to sell to less affluent consumers. It is therefore not clear that we can rely solely on the increase in the price cap to correct any distortion in the market caused by COB 5.3.16R(3).
- 3.5 In summary, to the extent that COB 5.3.16R(3) continues to constrain prices and contributes to lower sales effort under the increased SHP price:
- the market may continue to contract and, as a result of inadequate revenues, may fail to innovate and compete effectively in the market for pensions;
 - some individuals may continue to lose out from COB 5.3.16R(3) by not being offered the type of pension that best meets their needs, or any pension at all where that would have been the best option for them; and
 - some individuals will continue to gain from pensions being available at lower charges.

Q2 : Do you agree with our analysis of the future of the market if we retained the rule?

What happens if we lift COB 5.3.16R(3)?

- 3.6 Removing COB 5.3.16R(3) could result in two possible high-level outcomes. The first possible scenario is that there would be little or no change to the market. This could occur either because the rule has no effect on the market or because of the restraining effects of market developments since 1999 (including recent changes such as the rise in the price cap for SHPs). The price of personal pensions would settle either at the level or below the SHP charge cap if competition is effective and the efficient price is lower than 1.5%. In this case, there would be no detriment suffered by consumers.
- 3.7 We do not believe that this scenario is the most likely since the industry takes the view that (pointing to the evidence cited above) the revised price cap is too low to support a fully-developed market for advised sales in personal pensions across all consumer segments.
- 3.8 The second and more plausible outcome is that personal pension contract charges will increase beyond the level of the SHP cap to finance higher selling costs (especially with more advice) and to cover the costs of small policies. The key issue in this case will be the extent to which charges rise above the new price cap.

14 See, for example, the Pensions Commission First Report, page 220.

- 3.9 If the price rises, consumers who would have bought a pension even if COB 5.3.16R(3) were retained would pay more than they would otherwise have done. If the price rises to a level that represents the efficient costs of bringing the product to the market, then the cost to those paying more may be counterbalanced by the benefit of potential purchasers of smaller policies gaining access to advice. And any cross-subsidies needed to fund the formerly lower prices could be removed. A barrier to entry to the personal pension market will also have been removed, which might encourage more providers to enter the market, leading to more competition and more choice for consumers (although entry is expensive and there are no grounds to expect new entry on a large scale).
- 3.10 With increased supply, some consumers might also have access to products that more precisely fit their preferences. However – and this is a point that consumer representatives would wish to emphasise – while higher charges might allow the industry to finance the cost of advice and distribution more effectively, these inevitably reduce the performance of a product. Potentially, this makes it less suitable than alternative options.
- 3.11 It is also possible, and is also a matter of serious concern to consumer representatives, that prices could rise beyond the competitive market equilibrium to a level that represents excess profits for providers. In a market where many consumers are not sensitive to product charges, providers may compete for distribution, and a simple, but expensive, way to target wider distribution could be by paying higher commissions. The higher contract charges needed to fund this behaviour would eventually result in greater profits for providers and poorer value for consumers.
- 3.12 Advisers may also be more likely to focus on the sale of personal pensions with their (expected) larger commissions, even when advising those individuals whose needs could be fully met by lower-price SHPs. And greater incentives to sell pensions may increase the chance of some consumers buying a pension when it is not the best choice for them.
- 3.13 In this context, removing COB 5.3.16R(3) could encourage a move towards more complicated charges and less transparency in general. This could encourage firms, and tied and multi-tied advisers, to stop providing SHPs or to make the terms of their SHPs less favourable. However they would still have to let consumers know – via the Key Features Document – that SHPs could be at least as suitable as the products that they offer from within their selected range.

Q3: Do you agree with our analysis of what might happen if we remove COB 5.3.16R(3)?

