

CRANFIELD UNIVERSITY

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THE IMPACT OF REGULATION  
ON THE UK RETAIL PENSIONS MARKET

SCHOOL OF MANAGEMENT

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## **ABSTRACT**

This thesis presents a longitudinal study of the regulation of the UK retail pensions market. A framework is developed to analyse regulation and regulatory change and to identify the policies and events which may be hypothesised to affect the operation of the market. A provisional model is devised to show the relationships among regulation, the strategic decision-making of market participants and key dimensions of the market (products, prices, demand, distribution channels, costs and industry structure). The empirical evidence shows that over an extended period of time (from the mid-1980s to 2007) regulation affected product development, product pricing, demand, the evolution of distribution channels, producer costs and margins and ultimately the industry structure. The cumulative effect of and interaction among three separate but related public policies shaped the market that is observed in 2008. Over the period since the mid-1980s, the market has been affected more by regulation than by any economic, social or technological change. An evaluation of public policies towards the market shows that policy objectives have not been met and that policies have led to unforeseen and undesirable outcomes. The provisional model is developed to contribute towards the theory of regulated competition. This thesis makes a methodological contribution by developing techniques to assess and evaluate government intervention in a market over the longer term and to consider the interactions between different but related public policy initiatives. An agenda for further research building on this study is proposed. This thesis also makes a contribution to business history in relation to the UK insurance industry. The change in the structure of the industry over the last twenty years is significant in the light of the long history of the industry and the role it has played in the development of retail financial markets in the UK.

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## CONTENTS

List of figures .....	I
List of tables.....	III
List of acronyms .....	IV
<b>CHAPTER 1: INTRODUCTION .....</b>	<b>1</b>
1.1 The purpose of this thesis .....	1
1.2 The background to this thesis.....	1
1.3 The scope of this thesis.....	2
1.4 The UK retail pensions market and its regulation: a brief overview .....	3
1.5 The structure of this thesis.....	4
<b>CHAPTER 2: LITERATURE REVIEW: THE COSTS, BENEFITS AND IMPACTS OF GOVERNMENT REGULATION.....</b>	<b>6</b>
2.1 Overview of this chapter .....	6
2.2 Introduction .....	6
2.3 What is regulation and what is its rationale? .....	9
2.4 The scope of the literature on regulation .....	11
2.5 A framework for the analysis of the literature on regulation.....	13
2.6 The evaluation of regulatory policy .....	15
2.7 The broader effects of regulatory policy on markets and firms.....	19
2.8 Summary and conclusions .....	25
<b>CHAPTER 3: RESEARCH DESIGN AND METHODOLOGY .....</b>	<b>29</b>
3.1 Overview of this chapter .....	29
3.2 The research question .....	29
3.3 Defining and assessing 'regulation' .....	30
3.4 Defining and assessing 'the UK retail pensions market' .....	34
3.5 Assessing the impact of regulation on the market .....	39
3.6 The presentation of the empirical results.....	40
<b>CHAPTER 4: THE REGULATION OF THE UK RETAIL PENSIONS MARKET .....</b>	<b>42</b>
4.1 Overview of this chapter .....	42
4.2 Regulations in place in the mid-1980s - the starting point of the study .....	42
4.3 Framework for analysis of regulation populated with data .....	44
4.4 Pensions policy under the Conservative government 1983-1989.....	47
4.5 Investor protection policy 1981-1988.....	50
4.6 Structure of the regulatory institutions and rules under the Conservative government 1986 - 1994.....	52
4.7 Competition issues on the content of the rules: the MCA and disclosure..	55
4.8 Interpretation and enforcement of the rules 1987-2004.....	58
4.9 Pensions policy under the Labour Government 1997 to date .....	61
4.10 Changes to investor protection policy 1998 - 2004.....	65
4.11 Structure of regulatory institutions and rules under the Labour government 1997-2001.....	67
4.12 Competition issues on the content of the rules: polarisation and depolarisation.....	68
4.13 Summary: the regulation of the retail pensions market since the mid-1980s .....	71

<b>CHAPTER 5: THE IMPACT OF REGULATION ON THE DEVELOPMENT OF PRODUCTS .....</b>	<b>76</b>
5.1 Overview of this chapter .....	76
5.2 The development, launch and sale of personal pensions products: 1987 to 1997 .....	77
5.3 The development, launch and sale of personal pensions products: 1997 to 2007 .....	85
5.4 Summary: The impact of regulation on the development of products .....	104
<b>CHAPTER 6: THE IMPACT OF REGULATION ON THE EVOLUTION OF DISTRIBUTION CHANNELS.....</b>	<b>107</b>
6.1 Overview of this chapter .....	107
6.2 The evolution of distribution channels 1987 to 1997 .....	107
6.3 The evolution of distribution channels 1997 to 2007 .....	121
6.4 Summary: The impact of regulation on the evolution of distribution channels .....	148
<b>CHAPTER 7: THE IMPACT OF REGULATION ON PRODUCERS' COSTS.....</b>	<b>150</b>
7.1 Overview of this chapter .....	150
7.2 The nature of companies' costs .....	150
7.3 A model for the costs of the acquisition of new business .....	153
7.4 The regulatory events likely to influence the costs of acquisition of new business .....	155
7.5 Testing the hypotheses .....	157
7.6 The period 1998 to 2002 .....	158
7.7 Summary: the impact of regulation on costs .....	171
<b>CHAPTER 8: THE IMPACT OF REGULATION ON INDUSTRY STRUCTURE .....</b>	<b>173</b>
8.1 Overview of this chapter .....	173
8.2 Definitions and source of data .....	173
8.3 Changes in industry concentration 1985 to 2007 .....	174
8.4 The drivers of the observed changes in industry concentration .....	180
8.5 Summary: the impact of regulation on the changes in industry structure .....	182
<b>CHAPTER 9: EVALUATION OF PUBLIC POLICY TOWARDS THE UK RETAIL PENSIONS MARKET .....</b>	<b>184</b>
9.1 Overview of this chapter .....	184
9.2 The UK retail pensions market in 2008 .....	184
9.3 The evaluation of public policy towards the retail pensions market .....	195
9.4 The evaluation of pensions policy .....	196
9.5 The evaluation of investor protection policy.....	201
9.6 The evaluation of competition policy.....	206
9.7 The interaction between the three policy strands.....	207
9.8 The overall evaluation of public policy .....	209
9.9 A counterfactual .....	210
9.10 Conclusions.....	213
<b>CHAPTER 10: SUMMARY AND CONCLUSIONS .....</b>	<b>214</b>
10.1 Overview of this chapter .....	214
10.2 Summary of empirical results .....	214
10.3 Towards a more general theory of regulated competition .....	215
10.4 Towards a methodology for the evaluation of public policy .....	220
10.5 The contribution of this thesis and the agenda future research.....	220
<b>APPENDIX A: PRINCIPAL SOURCES OF EMPIRICAL DATA .....</b>	<b>224</b>
<b>APPENDIX B: FRAMEWORK FOR ANALYSIS OF REGULATION .....</b>	<b>229</b>
<b>APPENDIX C: ECONOMIC TRENDS.....</b>	<b>261</b>
<b>REFERENCES .....</b>	<b>265</b>

## LIST OF FIGURES

Figure	Title	Page
2.1	The scope of the literature on regulation	12
2.2	A framework for the analysis of the literature on regulation	14
3.1	A framework for the analysis of regulation and regulatory events	32
3.2	The Structure, Conduct and Performance Model	36
3.3	A provisional model for structuring the study	36
4.1	The framework for the analysis of regulation populated with data (abridged version)	45-6
4.2	The pattern of overlapping regulatory change	72
4.3	Summary of the main regulatory events	75
5.1	FSAVC product announcements each month	78
5.2	PP/GPP/SIPP product announcements each month	78
5.3	APE of new personal pensions business	81
5.4	Cumulative number contracted out of SERPS at end of tax year	82
5.5	Business mix: Sources of total premium income	82
5.6	Stakeholder pension new business	87
5.7	Stakeholder pensions: Average premium per new contract	87
5.8	Number of companies offering PPs at the beginning of the year	88
5.9	APE of new business	91
5.10	Number of companies offering GPPs at the beginning of the year	92
5.11	GPPs new business	93
5.12	Number of SIPPs on the market at the beginning of the year	95
5.13	SIPPs new business	96
5.14	Net inflows excluding movement of value of assets	100
6.1 to 6.3	APE of Life and Pensions business: Distribution channel of origin	111
6.4 to 6.6	APE of Pensions business: Distribution channel of origin	113
6.7	Banks and Building Societies own L&P companies: market share	117
6.8	Employment in the insurance sector	119
6.9	APE of Life and Pensions business: Distribution channel of origin	122
6.10	APE of Pensions business: Distribution channel of origin	122
6.11	A change of strategy: Prudential	141
6.12	A change of strategy: Britannic Assurance	142
6.13	A change of strategy: Lloyds TSB/Abbey Life	143
6.14	A change of strategy: Zurich Financial Services/Allied Dunbar	143
6.15	Banks and Building Societies own L&P companies: market share	144
7.1	Business model for the pensions business	151
7.2	Histograms showing distribution of company average premiums per policy for 1998	162

## LIST OF FIGURES (CONTINUED)

<b>Figure</b>	<b>Title</b>	<b>Page</b>
8.1	Concentration based upon APE	175
8.2	Entry and exit numbers	176
9.1	Earned pension premiums net of transfers	186
9.2	Household savings ratio	187
9.3	Tax relief on pensions – a gift from the Chancellor?	199
10.1	A model of regulated competition	219
C1	FTSE 100 at year end	261
C2	FTSE 250 at year end	261
C3	Interest rates at year end	262
C4	Inflation (RPI)	262
C5	Annual increase in average earnings	263
C6	Unemployment	263
C7	GDP growth	264
C8	Percentage increase in Halifax House Price Index	264



## LIST OF TABLES

<b>Table</b>	<b>Title</b>	<b>Page</b>
5.1	Number of stakeholder products on the market	85
5.2	PP and SHP products of the top five providers in 2002	89
5.3	PP and SHP products of the top five providers in 2008	90
5.4	Numbers of small occupational pension schemes	94
5.5	Panel of 25 non-insurance companies	96
5.6	Single premium new business consisting of transfers	98
5.7	Ratio of surrenders to new single premiums	99
6.1	Commission as a percentage of MCA	118
6.2	Companies distributing wholly or mainly through DSFs in 1997	125
7.1	Commission as a percentage of MCA	155
7.2	Costs as a percentage of first year premium	156
7.3	Descriptive statistics: life, pension and overseas business	159
7.4	Distribution of company average premiums per policy (1998 data)	161
7.5	Regression results 1998-2002	164
7.6	Unit costs	165
7.7	Pension business levels of market leaders	166
7.8	Pensions business mix	167
7.9	Pension premiums per policy	168
7.10	Regression results 2005-2007	169
7.11	Pensions business mix	170
8.1	Market share of SIPP business	178
8.2	The top eleven groups and their brands in 2008	179
9.1	Contribution to personal pension and money purchase schemes	187
9.2	Ratio of total cost to premiums earned: the top eleven	190
9.3	The leading consolidators	191

## LIST OF ACRONYMS

Acronym	Meaning	Explanation
ABI	Association of British Insurers	Representative body for Life and Pensions companies
APE	Annual premium equivalent	An industry wide measure of the value of new business acquired in a year. The APE is the full amount of the first year's premiums plus 10% of single premiums for new contracts signed in any year.
AVC	Additional voluntary contribution	A pension product linked to an OPS
DB	Defined benefit	An OPS where the benefits are normally based on employees length of service and final salary
DC	Defined contribution	An OPS (and PP) where the benefits are based on the value of the fund accumulated
DGFT	Director General of Fair Trading	The head of the OFT
DHSS	Department of Health and Social Security	Government department (became DSS)
DSF	Direct Sales Force	Distribution channel owned by producer
DSS	Department of Social Security	Government department (became DWP)
DTI	Department of Trade and Industry	Government department
DWP	Department for Work and Pensions	Government department
ESHP	Employer sponsored SHP	A personal pension product
Fimbra	Financial Intermediaries, Managers and Brokers Association	An SRO authorised by the SIB and a regulator of IFAs from 1988 to 1994
FSA	Financial Services Authority	Industry regulator from 1997
FSAVC	Free standing additional voluntary contribution	A personal pension product
GAD	Government Actuaries Department	Government department
GPP	Group personal pension	A personal pension product marketed to a group of individuals typically employees of a small to medium enterprise
HMT	Her Majesty's Treasury	Government department
IFA	Independent Financial Adviser	A distributor of pensions and savings products

## LIST OF ACRONYMS (CONTINUED)

<b>Acronym</b>	<b>Meaning</b>	<b>Explanation</b>
Lautro	Life Assurance and Unit Trust Regulatory Organisation	An SRO authorised by the SIB and a regulator of Life and Pensions companies from 1988 to 1994
MCA	Maximum Commissions Agreement	An agreement entered into by Life and Pensions companies to limit commission payments to IFAs
NAPF	National Association of Pension Funds	Representative body of OPSs
NIC	National insurance contribution	A tax/levy paid on an employee's earnings
OFT	Office of Fair Trading	Competition regulator
ONS	Office of National Statistics	Government agency
OPS	Occupational Pension Scheme	A pension scheme run by an employer for employees
PIA	Personal Investment Authority	Regulator for all producers and distributors of investment products from 1994 to 1997
PP	Personal pension	A pension product for an individual from July 1988
RIY	Reduction in yield	A calculation of the effect of charges on the yield of a product to an investor
RAC	Retirement Annuity Contract	A pension product for an individual until June 1988
SERPS	State Earnings Related Pension Scheme	A government pension scheme for employees
S2P	Second state pension	Successor to SERPS
SHP	Stakeholder Pension	A pension product for an individual from April 2001
SIB	Securities and Investment Board	Lead industry regulator from 1988 to 1997
SIPP	Self-invested personal pension	A personal pension product
SRO	Self Regulating Organisation	A regulator authorised by the SIB

## **CHAPTER 1: INTRODUCTION**

### **1.1 The purpose of this thesis**

The purpose of this thesis is to examine the regulation of the UK retail pensions market. The principal research question is:

*What was the impact of regulation on the UK retail pensions market?*

After answering this question, this thesis then evaluates regulatory policy towards this market.

An example will illustrate the questions addressed in this thesis.

On 16 September 2006 Sir Callum McCarthy, Chairman of the UK Financial Services Authority (FSA) addressed the Savings and Pensions Industry Leaders' Summit, asking the question 'Is the present business model bust?' (McCarthy, 2006). The business model McCarthy was referring to is the distribution system for financial services to retail customers, the system under which an individual buys a pension plan or savings product (other than a simple interest bearing deposit) from a provider such as an insurance company, a bank or a unit trust company. In his speech, McCarthy answers his question in the affirmative and then sets out what the FSA, as industry regulator, proposes to do about it. But the business model in question has been subject to strict regulation since 1988, so what has gone wrong? Why is the business model now bust? Did the regulation fail to achieve its objectives? Did the regulators fail to foresee the effect of regulation? Why do we think that more regulation will fix the business model now?

The purpose of this thesis is to answer these and related questions and to examine the effect that regulation has had on the operation of the market.

### **1.2 The background to this thesis**

There are two core public policy issues in the background to this thesis.

The first concerns regulation generally. There is considerable public debate not only in the UK but also in the US and EU about the costs, benefits and impacts of regulation. In the literature review in Chapter 2 I cite a number of sources which articulate the concerns which business and industry leaders have about the intervention by governments in markets and companies. Governments have responded by setting up a

range of initiatives to measure the costs of regulation, to assess the benefits and to evaluate whether or not the benefits of specific regulations justify the costs. This thesis contributes to this debate and to the literature on the economic regulation of markets by examining a particular regulated market and by developing a methodology to assess the impact that regulation has had on that market over the longer term.

The second public policy issue concerns pension provision. Since the early 1980s UK governments have been concerned about the level of private pension savings and the potential future cost of the state pension schemes. The Conservative government introduced a major initiative in 1988 to promote personal pension saving. The Labour government followed with its own initiative in 2001 and with a major review of future pension provision (*The Pensions Commission* led by Lord Turner) which concluded in 2006. The context for this review was the increasing concern over the impact on future public finances of increasing longevity and falling birth rate and the impact on people in retirement from inadequate pension incomes. The government has adopted Turner's recommendations and initiated a major new project to promote pension saving particularly among those not currently participating in any pension scheme. The new government scheme is expected to start in 2012. This government initiative raises the question about the role that the UK retail pensions industry will have in the future. The government rejected the industry's proposals for addressing the problems identified in the reports of the Pensions Commission implying that it sees no role for a market solution to these problems.

### **1.3 The scope of this thesis**

The word 'regulation' covers a wide range of government policies and activities. I define the term in the literature review in Chapter 2 and identify the focus of this thesis. Briefly, I am concerned with 'economic regulation' which essentially involves interventions by government or its agencies in the economic management of markets and companies. I am not concerned with 'social regulation' which covers such matters as health, safety and environmental issues. I am also concerned solely with the regulation of competitive markets and not monopolies. The regulation of monopolies involves different issues from the regulation of structurally competitive markets.

The retail financial services markets and the distribution system referred to by McCarthy cover a wide range of products and services offered by a wide range of companies. In terms of products, my focus is retail pensions. I distinguish between the

retail pensions market and the occupational pensions market. I also distinguish between retail pension products and other retail products such as life assurance policies and bonds, collective investment products such as unit trusts and other savings product such as ISAs. The market I study in this thesis is defined more precisely in Chapter 3 where I outline my methodology.

The companies operating in the UK retail pensions market include insurance companies, banks and building societies, friendly societies and other financial institutions including at one time Marks & Spencer Financial Services and Virgin Money. Insurance companies dominate this market but I examine the entry by other types of company, notably the banks and building societies, in the context of the government regulations which affected that entry. The industry structure is examined specifically in Chapter 8.

While the UK retail pensions market can be defined fairly precisely, I recognise that it shares distribution channels with the market for other investment and savings products. In examining empirical data in this thesis I show how I have distinguished between pension products and other products. Similarly, the companies operating in the UK retail pensions market also operate in other investment and savings markets and in the occupational pensions market. Again, in examining empirical data I show how I have distinguished the various lines of business of the companies concerned.

#### **1.4 The UK retail pensions market and its regulation: a brief overview**

The purpose of this section is to provide a brief overview of the context for this study.

##### *Retail pension products*

The purpose of a retail pension product is to enable an individual to save during working life and to accumulate a fund which can be turned into an income for life in retirement. For many decades government has supported this concept with tax relief on contributions. Until 1988 there was only one product, the 'Retirement Annuity Contract' which was available only to the self-employed and to employees not in an occupational pension scheme. In 1988 the government extended the availability of fiscal incentives to create the 'Personal Pension' which has a number of variants. The basic concept however is the same: a mechanism for accumulating a fund to turn into an annuity on retirement. The personal pension is still available today.

### *The producers and distributors of personal pensions*

Until 1988 insurance companies were the sole providers of retirement annuity contracts but changes to regulations allowed other financial institutions to produce personal pensions. Until 1988 retirement annuity contracts were sold through insurance brokers and other intermediaries such as accountants and also through producers' own direct sales forces. After 1988 personal pensions could be obtained through these sources and also through the branches of banks and building societies.

In the mid-1980s the industry was fragmented with 93 producers. Today just eleven groups control 90% of the market. There are many thousands of brokers selling pensions, although the numbers are much lower than in the mid-1980s. Today, the direct sales force owned by the producer has almost disappeared. In this thesis I identify the proximate causes of this transformation in the industry, and in particular, the role that regulation has played in the transformation.

### *The regulation of the market*

Until 1988 there was limited market regulation. Insurance companies were regulated primarily to ensure that they held sufficient capital and were appropriately managed. In 1988 the government introduced new regulations for investor protection to cover financial services markets generally. The implementation of these regulations in retail markets coincided with the introduction of the new regulations for personal pensions. Since 1988 the investor protection regime has been subject to regular and major change. This regime proved to be very contentious in the industry and many of the issues remain unresolved today. It is to one of these issues that McCarthy refers in his speech cited above. In this thesis I analyse this changing regulatory environment (including changes to pensions policy) and assess the impact of these changes on the operation of the market.

## **1.5 The structure of this thesis**

I begin in Chapter 2 by reviewing the literature on the subject of economic regulation and I identify the themes within the literature to which this thesis contributes. The first theme concerns the impact that regulation has on the way that a market works and on the strategic decision-making of market participants. The second theme concerns the methods of evaluating regulatory policy, including cost-benefit analysis and regulatory impact analysis. I identify a gap in knowledge in each of the themes. The first

knowledge gap concerns the longer term cumulative impact of a series of regulatory initiatives and the interaction of separate but related regulatory policies towards a market. There is a need for more longitudinal studies. I therefore study the regulatory change in the UK retail pensions market over a twenty year period starting in the mid-1980s. The second knowledge gap concerns the methodology for carrying out an evaluation of government policy. Cost benefit analysis and regulatory impact analysis have their uses but do not address the longer term and more complex interactive effects of different policies.

After reviewing the literature I set out in Chapter 3 my research design and methodology. I develop a framework for analysing regulation and regulatory change. I also develop a model to assess the impact of regulatory change on various dimensions of the market (products, prices, demand, distribution, costs and industry structure) and the strategic decision making of firms. In assessing the impact, there are two possible perspectives: that of the public policymaker and that of the strategic manager of a market participant. Both are important but to give this thesis a clear focus and because I am also concerned about the method of evaluation of public policy, I take the public policy perspective. I still consider the impact of regulation on strategic decision-making where it is appropriate to assist understanding of the impact of regulation on the market.

In Chapters 4 to 8 I present the empirical evidence collected to answer the principal research question: what was the impact of regulation on the UK retail pensions market? I start with the analysis of regulation and regulatory change identifying the main policy strands and events which can be hypothesised to affect the market. I then consider the impact that those strands and events have had on the market in terms of products (including prices and demand), distribution, producers' costs and industry structure. This answers the research question. In Chapter 9 I summarise the evidence to present a picture of the market as it exists in 2008 which leads into an evaluation of the various strands of public policy towards the market.

In the concluding chapter I consider the implications of my findings for the theory of regulated competition and for the methodology for evaluating public policy. I develop the model to show how government policy affects the market and leads to outcomes. Finally I assess the contribution of this thesis and present an agenda for future research.



## **CHAPTER 2: LITERATURE REVIEW: THE COSTS, BENEFITS AND IMPACTS OF GOVERNMENT REGULATION**

### **2.1 Overview of this chapter**

In this chapter I review the literature on the economic regulation of competitive markets in the context of the growing public debate about the increasing burdens being placed on businesses by government. I present a framework for analysing and understanding the extensive literature on regulation and then look specifically at the literature which concerns the evaluation of regulation as an aspect of public policy making. I assess the state of knowledge on various techniques for evaluating the costs, benefits and impacts of regulation. While progress is being made in a number of areas, much remains to be done to develop sound methodologies for cost-benefit analysis (CBA) and regulatory impact assessment (RIA). Much of our knowledge of the broader impacts of regulation on structurally competitive markets comes from studies of the US experience of regulation up to the deregulatory initiatives in the 1980s. Since then there has been a new phase of regulation not only in the US but also across Europe. There is a need for more research into the long term impact of this new phase of regulation on the structure of markets and the strategic behaviour of firms operating in these markets.

### **2.2 Introduction**

*Why is the subject of regulation important now?*

The debate about the costs and impacts of government regulation has been running now for several decades but in the last five to ten years the discourse has proceeded with increasing vigour. As can be seen from the citations below, businesses large and small complain about the burgeoning volume of legislation and regulatory rules with which they have to comply. Businesses question whether the perceived benefits of regulation outweigh the costs of complying with the rules and the costs of dealing with negative or unintended consequences.

The costs of regulation to economies in the US and Europe have been estimated at around 10-12% of GDP (Better Regulation Task Force, 2005). These costs are divided into 'policy costs' which are the costs of delivering the policy outcomes, and 'administrative costs' which involve the costs of providing information to, and undergoing inspections from, regulators. Policy costs amount to around 70% of the total, with the remaining 30% being administrative costs. Some businesses now report their own costs in their annual accounts. For example, the bank HSBC reported that its

costs of dealing with 370 regulatory authorities world wide were around US\$400m in 2003 (HSBC, 2003).

Regulation is seen by business commentators as more than just an issue of direct costs. It affects the economics of products, the structure of the market place and the risk/reward balance for each and every institution (Institute of Financial Services, 2004). In network industries such as airlines and utilities, as well as in banking, pharmaceuticals, retailing and many other businesses, regulation is the single biggest uncertainty affecting capital expenditure decisions, corporate image and risk management (Beardsley *et al*, 2005). Regulation creates a risk averse culture, retarding innovation (Blundell, 2006). Government at both EU and UK level fails to understand the economics of small to medium-sized enterprises which are disproportionately affected by regulation (Ambler *et al*, 2007).

At the same time that businesses argue for less or better regulation, government and regulators come under political pressure to account for company failures and to provide more regulation. A number of examples can be cited:

- In 2007 the UK bank Northern Rock ran into financial difficulties. The government stepped in to stop a run on the bank and eventually nationalised the bank. The participants in the tripartite arrangement between the UK Treasury, the Bank of England and the Financial Services Authority (FSA) which were responsible for the regulation of Northern Rock have been called upon to explain why they failed to foresee and prevent the crisis. Further regulation was predicted (Kaletsky, 2007), and indeed this prediction was fulfilled when the government announced its intention to extend the powers of the FSA.
- The failure of companies like Enron and WorldCom in the US led to further regulation (the Sarbanes-Oxley Act, 2002) in an attempt to improve corporate governance.
- Following the fall in value of mortgage endowment policies in the UK retail savings market, the FSA was asked to explain. At a public hearing in December 2003, the Chairman of the Treasury Committee of the House of Commons John McFall addressed the Chief Executive of the FSA John Tiner: "You have heard the evidence that has been give to us: you are not just asleep on the job, Mr Tiner, you are comatose. Discuss" (House of Commons Treasury Committee, 2003). The FSA says that it does not operate a no-failure regime (Davies, 2003) but the FSA will

inevitably be called to account for any corporate failure that affects the savings of retail consumers.

- The Parliamentary Ombudsman issued in July 2008 a report on the fall of Equitable Life which was very critical of the regulation of the company (Abraham, 2008). This is likely to lead to claims for compensation from government and calls for more regulation.

Governments have responded to the pressure for action on controlling the costs of regulation and improving the effectiveness of regulation. In the US, the White House Office of Management and Budget is required to provide to Congress each year estimates of the total annual benefit and costs of all federal regulatory programmes and estimates of the benefits and costs of individual regulations. In the UK, the government has sponsored an independent body, the Better Regulation Task Force, now set up as a permanent Commission, to help foster a continually improving regulatory framework for the public, private and voluntary sectors. Similar initiatives have been started in other European states. These initiatives pose difficult questions for governments and regulators. The fundamental questions are about when and how government should intervene, and how they should manage the expectations of consumers and businesses. The technical questions are about how to assess the potential costs and impacts of proposed regulation, and how to evaluate the outcomes of regulatory policies adopted.

#### *The scope of this literature review*

The literature on regulation is extensive and I therefore focus on the papers which contribute to the issues raised in the current political discourse. I describe in more detail below how I have organised and focused this review but briefly, I concentrate on the evaluation of regulatory policy and the broader effects of regulation on markets and firms.

#### *The structure of this review*

I begin by defining 'regulation' and outlining its rationale. I then describe the scope of the literature on the subject and present a framework for the analysis of the literature, identifying the area on which I focus in this chapter. In the heart of this chapter I review the literature on the evaluation of regulatory policy, which includes commentary on the nature of regulatory policy and the methods of evaluation in use by governments. I then turn to the broader effects of regulation on markets and industry structures, and on the

realised strategies and financial performance of firms. Finally, I summarise what is known about the key questions and identify gaps in knowledge; and I conclude by proposing a research agenda, identifying the priorities in the light of the current political discourse.

### **2.3 What is regulation and what is its rationale?**

#### *Definition of regulation*

Regulation has been defined as the partial or complete intervention in the economic decision-making of firms by the government or one of its agencies (Rutherford, 2002). A key resource of government is its power to coerce and regulation is the use of this power for the purpose of restricting the decisions of economic agents (Viscusi *et al*, 2005). There is however no single agreed meaning. Baldwin *et al* (1998) suggest three main meanings:

- At its simplest, regulation refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically an agency, for monitoring and promoting compliance with the rules.
- A second broader conception of regulation, found in the political economy literature, takes in all the efforts of the state agencies to steer the economy. This will include taxation and disclosure requirements and the use of government expenditure. It covers not just commands but incentives to behave in a particular way.
- A third definition is broader still, and considers all the mechanisms of social control including unintentional and non-state processes. This will include social norms and the effect of markets in modifying behaviour.

The general assumption in the literature which I review is that regulation is a term which denotes the ways in which government and its agencies engage in the micro-management of industries and markets. This in turn includes the use of both direct means (law making and enforcement) and indirect means (such as the use of power and influence, attempts to influence public opinion and the behaviour of firms' customers, and incentives to influence the behaviour of firms). In this literature, regulation does not include broader government macro-economic management i.e. interest rate and fiscal policy and the wider mechanisms of social control cited by Baldwin *et al*.

Joskow and Noll (1981) refer to 'administrative regulation' which excludes anti-trust policy (competition law) and laws administered directly by the Courts such as property, contract and liability law. All commercial activities need to be supported by a framework of law to ensure that property rights are protected, contracts are enforced and duties of care where appropriate are imposed. In this branch of law, action is initiated by the citizen or the commercial organisation, in contrast to regulation, which is generally enforced by a state agency. For lawyers, regulation refers specifically to instruments of public law enforced by government or semi-autonomous public agencies (Ogus, 2001). In the wider literature however, the boundaries are not clear cut, and anti-trust enforcement is a borderline case.

A further distinction is made in the literature between 'economic' and 'social' regulation (Reagan, 1987; Ogus, 2001). Economic regulation generally refers to regulations covering price, quality and industry entry and exit. The public purpose is to protect the economic interests of consumers, particularly in the case of natural monopolies but this type of regulation has also been used in competitive markets. Social regulation includes health and safety, environmental and employment regulations. Reference to the purpose of regulation brings us to the issue of the rationale for regulation. Consideration of what regulation is leads naturally to consideration of its purpose. In the literature, the perceived rationale depends on the starting point.

#### *Views on the rationale for regulation*

In neoclassical economic theory, it is posited that competitive markets normally lead to optimum resource allocation. It is recognised however that there are exceptions to this rule, and that there are circumstances (such as the case of natural monopolies and cases involving incomplete or asymmetric information) when markets fail to achieve optimum outcomes in terms of social welfare. Government intervention is then justified to address these 'market failures', and this provides the rationale for regulation.

An alternative economic perspective is provided by the Austrian School. Many features of real world markets which appear from a perfectly competitive ideal perspective as evidence of inefficiency turn out to be wholesome features of a vigorously and dynamically competitive world (Kirzner, 1997). This view emphasises the imperfect and disequilibrium view of markets, and the role of the market in discovering information and in innovation. This suggests that detailed regulation will not normally be desirable (Booth, 1997). Austrian theories of market structure do not assume perfect information

so the absence of perfect information is not a justification for regulation. Markets should operate in a broad framework of rules and arbitrary power should not be given to regulators. (Booth, 2003).

The political science view emphasises that regulation is political. It is an activity of government. It involves values, interests, conflicts, and the making of choices by persons concerned with constituencies and elections. It can therefore never be a simple application of microeconomic principles (Reagan, 1987). Regulation involves a contest for power (Hancher and Moran, 1989). Regulation is used by governments for ideological purposes such as the promotion of personal choice (Black and Nobles, 1998). In this view, the economic rationale for regulation is just one of the arguments within the political discourse. Regulation emerges from the political process and may not have a clear rationale.

#### **2.4 The scope of the literature on regulation**

A substantial literature now exists covering a wide variety of contexts and differing disciplinary, theoretical and methodological approaches. This is summarised in Figure 2.1 below.

In terms of the cultural context, the experience of regulation in the US extends over a much longer period than across Europe. Europe adopted nationalisation as a response to many public policy issues while the US retained private ownership of commercial enterprises but subject to federal and state regulation (Majone, 1994). There were differences in the extent of public ownership across Europe (Andrain, 1980), and there have been differences in the rates at which European states have proceeded with privatisation. Regulation has been applied in a wide variety of market and industry contexts, from natural monopolies to competitive industries, from utilities to financial services. Some regulations apply to all industries. A variety of regulatory structures and instruments have been employed to address the variety of economic and social policy issues referred to above.

The phenomenon of regulation has attracted the attention of scholars from a number of disciplines, mainly economics, political science, law and history but also to some extent from strategic management. These disciplines have brought with them differing analytical approaches and have generated a number of often conflicting theories.

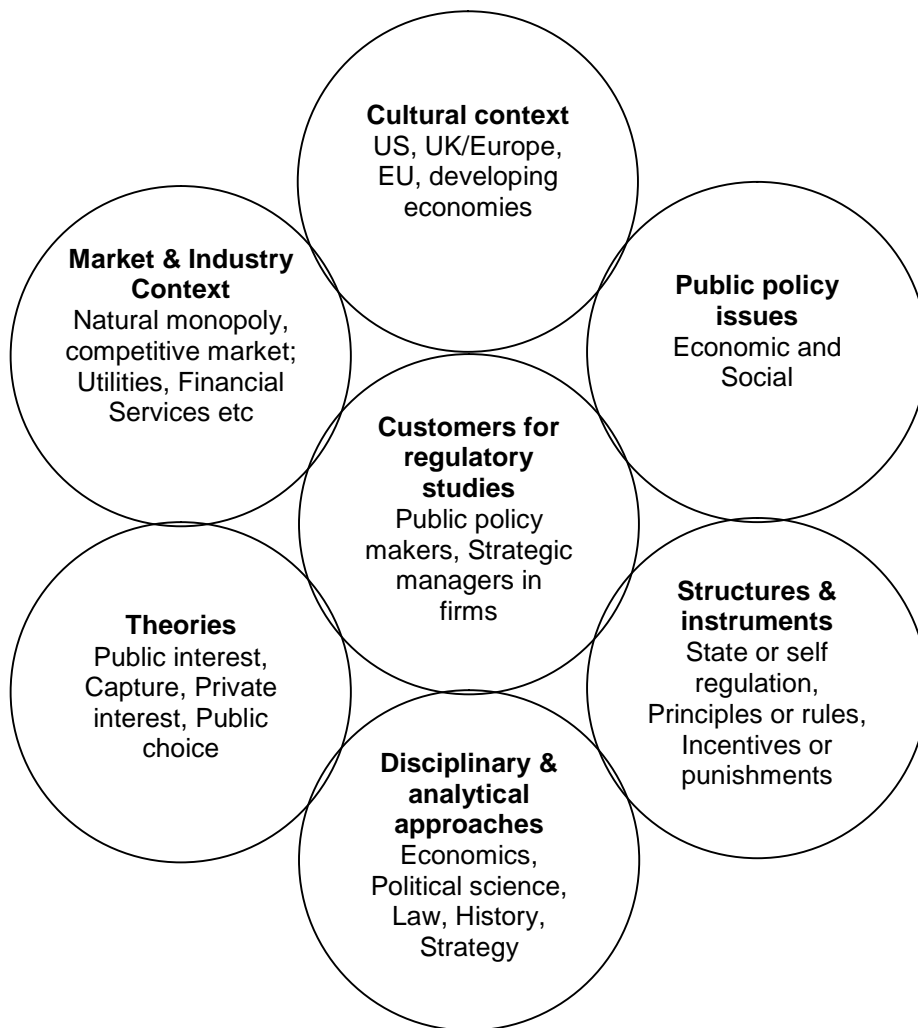


Figure 2.1 The scope of the literature on regulation.

This variety of context and approach has produced a vast and complex body of literature. Regulation has emerged as an institutional field of study but there is a risk of theoretical diffusion. The discipline needs to develop either a specific perspective on a general field of activity or a general perspective on a specific field of activity (Baldwin *et al*, 1998).

It is neither possible nor desirable to produce a comprehensive review which covers the whole of the literature on regulation. I focus this review on the specific issues arising from the current political discourse outlined in the introduction. In particular, I concentrate on the literature on economic regulation (including consumer protection) in the context of competitive industries rather than in monopoly markets. It is important however that this review is seen in the context of the greater body of literature. So I

present next a framework which captures the research questions that are asked in relation to regulation, and position this review in that broader context.

## **2.5 A framework for the analysis of the literature on regulation**

Baldwin *et al* (1998) identify two major themes in studies of regulation:

- *the natural history of regulation* - the evolution, development and observable life processes of regulation, the behaviour of regulatory actors in the regulatory landscape, and the practices of implementation and enforcement; and
- *the various species of regulation* - the variety of strategies used, scales of control encountered, and the modes of evaluation and holding to account.

To this analysis I have added the various research questions posed in theoretical and empirical studies to develop a framework for understanding the issues addressed in the literature. It is helpful to distinguish between the *positive* questions, which ask what the situation is in any particular context; and the *normative* questions, what ought to be. The result is shown in Figure 2.2 below:

Much of the literature is centred on the set of questions, both positive and normative, about the natural history of regulation. It is in this area that the commonly recounted and competing theories (public interest, private interest, capture, public choice) are advanced. These theories are well described in a number of reviews: Joskow and Noll (1981), Peltzman (1989), Baldwin *et al* (1998), Crew and Kleindorfer (2002). These reviews together provide a comprehensive account of the economic and political science perspectives and as they cover a twenty year period, they also give a good feel for the development of the theory. Further technical detail is provided in standard texts such as Kahn (1988) and Viscusi *et al* (2005). The legal perspective is provided by Ogus (1994, 2001).

Much less of the literature is focused on the various species of regulation and on the important questions about evaluation, which are the subject of the current debate within the business community. This chapter reviews the literature on the questions of evaluation, identifies what is known and proposes a research agenda for addressing the issues raised in the current debate.



<b>Baldwin et al (1998) major themes</b>	<b>Positive questions - what is ...?</b>	<b>Normative questions - what ought to be ...?</b>
<i>THE NATURAL HISTORY OF REGULATION</i>		
The evolution, development, observable life processes	When and why does regulation/deregulation arise? What are the perceived rationales/objectives for regulation/deregulation? What triggers regulatory change?	To regulate (deregulate) or not to regulate (deregulate) How do we achieve the best balance of competition and regulation to maximise efficiency and welfare?
The behaviour of regulatory actors in the regulatory landscape	What are the interests of politicians, regulators and other actors? How are these different interests reconciled? What are the relationships between actors? Who receives the benefits and who suffers the burdens of regulation?	How do we deal with principal/agent problems? How do we create the right incentives and avoid rent seeking behaviour?
The practices of implementation and enforcement	What designs are used for regulatory institutions and instruments? How do they work? How are rules interpreted and enforced?	How do we design effective regulators and regulations? What are the best instruments to meet policy objectives?
<i>THE VARIOUS SPECIES OF REGULATION</i>		
The variety of strategies, styles and techniques used and the scales of control encountered	Why do different jurisdictions produce different responses to the same/similar problems? How do cultural differences manifest themselves in different approaches? What is the relationship between different jurisdictions and different levels of regulatory activity (e.g. federal v state, EU v national)?	
The modes of evaluation	What are the costs and benefits of regulation? What are the consequences of regulation? short term? long term? What is the effect of regulation on the allocation of resources, on competition, on innovation, on market/industry structures, on firm strategy...? Are the objectives of regulation achieved? What are the unintended consequences of regulation?	How do we ensure that the lessons learnt from the evaluation of regulatory policy influence public policy making?
The mode of holding regulators to account	How do regulators account for their actions?	How do we provide the right incentives?

Figure 2.2 A framework for the analysis of the literature on regulation

## **2.6 The evaluation of regulatory policy**

### *The characteristics of regulatory policy*

Posner (1971) argues that regulation can be seen as a form of taxation. He refers to a common form of regulation which requires a regulated company to provide certain products or services to some customers at below cost, to be paid for by higher than market prices elsewhere. This form of cross-subsidisation imposes a 'tax' on those who pay higher than market prices. This subsidy is a form of public taxation and expenditure. Posner's view of regulation could be applied to any regulatory policy which creates winners and losers. Crew and Kleindorf (2002) argue that elected representatives exploit this property of regulation. Regulation provides politicians with the opportunities to raise taxation and to distribute benefits without the accountability of normal forms of taxation and public expenditure. This in turn leads to different interest groups lobbying politicians in order to gain a share of the economic rents created by the regulatory process.

Majone (1994) points out that there are significant structural differences between regulation, as a type of public policy making, and the main type of policy making involving the direct expenditure of public funds raised by normal taxation. An important characteristic of regulatory policy making is the absence of a regulatory budget procedure. The size of a regulatory programme is not significantly constrained by legislative appropriations and by the level of tax revenues, as is the case for non-regulatory programmes. In the case of regulation, no mechanism exists requiring policymakers to solve what Majone calls "the two-level budget problem": how much to spend during a given period and how to allocate this total among alternative uses. It has been argued that the solution is to develop a regulatory budget procedure, but as Majone states, there are technical difficulties in estimating the costs of regulation. Notwithstanding these difficulties, measuring the costs and also the benefits of regulation is now being attempted by governments and regulators. It is to this subject that I now turn.

### *Cost-benefit analysis of regulatory policy*

Cost benefit analysis (CBA) is a long standing technique designed to assist decision-making on public projects. A firm theoretical framework for CBA was established in 1958 with the publication of work by economists which methodologically used neoclassical welfare economics in relation to CBA (Mishan and Quah, 2007). A benefit

is construed as any gain in welfare and a cost is any loss of welfare. The concept of cost is opportunity cost, so that (ideally) the benefit-cost rule is one of maximising the difference between the benefits of the proposed project and the benefits foregone in the project displaced by the chosen project. As no project is likely to meet the ideal 'Pareto rule', the 'Kaldor-Hicks rule' is used so that any project should be sanctioned if it improves the welfare of some people, even if others might lose, provided that those who gained could (in theory) compensate those who lose and still remain better off (Pearce, 1983).

The application of CBA to regulatory policy started in the US in the 1970s. Then in 1981 President Reagan issued an Executive Order requiring all major regulations to undergo CBA. Baldwin and Vejanovski (1984) examine this development and identify a number of conceptual issues and data constraints in the use of CBA. There is substantial disagreement among economists about which costs and benefits should be taken into account and how these should be evaluated. It is therefore highly unlikely that CBA will offer definite conclusions. The real drawback of CBA is the measurement problem. But even before this task is faced the regulators must first identify the impact of a proposed regulation. In many areas this will be extremely difficult if not impossible. CBA studies generally fail to identify adaptive responses to regulation. There are hidden costs such as reduced productivity and incentives, expenditure on evading regulation and distortions in investment and production decisions. CBA also tends to consider the total costs and benefits and not the distribution between individuals. The way people value the effects of regulation will depend on their income and wealth. The marginal utility of consumption reduces with increasing income.

Notwithstanding the difficulties, the use of CBA was reinforced when the US Congress required, from the Office of Management and Budget (OMB), annual estimates of the total cost and benefits of all federal regulatory programmes and estimates of the cost and benefits of individual regulations. Hahn (1998) examines the OMB report for 1997 and highlights the limitations of the analysis and our knowledge. We know very little about the benefits and costs of banking and securities regulation and regulation aimed at protecting consumers from fraud. We know very little about the dynamic impacts of regulation on innovation, investment and productivity.

Hemphill (2007) looks at the OMB report for 2005. The OMB has developed the methodology to deal better with non-monetised benefits. The OMB report says that the

benefits of major regulations issued from 1992 to 2004 exceed costs by more than three-fold. The average yearly net benefit during the Administration of G W Bush is over double the yearly average for the previous eight years. Hemphill quotes a number of advocacy organisations which question the utility of CBA and argue that CBA in the hands of the Bush Administration is not to be trusted at face value. Despite the apparently positive net benefits of regulation produced by the CBAs, some commentators fear that the methodology will favour the interests of the regulated community over that of the citizen.

In Europe, a number of countries have adopted some form of cost benefit analysis of their regulations. In 2003 several countries formed a network and adopted a Standard Cost Model (SCM) for measuring administrative burdens. A number of OECD countries have introduced a Regulatory Impact Assessment (RIA) for each new regulation before introduction (Kirkpatrick, 2006). RIA is wider than CBA. RIA attempts to assess the risks associated with a proposed change as well as the costs and benefits. RIAs can in theory be used both *ex ante* and *ex post* but to date very few *ex post* assessments have been done, possibly because government is reluctant to have judgements made on past decisions (Parker, 2006).

Governments have made a great deal of progress in developing CBA and RIA techniques. Methods of measuring administrative costs in particular are developing well, but the assessment of policy costs and benefits remains problematic. Simpson (2000) argues that the theoretical as well as the practical limitations of CBA mean that the technique is unlikely to be helpful in assessing the impact of regulation; but a wider and deeper economic analysis should play an important part in making such assessments. In the next section I look in more detail at the limitation of existing techniques of evaluation and I then examine reported studies which attempt a broader and deeper analysis.

#### *The limitations of CBA and RIA techniques*

The *ex ante* evaluation of a proposed change in regulation assesses the incremental costs, benefits and risks of the various options under consideration. The process identifies the difference between the world as it would be if the proposed option were adopted and the situation which would pertain if the option were not adopted. The evaluation identifies the incremental impacts of each possible option to aid decision-making by public policy makers (Alfon and Andrews, 1999). Simpson (2000) identifies

the fundamental weakness of this approach. The approach is a linear one; it assesses the impact of each proposed change essentially in isolation. But the competitive market place into which these regulations are introduced is far from a linear process. Competition is a process of continuous interaction over time between buyers and sellers, each of whom adjust their behaviour in the light of new information revealed by the process itself. Outcomes are not monocausal and an acceptable model of the market cannot be an additive one. A comparative static analysis ignores the dynamics of the market place.

A related problem is that an *ex ante* evaluation could produce a result that strongly suggests that a new regulation would justify the costs and the potential risks but may overlook a market solution. Gwilliam *et al* (2005) examine the case of new accounting regulations at Lloyds of London introduced under primary legislation. Agents controlling Syndicates were required by these new laws to produce to their principals (the Names), accounts of the syndicate, auditors reports and disclosures of interests. These regulations clearly had major benefits for the Names at entirely justifiable costs to the Agents. But the question is why the Lloyds market did not adopt these common accounting practices on its own initiative and why primary legislation was necessary.

An *ex post* evaluation, if performed, could attempt to assess whether the stated or implied objectives of a regulatory measure were actually achieved. Goodhart (2001) addresses this issue in relation to the statutory objectives of the UK Financial Services Authority (FSA). The FSA's objectives are:

- a) maintaining confidence in the financial system
- b) promoting public understanding of the financial system
- c) securing the appropriate degree of protection for consumers
- d) reducing financial crime.

Goodhart identifies the difficulties in assessing whether these objectives are met. Objectives (a) and (b) concern states of mind. In principle 'understanding' could be measured by examination but 'confidence' is a much more subjective issue. In relation to objective (c), what is 'appropriate' and who decides? In relation to (d), what data could be used? Goodhart therefore concludes that holding the FSA to account for the delivery of these objectives is very difficult.