Factors which could constrain the extent of price increases

- 3.14 Clearly, the negative effects that might arise would cause us concern. But the lack of hard data on some factors, together with the unpredictability of the market reaction, means we are unable to predict the extent to which prices might rise if COB 5.3.16R(3) were lifted. We would expect a price increase; but we cannot predict with any certainty the scale, or the likelihood, of excessive increases. We therefore consider below whether there are sufficient factors in place to restrain the market from increasing charges excessively, and discuss how we might monitor changes in the market to detect any potential problems as early as possible.
- 3.15 We have identified a number of factors that could mitigate excessive increases in charges on personal pension contracts. Some of these are continuing competitive forces that constrain prices in the investment market generally; others have emerged since the standard was introduced. However, we acknowledge that some, such as the introduction of the Menu¹⁵ (which should make consumers generally aware of the cost of advice) and improved product disclosure at the point of sale, have not yet been demonstrated to be effective. This is because they are either new regulatory features or have yet to be introduced.
- 3.16 The price transparency delivered by Key Features disclosure and, in due course, the improved charge disclosure that will be provided from our review of product disclosure at the point of sale, may promote price competition. Clearly, if more consumers begin to compare charges, this can be expected to affect provider behaviour and restrain any excess charges. Improved price competition is not dependent on individual consumers' behaviour; the increased transparency from disclosure can act on the market in other ways to restrain price increases. For example, media comment can draw attention to the availability of better value products, and firms themselves can observe their competitors' prices.
- 3.17 Even without COB 5.3.16R(3), our product disclosure rules require non-stakeholder pension providers to include a clear and prominent indication in their Key Features of the general availability of SHPs and the fact that a SHP may meet the consumer's needs at least as well as the pension on offer (COB 6.5.21G(5)).
- 3.18 Disclosure of the cost of advice through the new 'Menu' documents may strengthen competitive downward pressure on commissions for all packaged products, as discussed in the cost benefit analysis (CBA) in CP04/3. The policy objective of the Menu is to empower consumers to shop around, which would in turn restrain excessive increases in charges.

15 The menu gives the consumer information about the different ways of paying for advice, an indication of the fees or commission which might be payable plus how the commission cost compares to the market average.

- 3.19 We have influenced a cultural shift in the market since RU64 was introduced and will continue to do so with industry-focused initiatives – such as Treating Customers Fairly – that will help promote customer-focused product design.
- 3.20 The ABI has introduced the Raising Standards initiative that bans unclear charging structures, such as ‘initial capital units’, and keeps up-front charges low through its first-year ratio measure. This ratio calculates the cost to consumers who lapse their policies in the first year as a proportion of the total first-year new business premiums received.
- 3.21 The FSA Comparative Tables (introduced in 2001), and the publicity about the new stakeholder products, will highlight the existence of competitively-priced products. They will also act as a deterrent for firms against developing expensive products.
- 3.22 In addition, removing the specific rule that requires an adviser to explain in writing to a customer why they are recommending a personal pension over a SHP or FSAVC does not mean that advisers will then be able always to ignore SHPs. Advisers, whether tied or whole-of-market, must still provide suitable advice. In a depolarised world, whole-of-market intermediaries will have to consider SHPs when advising on retirement savings. Other advisers would need to consider a SHP if one was available within their range. However, this may provide an incentive for single-tied and multi-tied advisers to not include SHPs in their ranges. So we accept that it is only for advisers committed to a whole-of-market strategy that such a constraint may be important.

Q4: Do you agree that the factors listed would mitigate increases in prices for personal pensions?

Monitoring of the market after removal of COB 5.3.16R(3)

- 3.23 If we removed the rule from the Handbook, we would also propose to monitor the market very carefully to see how it develops. If firms were disregarding the over-arching requirements of suitability, we would take steps to address the situation.
- 3.24 We believe that we could use either data sources already available or used in other post implementation reviews such as the depolarisation review. In particular, we would examine data in the following broad categories:
- the total level of premiums being invested in personal and stakeholder pensions;
 - the average case size of personal pensions;
 - the average reduction in yield figures for personal pensions;
 - the dispersion of charges in the personal pension market; and
 - the number of products with lock-ins and penalties applicable on transfer.

3.25 We would also be interested in looking at the data broken down by distribution channel. There will be some factors in the market which will make it difficult to determine which changes in the market are as a result of removing COB 5.3.16R(3) from those which are due to other elements. These complicating factors include the effects due to depolarisation and the increase in the SHP charge cap.

Q5: Do you agree with our proposals for monitoring the market?

Q6: Are there any other factors we should observe?

Q7: Do you have any other concerns about the proposal to remove COB 5.3.16R(3)?