In cases where the objectives are more precise (e.g. improving efficiency and productivity), it may be possible to assess whether the objectives of a regulation were

achieved. The problem then is finding a control sample, i.e. where there is no regulation, or a different regulatory regime. Where a regulatory change is made in a narrow time window, a comparison can be made, for example, of efficiency before and after the change. In other cases, however, the regulatory process is lengthy and noisy and it is difficult to specify a model for examination; and there may be confounding events, such as technological change (Mulherin, 2007). Kumbhakar and Lozano-Vivas (2005) present a study of the Spanish Banking Industry to assess whether various deregulatory measures motivated by the desire to promote competition and improve productivity result in improved total factor productivity (TFP). In this study the authors identify six regulatory changes over an eight year period and specify a translog cost function including a dummy variable for each change. The function also contains technical change components. They find that deregulation contributed positively to TFP growth for both savings and commercial banks. Kumbhakar and Lozano-Vivas acknowledge however that in the banking literature there is considerable disagreement about the definition of inputs and outputs, and that studies of the efficiency of banks have led to inconsistent results. It may be added that this literature also discourages the use of translog cost functions (Berger *et al*, 1993). Assessing changes in the efficiency of financial services industries is, therefore, not easy.

Despite the limitations, the adoption of CBA and RIA techniques in government is clearly a positive move. The adoption and development of these methods of evaluation is certainly better than having no evaluation at all. The issue is how we develop the broader and deeper methods called for by Simpson (2000). The key weaknesses of CBA and RIA techniques are their incrementalism and the difficulty of identifying adaptive or behavioural responses. Regulation accumulates over time, so the questions are about how different regulations interact and what the cumulative effect of regulation is over time. In particular, we need to know how regulation affects the structure of the market environment, the strategies adopted and profitability of companies operating in that environment. I now turn to these questions.

## **2.7 The broader effects of regulatory policy on markets and firms**

### *The effect of regulation on the structure of the market environment*

Vietor (1994) assesses the long term effects of regulation and deregulation and examines the impact on markets and industries. He traces the history of Roosevelt's *New Deal* regulation introduced in the 1930s through to the deregulatory events of the

late 1970s and early 1980s. His conclusion is that, prior to the 1930s, the development of market and industry structures in the US was shaped primarily by technological and economic characteristics, by executive leadership and strategy and by competition among firms. Government policy was a factor in this development but was not the dominant one. During the era of regulation from the 1930s to the 1970s government policy was the pre-eminent determinant of market and industry structure. Regulation shaped the collective behaviour of firms, right down to their organisational resources and basic operations.

Vietor studies four industries (Airlines, Natural Gas, Telecommunications and Banking) and the four leading companies in those industries (American Airlines, El Paso Natural Gas, AT&T and BankAmerica). The methodology involves examining the regulations introduced, the market response, and the regulator's response to the market response, etc, as a dynamic process occurring over several decades. With this methodology, Vietor assesses the long term cumulative effect of regulation, the effect of regulation on the behaviour of firms and markets, and the outcome in terms of the institutional factors in the market place (such as the pricing mechanism, product quality, cost structure, standard operating procedures and the nature of competition).

Vietor describes how the new regulatory regime initially stabilised these industries following the depression of the 1930s, and then how the regime failed to keep up with technological and economic change. Regulation had many unintended and unforeseen consequences but the regulators became gridlocked by political process. The regime became unsustainable and following a loss of public confidence, a wave of deregulation followed which acted as a trigger for a major transformational change in the market place as companies adapted to a more normal competitive environment.

Another set of studies examine the collapse of a number of Savings and Loan (S&L) institutions in the US in the 1980s. Benston (1985) studied 200 institutions that failed. The principal cause of failure was the specialisation of S&Ls in fixed interest rate long term mortgages funded by short term savings deposits with regulated interest rates and subject to federal deposit insurance. This unbalanced portfolio was imposed by regulation going back to the 1930s and supported by tax subsidies and by custom. When short term interest rates rose from around 7% in 1978 to 16% in 1981, S&Ls faced a run on their deposits. Congress began to deregulate deposit rates in 1980 which helped S&Ls stem the outflow of funds but also led to interest margins becoming

negative as the rate on mortgages could not be increased. Further regulatory changes followed and subsequent S&L failures did not have a single cause. Starbuck and Pant (1996) argue that various long term trends framed the disaster which all involve the nature of the regulatory regime and the relationship between the S&Ls on the one hand and Congress and the regulators on the other.

A further set of studies cover the period of regulation and deregulation in the US of the railroad industry. The consensus is that deregulation in 1980 led to significant improvements in economic welfare. Regulation hampered both allocative and technical efficiency (Ellig, 2002). More generally, there is a consensus among students of US regulation that in structurally competitive industries (including those such as transport where there is inter-industry competition) regulation has suppressed innovation, sheltered inefficiency, encouraged a wage/price spiral, promoted the misallocation of resources by throwing prices out of alignment with marginal costs, and denied the public the variety of price and quality choices that a competitive market would have provided (Kahn, 1988).

The studies of the US experience of regulation and deregulation outlined above show the necessity of long term *ex post* studies of the effect of regulatory regimes on the institutional development of markets and industries. It is not sufficient to analyse the incremental impact of one regulatory change. A long term *ex post* study evaluates the development of the regulatory regime; it provides an assessment of the cumulative impact of a number of regulations; and it provides invaluable lessons for future regulatory policy. The studies cited above raise the question about the wisdom of certain types of regulatory intervention. Vietor (1991) concludes that "...regulated competition, in contrast to regulated monopoly, is a flawed concept ... The idea that certain market characteristics could be shaped by government, without affecting management's other prerogatives, reflects a kind of hubris." Isaac (1993) states that the lesson from the S&L crisis is that "government policies designed to impede the operation of markets, no matter how well intended, are doomed to fail."

Black and Nobles (1998) make a less strident judgement of regulation in their study of the pensions mis-selling scandal in the UK between 1988 and 1994. The scandal was that a new regulatory regime of consumer protection did not prevent retail pension providers from persuading individuals to opt out of their occupation pension schemes into inferior personal pension schemes. Black and Nobles see the scandal as



manifesting a critical failure of the regulatory structure. One of the principal features of the scandal was regulatory blindness on the part of firms and regulators. These authors state that no-one took a strategic look at what regulation required in any one instance. No-one looked at pensions as posing particular problems because no-one thought to look. The lessons of the scandal may be summarised: for firms, regulation has to be central to management strategy and compliance cannot be an 'extra'; for regulators, there has to be an awareness of risk. Black and Nobles do not question the wisdom of the regulatory regime as such. They observe that changes made by government fundamentally altered the pensions market, but they see the issues arising from the scandal as matters of compliance with the law. Ross (1984) and White (1984) did however question the rationale for this regime during the consultation phase prior to implementation: the architect of the regime, a lawyer, failed to understand the nature of competition in, and the economics of, the industry. These authors to some extent anticipated the problems with the UK regime of consumer protection in financial services. The lessons of regulatory failure must therefore be used to address not just questions about the implementation of a regime, or indeed just about its design, but also about whether or not regulation is a sensible policy option for competitive markets.

*The effect of regulation on strategies adopted by companies and on profitability*

The outcome for companies operating under many years of regulation is illustrated by Vietor in his studies of the four companies mentioned above. Taking a snapshot in 1975, the point at which regulatory reform was just emerging as a public issue, all four companies had significant slack in their organisations: excess operating capacity and personnel. Cost control systems were weak or non-existent. Marketing, especially pricing, sales and distribution, was underdeveloped. In contrast, customer service and operations were very strong. In the structurally competitive markets of airlines and banking, regulations only allowed firms to compete on service. When regulation prevented prices from being driven down to marginal costs, non-price competition inevitably drove costs up to price. The reintroduction of price and entry competition under deregulation had a major impact on companies. BankAmerica had been very successful under regulation but this led to a degree of strategic inertia. The company did not start its strategic adjustment to deregulation until 1981. Initially the new strategies were not successful, and by 1986 it was in trouble with losses of almost \$1billion in total. Drastic cost reductions and asset sales were required to turn the company around.

The strategic management literature contains reports of studies of the impact of regulation on companies. Some examine the process of decision-making, the role of the regulator and the relationship between the regulated company, the regulator and other interested parties. These studies contribute to the line of literature on the behaviour of actors in the regulatory landscape, referred to in Figure 2.2 above. A few studies examine the outcome of this process, and address questions about the realised strategies of companies in a regulated environment and the ultimate effect on competitive advantage and financial performance. I now turn to these studies

Reger *et al* (1992) develop a path analytic model to explore the effects of deregulation on strategic choice and performance in the US banking industry. Two regulation variables, *scope* and *rate of change*, were defined. Using data obtained from regulators, *scope* was measured at a point in time, and *rate of change* was assessed over a five year period (all changes being deregulatory). Various strategic choice variables (product mix, geographic and product diversification and risk) and one performance variable (return on assets) were defined. Data on these variables was gathered for one year (following the five year period) from a sample of bank holding companies. The results show that the influence of deregulatory change on strategic choice and performance is complex, but significant. Deregulation has direct effects on firms' strategic choices and both direct and indirect effects on risk and return. The authors acknowledge that the timeframe of the study did not permit conclusions to be drawn about the long term impact of deregulation, particularly on product/market decisions.

Suponcic and Tennyson (1998) summarise the results of various studies into the effect of rate regulation on the automobile insurance industry in the US. This regulation is administered at state level and different states impose different regulatory regimes. In a few states the rates are set by an insurance commissioner or industry rating bureau but the most common method of regulation is the prior approval system under which rates must be approved by a state insurance commissioner prior to introduction. Some states allow rates to be competitively determined but most of these require insurers to notify the state commissioner of rate changes. The effects of rate regulation on insurers' underwriting margins have been subject to numerous analyses. Early studies (of the period when rates were generally set by state agencies) tended to find that regulation raised unit prices (the ratio of premium received to losses incurred) suggesting that

regulation inhibited price competition. Later studies (which involved a greater variability in regulatory regimes) found the opposite result: lower unit prices for insurance in states that regulated rates. The reduction in prices were generally small, between 0.03 and 0.07, but was significantly higher in some states. Stringent regulation reduces prices significantly but also reduces insurance availability and increases the risk of insurer insolvency.

Suponcic and Tennyson (1998) report their study of the effect of rate regulation on insurers' decisions about entry, exit, and also output. The hypothesis is that where rate regulation reduces returns below those available in other markets, firms will be deterred from entering and will consider exiting. In some states regulators have mechanisms for controlling exit such as the right to withdraw licences for all business if the insurer wishes to withdraw from a heavily regulated line. In these situations insurers may respond by reducing their output and market share rather than exiting. In this study, each state is identified as regulated, unregulated or stringently regulated. A comparison across these categories using a multivariate analysis controlling for other variables shows that the number of firms operating in the market is lower in regulated states and lower still in stringently regulated states. In the case of national and low cost producers, market shares are lower in the stringently regulated states.

Born (2001) presents a study of the relationships between the profitability of property and casualty insurers and various measures of the regulatory and legal environment in which the insurer operates. Born's study involves a wider group of insurers and a wider set of regulatory measures than the study of Suponcic and Tennyson, but again is focused on the differences between US states. In characterising state regulatory and legal regimes, Born uses variables to cover different rate regulations, different investment restrictions and minimum capital and surplus requirements, and different tort laws covering the nature and level of liability for loss or injury. Using firm level data and a quantile regression methodology, Born finds that the distribution of profitability (return on equity) is only weakly related to the insurers' regulatory and legal environments, and is significantly related to other factors such as firm size and the effective number of competitors. While previous studies generally agree that restrictive rate regulation in particular is negatively related to underwriting performance in certain lines, this study suggests a very different relationship when overall operations of the insurer are considered.

The above studies suggest that regulatory change affects outcomes in terms of realised strategies and financial performance but much remains to be done in this area. Parker (2001) comments that very little is known about how regulation and deregulation affect strategic choices, such as risk profiles, products and services offered, geographical coverage and product diversification.

## **2.8 Summary and conclusions**

In response to pressure from the business community, governments have started to develop CBA and RIA methodologies to assess the costs, benefits and impacts of regulation. Considerable progress has been made in assessing the administrative costs of regulation but much remains to be done to assess the policy costs, and even more to develop sound methodologies for assessing the benefits and potentially negative impacts. We are some way from developing the regulatory budget process envisaged by Majone (1994). However, even if these further developments take place, these techniques will not by themselves answer some of the important questions about the effect and impact of regulation on markets and companies. The limitations of CBA and RIA have been identified in the literature. These methodologies do not adequately address questions about the interaction of different regulatory regimes, nor do they assess the cumulative long term impact of regulation on the structure and operations of markets, industries and market participants.

Vietor (1994) illustrates one possible approach. His methodology involves a detailed long term study at both industry and company level. It is both quantitative and qualitative. It addresses the economic and political issues. Each of his studies shows how the regulatory regime changed over time, and how these changes affected the behaviour of companies and the development of the market and the industry. Each of the studies shows how a particular regulatory approach initially produced benefits but ultimately collapsed.

The static comparative approach does not provide the same insights as the longitudinal approach. A number of studies over a period of time can however lead to a consensus, such as can be seen in the studies of the US Savings and Loan industry, in the railroad industry and to some extent in property and casualty insurance. Although not covered in this review, the studies of natural monopolies such as those in the utility industries have generally led to clear conclusions.

Baldwin *et al* (1998) raise the question about the direction of future research on regulation. They call for either a general perspective on a specific field of study or a specific perspective on a general field of study. My review of the studies of the US experience of regulation suggests that focusing on specific industries can provide a unifying theme. Questions about regulation depend upon the specific characteristics of individual products and markets (Joskow, 1988). It is the understanding of the institutional detail within an industry that leads to insights into how the regulatory regime actual works and what its outcomes are. Comparisons across different industries can of course be made, but these are only likely to be successful when the institutional differences between each industry, and the way the regulatory regime works in each industry, is fully understood.

One industry which is particularly ripe for study is financial services. This is because it is an industry in which there has been an increase in economic regulation at a time when other industries have been gradually deregulated (Peltzman, 1989) and in which some of the most detailed and prescriptive regulations have been generated (Llewellyn, 2000). In the UK, the financial services industry has been subject to a rapidly changing regulatory environment with sometimes conflicting public policy objectives (Slattery and Nellis, 2005). More generally, financial services is seen as an industry with particular risks (e.g. the failure of a bank leading to failures in other firms and an adverse impact on the economy as a whole) justifying a different approach from other industries. Financial products themselves are regulatory creations (Moran, 1990). Financial markets are essentially concerned with the production, processing, dissemination and utilization of information, and on the basis of microeconomic theory, they must be presumed to be inefficient (Stiglitz *et al*, 1993). However, Benston (1998) questions the general view that financial products and markets are fundamentally different from other products and markets; and Kaufman (1994) questions the perceived level of risk of bank contagion. The regulation of financial services is therefore a contentious area.

In this review I have concentrated on the evaluation of regulatory policy and on the assessment of the outcomes of regulatory policy. I have covered a number of different industries and so I have taken a specific perspective on a general field. I have focused on the methodologies by which we can assess the costs, benefits and impacts of regulation. This again could be a unifying theme for future research. Fewer studies

have been conducted into this area than on the process and politics of regulation, so there is much more to be learnt about the outcomes of regulation.

A study of the politics of regulation is still important, as economic analysis is just one of the sources of argument for the political discourse. Economic analysis of regulation in the US was slow to influence policy makers (Joskow and Noll, 1981). Deregulation in the US was not the result of a belated recognition of policy error (Peltzman, 1989). Economic analysis can illuminate choices, but not decide them (Reagan, 1987). All governments operate within the bounds of the conventional wisdom of their elites and governing ideas change only incrementally (Wallace, 2004). It is important therefore to understand how new knowledge can be applied to influence policy making. But the current public debate about regulation provides a valuable opportunity for well targeted research to influence policy making.

It follows then that research into the assessment of costs, benefits and impacts of regulation could have an early influence on policymaking. In particular, further studies into the long term effects of regulation would make a contribution to an underdeveloped theme. The bulk of reported studies on this issue examine the regulatory regimes in the US from the 1930s through to the deregulatory changes in the 1980s. Since then there has been a substantial wave of new regulation not only in the US but also in the UK and across Europe. This new phase of regulation has significant differences from the first phase in the US and has taken place in a different economic and social context. This new phase is now ready for detailed longitudinal study into its impacts on markets and companies.

In this thesis I present a longitudinal study of the UK retail pensions market. This market has been subject to substantial regulatory interventions and significant regulatory change over a twenty year period. The regulation of this market is still developing and is contentious. In 2007 the regulator, the FSA, launched a major new initiative, the Retail Distribution Review, to solve what it sees as deep seated and long standing problems. This industry is also important to another major area of public policy, namely pension provision in the context of increasing longevity. This thesis presents an evaluation of the effect of regulation on the institutional dimensions of the market: products, prices, demand, distribution, costs and industry structure. It assesses the cumulative impact of different regulatory initiatives over a long period of time. It evaluates the effectiveness and efficiency of the regulatory interventions in terms of

their explicit or implicit objectives and in terms of the overall outcomes for market participants and consumers. This thesis therefore contributes to the literature on economic regulation reviewed above. In particular it contributes to the development of methodologies to evaluate the long term impact of regulation and to the understanding of the relationship between regulation and the performance of markets.

In the next chapter I turn to the methodology for this study.

## **CHAPTER 3: RESEARCH DESIGN AND METHODOLOGY**

### **3.1 Overview of this chapter**

In the last chapter I reviewed the literature on the economic regulation of competitive markets. I identified research gaps in terms of our understanding of the longer term impact of regulation on the operation of markets and in terms of the methodologies for assessing that impact and for evaluating public policy. I highlighted the value of studies into financial services markets and I outlined the reasons for choosing the UK retail pensions market as the context for this study.

In this chapter I set out the research design and the methodology to be adopted in carrying out this study. I begin with the research question. I then define the constructs in the research question and outline how I intend to measure and assess the constructs in order to answer the question. I present a framework for analysing regulation and a provisional model to structure the study. I identify the sources of data which I have collected and describe the analytical techniques I use to collate, validate and analyse that data. I explain how I intend to explore the impact of regulation on the market, considering also the effect of economic, social and technological factors. Finally I describe how the empirical results are presented.

### **3.2 The research question**

The literature reveals a number of concerns expressed by practitioners in industry about the impact of regulation on businesses, large and small. The concerns are not just about direct costs but about the effects of regulation on the economics of products, the structure of the market place, the risk/reward balance, on innovation, strategic decision-making and corporate image. The issues are about the effect of regulation on the operation of the market and on the strategic decision-making of firms. The concern is about the rapid growth of regulatory activity and the impact this is having. The research study needs to begin by understanding the impact that regulation has actually had in the market place. The basic research question is therefore:

*What was the impact of regulation on the UK retail pensions market?*

There are two perspectives here representing two interested parties: public policy makers (government and regulators) and strategic managers in business. The question can therefore be approached from two directions. As government and regulators are the decision-makers in relation to regulation and as I am also seeking to develop



methodologies for evaluating public policy, I take the public policy perspective. This is not, however, to ignore the position of strategic managers and the questions they have about how they respond to regulatory interventions. Regulatory decisions affect the strategic decisions of market participants (and indeed consumers) which then affect the way the market works. The impact of regulation on strategic decision-making therefore needs to be understood to answer the research question. I return to this point later in this chapter. But I define my perspective to create clarity in the approach to the research question and also because taking this perspective naturally leads to an evaluation of public policy.

### **3.3 Defining and assessing 'regulation'**

#### *General approach*

The literature defines economic regulation in terms of an intervention in the decision-making of economic agents. Regulation therefore involves an intervention by government or regulators in a market. Regulation involves rules and the use of the coercive power of the state to enforce those rules but it also involves the use of influence and incentives to change the behaviour of market participants.

There is no framework in the literature to enable a structured analysis of regulation. Authors have described the UK pension regulations (Blake, 2003) and the UK investor protection regulations (Black, 1997) but have used a largely unstructured narrative approach. I therefore create my own framework starting from the definition above and by an iterative process of analysing empirical data.

The process for creating this framework and for populating the framework is as follows:

- Identify sources of data.
- Collect and collate data and check internal consistency.
- Capture data in the text analysis tool NVivo.
- Create coding framework using low inference descriptors.
- Classify and code data, and build up framework by an iterative process.
- Select relevant data.
- Present selected data in resulting framework.

### *Sources of empirical data about regulation*

There are several sources of data about the regulation of UK retail pensions market:

- Government and regulators: this consists of announcements of intent, consultation papers, the rules themselves in various legal formats and the record of the process of creation of the rules (e.g. parliamentary debates and committee hearings), publicity campaigns, sponsored reviews of the rules and of current issues, official reports etc;
- The companies in the market and their representative bodies, especially the Association of British Insurers (ABI): this consists of responses to announcements and consultation papers, commentary in press releases, annual reports, communications to shareholders and customers, etc;
- The press and professional journals: of particular interest is the Financial Times and its various publications addressed to participants in the industry such as the weekly news sheet *Financial Adviser* and monthly journal *Money Management*;
- Academic journals and books.

These sources provide a comprehensive record of events over the last twenty years, together with a commentary on those events from government, regulators, participants in the market and observers.

### *Collecting, collating and analysing the data*

Much of the data is available in electronic format from websites and from databases such as *Factiva* which can be searched by keywords. Some data is available only in paper form, especially records going back to the 1980s. The British Library has a comprehensive archive which I have accessed. I started the search from the sources identified in the literature review, especially Black (1997) on the investor protection regulations introduced in the mid-1980s and Blake (2003) on pensions. These texts provide references to official sources which I have supplemented by searches on the websites of government departments and agencies. Keyword searches on *Factiva* and on the British Library catalogue produced other data and further leads which I have followed up. I also went through the annual reports and accounts of a number of companies such as Standard Life and Prudential, recording the companies' observations about regulatory initiatives and explanations of their strategic decisions. By these methods I collected a comprehensive dataset covering government policy and

regulation relating to the UK retail pensions market since the early 1980s. Further details of the sources and the data are shown in Appendix A.

The data was captured into NVivo with appropriate editing to reduce repetition and volume. This is textual data and I analyse it using well established methods of handling such data (Silverman, 2001; Barr, 1998). I start with low inference descriptors, so if a regulation says it is about pensions I use 'pensions' as a description. I code the stated purpose of the regulation by government and regulators but I recognise that as regulation is political (Reagan, 1987) this statement of purpose might not be a fully accurate or complete description. I code the key dates and events as they unfold. I also code participants' and observers' perceptions and views about the intention, likely impact and actual impact of regulation, but without accepting those perceptions and views as objectively true.

By an iterative process of reading, coding and cross references different sources I have been able to build up a consistent picture of government intervention in this market since the early 1980s. This also leads to a framework for prioritising and capturing the data in a coherent and accessible form.

*The resulting framework*

Figure 3.1 below show the framework developed from the analysis described above:

<b>Subject</b>	<b>Rationale and objectives</b>	<b>People</b>	<b>Key dates</b>	<b>Contemporaneous observations and perceptions</b>
Pensions policy				
Investor protection policy				
Structure of regulatory institutions and rules				
Competition issues on content of rules				
Interpretation and enforcement of rules				

Figure 3.1 A framework for the analysis of regulation and regulatory events

The column headed 'Subject' defines a broad area of government intervention. It is a heading under which a group of related issues and events can be brought together and

described. I identify five subject areas from the analysis of the empirical data. Although these subject headings are derived from data which is specific to the UK retail pensions market, some aspects are common to all regulatory interventions in markets. The public policy issues in the market I am studying concern pensions and investor protection. Pensions policy is very specific to retail and occupational pensions markets, but investor protection could apply to a wide range of financial markets. The other three subject areas could apply to any regulatory intervention in any market. Once a government has decided on certain public policy issues which require intervention, the government must set up the necessary regulatory institutions and rules, and deal with any competition issues arising. The regulatory institutions must then manage the implementation of the rules which involves the interpretation of those rules and their enforcement.

The column headed 'Rationale and objectives' records the stated purpose of the intervention, and the public policy issues addressed by the intervention. I record also any significant dissenting voices, i.e. where there is some doubt about the regulators true intentions.

The column headed 'People' records the names of the leaders of various initiatives. Each subject heading tends to become associated with one or more key individuals. For example, pension policy in the 1980s was associated with the government minister Norman Fowler, while pension policy today is associated with Lord Turner.

The column headed 'Key dates' records the dates on which government or regulators made the main announcements or decisions on the subject matter concerned, or the dates on which new rules took effect, or the dates of events in the market which may have led to changes in regulatory policy.

The column headed 'Contemporaneous observations and perceptions' records the observations of participants and observers. As I am concerned with the impact of regulation on the market I record these observations under the following headings:

- product design, differentiation, price and demand
- distribution channels
- costs
- industry structure.

I do not rely on these observations as objective statements of fact but use these data and other data to assess the impact on the various dimensions of the market.

The populated framework is presented in Chapter 4 and Appendix B.

### **3.4 Defining and assessing 'the UK retail pensions market'**

#### *The boundaries of the market*

The market can be defined in terms of its principal participants, the UK insurance companies and their products. These companies are regulated by the FSA and most of them are members of the Association of British Insurers (ABI). There are some competitors which are not insurance companies and not members of the ABI but these have not obtained a significant market share. I identify these companies where relevant in presenting the empirical results.

The insurance companies' products can be grouped into three main business areas:

- life business: this consists of the traditional life insurance and assurance (endowment) products together with life insurance bonds and similar collective investment products;
- retail pensions business: personal pensions and annuities;
- services to occupational pension schemes: this consists of fund management and actuarial services and some packaged occupational pension scheme products for small employers.

This study concerns the retail pensions business. The customers are individuals or groups of individuals (such as employees of a small employer). This market can be distinguished from the occupational pensions market where the customer of the insurance company is the employer, or the body sponsored by the employer which manages the pension scheme. The key distinction is that in the retail pensions market the legal and commercial contract is between the insurance company and an individual, although an employer may act as a facilitator and may make contributions to an employee's contract. In the case of an occupational pension scheme, the individual has a contractual relationship with the employer's scheme. Such a scheme may be managed internally by the employer but the employer may outsource some functions to an insurance company; but in this case the contract is between the employer and insurance company. The retail pensions market and the occupational pensions market are therefore separate and distinct. The retail pensions market and the life market are

also distinguishable in terms of their products although they share the same distribution channels.

### *The characteristics of the market*

In Industrial Organisation economic theory, a market can be characterised on a number of dimensions such as:

- the products and the degree of differentiation between different companies' offerings;
- the price mechanisms and the level of prices of the companies' offerings;
- the demand from consumers;
- the distribution channels by which producers connect with consumers;
- the cost structure, economies of scale and the level of costs of companies;
- the number and nature of the participants, their relative market shares, barriers to entry and exit, the degree of vertical integration (industry structure);
- the nature of competition in the market.

Industrial Organisation economic theory posits that there is a relationship between these various structural dimensions and firm conduct (strategy) and ultimate financial performance. Hay and Morris (1991, p240) present a typical model, shown in Figure 3.2 below. Although the relationships in this model are shown explicitly, Hay and Morris recognise in their text that there is a complex set of linkages between all the variables. In particular, a range of conduct variables may be in part determined by profitability and may both influence and be influenced by structural characteristics. Simultaneous equation models which allow for this are not without drawbacks, but generally serve to diminish further the single direct line causality from structure to profits on which the theory has been so heavily focused. The issue of conduct comes to the foreground. Individual firm characteristics, in particular their efficiency and market share, are likely to be significant in the determination of both structure and performance.

Industrial Organisation economic theory recognises, therefore, that a market has a certain structure, a set of institutional factors, or various dimensions by which it can be characterised. This 'structure' affects and is affected by the strategic decisions of market participants. In turn both structure and strategic decision-making are affected by external environmental factors: political, economic, social and technological.

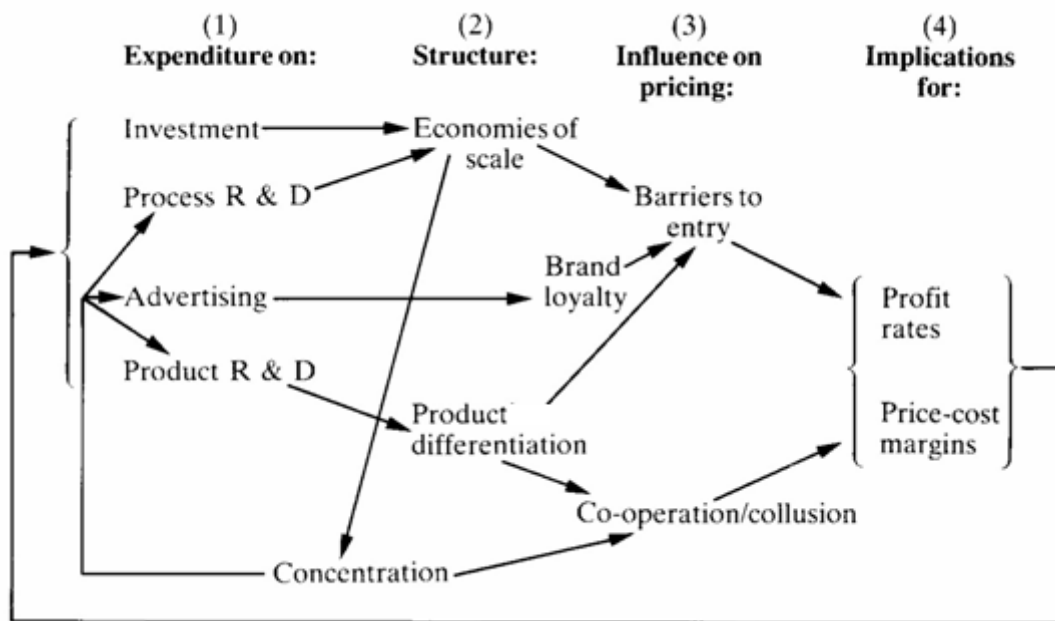


Figure 3.2 The Structure, Conduct and Performance Model (Hay and Morris, 1991)

*A provisional model*

My research question suggests that there is a connection between regulation and the market. Taking regulation to be a political environmental variable, and characterising the market by the dimensions listed above, the following provisional model may be used to structure the study and to answer the research question:

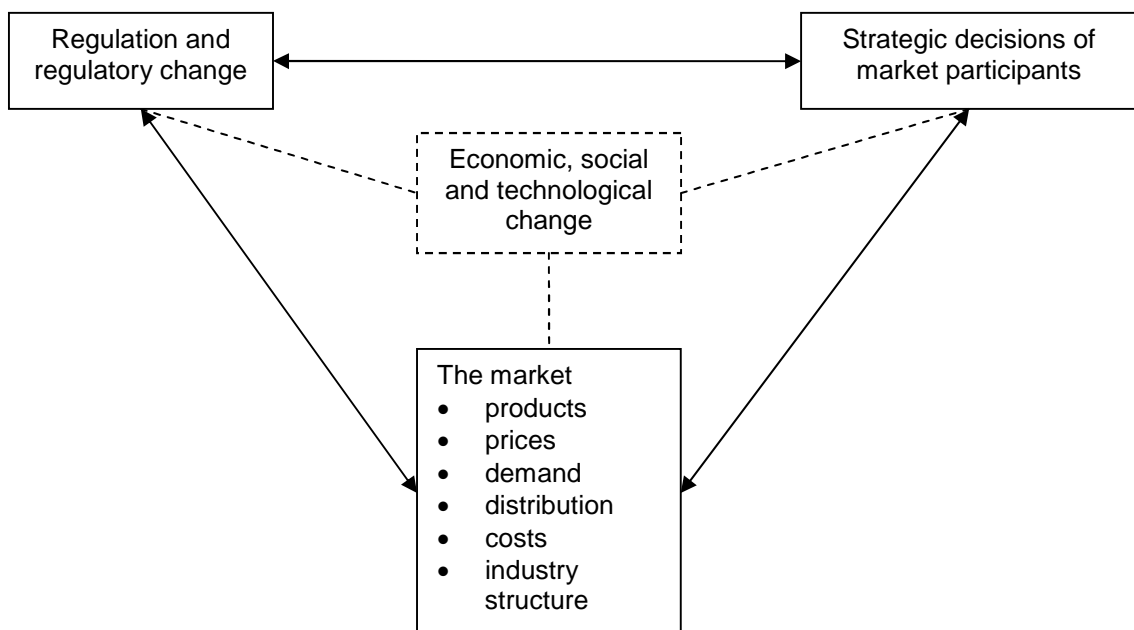


Figure 3.3 A provisional model for structuring the study

The model shown in Figure 3.3 above is provisional in the sense that it is subject to change and development as the empirical data is analysed. The final model is presented in Chapter 10.

The research question asks what the impact is of regulation on the market. Regulation can be assessed as shown in section 3.3 above. The market can be assessed in terms of key variables such as the products on offer, the degree of differentiation between them, the price of those products, consumer demand, distribution channels, producer's costs and the industry structure. The provisional model recognises that regulation affects the strategic decision-making of producers which in turn will determine some of the market factors. Also, the strategic decisions of one company will be affected by its perception of the market and the decisions of other companies. To understand the impact of regulation on the market as an entity it is necessary therefore to understand the impact of regulation on the strategic decision-making of market participants. This model also recognises that regulation is influenced by market change and by the decisions and behaviour of market participants. Finally, the whole domain is affected by external economic, social and technological change.

#### *Sources of data about the market dimensions*

There are two principal databases. The first is provided by the ABI which collects data from its members on a quarterly basis. This data consists of premiums received, claims paid, marketing and administration costs. A section of the premiums received data shows the amounts received in respect of new business, i.e. new policies sold in any quarter. New business volume, and particularly the monetary value of this business, is the primary measure of success in this industry. New business data is shown in respect of life, retail pensions and occupational pensions business and also at product level. The data shows the channel through which the new business has been secured. Companies also provide the ABI with data on funds under management and investment income received and with some other miscellaneous data.

Because of the commercial sensitivity of some of the data, the ABI only provides access to industry aggregate data. The data is available from the early 1980s but there have been various changes to the categories of data provided and to the reporting conventions. The ABI does however show comparative figures for some previous years following a change so I have been able to compile a consistent dataset on a year by year basis from the mid-1980s onwards.



The second source of data is the returns of insurance companies to the regulators which are made on an annual basis. The primary purpose of this data is to enable the regulators to assess the solvency of each company. Each company's return therefore includes detailed information about the assets held in the various funds and the calculation of liabilities. Also provided are details of premiums received (including new business volumes), claims paid, marketing and administration costs and other miscellaneous data. Sometimes this data is broken down into life and pensions business but product level data is not available. Unlike the ABI data, however, the regulatory data is available at company level. The data has been captured and collated by Standard and Poor's in their 'Synthesys Life' product. The dataset starts in 1985 and is presented on a consistent basis year by year. Standard and Poor's has also tracked the history of each company including changes of name and changes of ownership so Synthesys Life can be used to produce data on entry and exit, merger and acquisition.

Other sources of data are the industry publications such as *Money Management*, *Pensions Management*, *Money£acts* and *Financial Adviser*. *Money Management* and *Pensions Management* conduct annual surveys of insurance companies to which many companies do respond. Some companies inevitably decline to provide data they consider to be commercially sensitive so the data does not cover the whole market. Nevertheless, these surveys do provide data which is complementary to the ABI and Synthesys Life databases. *Money£acts* collates data on the products on the market and presents the data in a tabulated form showing product features and charges to the customer (prices). The other publications also contain product announcements and surveys of products on the market. These publications together provide a comprehensive record of products on the market going back to the mid to late 1980s. Further details are shown in Appendix A.

The quantitative data from the three sources described above are not directly comparable as the data has sometimes been compiled using different reporting standards and each source does not cover quite the same population. It is not possible therefore to take quantitative data from one source to fill gaps in another. I have therefore analysed the data from each source separately and only brought the conclusions from each analysis together in the narrative. The tables and charts in which I present the data all show the source and the narrative explains how I have used the data.

The above sources provide data at company and industry level on:

- products on the market,
- differentiation between products,
- product charges or prices,
- consumer demand,
- distribution channels,
- producers' costs,
- the number of participants in the market and their market shares which enable concentration indices to be calculated,
- entries and exits, mergers and acquisitions.

The various dimensions of the market can therefore be assessed.

### **3.5 Assessing the impact of regulation on the market**

An examination of the data on the regulation of the UK retail pensions market shows a complex picture of government intervention in the market starting in the mid-1980s. In 1988 major government initiatives were implemented in relation to personal pensions and investor protection which gave rise to issues of competition policy. Since then there has been regular change to policy and to the regulations which implement policy. The market which exists today has evolved after 20 years of regular and intensive regulatory activity (which is continuing).

In some studies of regulation, researchers define regulatory *scope* and regulatory *change* variables to capture the nature of regulation and its rate of change (Reger *et al*, 1992). A quantitative model is then built to relate metrics of regulation to other variables. As will become apparent in chapter 4, the nature of the regulation of the UK retail pensions market and its rate of change cannot be modelled in any simple way. In this study, I do not attempt to develop any mathematical models relating metrics of regulation to metrics of market dimensions.

My starting premise for this study is that I am examining a complex system. The model shown in Figure 3.3 above assumes that each of the relationships between regulation, strategic decision-making and market dimensions are two way. The other premise on which this study is built is that history, and the sequence of events, is important. Government and regulators on the one hand and strategic managers on the other hand

make decisions on the basis of their current assessment of the environment and its future development. Decisions build on previous decisions, change builds upon change. My approach to this study is therefore a longitudinal one. I track events as they unfold and assess the trends in the various market dimensions, relating those trends to changes in regulation, and to other external factors (economic, social and technological change). I present an analytic narrative (Bates *et al*, 1998) which combines analytic tools from economics with narrative form from history and which pays close attention to context. I adopt an approach which is common in Industrial Organisation economics which is inclined towards explanations rich in both quantitative data and institutional detail (Scherer, 1980). I use the methods of historical analysis which enables the interpretation of structures not as determined by laws but as the result of decisions in past choice opportunities (Kieser, 1994).

In assessing the impact of regulation on the market, I refer to contemporaneous opinion in the industry journals and in the *Financial Times*. I do not rely solely on this opinion; rather I use it as the starting point for my own search for causes (Howell and Prevenier, 2001). I use contemporaneous opinion also as a check on my interpretations as these are inevitably based on a retrospective view. I also refer to the explanations given by strategic managers in companies for decisions taken, contained in annual reports and other communications to shareholders. Managers make decisions based upon their interpretation of events and their public statements reveal their reasoning (Barr, 1998).

In summary, I use different sources of evidence to present a picture of the way in which the UK retail pensions market has evolved under the influence of regulation and thereby I demonstrate how regulation has impacted the market. I also consider other explanations for the market changes observed, namely economic, social and technological change. The trend in some key economic indicators is shown in Appendix C.

### **3.6 The presentation of the empirical results**

From the various sources referred to above, I have compiled for this study a unique data set to enable the research question to be answered. I present the analysis of this data set in the following way:

Chapter 4 describes and analyses the regulations put in place since the mid-1980s in relation to the UK retail pensions market. The data is presented in the framework described in Section 3.3 above.

In Chapters 5 to 8 I present the data on the dimensions of the market identified in Section 3.4 above. I assess the impact of regulation on those market dimensions using the model in Figure 3.3 and the approach outlined in Section 3.5. For convenience, I have grouped some of the market dimensions together so that I assess the impact of regulation on

- the development of products, including differentiation, pricing and demand in Chapter 5;
- the evolution of distribution channels in Chapter 6;
- producers' costs in Chapter 7;
- industry concentration, including entry and exit, merger and acquisition, in Chapter 8.

In Chapter 9 I summarise, presenting a picture of the market in 2008 and an overall assessment of regulation as the determinant or as an antecedent of the market outcome observed. I then proceed to evaluate regulatory policy in terms of a set of criteria which I define and which relate back to the literature review in Chapter 2.

## **CHAPTER 4: THE REGULATION OF THE UK RETAIL PENSIONS MARKET**

### **4.1 Overview of this chapter**

In this chapter I describe in detail the regulation of the retail pensions market. I begin with a description of the regulations in place in the mid-1980s, the starting point of this study. I then present the framework for the analysis of regulation populated with data showing the changes in regulation made between the mid-1980s and 2007. Next, I describe the regulatory initiatives in more detail using the headings in the framework but setting out the subject matter in chronological order as far as possible to show the sequence of events. Finally, I summarise the regulations introduced to lead into the following chapters which address the question of the impact of these regulations on the evolution of the market.

The various sources of information to populate the framework are listed in Appendix A. In order to keep the text free of references and footnotes I do not show the specific source for each piece of evidence but some of these sources are shown in the completed framework which is in Appendix B.

### **4.2 Regulations in place in the mid-1980s - the starting point of the study**

#### *Regulations relating to pensions in the mid-1980s*

The regulations which referred specifically to pensions were mainly related to the question of tax liability. There were long standing tax regimes covering occupational pension schemes (OPSs) and retirement annuity contracts (RACs).

The rules on OPSs included the following elements:

- tax relief was granted on employees' contributions to *approved* schemes;
- tax charges were raised on employees in respect of employers' contributions to *unapproved* schemes;
- the income and gains arising on the funds within an approved scheme were exempt from tax;
- employers running approved schemes could contract out of the state earnings related pension scheme (SERPS) and thereby reduce liability to national insurance contributions (NICs).

For employees not in an OPS and for the self-employed:

- tax relief was granted on the individual's contributions to *approved* RACs;
- the income and gains arising on the funds within an approved RAC were exempt from tax.

*Approved* schemes and *approved* contracts were those approved by the Inland Revenue on the basis that they conformed to a number of statutory rules. These rules varied over the years but included:

- limits on the level of contributions;
- restrictions on the benefits payable;
- restrictions on the classes of investment permitted for the fund.

Failure to comply with these requirements could lead to the denial or suspension of approval and in turn to the removal of tax and NIC concessions.

#### *Regulations relating to investor protection in the mid-1980s*

Self-regulation was the primary means of control within the financial services industry. The culture at the top of the financial services industry in the early 1980s was one of "gentlemanly capitalism": public school, Oxbridge, dress codes, "my word is my bond". The institutions of the City (the Bank of England, the Stock Exchange, the big banks and insurance companies) played a leading role in regulating financial services with a light touch from government. This was supported by single capacity, or 'allowable business' rules, which restricted the business in which a company could engage. So insurance companies sold insurance and pensions, building societies sold short term savings products and mortgages, unit trust companies sold unit trusts and banks concentrated on banking. This restricted conflicts of interest but also restricted competition.

There were some statutory regulations. Insurance companies were regulated to some degree by the Insurance Companies Acts which provided for supervision by government to ensure the solvency of companies (so-called 'prudential' regulation). Insurance brokers had to register and to meet a level of competence but these rules only covered intermediaries calling themselves 'brokers' and not those calling themselves 'advisers'. There was little regulation of the marketing and sale of life and pensions products.

### *Regulations relating to competition in the mid-1980s*

The competition regulator was the Office of Fair Trading (OFT) which was charged with investigating restrictive practices which it could refer to the Restrictive Practices Court. The Director General of Fair Trading (DGFT) was Gordon Borrie who played a high profile role in relation to the reform of the Stock Exchange and who was to play a high profile role with his rulings on competition issues during the changes to investor protection regulations made in the late 1980s.

In the early 1980s the OFT began an investigation into restrictive practices in the Stock Exchange which led in July 1983 to an agreement between the Exchange and government (the Goodison-Parkinson agreement) whereby the Exchange agreed to reform its rules by 1986 and the government agreed to drop the OFT action. Single capacity, allowable business rules and fixed commissions were to disappear. The changes were made in the so-called "big bang" in October 1986.

The reform of the Stock Exchange set the agenda for a wider reform of financial services. Entry restrictions were removed across all markets and fixed commission agreements were outlawed. In particular, banks, building societies and unit trust companies were allowed to enter the developing pensions market.

### **4.3 Framework for analysis of regulation populated with data**

The completed framework populated with data is shown in Appendix B. An abridged version showing the data at the highest level is in Figure 4.1 below.

In Section 4.4 I present a narrative describing the regulations in more detail, setting the material out in chronological order as far as possible to show the sequence of events.

Figure 4.1: The framework for the analysis of regulation populated with data (abridged version – full version in Appendix B)

Subject matter	Rationale and objectives	People	Key dates
<b>Pensions policy</b>			
Pensions policy under the Conservative government 1983 - 1989 (no change 1990 to 1997)	<ul style="list-style-type: none"> <li>• Reduce cost of SERPS to the State</li> <li>• Provide portability of pensions and remove impediments to job mobility</li> <li>• Increase individual freedom and choice</li> </ul>	Fowler	Dec85 Government White Paper Apr87 Govt to promote PPs but not to control charges Jul88 Start of PPs
Pensions policy under the Labour government 1997 to date	<ul style="list-style-type: none"> <li>• Encouraging pension provision among lower-middle income earners</li> <li>• Reduce cost of personal pensions to consumers</li> <li>• Improve long term provision of pensions in the light of demographic change</li> <li>• Simplify tax rules to reduce costs</li> </ul>	Darling Brown Sandler Turner	Nov98 Stakeholder pensions to proceed Mar99 PIA's RU64 issued Jun99 Stakeholder pensions 1% price cap announced Apr01 Start of stakeholder pensions Apr06 'A' day for pensions simplification May06 Government White Paper on Turner recommendations Sep06 ABI response to White paper Dec 06 White paper on Turner rejecting ABI solution
<b>Investor protection policy</b>			
Investor protection policy 1981 - 1988	<ul style="list-style-type: none"> <li>• Respond to scandals</li> <li>• Rationalise the rules</li> <li>• Stop reasonable people being made fools of</li> </ul>	Gower	Jan85 Government White Paper Nov86 Financial Services Act Apr88 Start of new regulations
Changes to investor protection policy 1998 - 2004	<ul style="list-style-type: none"> <li>• Respond to GAR problem</li> <li>• Improve governance of WP funds</li> <li>• Calculate minimum capital levels on more rational basis</li> <li>• Embed fairness to customers in companies strategic plans and move to risk based approach to regulation</li> </ul>		Oct98 First indications of problem with GARs Jul00 Equitable loses in Court on GARs Dec00 Equitable closes to new business Aug03 New FSA rules on capital requirements Jul04 Revised rules for realistic balance sheets



Figure 4.1 continued

<b>Structure of regulatory institutions and rules</b>			
Structure of regulatory institutions and rules under the Conservative govt 1986 - 1994	<ul style="list-style-type: none"> <li>• Find compromise between self-regulation and statutory regulation</li> <li>• Continue existing attempts at self regulation of commission levels and avoid disclosure of commissions and charges to consumers</li> </ul>	Berrill Walker Large	Feb88 Lautro rules approved by SIB Jul94 PIA starts
Structure of regulatory institutions and rules under the Labour govt 1997 - 2001	<ul style="list-style-type: none"> <li>• Respond to failure of self-regulation</li> </ul>	Brown Darling Davies	Oct97 FSA starts Dec01 Merger of 10 agencies to form FSA operations
<b>Competition issues on the content of rules</b>			
MCA and disclosure of commission and charges	<ul style="list-style-type: none"> <li>• Stop regulators' rules restricting or distorting competition</li> <li>• Address conflicts of interest in the distribution system</li> </ul>	Borrie Carsberg	Jan90 MCA abolished, new disclosure rules in place Jan95 New disclosure rules implemented
Polarisation and depolarisation	<ul style="list-style-type: none"> <li>• Stop regulators' rules restricting or distorting competition</li> <li>• Address conflicts of interest in the distribution system</li> <li>• Reform the distribution system</li> </ul>	Davies McCarthy Tiner	Aug99 OFT report against polarisation (and new EU rules make polarisation unviable) Nov00 FSA announces way forward on polarisation June05 New rules come into force June06 Retail distribution review announced by FSA
<b>Interpretation and enforcement of the rules: 1987 - 2004</b>	<ul style="list-style-type: none"> <li>• Identify what "best advice" means in practice</li> <li>• Deal with the consequences of bad advice given to consumers</li> <li>• Improve the standard of competence and training of advisers</li> </ul>	Large Bowe Davies	Oct94 SIB plan for reviewing mis-selling cases Jul97 PIA deadline for FPC 2004 TSC hearings on mis-selling

#### **4.4 Pensions policy under the Conservative government 1983-1989**

##### *Subject matter*

The policy related to schemes organised by employers, to contracts entered into by individuals and to SERPS; and there were relationships between these three elements.