Cost benefit analysis

1. Sections 155 and 157 of FSMA require us to undertake and publish a cost benefit analysis (CBA) – an estimate of the costs of, together with an analysis of the benefits arising from, our proposed changes in rules or general guidance. The purpose of this CBA is to assess the costs and benefits of the proposal set out in this CP. It compares the situation that could arise if COB 5.3.16R(3) is lifted against the situation if COB 5.3.16R(3) is kept – the latter is called the ‘counterfactual’. In this, we take account of the new charge cap for stakeholder pensions, which will be 1.5% of the fund for the first ten years reducing to 1% after that. We also take account of other requirements on suitability and disclosure, as described in Chapter 3.
2. In conducting a CBA we consider four possible impacts of regulation. These are:
 - the direct costs to the regulator;
 - the compliance costs for the regulated parties;
 - the impact of our proposals on the quantity, quality and variety of transactions; and
 - the efficiency of competition.
3. We have identified the main potential impacts of removing COB 5.3.16R(3) as follows:
 - benefits to those consumers previously excluded from the pension market who will gain access to it and get value for money;
 - cost of more expensive personal pensions to those consumers who would in any case have bought a personal pension even with COB 5.3.16R(3) in place but who will have to pay more if pension charges rise on removal of the rule; and
 - possible cost to those consumers previously excluded from the pension market who will buy personal pensions on the recommendation of an

adviser but where these are not the most suitable product (for example where a firm recommends a personal pension but an ISA would have been more suitable and the customer would have bought one if COB5.3.16R(3) had not been removed).

4. Central to this analysis are the economics notions of a competitive equilibrium and an efficient firm. There may be more than one such equilibrium reflecting different degrees of concentration and different degrees of promotional spending by each firm. It is likely that higher promotional effort at any given level of charges will increase sales. The rate at which it does so will influence the level of promotional expenditure and possibly the number of firms in the market. This CBA considers just two of the range of possible outcomes that might arise from removing COB 5.3.16R(3); they are:
 - prices settle at a competitive equilibrium which includes no excessive or wasteful promotional expenditure; or
 - prices rise beyond that competitive equilibrium level.
5. We do not comment on whether the new stakeholder charge represents the level of competitive equilibrium.
6. We believe that the cost benefit balance of lifting the COB 5.3.16R(3) requirement is unclear. We will monitor developments in the market to see whether the possible costs and benefits set out in this paper materialise in practice.

Direct costs to the regulator

7. We consider that the extra one-off costs to the FSA of our proposal will be negligible. There will also be some costs for monitoring the development of the market after the rule is removed but, again, we believe that these will be of minimal significance.

Compliance costs to firms

8. There could be small compliance cost savings for firms associated with lifting COB 5.3.16R(3). These savings arise because advisers will not have to make the current disclosure and so administering the sales process would become slightly shorter and less complex. Recommendations and suitability letters for advised sales would also be more easily monitored without the extra complexity of COB 5.3.16R(3).

The impact of our proposals on the quantity, quality and variety of transactions

Quantity

9. We have defined two plausible scenarios of what might happen if the suitability standard for personal pensions becomes the same as applies to other packaged products.

Scenario 1 – Lifting the rule has virtually no impact on the market

10. One outcome is that there would be little or no change in the market from lifting COB 5.3.16R(3). This would be the case if, for example, following the development of new supply models prompted by depolarisation:
 - the long-run marginal cost for a personal pension policy – including an efficient level of promotional effort – is less than or close to the revised price cap for SHPs; and
 - the market is competitive so that charges settle close to that long-run marginal cost.
11. In this scenario, there is no incremental impact due to the removal of COB 5.3.16R(3) compared to the counterfactual.
12. We do not consider this is the most likely outcome.

Scenario 2 – Charges for personal pensions increase beyond those for SHPs

13. It is more plausible that contract charges for personal pensions will increase beyond those for SHPs to finance the costs of distribution, including the costs of advice and administration and the promotional costs of selling to a wider set of consumers. The question here is the extent to which the charges might increase. Either:
 - 1) charges rise to a level that is a competitive market equilibrium but that is above the levels charged for SHPs; or
 - 2) competitive forces are relatively weak – with many consumers not highly sensitive to price differences – and prices rise to levels that represent excess profit for providers and/or advisers and poor value for consumers.
14. Charges would increase to support more active selling by companies whose distribution costs exceed what is affordable under SHP charges. This would allow more consumers to be provided for.

Benefits

15. The extent of any benefits depends on:
 - how many additional consumers make advised purchases of personal pensions (and SHPs) because of the increased promotional effort by providers and increased availability of advice;
 - the proportion of those additional consumers who gain from investing in pensions rather than other investments; and
 - the amounts that those consumers gain.
16. We believe that there is potential for benefits from additional sales but have been unable to quantify their likely scale.

Costs

17. Where charges are above those for stakeholder pensions, there is scope for the following sources of consumer detriment:
 - those consumers who under COB 5.3.16R(3) would have been able to purchase personal pensions at a lower price will face increased charges and a relative welfare loss;
 - other consumers may make advised purchases of personal pensions which leave them worse off than the choice they would have made under COB 5.3.16R(3). Even if prices settle to their competitive level, a consumer may, because of additional incentives but in spite of regulatory protection, purchase a personal pension on advice that was not suitable. We do not expect these costs to be material.
18. We can illustrate the cost to those consumers who would buy personal pensions at a higher price if COB 5.3.16(3) were removed than if it were kept. Using a typical 25-year monthly premium policy as an example, the net present value of a 0.1% increase in reduction in yield (RIY) is equivalent to roughly 18% of the annual premium (assuming investment returns of 7% and discounting at 6%). This assumes that premiums are paid for the full term. If we allow for persistency by making some plausible assumptions about lapsing, the net present value of a 0.1% per annum increase in RIY might be around 12% of the annual premium. Applying this to total personal pension regular premium new business for 2004 implies that, for every 0.1% per annum increase in RIY, the net present value of charges on regular premium personal pensions sold in a single year increases by around £35 million. The equivalent net present value for single premium business is around £80 million if the average term is assumed to be 25 years or £35 million if ten years is assumed. As already noted, we cannot estimate the increase in charges that might flow from removing COB 5.3.16R(3). But the above numbers may help to illustrate the scale of the possible costs.

19. Of course, the actual cost will depend on the extent to which the products and services offered are comparable, the actual level of premiums paid, the actual maturity of the policies, the observed levels of persistency etc. It is also possible that price structures might change in a way that makes low persistency and switching more costly.
20. So a key issue would be how firms levied charges and this would be a factor in our monitoring of the market if COB 5.3.16R(3) were removed.

Quality of transactions

21. The main area where the quality of transactions could improve is if removing COB5.3.16R(3) allows consumers to purchase pension products which are more suitable for them because there is a greater scope for full advice.
22. While we expect withdrawing COB 5.3.16R(3) would make pensions available to at least some consumers that have become excluded from the market, we have not been able to quantify this class of consumers. We do, however, expect some benefits of increased access and choice for this group if pension charges were allowed to rise to a level that would permit more active selling in the market. Those benefiting in this group would include consumers for whom basic advice and SHPs are not adequate substitutes for full advice and, perhaps, a wider range of product characteristics.
23. However, there are also potential ways that the quality of transactions may be reduced.
 - Other things being equal, an increase in charges reduces the value of a pension as it reduces the eventual return. However, if the increase in charges reflects a move to the competitive level in an efficient market, that would represent an improvement in resource allocation, as prices would more accurately reflect costs.
 - Higher charges could also bias advisers towards personal pensions that pay higher commissions even if they are not the best products. In a market where competition is weak, providers may compete for distribution, and the risk of inappropriate purchases of personal pensions may increase. This could especially be the case for tied and multi-tied advisers as they would not have to consider SHPs in the suitability letter anymore if SHPs are not part of the range of products they offer.
 - There is also a possibility that the charge structures will become more opaque to consumers.

Variety of transactions offered

24. There may be more innovation in personal pensions if the SHP benchmark is removed, leading to an increased variety of products on offer. As a general

rule, an increase in choice creates a benefit, since the consumer can find a product that more precisely fits their preferences – in this case, either more suitable funds or a style of charging structure which suits the consumer more. However, that is conditional on consumers having the information about – and understanding of – products to make appropriate choices. And it depends on advisers’ interests being completely aligned with those of consumers.

25. It is, however, possible that some firms may withdraw from supplying SHPs or that the terms of SHPs on offer could become less favourable, as firms see more opportunity for profit in marketing higher charging personal pensions. This would reduce the quantity and variety of SHP products available.
26. There may be tensions pulling in different directions. With the removal of COB 5.3.16R(3), tied and multi-tied advisers have scope for excluding SHPs from their range (hence avoiding the SHP in the suitability statement). If many do so, the variety available to consumers may decline.
27. However, tied and multi-tied advisers may also be able to provide advice at lower costs than whole-of-market advisers, making the SHP option more viable for them. It is also possible that if consumers shop around and choose pension products purely on the basis of charges, there may be no increase in the variety of products offered, due to lack of demand (assuming that SHPs are the lowest cost pension products).