The legislation introduced had the following effects:

- Employers were required to allow employees ceasing employment before retirement to take the value of their pension rights with them when they left to reinvest elsewhere; and where the employee did not exercise this right, the employer had to protect the employee's rights including uprating benefits for inflation up to certain limits.
- Employers were no longer allowed to make membership of an OPS compulsory for their employees; employees had the right to opt out.
- Employees could opt out of SERPS to set up their own personal pension (PP) arrangements. As an incentive, they were given rebates of their NICs plus bonuses, to be invested in their own pension; and as a further incentive, the benefits of SERPS were reduced.
- A new tax regime was introduced to replace RACs with PP contracts. The tax breaks for PPs were similar to those of RACs (as described in Section 4.2 above) but they were available to new groups of people in addition to those who qualified under the old RAC rules. Employees leaving an employment and taking the value of their rights with them could put that value into a PP contract; those opting out of an OPS could now qualify; those opting out of SERPS came within this new regime; and employees could make their additional voluntary contributions (AVCs) to a PP instead of to their OPS.
- Funds accumulated in a PP contract must be used to purchase an annuity on retirement. Annuities are fully taxed as income.
- Insurance companies lost their monopoly of personal pension provision; banks, building societies and other financial institutions were allowed to compete for the new PP business.

##### *Rationale and objectives*

In the early 1980s the Conservative government was concerned about the cost of state pensions. It took the immediate step of changing the basic state pension, linking it to prices instead of earnings, but it remained concerned about the increasing cost of

SERPS. There was also a public debate about the problem for so called "early leavers", people leaving an employment who must leave behind their rights in an OPS. The government wanted to increase job mobility at a time of high unemployment but the lack of portability of pensions was perceived by some to be a problem. The government was also pursuing an ideological agenda emphasising free enterprise, private ownership and personal choice over control by the state and by large institutions (including occupational pension funds). It was argued that capital markets would work better if assets were owned by a large number of private investors rather than by several hundred giant institutions.

It was in this context that the government started a debate in 1983 about the future of SERPS, about how pensions could be made portable and about how people could be given more control over, and encouraged to become more involved in, their own pensions.

#### *Key people*

The government's initiative was led by Norman Fowler. His consultation document of July 1984 began "This Government believes in people having a choice. This paper is about one important aspect of that choice – giving people more choice in the way they save for their old age."

#### *Key dates*

The debate started in earnest in May 1983 with simultaneous publications by the government and by a Conservative think tank, the Centre for Policy Studies. The government was reported in February 1985 as intending to proceed and it issued detailed proposals for personal pensions in June and December 1985. The government aggressively promoted its policy in the media in the early part of 1988 in time for formal launch of the new PP contracts from 1 July 1988. Government adverts showed people in handcuffs, chains and straight-jackets releasing themselves from the grip of both the state and their pension scheme institutions.

#### *Contemporaneous observations and perceptions*

There was general support for the government's policy of providing early leavers either a transfer value or protection of their rights on termination of their employment. The further proposals, particularly the right to opt out of an OPS and the new concept of personal pensions were much more contentious. Those who had a vested interest in

the existing system such as the National Association of Pension Funds and the traditional life assurance companies which provided services to OPSs spoke out against the government's policy. Those who had an interest in the new system were split; the newer linked-life assurance companies spoke in favour but the Building Societies Association was against. For the business community, the Institute of Directors was in favour but the CBI thought that the policy had not been thought through. The trade unions and the Consumer Association were opposed to the new policy. The Institute of Actuaries and the Society of Pension Consultants were against, as were the financial journalists at the Financial Times.

A number of risks to employees and personal pension savers were clearly identified in the discourse:

- Employees would be persuaded by aggressive sales people on commission to opt out of their OPS into a PP, against their interests.
- PP plans presented substantial financial risks to employees compared with the guaranteed benefits of final salary OPSs.
- Opting out of SERPS would only benefit younger people; the cut off date depended on the assumptions about future investment returns, but even at the most optimistic projections opting out would only benefit women under 30 and men below the age of 37.
- People in PP plans would suffer much larger administrative costs than those in OPSs. Life companies were seen to make unreasonably high administration charges.

Among observers, there was a feeling that the government was concentrating on the advantages of PP schemes and failing to address the disadvantages; and that the risks of opting out and running a PP scheme were not adequately spelled out to consumers. The government's adverts were thought to be misleading. The government rejected calls for controls on PP contract charges but did however acknowledge the investor protection issue and linked the introduction of PPs to new investor protection rules outlined in Section 4.5 below.

#### **4.5 Investor protection policy 1981-1988**

##### *Subject matter*

A new regime for investor protection was introduced by the Financial Services Act 1986 which took effect in April 1988. Under this regime all companies engaged in investment business (including personal pensions business) had to be authorised by a regulator and had to comply with the rules set by that regulator. Those rules included in particular 'conduct of business' rules to protect investors. The basic principles of the conduct of business rules were that sellers of investment products must 'know their customer', offer 'best advice' and advise customers to purchase only products 'suitable' for their needs. The new law therefore required sellers of investment products to exercise a duty of care towards investors.

##### *Rationale and objectives*

The new regime was a response initially to a number of scandals in which investors lost money. Later, after the government decided to open up the financial markets to competition, the new regime was intended to provide a new framework to support the new competitive markets and to maintain investor confidence in the financial services industry.

The objective of the new regime was to rationalise firstly the existing mix of statutory regulation and self-regulation and secondly the differences of treatment of similar investments such as unit trusts and life assurance policies.

The rationale for the conduct of business rules was that without such rules investors would be at risk from

- the loss of their investments through fraud or incompetence of their product providers or distributors;
- being persuaded by aggressive sales people into investing in products that were not suitable for their needs.

The objective of the new rules was to provide regulation that was 'no greater than is necessary to protect reasonable people from being made fools of' by financial institutions.

### *Key people*

The architect of the new regime was Professor L C B Gower. However, at a key stage in Gower's review the Governor of the Bank of England, Robin Leigh Pemberton, stepped in and formed an advisory group of senior city figures to produce the final blueprint for the regulatory structure which was approved by government.

### *Key dates*

Gower was commissioned by the government in 1981 to investigate the question of investor protection. Gower issued a discussion document in January 1982 and a report in January 1984. In January 1985 government issued a White Paper setting out its proposals which after much debate and change in Parliament became law in the Financial Services Act 1986. This took effect in April 1988.

### *Contemporaneous observations and perceptions*

Gower's review gave rise to a major debate within the industry. Initially, many sectors of the investment industry were against Gower's proposals and against change. But the atmosphere was changed by the Goodison-Parkinson agreement of July 1983 and by a number of new scandals. Most of the industry acquiesced with the government's view that the process of opening the industry to increased competition was decisive and that the existing informal self-regulatory system should be replaced by a more formal structure.

Most of the debate about the new regime concerned the structure of the regulatory institutions and the detail of the rules, which are described in Sections 4.6 and 4.7 below. There was some comment about the general principles of Gower's approach. Writers from the free market think tank The Institute of Economic Affairs thought that Gower's proposals were a retrograde step. They criticised him particularly for failing to understand the economics of the financial services industry and for failing to undertake a cost benefit analysis of the proposed rules. A writer in *The Modern Law Review* criticised Gower for focusing on bureaucratic rationalisation of the rules at the expense of a thoroughgoing examination of the purposes, objects and desirability of regulation, its economic cost and the likelihood of the proposed regulatory apparatus actually achieving its objectives.

#### **4.6 Structure of the regulatory institutions and rules under the Conservative government 1986 - 1994**

##### *Subject matter*

The basic concept of the new investor protection regime was self-regulation under a statutory framework. The Act set up a Securities and Investments Board (SIB) whose members were appointed by government but which was otherwise independent of government. The Department of Trade and Industry (DTI) delegated statutory powers to the SIB which in turn authorised Self Regulatory Organisations (SROs) to regulate firms. All firms engaging in investment business had to be authorised to do business and be supervised by an SRO (or by the SIB directly). The life and pensions companies joined the SRO called the 'Life Assurance and Unit Trust Regulatory Organisation' (Lautro). Intermediaries and brokers joined the 'Financial Intermediaries, Managers and Brokers Regulatory Association' (Fimbra). Later Lautro and Fimbra merged to form the 'Personal Investment Authority' (PIA).

The legislation set out a framework for conduct of business rules but it was for the SIB and the SROs to create detailed rules. The SIB submitted its rules to the DTI to obtain delegation of statutory powers; and the SROs submitted their rules to the SIB to obtain recognition. The rules of an SRO had to provide investor protection at least equivalent to that provided by the SIB rules.

The SIB rules, along with the Lautro and Fimbra rules, introduced a concept known as 'polarisation' for the retail distribution of investment products. A seller of investments (including personal pensions) had to be either an independent financial adviser (IFA) offering advice on all products on the market, or a representative of one producer offering advice only on that producer's products. Representatives could be either members of the producer's own direct sales force (DSF) or tied agents such as banks and buildings societies engaged to sell that producer's products. It was not permitted for any seller to offer to customers products from a limited range (or panel) of producers.

The regulators' rules also required IFAs to disclose to their clients the specific amount of commission receivable from the producer with whom the client's business was placed. But this was not required where the producer in question subscribed to a maximum commission agreement (MCA) supervised by Lautro. In this case the IFAs was required to disclose no more than that the commission receivable was within the

maximum; and the IFA was not obliged to disclose what that maximum was unless specifically asked by the customer. The rules made no provision for disclosure of expenses other than those attributable to IFA's commission. These rules were however regularly amended under pressure from the OFT, which is discussed below in Section 4.7 below.

### *Rationale and objectives*

The concept of self-regulation under a statutory framework was a compromise between the financial institutions and the government. The City was determined to preserve its independence from the state but government thought that there was a need for statutory authority behind the investor protection regime. Practitioners were to write their own rules but within a legislative framework.

The polarisation, MCA and disclosure rules were part of the detailed conduct of business rules. The origin of these rules is complex, going back into the history of the life and pensions industry. For many years the industry had operated, through representative bodies, an MCA to avoid commission wars but problems started in the early 1980s. Until then the MCA only applied to independent intermediaries, and not to producers' own sales people who were also paid wholly or mainly by commission. These sales people started to represent themselves as independent to get the best of both worlds: uncontrolled commission and the appearance of independence to their clients. The industry representative bodies tried to tighten up the rules by requiring these sales people to disclose to their clients their ties to producers but the agreement broke down as producers withdrew from the agreement to gain competitive advantage.

The industry bodies then approached government for support. Government declined to legislate to control commission payments but agreed to use its powers to require disclosure of commission. This was then picked up by the new regulators who regarded commission control and polarisation as the centre pieces of the new regime. Disclosure of commission was feared by producers as it might discourage potential customers, so the regulators used the threat of disclosure to persuade producers to join and stick to an MCA. In addition to the MCA rules, advisers and sales people were required to disclose their status to their customers and the polarisation rule was introduced ostensibly to simplify that status for the benefit of customers. Customers would know whether their adviser was independent or tied to just one producer. There was no in-between for customers to worry about.



This package of measures was presented as being for the purpose of protecting investors. This was its stated rationale. The objective of the rules was stated to be to prevent an escalation in marketing costs which would eventually be borne by investors and to prevent investors from being misled about the interests of advisers and sales people. But these measures represented a continuation of the policy adopted by the industry's representative bodies.

#### *Key people*

The first chairman of the SIB was Kenneth Berrill but his contract was not renewed. He was replaced by David Walker, a director from the Bank of England. David Walker stood down at the end of his term and was replaced by Andrew Large.

#### *Key dates*

The SIB began issuing draft rules in March 1986 and it was endowed with statutory powers in May 1987. Final rules were published in October 1987. Lautro and Fimbra then finalised their rules and these bodies were recognised prior to the regime coming into force in April 1988. The SIB began the task of rewriting its rules immediately in response to criticism of their complexity and lack of clarity. In 1990 the SIB issued 10 principles and 40 core rules and in 1993 restated the objectives of regulation. In March 1992 it was announced that Lautro and Fimbra were to merge to form the PIA, which became the regulator from July 1994.

#### *Contemporaneous observations and perceptions*

During the whole of the period 1986 - 1995, a fierce debate took place about the regulatory rules on polarisation, the MCA and the disclosure requirements. The polarisation rule was opposed by the banks and building societies who wanted to use their branch networks as investment supermarkets, offering a range of products from different producers. This strategy was prohibited by the polarisation rules. The polarisation rule, and also the MCA and disclosure rules came under criticism from the OFT, from consumer groups and from observers (see section 4.7 below).

Apart from these substantive issues, there was widespread criticism of the SIB and particularly of the first chairman Kenneth Berrill, who was seen by financial institutions as having a rigid and bureaucratic approach to rule making. Concern was expressed by City figures that the regime which was implemented was more statutory and less self-

regulatory than expected. The regulations introduced were criticised as being out of proportion to the scale of the scandals which had given rise to concerns about investor protection.

In addition to those issues, there were other tensions in the system stemming from the relationship between the SIB and the SROs, and the relationship between the SROs. There were many arguments about the distribution of power and responsibility between the SIB, Lautro and Fimbra. This also fragmented the industry, with a group of life assurance companies led by the CEO of the Prudential calling for an end to self regulation. Financial journalists commented on the complex politics within the regulatory system and the compromises required to keep vested interests on board. Meanwhile, Fimbra was in constant financial difficulties as there was a limit to the fees it could raise from its members most of whom were small businesses. The merger of Lautro and Fimbra was a highly contentious issue with many large institutions being very slow to announce their intention to join the new PIA. The PIA did eventually get underway in July 1994, but the arguments never went away and was finally settled by the incoming Labour government in 1997 (see Section 4.11 below).

#### **4.7 Competition issues on the content of the rules: the MCA and disclosure**

##### *Subject matter*

The Director General of Fair Trading (DGFT) was required by the Financial Services Act to examine the rules of the SIB and the SROs to see if any of those rules significantly restricted, distorted or prevented competition. Although the DTI had delegated its responsibilities for investor protection under the Act to the SIB, it retained control of competition policy through the agency of the DGFT and his office, the OFT. The DGFT was required to produce reports to the DTI and subsequently to Her Majesty's Treasury (HMT) after the responsibility for competition policy was transferred between those departments.

The OFT engaged in dialogue with the SIB and the SROs prior to the issue of rules by the regulators but this did not give rise to any consensus on the issues of the MCA, on disclosure to customers of product details and charges and on polarisation. The DGFT issued a number of critical reports on the regulatory rules which he felt did restrict and distort competition.

The DGFT first of all strongly criticised the MCA (and the associated limited disclosure rules) as being an anti-competitive. Similar criticism came from the EU commission responsible for competition policy. As a result the MCA was abandoned.

The DGFT also criticised the disclosure rules more generally and this issue passed to and fro several times between the OFT, the DTI/HMT and the regulators before being finally settled. The dispute was about the extent and nature of the information to be disclosed by advisers and sales people to customers about the product and its charges prior to sale. From an initial position of practically no disclosure the regulators were forced to move in stages up to full disclosure of product details and charges.

The DGFT expressed concern also about the polarisation rule but was over-ruled by the DTI. Although this issue did not die down, it did not feature again in a formal report by the DGFT until 1999 (see Section 4.12 below).

#### *Rationale and objectives*

The risk of self-regulation creating restrictive practices in the financial services industry was well known and indeed this issue was the reason for the dispute between the OFT and the Stock Exchange which was settled by the Goodison-Parkinson agreement. The Financial Services Act therefore required the OFT to scrutinise new regulations, although the decision-making power rested with government ministers. The Act did allow ministers some discretion to decide whether restrictions were necessary for the protection of investors. The minister did not need to act if satisfied that the effect of the rules on competition was not greater than necessary for the protection of investors.

In relation to the regulators' rules for the MCA and the limited disclosure of charges, the DGFT argued that with these rules there were no market forces which would serve to exert a downward pressure on the level of commission, and therefore the MCA was likely in practice to serve as a price fixing agreement. More generally, the DGFT argued that disclosure of product details and charges was required to create competition on price, on the quality of the product and on the quality of advice. The investor would need information to judge the quality of the product, to be able to compare alternatives before a contract is made and to be able to compare the services offered by IFAs with those offered by tied agents. Without such disclosure, competition between the two distribution channels was likely to be distorted.

The DGFT also commented on the conflict of interests facing advisers and sales people: they were required to act in the best interests of the customer but were remunerated by commission only on successful sales. He noted also that the remuneration system encouraged producers to compete on the basis of the level of income offered to intermediaries rather than on the quality and price of the product itself. For these reasons, complete transparency was required.

In relation to polarisation, the DGFT argued that this rule imposed much more stringent and costly requirements on independent intermediaries than on representatives; and that this rule restricted the options open to banks and building societies.

The DGFT's reports reveal a difference of opinion with the regulators on the purpose and nature of the commission paid to IFAs. The DGFT took the view that the IFA was the customer's agent and that the commission represented an indirect payment for the advice given. The customer was therefore entitled to information about the commission which he/she indirectly paid. Also, the DGFT thought that there was a problem in that the level of commission related to the level of the investment actually made and not to the level of service offered to the client. There was an element of cross-subsidisation between clients who took up much of the advisers time (including those who did not proceed with a purchase) and those who took up little time. The regulators thought that the commission was a reward from the producers for the introduction of business and that the advice to the client was free. This argument reflects the ambiguous position of the IFA and the conflicts of interest to which the IFA is subject.

#### *Key people*

When the Financial Services Act became law in 1986, the DGFT was Gordon Borrie. When he retired he was succeeded by Bryan Carsberg. A number of ministers at the DTI and then HMT were engaged in making decisions but generally they supported the DGFT's position.

#### *Key dates*

The DGFT reported in March 1987 and March 1988 on the SIB's and Lautro's rules. Lautro announced the withdrawal of the MCA in May 1988, effective from January 1990, at which time new disclosure rules would also come into force after consultation on those rules. In April 1990, the DGFT again reported that while the new rules increased disclosure, they fell short of the full disclosure required to avoid competition

being distorted. In April 1991 the SIB announced a full review of retail investment regulation including the disclosure rules and the polarisation rule. More consultations followed and new disclosure rules were announced in July 1992. The polarisation rule was unchanged. The DGFT again reported in March 1993 that these new disclosure rules still did not go far enough. The matter was finally settled by a decision of the Chancellor of the Exchequer in July 1993, with new rules coming into force in January 1995 requiring full disclosure.

#### *Contemporaneous observations and perceptions*

The issue about the disclosure of product details and charges was a straight fight between the industry and its regulators in one corner and the OFT, government ministers, consumer bodies and financial journalists in the other corner. The industry eventually gave way to the inevitable but held out for 8 years from 1987 when the issue first arose until 1995 when the full disclosure rules came into effect.

The resolution of the disclosure issue did not however deal with what many observers saw as the anomalous position of IFAs and the distorting effects of polarisation. These other issues were to arise again in 1999, which will be described in Section 4.12 below.

### **4.8 Interpretation and enforcement of the rules 1987-2004**

#### *Subject matter*

The regulators' conduct of business rules which came into effect in 1988 required sellers of investment products to "know their customer", to offer "best advice" and to recommend only products which were "suitable" for the customer. There was initially no clear guidance about what this meant in practice and Fimbra said that the issue of "best advice" was grey and uncodifiable.

Also both Lautro and Fimbra were new organisations in 1988. They had to recruit and train their own staff, to write and rewrite their rules in response to changes in SIB rules and challenges from the OFT, and to set up their enforcement systems and procedures. Fimbra ran into financial difficulties almost from the start which inevitably affected its operational effectiveness. As a result, the practical application and enforcement of the rules by Lautro and Fimbra got off to a slow start.

For their part, producers and their tied agents and IFAs all had to train their staff in the new rules and to set up their own governance procedures while at the same time

gearing up to create competitive advantage in the new personal pensions market. Producers and distributors saw the latter task as more important.

It was four years after the start of the new regime before the regulators discovered a major problem, which became known as the "personal pension mis-selling scandal". Individuals had been advised by sales people and advisers to opt out of (or not to join) their occupational pension schemes (OPS) and to take out inferior personal pension (PP) plans. In addition, some of those leaving an employment had transferred the value of their rights into a PP when they may have been better off leaving their rights with their old scheme or transferring the value to their new employer's scheme.

This problem affected several hundred thousand people who would suffer reduced retirement benefits as a result of bad advice. The regulators took some immediate action issuing new guidance on the conduct of business rules and initiating reviews to ascertain the extent of the problem. But it was still some time before the regulators began detailed inspections of firms and taking enforcement action for breaches of the rules; and meanwhile mis-selling continued.

A further two years passed before the regulators required firms to review all their sales which involved opt outs, non-joiners and transfers; and later the review was extended to the sale of free standing additional voluntary contributions (AVC) products where the customer had an opportunity to contribute to an AVC scheme run by their employer. Where customers were badly advised and mis-sold personal pensions, they were to be compensated. But again the enforcement of this requirement was slow. The scandal of mis-selling turned into the scandal of regulatory failure: the PIA came under increasing public criticism for failing to make progress with the review.

It took eight years to complete the review by which time 1.7 million consumers had had their cases reviewed and had received compensation amounting to £11.8 billion. In addition firms had incurred administrative costs estimated at £2 billion.

As the review was being undertaken, the regulators issued new rules to improve the recruitment and training of advisers and sales people, all of whom had to meet a minimum standard in an examination. The PIA also required producers to provide details of policy lapse rates, the percentage of policies sold where policyholders cease making payments. High lapse rates were seen as a good indicator of mis-selling. Tables showing the results at company level were published.

### *Rationale and objectives*

When the changes to pensions policy introduced by Fowler (described in section 4.4 above) were being debated, many observers identified the risk that people would be persuaded by aggressive sales people on commission to opt out of their OPS into a PP against their interests. The government's response was to tie the introduction of PPs to the introduction of the investor protection regime. But in practice the implementation of PPs proceeded much more rapidly, backed by aggressive government promotion, than the implementation of the investor protection regime. The regulators therefore had a great deal of catching up and repair work to do, under the glare of adverse publicity.

### *Key people*

The burden of dealing with the mis-selling scandal initially fell upon the SIB Chairman Andrew Large and the PIA CEO Colette Bowe. Labour government ministers intervened in 1997 after their election victory to respond to the criticism of the regulators for the lack of progress with the review. The responsibility then passed to the new chairman of the FSA, Howard Davies who saw the review through to its conclusion.

### *Key dates*

The mis-selling of personal pensions occurred largely in the period 1988 – 1992, but some mis-selling continued after that period in view of the lack of effective enforcement of the rules. Firm action from the regulators started in 1994 with increased enforcement activity and the requirement to review all sales up to 1994. The review finally came to an end in 2002 but by that time a further scandal had emerged, the mis-selling of endowment mortgages. Adverse publicity therefore continued for some time after the end of the pension mis-selling review particularly in 2004 with the publication of a report by the House of Commons Treasury Committee entitled "Restoring confidence in long term savings".

A key date in the midst of this activity was the deadline of July 1997 set by the PIA for all sales people and IFAs to obtain the Financial Planning Certificate, which set a minimum standard for knowledge and competence.

### *Contemporaneous observations and perceptions*

During the review process, a steady stream of reports appeared in the national and specialist press as producers and IFAs were fined, required to suspend and retrain their staff, change their procedures, and improve the handling of the review cases. This criticism affected the whole industry, from the smallest IFA to the largest pension providers. The Prudential was particularly affected as it initially took a firm line against the regulators, denying any mis-selling, but it was later identified as one of the main offenders.

The regulators themselves, the SIB and PIA, also came under regular and intense criticism for their failure to progress the review, and this continued until those bodies were taken over by the newly formed FSA.

At one point in the review process, in 1998, the government started a television campaign featuring an ostrich to encourage victims of mis-selling to claim compensation. The irony of the previous government's campaign a decade earlier encouraging people to take out personal pensions was not lost on the journalists.