Efficiency of competition

28. Removing COB 5.3.16R(3) could have several possible impacts on the efficiency of competition.
29. If the level of charges were to rise to a point close to the long-run marginal cost for an efficient firm in a competitive market, then this would represent more efficient competition with prices more fully reflecting costs and underlying demand. Under such conditions, the market share of efficient firms would be expected to rise over time. It is not clear what the efficient level of charges is for personal pension products. Nor is it clear how strong the forces pushing the sector towards a competitive level would be without COB 5.3.16R(3).
30. On the other hand, if the market is not a wholly competitive one, with many price-insensitive consumers, then removing COB 5.3.16R(3) may lead to a decline in the efficiency of competition. For example:
 - inefficient firms may be able to flourish; and
 - large-scale promotional activity to capture sales may become attractive, even if the information content is low and competition is pushed towards false focal points.

31. This is most likely if, after removing COB5.3.16R(3), the level of charges moves above the competitive equilibrium.
32. Removing the requirement for advisers to state in the suitability letter why the recommended product is at least as suitable as a SHP may make tied and multi-tied advisers less likely to mention the SHP alternative when selling a personal pension. As a result, consumers will have to rely on the disclosures required in the Key Features documents and may therefore have less information on which to base buying decisions. This could be said to increase slightly the information asymmetry – the imbalance in information between consumers and firms – prevalent in the industry.
33. In the long run, charges should converge towards the marginal cost of providing the product. As mentioned earlier, in a depolarised world the efficient price for individual personal pension sales is unclear. This may be below, equal to or above the new stakeholder price cap. To the extent that some firms manage to operate within the price cap, the COB 5.3.16R(3) requirement could have forced firms to become more efficient, which is clearly beneficial. However, as competitive forces might not be very strong, transparency might be poor and consumers price insensitive in their decision in the market for pensions, then removing COB 5.3.16R(3) could help inefficient firms to operate in the market.

Q8: Do you agree with our analysis of the costs and benefits of our proposals?

Compatibility with our general duties under the Financial Services and Markets Act 2000

Introduction

1. In this annex, we explain why we believe that the proposals for lifting COB 5.3.16 R(3) are compatible with meeting our general duties under section 2 of the Financial Services and Markets Act 2000 (FSMA) and with our regulatory objectives in sections 3 to 6. Sections 155 and 157 of FSMA require us to make this statement. The annex also sets out how our proposals take account of the principles of good regulation.

Our statutory objectives

2. The proposals in this paper are designed to help meet our statutory objectives of: promoting public understanding of the financial system (which includes the provision of appropriate information and advice) and securing the appropriate degree of protection for consumers. They may also contribute to achieving our objective of maintaining confidence in the UK financial system, but any such effects are very much secondary. We do not believe that our proposals have any material impact on our financial crime objective.

Securing the appropriate degree of protection for consumers

3. The proposals in this paper have been designed to provide an appropriate degree of consumer protection. FSMA requires us to take account of four specific criteria in considering our consumer protection objective.

(i) The different degrees of risk involved in different kinds of investment or other transaction.

We have retained other suitability standards and requirements which give important, proportionate protections to those investing in personal pensions. Removing COB 5.3.16(3) may also help ensure that consumers get access to appropriate advice relating to complex long-term savings decisions and make

decisions that reflect the relevance of risks inherent in different kinds of product, given their own circumstances.

(ii) The differing degrees of experience and expertise that consumers may have in relation to the different kinds of regulated activity.

Personal pensions are complex products and expertise among consumers varies. Removing COB 5.3.16R(3) should encourage the provision of advice, including for lower income customers, and so ensure that choices are based on a good understanding of the products.

(iii) The needs that consumers may have for advice and accurate information.

The proposal recognises the need that consumers have for advice, especially among the Government's target group of those not currently saving for retirement. The removal of COB 5.3.16R(3) should give more scope for advice for those who need it. While there is a risk that removing COB 5.3.16R(3) could reduce transparency in the advice process, we believe the risk to be limited, as advisers will still need to comply with our general COB rules.

(iv) The general principle that consumers should take responsibility for their decisions.

Removing COB 5.3.16R(3) has some impact on consumers' responsibility for their decisions in that they will no longer be able to rely on advisers making an unprompted assessment of the relative suitability of stakeholder pensions where these are not part of the adviser's range. So the consumer will have to select his or her adviser carefully to ensure that he or she will receive advice on the full range of pension choices. In the absence of relevant comments in the suitability letter, the consumer will also have to take account of – and act on – the information provided in the Key Features document about the existence of stakeholder products.

Promoting public awareness

4. To the extent that removing COB 5.3.16R(3) leads to increased provision of appropriate advice and encourages providers to market pension products more actively, it may lead to a wider awareness of the availability of advice and the nature of pension products.

Maintaining confidence in the financial system

5. The removal of COB 5.3.16R(3) may lead to an increase in the provision of advice, so at the margin it may increase the confidence of consumers in taking on pension products. Of course, if the advice leads to unsuitable or poor value purchases, that confidence could be reduced. Doubts over the viability of any firms currently providing might also be reduced if they are able to align the

charges of their products to the cost of providing them. However, all of these are very much secondary impacts.

Financial crime

6. Our proposals have no material impact on meeting the objective of reducing financial crime.

Compatibility with the principles of good regulation

Matters which we must have regard to when we carry out our general functions

7. In carrying out our general functions under the requirements in section 2(3) of FSMA, we have had regard to the specific matters below.

The need to use our resources in the most efficient and economic way

8. We do not expect our proposals to materially affect either our systems or processes for supervising firms or the costs that we incur.

The responsibilities of those who manage the affairs of authorised persons

9. Our proposals do not materially affect the balance of responsibility that boards and senior managers have for managing their affairs in line with the Principles for Business.

The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

10. Our proposals are concerned with the lifting of a restriction, not adding regulatory burdens to firms.

The desirability of facilitating innovation in connection with regulated activities

11. The lifting of COB 5.3.16R(3) may pave the way for firms to be innovative in pension products, which may offer greater choice to some consumers.

The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

12. Lifting COB 5.3.16R(3) could increase the attractiveness of market entry and offer firms the opportunity to develop the market for pension provision in the UK.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions

13. Our proposal may remove an adverse effect on competition by allowing charges to rise towards the long-run marginal costs of an efficient firm, provided that level is above the new charge cap.

The desirability of facilitating competition between those who are subject to any form of regulation by us.

14. On balance, we believe that our proposal to remove the COB 5.3.16R(3) requirement may have positive effects on competition in the UK financial services industry, by encouraging the provision of, and possibly entry in the market for, personal pensions.

Acting in a way which we consider most appropriate for the purpose of meeting our regulatory objectives.

15. Given the option of removing the requirement, or not, and given that it might be contributing to restraining the market for personal pensions, we consider that our proposals are the most appropriate way to achieve our objectives. We believe that other elements of our rules already provide appropriate protection to consumers. The proposal to remove COB 5.3.16R(3) takes account of the need for competition in regulated financial services markets so they can operate in as unconstrained a manner as possible.

Summary of questions

- Q1: Do you agree with our analysis of the consequences which COB 5.3.16R(3) may have had on the market?
- Q2: Do you agree with our analysis of the future of the market if we retained the rule?
- Q3: Do you agree with our analysis of what might happen if we remove COB 5.3.16R(3)?
- Q4: Do you agree that the factors listed would mitigate increases in prices for personal pensions?
- Q5: Do you agree with our proposals for monitoring the market?
- Q6: Are there any other factors we should observe?
- Q7: Do you have any other concerns about the proposal to remove COB 5.3.16R(3)?
- Q8: Do you agree with our analysis of the costs and benefits of our proposals?

Draft instrument

SUITABILITY STANDARDS INSTRUMENT 2005

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 138 (General rule-making powers);
 - (2) section 156 (General supplementary powers); and
 - (3) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

- C. This instrument comes into force on [January 2006].

Amendments to the Handbook

- D. The Conduct of Business (COB) module of the FSA's Handbook of rules and guidance is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Suitability Standards Instrument 2005.

By order of the Board

Annex

Amendments to the Conduct of Business sourcebook

In this Annex, underlining indicates new text. Where an entire section of text is deleted, the place where the change will be made is indicated and the text is not struck through.¹

All of the text in COB 5.3.16R(3), COB 5.3.28R, and the material in section B of the Suitability guidance table in COB 5.3.29G, is to be deleted in its entirety.

5.3.16 R ...

(3) [deleted];

...

...

5.3.28 R [deleted]

5.3.29 G Guidance on matters which should be taken into account when assessing the suitability of various personal recommendations. This table belongs to *COB 5.3.13G(4)*.

Suitability guidance

A Pension Transfers and Pension Opt-outs

...

B [deleted]

C Hybrid Products

...

...

¹ This page revised 30 June 2005.

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