As the size of the compensation bill became clear, pension providers came under further criticism for the way in which they passed on all or most of this bill to the general body of policyholders. Mutual companies which were owned by their policyholders had no choice but to charge the compensation to their life funds, so it was policyholders in general that funded the compensation to the mis-selling victims. But proprietary companies like Prudential passed on 90% of the bill to the general body of policyholders in the form of a charge on their life fund. The argument was that the profits and losses in the life fund were shared 90% by the policyholders and 10% by the shareholders. This gave rise to the cry in the press that innocent policyholders were being penalised for the errant behaviour of sales people.

## **4.9 Pensions policy under the Labour Government 1997 to date**

### *Subject matter*

Since it was elected in 1997, the Labour government has not changed the basic principles of the personal pension (PP) policy of the previous government but it has introduced a new PP product called the 'stakeholder pension'. These pensions are to be provided by a partnership of employers and financial services companies. Employers which do not have existing pension arrangements for their employees are



required to set up arrangements with a financial institution to enable their employees to acquire a stakeholder pension. Stakeholder pensions (SHPs) enjoy similar tax and NIC breaks to existing PP products, but in addition they have an annual charge cap initially set at 1% of the fund value (increased in April 2005), and simplified rules to reduce the cost of compliance with the investor protection regime. SHPs were particularly targeted at the lower to middle income earners (£10,000 to £20,000 per annum) who were less likely to have an existing pension arrangement and who could not afford the PP products on the market. The self-employed could also buy stakeholder pensions and those not earning at all could contribute up to £3,600 pa.

The PIA (then part of the FSA) responded to this initiative by issuing advice (in Regulatory Update 64 or RU64) to firms on the selling of PP products in advance of SHPs becoming available. Sellers were required to have regard to the fact that it may be advantageous for a client to switch to a SHP when they became available. Sellers were required therefore to take into account, in recommending a product to the customer in advance of the availability of SHPs, any penalties their customers might incur from switching from that product into a SHP. When SHPs did become available, sellers were required to explain any recommendation to buy a product with higher charges than the stakeholder maximum of 1%.

The government followed up the introduction of SHPs by commissioning Ron Sandler to look more generally at the retail savings market and to examine whether the stakeholder concept could be more widely applied. In his report Sandler commented on the inherent tendency towards complexity in the savings market and the consequent need to regulate the sales process, which in turn makes it uneconomic for the industry to adequately serve lower income consumers. Sandler recommended the introduction of a suite of simplified stakeholder savings products with capped charges and a simplified investor protection regime. The government accepted his recommendations but the FSA was concerned about the implications for investor protection and it took some years for this issue to be resolved.

The government also commissioned Adair Turner to look in much more detail at the future for pension provision. Turner recommended that the government set up a new national pension savings scheme into which employees would be automatically enrolled if they were not in an existing scheme. Employers and employees will be required to contribute to this new scheme but employees can opt out. The self-

employed can opt in. The government accepted these recommendations and began the planning for the implementation of the scheme.

The government also introduced a major simplification of the tax rules relating to pensions ('Pensions Simplification') which included some important changes for pension savers. The basis of restriction of contributions was changed: under the new rules a saver can contribute up to 100% of annual income within a lifetime limit. The choice of permitted investments was widened further and a new type of annuity was permitted for those over the age of 75.

### *Rationale and objectives*

The government was concerned about the lack of pension provision among the lower to middle income group and about the cost of existing PP products on the market, which was increasingly putting these products out of the reach of this income group. The government recognised that the cost of PP products was partly due to the demands of the investor protection regime, so it aimed to keep the product as simple as possible. It also felt that the charges levied by PP providers were too high and it therefore introduced a price cap for the new stakeholder product.

The PIA's response to the government's announcement of stakeholder pensions was in one sense simply a re-statement of the existing conduct of business rules. Sellers were obliged to offer 'best advice' and to recommend only 'suitable' products. Sellers must take into account the costs to the client, and should not recommend the purchase of a product if there were a comparable product with lower charges. In another sense however, the government's announcement and the regulator's advice worked together to make products with charges higher than 1% more difficult to market. One of the government's implicit objectives therefore was to put pressure on PP providers to reduce their charges across the range of PP products.

The objective of reducing costs to savers and of tackling the complexity of the investor protection regime was more explicit in the Sandler report and in the government's response to it. Government has attempted to move to some degree from conduct of business regulation to product regulation. This created a problem for the FSA which has a statutory duty to protect investors and whose regime is built on conduct of business rules. It took some time to find a solution to the inherent conflict between the government approach and the FSA approach.

The reason behind the setting up of the Turner commission was the growing concerns about the consequences of demographic change (increasing longevity and the falling birth rate) and about how the cost of future pension provision was to be met.

The objective of pensions simplification was to rationalise a number of existing tax regimes to provide a single set of rules which was easier and cheaper for pension providers to administer and advisers to advise upon. This in turn was expected to reduce costs to pension savers.

#### *Key people*

The government's stakeholder pension policy was driven forward by Alistair Darling. Sandler and Turner both reported to the Gordon Brown, who was also responsible for pension simplification. Howard Davies, chairman of the FSA, held the line on the conduct of business rules.

#### *Key dates*

The commitment to introduce stakeholder pensions was in the Labour manifesto in 1997. The government announced its intention to proceed in November 1998. In March 1999 the PIA issued its regulatory update (RU64) advising firms on the selling of PP products in advance of the launch of stakeholder products, which became available in April 2001.

Sandler reported in July 2002 but it was April 2005 before the new products became available as there was a long debate between government and the FSA about the nature of the investor protection regime.

Turner started work in December 2002, issuing his first report in October 2004 and a final report in November 2005. Government issued two white papers in 2006, inviting comments on proposals for the new scheme. The ABI, on behalf of the life and pensions industry put in its own proposals but these were rejected by the government. The NAPF also put in its proposals but these were likewise rejected. The government took the first legislative steps to set up the scheme in 2007, with a view to implementation, perhaps in 2012.

Pension simplification took effect in April 2006.

### *Contemporaneous observations and perceptions*

The debate on the government's various initiatives centred on the issue of the merits of product regulation and price control on the one hand and conduct of business regulation on the other hand. The Labour government inherited the Conservative government's investor protection regime, which it institutionalised in a new mega-agency, the FSA (see Section 4.11 below) but clearly this conflicted with its other policy aims of promoting pension saving among the lower paid. The conflict delayed the introduction of stakeholder products and this conflict remains unresolved.

#### **4.10 Changes to investor protection policy 1998 - 2004**

##### *Subject matter*

The FSA issued a set of new rules relating to the management of with-profits (WP) funds and the valuation of liabilities for the purposes of calculating the minimum level of capital required to be held by companies. The new rules contained the following elements:

- Companies must issue a document 'Principles and Practices of Financial Management' setting out for policyholders how they exercise their discretion in the management of WP funds.
- Companies must make provision for policyholders 'reasonable expectations' in relation discretionary bonuses and benefits.
- Calculation of the minimum capital requirement should be based upon 'realistic balance sheets' rather than mechanistic rules.

The FSA began a new initiative 'TCF' – Treat Customers Fairly. This initiative did not involve any fundamentally new rules but consisted of a new approach to the application of the conduct of business rules. When assessing a company's compliance with those rules, the FSA would take into account the approach the company adopted to its customers, and to whether the company had built the idea of treating customers fairly into its corporate strategy.

##### *Rationale and objectives*

In changing the rules on minimum capital, the FSA was responding to a problem arising from a 'Guaranteed Annuity Rate' (GAR) offered by some companies guaranteeing a minimum annuity rate to policyholders when they took their pensions. In the era of high interest rates the market rate was higher than the GAR; but as interest

rates fell in the late 1990s, the GARs clicked in and companies found themselves with a liability for which they had not provided. One company, Equitable Life, had pursued a policy of distributing almost all of its profits to policyholders and had insufficient funds to meet GAR liabilities. It had to close to new business. Other companies were more fortunate in holding sufficient undistributed profits.

The changes to the rules also took place against the background of wider concerns about corporate governance and the accuracy of balance sheets. There was also an issue arising from the bear market of 2000-2, where companies were forced to sell equities in a falling market to maintain their required solvency levels. It was felt that a more realistic method of calculating liabilities for the future would avoid the need for such forced sales.

The TCF initiative is an attempt by the FSA to get the idea of fairness to customers embedded in the strategic thinking of firms and to ensure that firms embrace the spirit of the rules rather than just meet the letter of the law. This initiative was also part of the FSA's attempt to move to a more risk based approach to regulation.

#### *Key people*

The changes to the solvency rules were led by FSA officials.

The TCF initiative was very much owned by the leadership of the FSA, and particularly by Callum MaCarthy and John Tiner who actively promoted it in speeches at industry conferences.

#### *Key dates*

The GAR problem first emerged in 1998. Equitable Life closed for new business in December 2000 following the loss of its high profile legal action and its failure to find a buyer. The new solvency rules took effect in stages in 2003 and 2004, but with some pragmatic changes to the previous rules prior to the new rules coming into force.

The TCF initiative was launched in 2001.

#### *Contemporaneous observations and perceptions*

Most of the public debate centred on the Equitable Life affair: its legal action which ultimately failed in the House of Lords, the various enquiries into the collapse of the

company, and the disputes between the Equitable Life management and groups of policyholders.

The changes to the solvency rules caught Standard Life and forced it to abandon its cherished mutuality. This made headlines at the time but the attention soon shifted to the floatation itself.

There was widespread support for the changes to the solvency rules although there were some complaints that the new rules increased the level of capital required and therefore the cost of capital to firms.

The TCF initiative has featured in the national and specialist press but generally it has been low profile except when linked to the various mis-selling scandals.

#### **4.11 Structure of regulatory institutions and rules under the Labour government 1997-2001**

##### *Subject matter*

In opposition, the Labour party had committed itself to ending self-regulation. On taking office the Labour government acted quickly to announce its intention of setting up a new statutory regulator (the Financial Services Authority) to take over the existing regulatory agencies and also banking supervision from the Bank of England.

The new authority was given a set of statutory objectives which were:

- to maintain confidence in the financial system;
- to promote public understanding of the financial system;
- to secure the appropriate degree of protection for consumers;
- to reduce financial crime.

These objectives do not include the duty to promote competition. But the FSA is obliged when achieving its objectives to ensure that it does not impede or distort competition unnecessarily. In this respect competition policy was unchanged and the Director General of Fair Trading retained his responsibilities under the new legislation.

##### *Rationale and objectives*

Self-regulation and the two tier system of the SIB and the SROs were widely regarded as failures. The rationale for full statutory regulation was therefore clear. Less clear however was the rationale for one super regulator including banking supervision as

opposed, for example, to different regulatory agencies for wholesale markets and retail markets.

The rationale for statutory objectives simply followed that for a statutory authority. Not including competition policy in the statutory objectives and giving it secondary status represented a continuation of previous policy, but also implied that the FSA was to achieve its objectives primarily by direct intervention rather than by promoting increased competition.

#### *Key people*

The changes were led by Gordon Brown and Alistair Darling at the Treasury. Andrew Large stepped down as chairman of the SIB and Howard Davies took over to lead the creation of the new agency.

#### *Key dates*

The announcement of the formation of the FSA was made in May 1997, just after Labour's election victory. Merging the operations took place over several years, being completed in December 2001 after the new authority had been given statutory force by the Financial Services and Markets Act 2000.

#### *Contemporaneous observations and perceptions*

At the time of the announcement of the changes to the structure of regulation some commentators criticised the decision to create such a large agency as the FSA. There were several voices arguing for a split between the professional markets and the retail markets, or between securing systemic stability and investor protection. Later there were reports of tensions between the Treasury and the FSA and between the FSA and the OFT. More recently the role of the FSA in relation to the Treasury and the Bank of England has been brought into sharp relief by the Northern Rock affair.

### **4.12 Competition issues on the content of the rules: polarisation and depolarisation**

#### *Subject matter*

The FSA abolished the polarisation rule and put in place a new set of rules to govern the distribution of retail investment products. The abolition of polarisation allowed distributors to enter into 'multi-ties', arrangements with a number of product providers. Distributors could still if they wished tie with a single provider, or could offer advice on

all the products on the market. The abolition of polarisation was accompanied by new rules which

- increased the disclosure to the customer in respect of the status of the distributor and the nature of the advice provided,
- provided clear accountability for compliance with the conduct of business rules in the new context,
- required advisers wishing to call themselves independent to offer their clients the option of paying for advice by fee instead of the adviser receiving commissions from the provider.

After the changes to the rules took effect, the FSA announced a more far reaching review of retail distribution which, at the time of writing, is still ongoing.

#### *Rationale and objectives*

The DGFT issued a report criticising the polarisation rule but it was impending EU regulations that made the continuation of this rule impossible. The FSA also undertook research into the existing distribution systems in operation finding that:

- competition currently operates, via the commission system, to secure IFA distribution power for product providers, which is detrimental to consumers,
- the remuneration system for both tied advisers and IFAs give an incentive to sell a product and in some cases that product may be unsuitable for the consumer,
- the bundling together of the cost of advice and the cost of the product prevents consumers gaining a proper understanding of the role of advice and its cost,
- the regulatory system itself may put impediments in the way of consumers who might be minded to shop around.

The FSA's proposals, which went further than the OFT recommendations, were intended to address these issues and initially included the requirement that independent advisers should be remunerated only by the client. In the event however the FSA withdrew this latter rule following representations from IFAs, requiring that those wishing to call themselves independent only had to offer the opportunity to the client to pay by fee.

Another reason for the change in the rules may be inferred from the fact that the polarisation rules were initially relaxed for stakeholder pension products in time for their



launch in April 2001. The government was at this time seeking to promote its new pensions product and wanted to remove perceived impediments to its success.

After the full abolition of polarisation and after receiving evidence and representations to the effect that the new rules were not working well, the FSA announced a new wide ranging *Retail Distribution Review*. In a speech to industry representatives in September 2006 FSA chairman Callum McCarthy declared the present business model to be bust. The implications of further EU directives were a factor in the FSAs decision to launch yet another review.

#### *Key people*

The issues of polarisation and depolarisation were very high profile and were led by FSA chairmen Howard Davies and then Callum McCarthy and CEO John Tiner.

#### *Key dates*

The DGFT reported in August 1999 and in November 2000 the FSA declared its intention to abolish polarisation, introducing new rules after consultation. Firm proposals were issued in January 2002 in what became known as the 'infamous CP121'. In October 2002 the FSA backed down on the requirement that IFAs should be remunerated only by fees from the client and the new rules came into effect in June 2005. The *Retail Distribution Review* was announced in June 2006.

#### *Contemporaneous observations and perceptions*

The changes to the rules gave rise to a great deal of controversy. The argument about polarisation had been running on and off since the mid-1980s when it was first proposed. Regulators had looked at the issue on a number of occasions and until November 2000, had decided against change. The issue which was closely connected to polarisation was that of the commission basis of remuneration, and the effects that this had on the market and particularly on consumers. There were strong views expressed about its malign effects. The FSA's initial proposals reflected these concerns but its proposal to require advisers who wished to call themselves independent to be paid by their client aroused some of the strongest protests, alleging that this proposal would destroy the IFA sector. The FSA backed down but when he stepped down at the end of his term in 2007, CEO John Tiner said that he wished the FSA had stood firm.

#### **4.13 Summary: the regulation of the retail pensions market since the mid-1980s**

##### *Subject matter*

Three strands of public policy can be identified in the regulations affecting the retail pensions market: pensions policy, investor protection policy and competition policy. These strands are separate to a degree but they are closely linked together and mutually interdependent.

Pensions policy and investor protection policy developed separately but the government linked them together for implementation in 1988. Investor protection policy incorporated existing competition policy. The core principles of pensions policy and the conduct of business rules within investor protection policy have remain unchanged since mid-1980s but there has been continuous change in the detailed regulations and in implementation of those regulations as shown in Figure 4.2 below.

The regulations introduced to implement these strands of policy provide opportunities, incentives and risks for market participants and consumers. Pensions policy creates the concept of a personal pension. Producers and distributors do not have to sell personal pensions and consumers do not have to buy them. But the regulations provided incentives for both parties to a contract. Investor protection regulations then laid down 'conduct of business rules' to govern the relationship between the prospective parties to the contract. This creates rights for consumers and obligations for market participants. The rules of engagement are extensive. They are clear in many respects but inevitably ambiguous in part, and ever changing. Competition policy acts as a moderator on the investor protection rules.

Figure 4.2 The pattern of overlapping regulatory change

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pensions policy - Conservative		■	■	■	■	■	■	■																		
Investor protection policy	■	■	■	■	■	■	■																			
Structure - Conservative					■	■	■	■	■	■	■	■	■	■												
Competition: MCA/Disclosure							■	■	■	■	■	■	■													
Interpretation and enforcement						■					■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Pensions policy - Labour																	■	■	■	■	■	■	■	■	■	■
Investor protection policy changes																	■	■	■	■	■	■	■	■	■	■
Structure - Labour																	■	■	■	■	■	■	■	■	■	■
Competition: polarisation							■			■				■				■	■	■	■	■	■	■	■	■

### *Rationale and objectives*

The rationale and objectives for each policy strand are sometimes explicit, sometimes implicit and sometimes contradictory. In whole the three policy strands taken together are not internally consistent. There are many conflicts and contradictions. Many attempts have been made to resolve the problems but issues still remain.

Fowler's pension policy contained inherent contradictions. It was based largely on the ideology of freedom of choice for the consumer and the free market ideals of individual participation instead of dominance by large institutions. But generally it was never in the interests of the large majority of consumers to opt out of either their OPS or SERPS. The compromise was the link to the conduct of business rules so that in theory consumers were not advised to act against their best interests.

Darling's stakeholder pensions (and other stakeholder products) created a new concept of product regulation which conflicted with existing conduct of business regulation and the newly created statutory objectives of the FSA. It took several years to find a compromise.

Gower's investor protection regime also contained inherent conflicts and compromises. It made the sales agent for the producer also the agent of the consumer, institutionalising a conflict of interest. Self-regulation under a statutory framework was a compromise with existing vested interests. This was inevitably fragile and slow moving. Gower undertook no cost benefit analysis or regulatory impact analysis of his proposals. The rationale was largely political, to provide a framework for opening financial markets. There was no real assessment of the practicalities of the regime.

In the implementation of the investor protection regime, the self-regulators created what were sometimes referred to as restrictive practices (polarisation, the MCA and limited disclosure), continuing from where the industry representative bodies left off, using the new statutory framework as leverage. This produced inevitable complaints from potential new entrants and inevitable conflicts with competition policy and later EU directives. The investor protection rationale for polarisation, the MCA and limited disclosure was never clear.

The creation of the FSA under a new statute giving the regulator statutory objectives clarified a number of issues but competition policy in this new framework remains a

secondary consideration. There are issues also about the size and scope of the FSA and its relationships with the Treasury and Bank of England.

#### *Key people*

Decisions are made primarily by Ministers and by the heads of the various regulatory agencies. In the days of self-regulation, the Chairmen/CEOs of companies had a great deal of influence but this has declined substantially over the last 20 years. This was very apparent at the Treasury Select Committee hearings in 2004 entitled 'Restoring Confidence in Long Term Savings' where the views of the CEOs of Standard Life, Legal & General and others were received with far less deference than would have been the case in the 1980s.

#### *Key dates*

Figure 4.3 below shows the key dates for the implementation of the main policy initiatives. It needs to be recognised however that these events were never a surprise to market participants. They are preceded by other announcements and by consultation.

#### *Contemporaneous observations and perceptions*

As regulation is at its heart a political activity it inevitably creates a good deal of debate. The discourse can provide insights into the rationale and objectives of the various initiatives and also into the views of market participants which in turn influence the strategic decisions of companies in the market place.

<b>Date</b>	<b>Policy strand</b>	<b>Event</b>
April 1987	Pensions	Government announcement that it will promote PPs but not control charges
February 1988	Investor protection	Lautro rules approved by SIB
April 1988	Investor protection	Start of new investor protection regime
July 1988	Pensions	Start of new PP regime
January 1990	Competition	Abolition of MCA
July 1994	Investor protection	Start of PIA
October 1994	Investor protection	SIB plan for review of mis-selling cases
January 1995	Competition	Start of new hard disclosure rules
July 1997	Investor protection	Deadline for FPC qualifications
October 1997	Investor protection	Start of FSA
March 1999	Investor protection	PIA advice (RU64) on sale of PPs in advance of stakeholder pensions launch
April 2001	Pensions	Start of new Stakeholder pensions regime
August 2003 & July 2004	Investor protection	New FSA rules on minimum capital requirements and realistic balance sheets
June 2005	Competition	Polarisation abolished and new distribution rules came into force
April 2006	Pensions	Start of new simplified pensions taxation rules

Figure 4.3 Summary of the main regulatory events

### *Conclusion*

As can be seen from the above, government policy and regulatory activity relating to the retail pensions market has been extensive over the last 20 years. In the next chapter I turn to the question of what actually happened in the market place and to how regulations influenced the development of the retail pensions market. There is already some indication of how events unfolded in the above narrative where regulators had to respond. In the next four chapters I look in detail at the responses of firms and the evolution of the market under the above regulatory regimes using the summary above as the guide, and with reference back to the detailed regulatory events as necessary.

## **CHAPTER 5: THE IMPACT OF REGULATION ON THE DEVELOPMENT OF PRODUCTS**

### **5.1 Overview of this chapter**

In the last chapter I described and analysed the regulations put in place in relation to the UK retail pensions market since the mid-1980s. I summarised the main features of those regulations in Section 4.13. I identified three strands of government policy and the key events in the implementation of those policy strands.

In this chapter I address the response of market participants and their customers to those events in terms of the design, marketing and sale of pension products. I examine the development of products in this market and assess the impact that regulation had on those developments.

I analyse:

- the supply to the market in terms of the types of products launched, the degree of differentiation between different providers' offerings and the price of those offerings to the consumer;
- the demand for the various types of products in terms of the sales achieved and the customer segments which invested in the products; and
- the changes to each of these market elements over the period.

I show how market participants and customers responded to the various regulatory changes and how those responses in turn affected the development of products. I also examine other factors which might have affected the development of the market, namely changes in economic circumstances and technological advances. From this analysis I demonstrate how regulation impacted the development of products.

I divide the period since the mid-1980s into two phases: 1987 to 1997 and 1997 to 2007 which correspond to the period of the Conservative and Labour administrations respectively.

The sources of data are shown in Appendix A and a selection of contemporaneous commentary is in Appendix B.

## 5.2 The development, launch and sale of personal pensions products: 1987 to 1997

### *The supply*

During this period the following personal pension products were created and launched by companies:

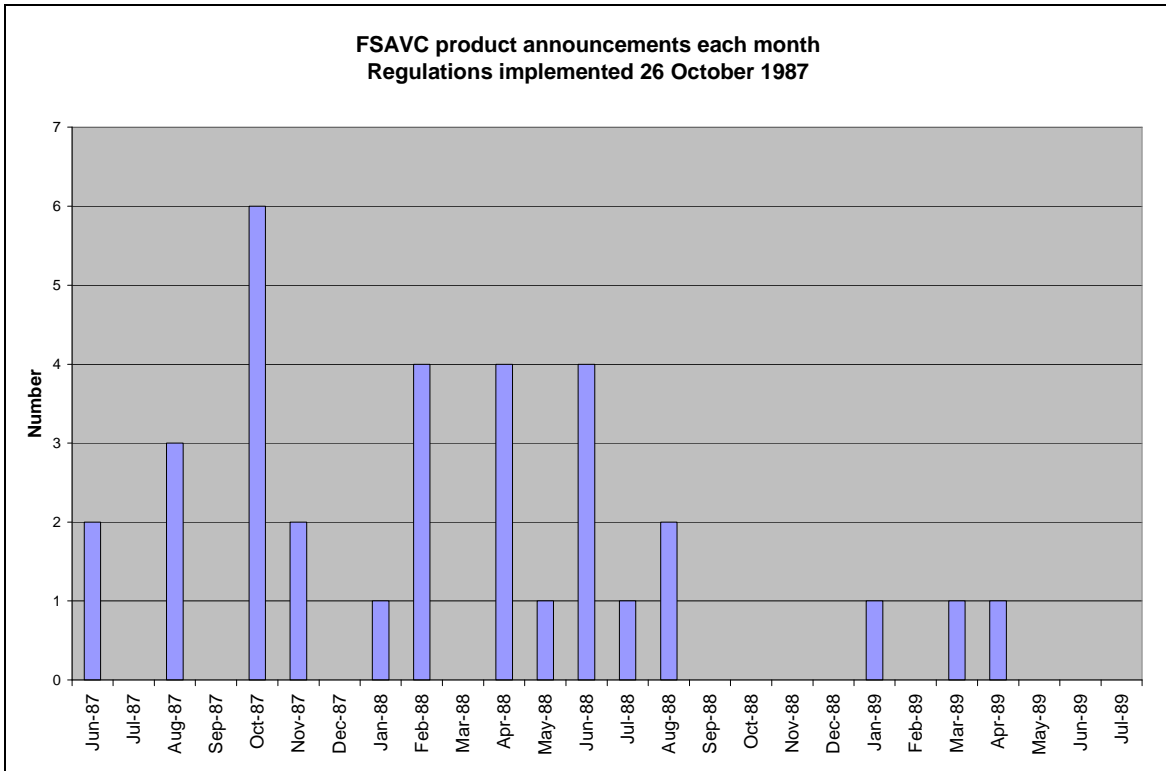
- The *personal pension* (PP). This was (and still is) the standard product. It came in two types: the with-profits contract (WP) and the unit-linked contract (UL). When this product was used by an individual opting out of SERPS it was called an "appropriate personal pension (APP)" but was basically the same product.
- The *group personal pension* (GPP). This was designed for small groups of individuals, typically employees of a small employer which did not want to set up an occupational pension scheme (OPS). It was (and still is) a set of individual PPs each of which has the same terms and conditions. This reduces administration costs while allowing individuals to have their own personal contract.
- The *free standing additional voluntary contribution* (FSAVC). This allows a member of an OPS to make additional pension contributions but in a personal pension outside the control of the OPS.
- The *self invested personal pension* (SIPP). This was (and still is) a PP which allows the customer to control the investment of the fund, with the minimum of restrictions.

The launch of these products into the market coincided closely with the finalisation of the regulations which governed them. The government made important announcements in April 1987 that it intended to promote PP products and would not control product charges. The re-election of the Conservative government in June 1987 removed any doubt about the launch of the new pension regulations. The regulations governing FSAVC products were finalised in October 1987, and the remaining PPs were authorised from July 1988.

The number of products announced by providers each month is shown in Figures 5.1 and 5.2 below. The large majority of product launches were clustered around the main implementation date of July 1988, with a smaller cluster around the implementation date for the FSAVC product. By May 1989 there were 84 PP products on the market, of which 75 had been launched before the end of August 1988. By January 1992 there were 85 PP products on the market, with some churn having taken place, but with no growth in product availability.

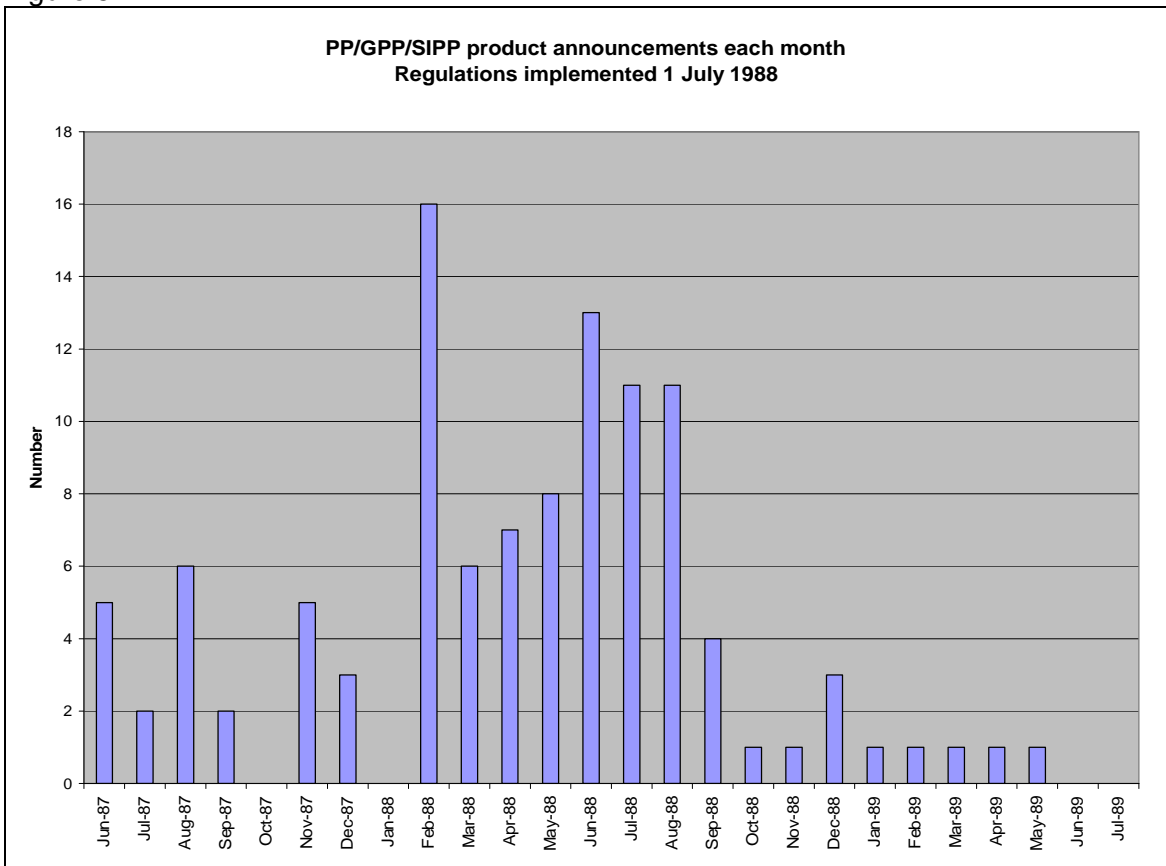


Figure 5.1



Source: *Financial Adviser*

Figure 5.2



Source: *Financial Adviser*

By April 1989 there were 33 FSAVC products on the market, of which 30 had been launched before the end of August 1988. There was some subsequent growth in this product availability, the number increasing to 60 by December 1992. FSAVC products were initially less popular among providers than standard PPs as they yielded smaller premiums and involved more administration to meet Inland Revenue rules governing the maximum contributions an employee could make. Nevertheless some companies actively marketed FSAVCs and found unexpected clients among professional groups. Other companies then launched their products to compete in this market.

The products in question are artefacts of law, and particularly of tax and NIC regulations. It is possible for a company to produce products which do not comply with the regulations but such products will not qualify for tax and NIC rebates and will not therefore be competitive. In practice therefore companies only launch products which comply with the tax and NIC regulations.

The nearest substitute products to personal pensions are executive pension plans and small self-administered schemes, both of which are occupational schemes. These small scale OPSs give a pension saver some choice of products where the saver's pension provision is supported by an employer. These products are by definition not available to the self-employed. It is open to a pension saver not to participate in the PP or OPS markets but to make alternative arrangements for retirement such as the accumulation of property, financial and business assets. But the choice of this alternative takes the pensions saver into different markets.

The complementary product to a PP is the retirement annuity which must be purchased from the fund created by a PP product. Consumers are allowed to buy an annuity from a company other than the one which sold them the PP, so the market in annuities is separate from PP.

The PP market that came into being in 1988 was therefore a discrete market with limited substitutes.

#### *The degree of differentiation between products*

Given the need for providers to ensure that their products complied with regulations in order to obtain tax and NIC benefits, the opportunities for differentiation were limited. Providers set minimum monthly or annual premium levels for regular premium contracts, and minimum contributions for single premium contracts. Penalties for early

termination (transfer to another provider) differed between providers. But apart from such contractual terms, product features were very similar.

The main variable for the consumer of a personal pension is the ultimate investment performance, which cannot be reliably predicted. Companies provided projections but the growth rates used were set by regulations. The main choice for consumers was between with-profits policies and unit-linked policies. New entrant unit trust companies and fund managers were able to offer savers a greater range of investment opportunities on unit-linked policies than many traditional insurance companies. This created a degree of differentiation and a new unique selling point for those companies. But for providers, product sales performance depended primarily on securing distribution outlets as will become apparent in Section 6.2 below.

#### *The price of products to the consumer*

The price of a product is the amount taken from the investor's premium for marketing and administration charges, together with any bid-offer spread taken on the investment of the remaining premium and annual management charges taken from the fund. Charge structures and charge levels varied between providers although it was common for costs to be front end loaded reflecting the up-front commission paid to the seller. Until 1995, actual charges were not disclosed to consumers routinely; before this date regulations stipulated that projections provided to customers had to use standard industry charges issued by the regulator which were often below the actual charge levied. It was very difficult for a consumer to compare one product with another.

#### *The demand*

The life and pensions industry uses a standard measure, the annual premium equivalent (APE) for the amount of new business secured in any year, i.e. the new contracts signed in any year. The APE is the full amount of the first year's premium for regular premium contracts signed plus 10% of the single premiums for single premium contracts signed.

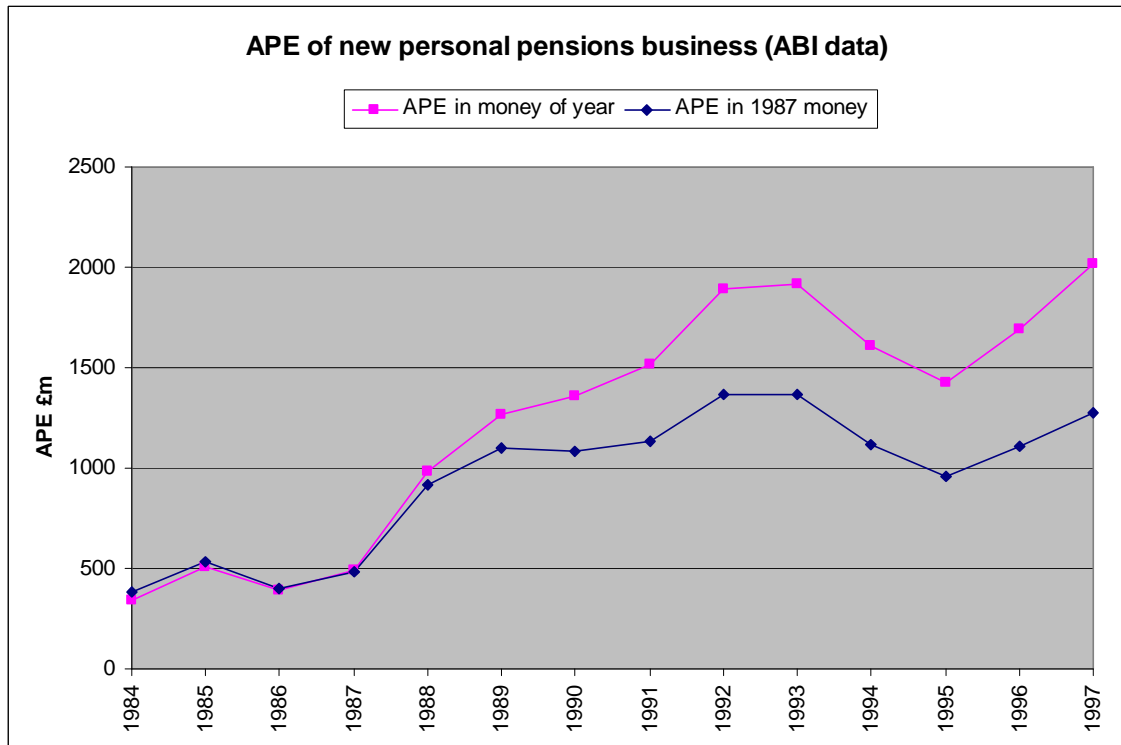
The APE of new business secured each year during the period 1984 to 1997 is shown in Figure 5.3 below. As can be seen, there is a substantial rise in 1988 and 1989 when the new products became available. In real terms, the APE of new business reached a peak in 1992. This pattern of consumer demand is also shown in the data for the cumulative number of employees opted out of SERPS into PPs which is shown in

Figure 5.4 below. Employees were allowed to backdate their opt out to April 1987. By April 1989 3.2m people had opted out of SERPS and this rose to 5.5m by April 1993. In addition, an unknown number of people opted out of their OPSs and into PP contracts before the regulators took action to stop this practice in 1994.

From the point of view of product providers and distributors, the years 1988 to 1993 were boom years, and this is reflected in the professional and financial journals at the time. The boom was widely anticipated and eagerly awaited by market participants. The first indications of the size of the boom were provided by announcements of sales by companies and by the ABI in late 1988 and early 1989.

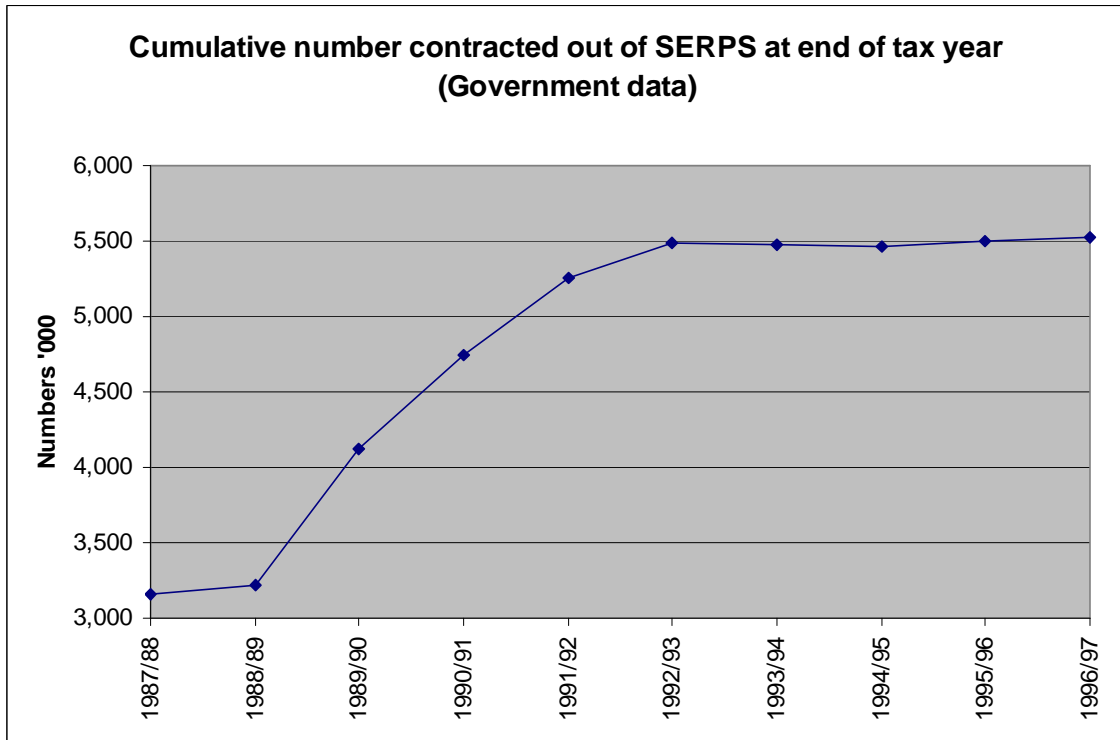
This boom also contributed to a change in the business mix of the insurance companies. Apart from personal pensions, companies sold life products (insurance and endowment policies) and provided services to the occupational pensions industry. Figure 5.5 below shows the percentage of total premium income arising from each of the three main sources. The contribution of personal pensions to total business rose from around 9% in 1987 to around 28% in 1992.

Figure 5.3



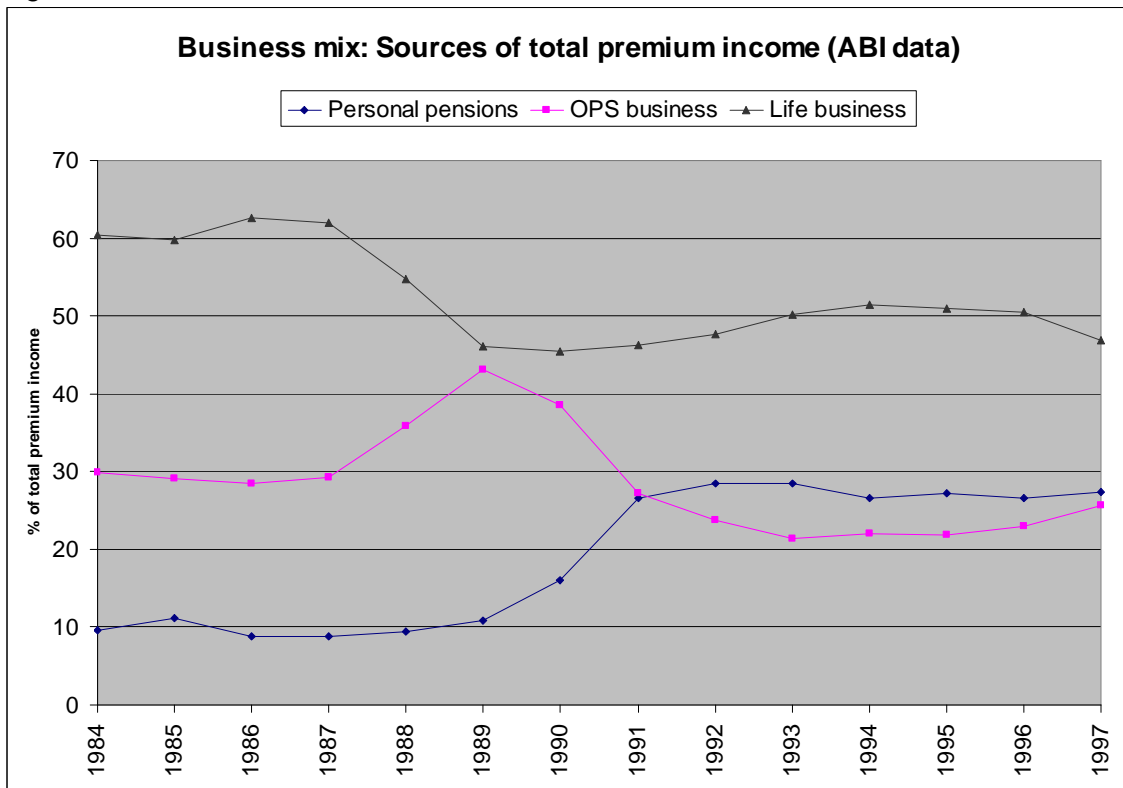
Source: ABI

Figure 5.4



Source: DSS

Figure 5.5



Source: ABI

*The impact of regulation on the development, launch and sale of personal pension products*

The direct antecedent of the boom in the personal pensions market is clearly the change to regulations implemented in 1988. New government regulations enabled the creation of new products, made these products available to new groups of consumers and provided new fiscal incentives. The government heavily promoted the new products in its own advertising campaigns and declined to control product prices. The National Association of Pension Funds ran a campaign to warn employees of the dangers of opting out of an OPS, and many Trade Unions also advised their members against opting out. But these campaigns had no significant effect. As described in section 4.8 above, the new conduct of business rules also introduced in 1988 were not rigorously enforced for many years, so these rules did not provide any check on selling. Product providers and distributors were therefore presented with an unfettered business opportunity which they took up with enthusiasm. Government therefore enabled the supply and created the demand.

SIPP products got off to a very slow start but did pick up in the mid-1990s following clarification of the rules on the classes of assets which may be purchased and relaxation of the compulsory annuity rules allowing 'income drawdowns' which enabled the fund to remain invested. Prior to this change only 12 SIPP products had been launched. After the change in regulations the number of products on the market rose quickly. I look at this in section 5.3 below.

GPPs suffered competition from small OPSs but the balance was changed following new pensions legislation affecting OPSs following a scandal (known as the Maxwell scandal) in which the funds of a pension scheme were misappropriated by the employer. The new regulations made OPSs less attractive than GPPs and sales of GPPs started to improve in the mid-1990s. I return to this subject again in Section 5.3 below.

The boom in personal pensions is particularly significant in the light of general economic circumstances at the time. The early 1990s saw a fall in house prices and the arrival of negative equity; there were falls in the stock market in 1987 and 1990; and the period 1990 to 1992 was a one of low growth, recession and rising unemployment (economic trends are shown in Appendix C). The level of pension sales

in these circumstances is a tribute to the marketing and selling prowess of the industry backed by government advertising and incentives.

The eventual fall in new business growth in 1994 and 1995 was attributed by companies and commentators partly to the lingering effects of recession and lack of growth in the equity markets and also to two regulatory factors: firstly the emerging mis-selling scandal and secondly the issue of the disclosure of product details and charges. Both of these issues caused adverse publicity for the industry. Increasing enforcement of conduct of business rules required suspension and/or retraining of sales staff and advisers, reducing sales effort and effectiveness. The new disclosure rules introduced in January 1995 put the spotlight on charging structures (particularly front end loading), on companies lapse rates and on poor early transfer values.

It was widely recognised by regulators, companies and commentators that the abolition of the maximum commission agreement (MCA) in 1989 led to a substantial rise in commission levels. Lautro data show that by March 1990, average commission to IFAs had reached 123% of the MCA figure, and commission to representatives had reached 134% of the MCA. The lack of hard disclosure to potential customers of commissions and charges and the lack of consumer awareness allowed companies to pass on these additional costs to customers without affecting demand. Producers and distributors therefore expected that the new disclosure regime would affect demand at least in the short term.

Overall however, the new disclosure regime did not have as big an impact on the ultimate level of charges as the regulators had expected. A PIA report in February 1999 showed that there had been only a very marginal decrease in the reduction in yield (RiY) from 1996 to 1998 on a 25 year PP plan. There was however a substantial difference between the charges of individual companies. In 1998 the average RiY was 1.7% with the best at 0.7% and the worst at 2.6%. A *Money Management* report in June 1998 based upon its own surveys of 25 year PP plans suggested that there was a reduction in charges in 1995, perhaps as a knee jerk reaction to the new disclosure regime, with the largest reduction being in relation to early transfers rather than policies proceeding to maturity. But over the period 1995 to 1997 the reduction in anticipated charges over the full 25 term was only around 7% measured in cash terms.

### 5.3 The development, launch and sale of personal pensions products: 1997 to 2007

#### *Introduction*

I now move on to consider the development of products since 1997. I examine in turn stakeholder pensions (SHPs), PPs, GPPs and SIPPs. In each case I describe and analyse the supply (the products launched or withdrawn, the degree of differentiation between products and the price) and the demand. I then assess the impact that regulation had on the market in this period.

#### *Stakeholder pensions*

The government announced in November 1998 that it intended to proceed with the introduction of SHPs with effect from April 2001. The regulator issued advice in March 1999 (called Regulatory Update 64 or RU 64) on the selling of existing PP products in advance of SHP products becoming available and as a result of this advice many companies re-branded their PP products as 'stakeholder friendly'. At the formal launch in April 2001 30 companies offered SHP products but this fell to 18 by the end of 2007 as companies withdrew from the market or merged with other companies in the general consolidation that was taking place during this period. The numbers of stakeholder friendly and stakeholder products on the market at the start of each calendar year is shown in Table 5.1.

Table 5.1 Number of stakeholder products on the market

	Jan 2000	Jan 2001	Jan 2002	Jan 2003	Jan 2004	Jan 2005	Jan 2006	Jan 2008
	Stakeholder friendly		Stakeholder					
Number of companies	43	26	30	25	21	21	19	18

Source: *Money£acts*

The degree of differentiation between SHPs on the market was very limited, given that these products not only had to meet the tax/NIC regulations which applied to all pension products but also specific stakeholder product regulations. To keep them simple and low cost, SHP products provided a limited choice of investment funds compared with PP and other pension products. The price was limited by regulations to a maximum 1% annual management charge (increased in April 2005 to 1.5% for the first ten years).



Figure 5.6 below shows the demand for these products in terms of the value of regular and single premiums derived from contracts set up on the initiative of individuals and contracts set up through employer designated schemes. Single premiums set up on the initiative of individuals made up the largest source of sales by value. As shown in Figure 5.7 the average premium per policy in this category varied over the period 2001 to 2007 between £10,000 and £24,000, well above that expected from the government's target group of lower to middle income earners, i.e. people earning between £10,000 and £20,000 per annum who were not currently contributing to a pension.

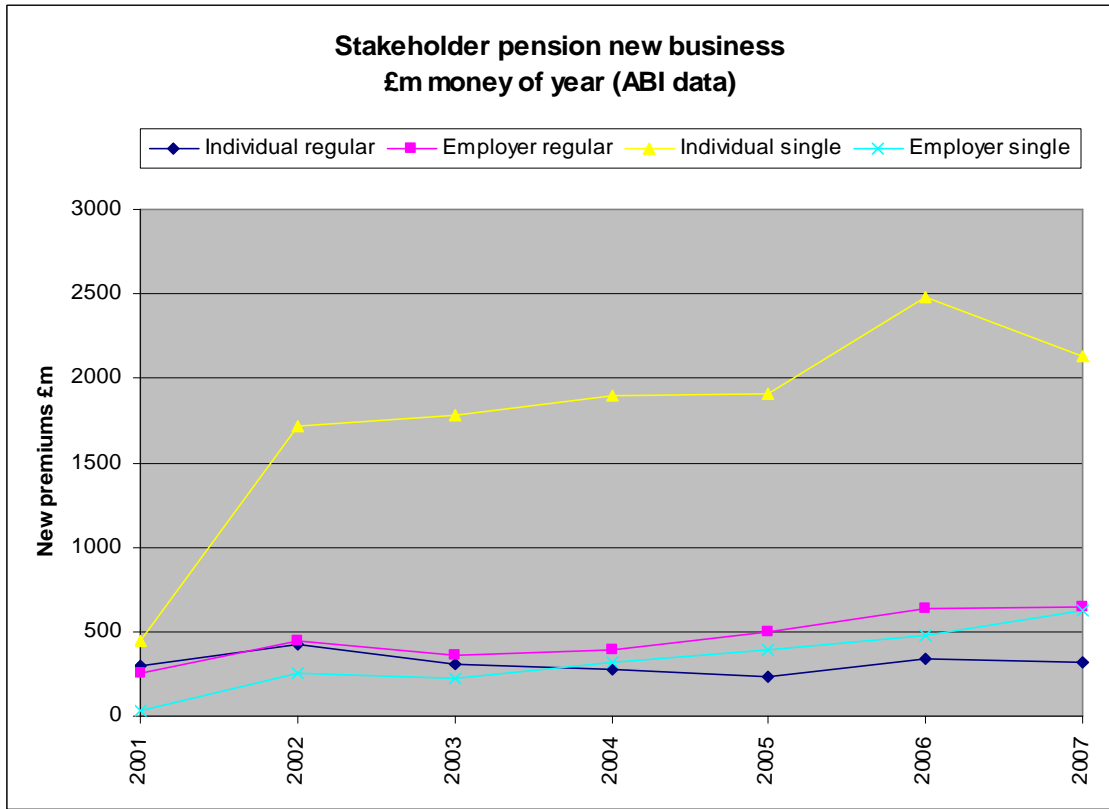
The ABI reported in November 2002 that in the first 18 months from April 2001 to September 2002, around 68%<sup>1</sup> of individual initiated single premiums were transfers from existing PP schemes. Also, 90% of employer designated schemes had no contributing members and only 9% of employers were contributing to contracts set up by their employees through these designated schemes. A later ABI report published in August 2003 showed that 82% of employer designated schemes had no contributing members and only 13% of employers were contributing. The data on the total contributions made through employer designated scheme does not distinguish between employer contributions and employee contributions.

The ABI had very little data on the incomes of contributors but the limited data available suggested that about 40% of all contracts taken out were by those within the target group. The government said that in the first 12 months of the scheme around two thirds of contributors earned less than £20,000 per annum, but this category is likely to include children and dependents of wealthier people who were simply using the scheme for the tax advantages. The stakeholder regulations introduced a new rule allowing anyone to contribute up to £3,600 per annum irrespective of earnings so wealthier people could buy SHPs for non-earning family members to take advantage of the tax breaks. The general consensus in the professional journals was that the scheme had failed to meet its objectives of substantially increasing pension saving among the target group.

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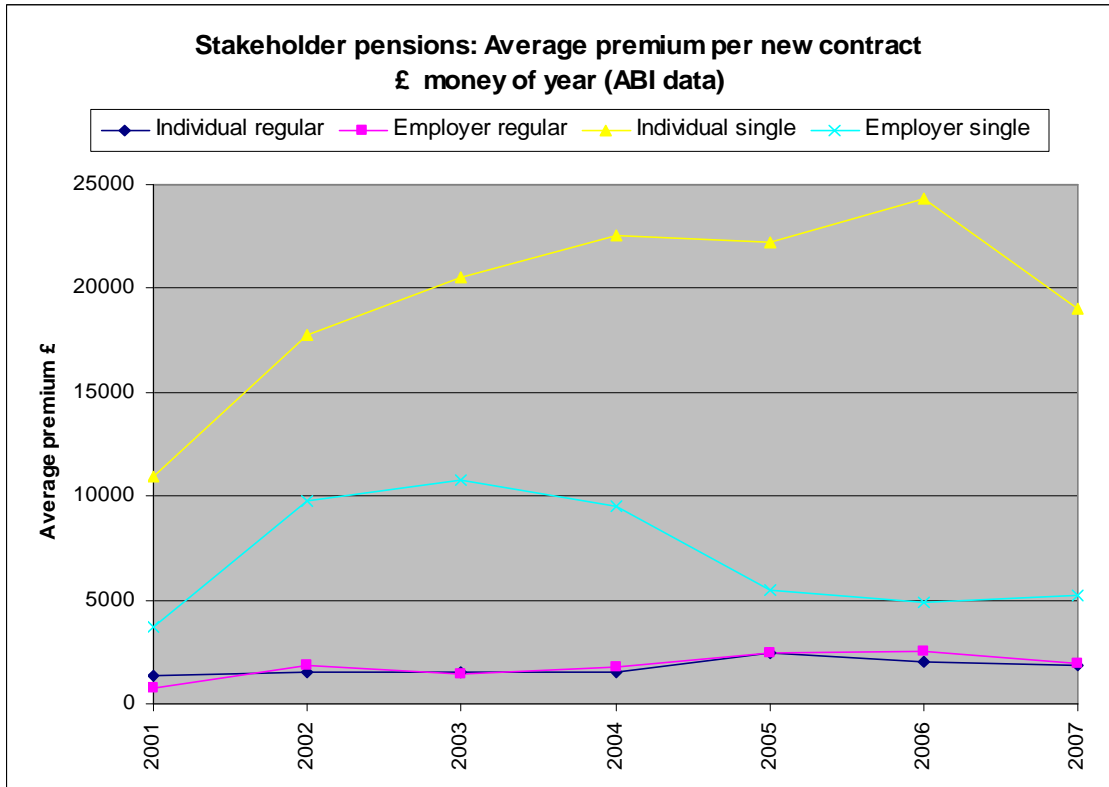
<sup>1</sup> Later data suggest that this figure may be high. The data in Table 5.6 below shows that transfers in this period were between 54% and 62%

Figure 5.6



Source: ABI

Figure 5.7



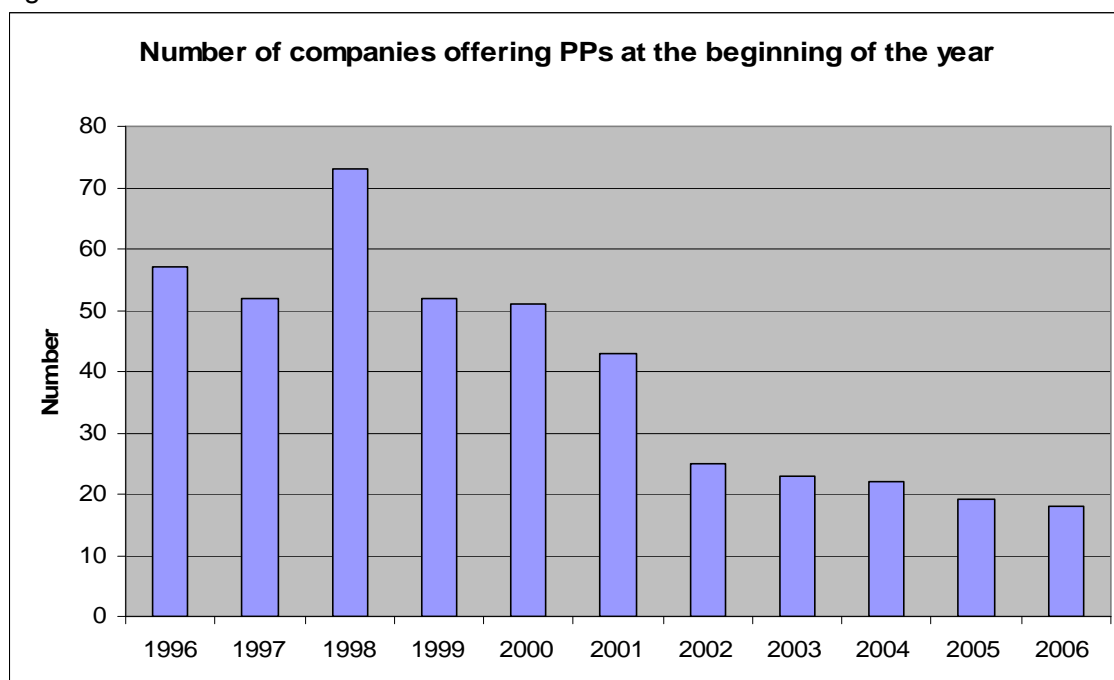
Source: ABI

Pension providers did not approach the stakeholder initiative with enthusiasm due to the price cap of 1%, and they were still lukewarm when government increased this in April 2005 to 1.5% for the first 10 years. In the calendar years 2001 to 2006, just five companies (Norwich Union, Standard Life, Axa, Scottish Widows and Legal & General) took 60% of the market in APE terms. The top ten companies took 83% of the market. Legal & General said that it would not sell individual SHPs to people on low incomes due to the price cap: its strategy was to sell through employers or affinity groups such as Trade Unions where there were some economies of scale. Standard Life attempted to sell SHPs through Post Offices but withdrew after disastrously low sales.

### *Personal pensions*

As mentioned above, many providers re-branded their PPs as stakeholder friendly following the regulator's guidance in RU64 issued in March 1999. However, after the formal launch of SHPs in April 2001 many providers still offered a PP product in addition to a SHP product. The number of companies offering PPs as distinct from SHPs is shown in Figure 5.8 below. There is a drop in numbers after 2001 but the PP does not disappear and by 2006 there were as many PPs on the market as SHPs. The decline in the number of product offerings is also a function of the decline in the number of pension providers following the consolidation in the industry in this period.

Figure 5.8



Sources: *Money Management, Money£acts*

The question arising from this is what the distinction was between PP and SHP products. Table 5.2 below compares the PP and SHP products of the top five SHP providers in January 2002. In each of these five cases, the PP and the SHP product differ in the range of funds available for investment. In the case of Norwich Union and Legal & General, there are no other differences. For the other three providers, there are differences in the minimum contributions and possible differences in the charges levied depending on the funds chosen.

Table 5.2 PP and SHP products of the top five providers in 2002

Provider	Product type and name	Gross minimum contribution £			Annual charges %	Funds
		Monthly	Yearly	Single		
Norwich Union	PP: Your Pension Select	20	20	20	0.6 – 1.0	Choice of 43
	SHP: Your Pension	20	20	20	0.6 – 1.0	Maximum of 6
Standard Life	PP: Personal Pension One	40	400	1000	1.0	Choice of 25
	SHP: Stakeholder Pension Plan	20	20	20	0.6 – 1.0	Maximum of 12
Axa	PP: New World PP Investor	20	200	20	Up to 1.3	Choice of 27
	SHP: Stakeholder Pension Investor	20	20	20	Up to 1.0	Maximum of 10
Scottish Widows	PP: Individual Pensions Solutions	65	780	2000	0.65 – 1.0	Choice of 65
	SHP: Stakeholder Pension	20	20	20	0.64 – 1.0	Maximum of 10
Legal & General	PP: Personal Pension 2000	20	20	20	0.3 – 1.0	Choice of 46
	SHP: Stakeholder Pension Plan	20	20	20	0.3 – 1.0	Maximum of 10

Source: *Money£acts* January 2002

The distinctions between PP and SHP products widened over time, as can be seen from Table 5.3 below which shows the products of these five companies at January 2008. In particular, charges for PPs moved upwards.

The explanation for the pattern of development in PP and SHP products can be traced back to the Regulatory Update (RU64) issued in March 1999 which required sellers to justify recommending PP products to customers where the charge was in excess of the SHP maximum. It was initially unclear what additional customer value would justify a higher charge and providers had to err on the side of caution, especially as at this stage the mis-selling review was not complete.

Table 5.3 PP and SHP products of the top five providers in 2008

Provider	Product type and name	Gross minimum contribution £			Annual charges %	Funds
		Monthly	Yearly	Single		
Norwich Union	PP: Your Pension Select	200	2400	10000	0.7 – 3.0	Choice of 130
	SHP: Stakeholder Pension	20	20	20	1.5 for 10 yr then 1.0	Maximum of 23
Standard Life	PP: Personal Pension Flex	40	400	1000	1.0 – 2.0	Choice of 50
	SHP: Stakeholder Pension Plan	20	20	20	0.3 - 1.0	Maximum of 12
Axa	PP: Personal Pension Plan	100	1200	1000	0.8	Choice of 200
	SHP: Stakeholder Pension Plan	20	20	20	Up to 1.0	Maximum of 10
Scottish Widows	PP: Individual PP Plan	100	1200	2000	0.55 – 1.5	Choice of 120
	SHP: Stakeholder Pension	20	20	20	0.46 – 1.5	Maximum of 10
Legal & General	PP: Personal Pension 2000	20	20	20	0.3 – 2.5	Choice of 70
	SHP: Stakeholder Pension Plan	20	20	20	0.3 – 1.5	Maximum of 10

Source: *MoneyFacts* January 2008

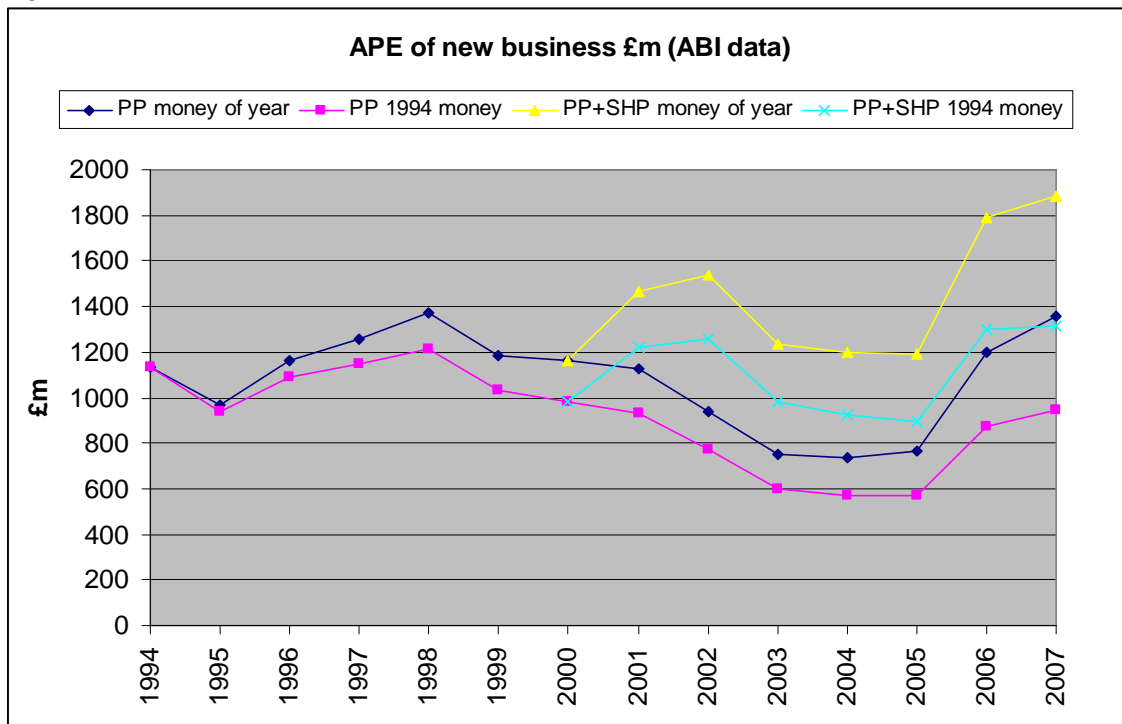
The problem for producers and distributors centred on the question of advice to customers (which must meet the standard of the conduct of business rules) and how this advice was to be paid for. The stakeholder charge cap did not yield sufficient funds to provide anything other than basic advice. The SHP was designed to meet the needs and the resources of lower to middle income earners. The problem for producers and distributors was how to meet the needs of higher earners and wealthier customers, while complying with both the conduct of business rules and RU64. The FSA's approach was to encourage the development of fee based advice, i.e. the FSA took the view that payment of advice should be a matter between the customer and the adviser. But this would remove the main incentive available to producers in relation to IFAs, which were taking 80% of the retail pensions market.

The SHP market leader Norwich Union took the first step in 2004 by announcing changes to its PP product to provide for the cost of advice. Standard Life then followed by reducing commission available to IFAs on its SHP. Thus, PP and SHP products became more clearly differentiated. This was seen in the professional journals at the time as a downgrading of the SHP product: the SHP product would be available to

meet regulatory requirements but the marketing effort of the producers would go elsewhere. The justification for the higher charges within PP plans was the access it provided to a wider range of investment funds. This facility was sought by IFAs.

The demand for PP products in APE terms is shown in Figure 5.9 below. In real terms, the demand in 2007 was no higher than that in 1995, which was the low point after the pension boom of 1988 to 1993. The decline in demand for PPs after 2001 can be associated with the launch of SHPs. The combined figures for PP and individual initiated SHP sales show a rise in 2001 and 2002. We know from the ABI reports mentioned above that some business is simply the transfer of funds from PP to SHP contracts. More generally, SHPs simply took some new business from PPs. Over the period 1994 to 2007, demand for PP/SHP products has been fairly stable in real terms, with just the normal annual fluctuations which might be expected, recognising that in the later part of the period the figures are distorted by some double counting arising from an increase in the level of transfers (which I refer to again later).

Figure 5.9



Source: ABI

### Group personal pensions

There were no changes in the basic design of a GPP product in this period although there have been some changes to features and charging structures similar to those described above in relation to PPs. The GPP product was subject to the RU64 requirement but the employer contribution could be used to justify higher charges so the effect of this regulation on GPPs is less than that on PPs.

The number of products on the market has declined steadily since 1998 as shown in Figure 5.10 below. This reduction is attributable to the general consolidation and closure of funds to new business which was a feature of this period.

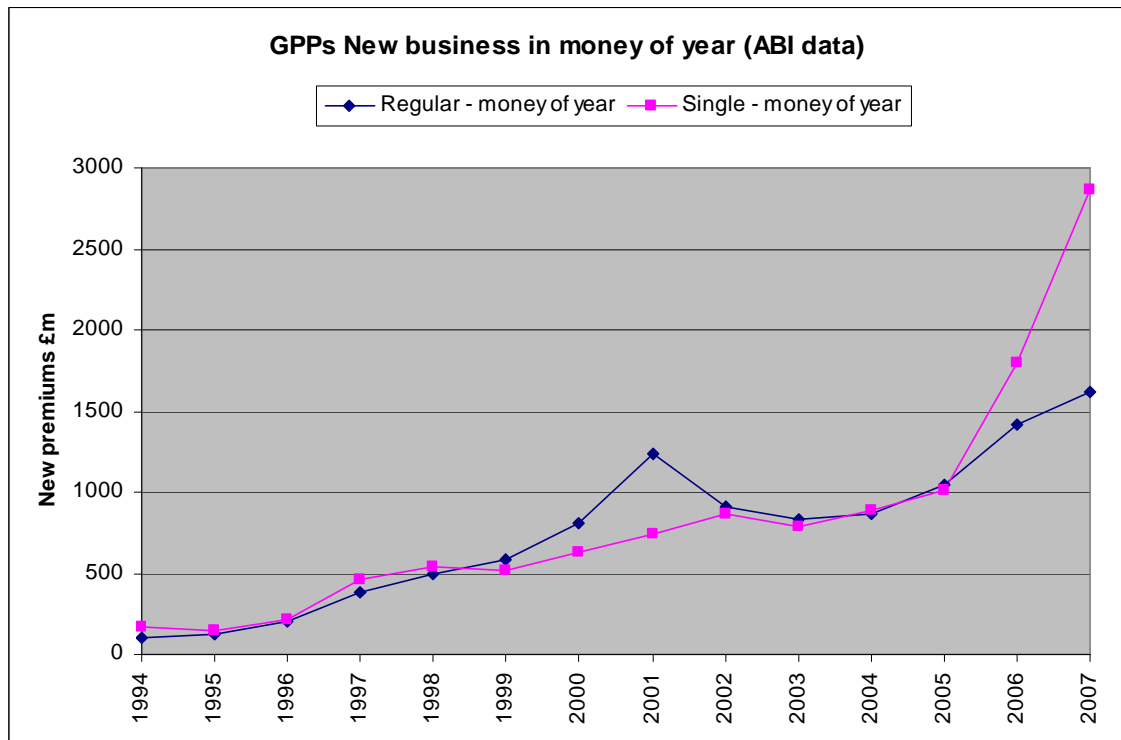
Figure 5.10



Sources: *Money Management, Pensions Management*

The demand for GPPs did, however, increase substantially during this period as shown in Figure 5.11 below. There was a steady rise in both regular premium business and single premium business. In real terms the APE of new business increased ten-fold of the period 1994 to 2007.

Figure 5.11



Source: ABI

There were three reasons for the substantial increase in GPP business.

Firstly, there was a change in strategy among producers involving an increase in marketing effort in GPPs relative to PPs to gain some economies of scale. In the mid-1990s the industry was under pressure to reduce costs from a combination of the new disclosure regime, the more rigorous enforcement of conduct of business regulations, increased training requirements for sales staff, the pension mis-selling review and a fall in demand. The Prudential explained the reasons for its change in strategy. The company had previously seen business success in terms of growing the client base. But they began to realise that the problem was not the size of the client base but the way it was serviced – one at a time. Prudential then began to consider marketing to clients in bulk using the many relationships it had with corporate clients to whom it provided services.

The second reason for the increase in GPP business can be attributed to changes in the regulation of OPSs which were introduced in the mid-1990s after the Maxwell scandal. OPSs were substitute products for GPPs for some employers. An employer, particularly a small to medium enterprise, wishing to set up a pension scheme for its employees had a choice between an OPS and a GPP. The introduction of new



regulations for OPSs substantially increased the relative advantages of a GPP. GPPs involved much lower regulatory risks for the employer as the employees have individual contracts with the pension producer and it is the pension producer or the IFA which advises on the scheme which bears the regulatory burden. The reduction in numbers of small OPSs (in two size bands) between 2000 and 2005 is shown in Table 5.4 below.

Table 5.4 Numbers of small occupational pension schemes

	Open	Closed	Frozen	Winding up	Total
<b>100-999 members</b>					
mid 2000	4240	810	156	426	5630
April 2005	1760	2010	683	379	4830
<b>12-99 members</b>					
mid 2000	5650	3480	724	1830	11700
April 2005	3030	2670	826	1280	7810

Source: GAD survey data

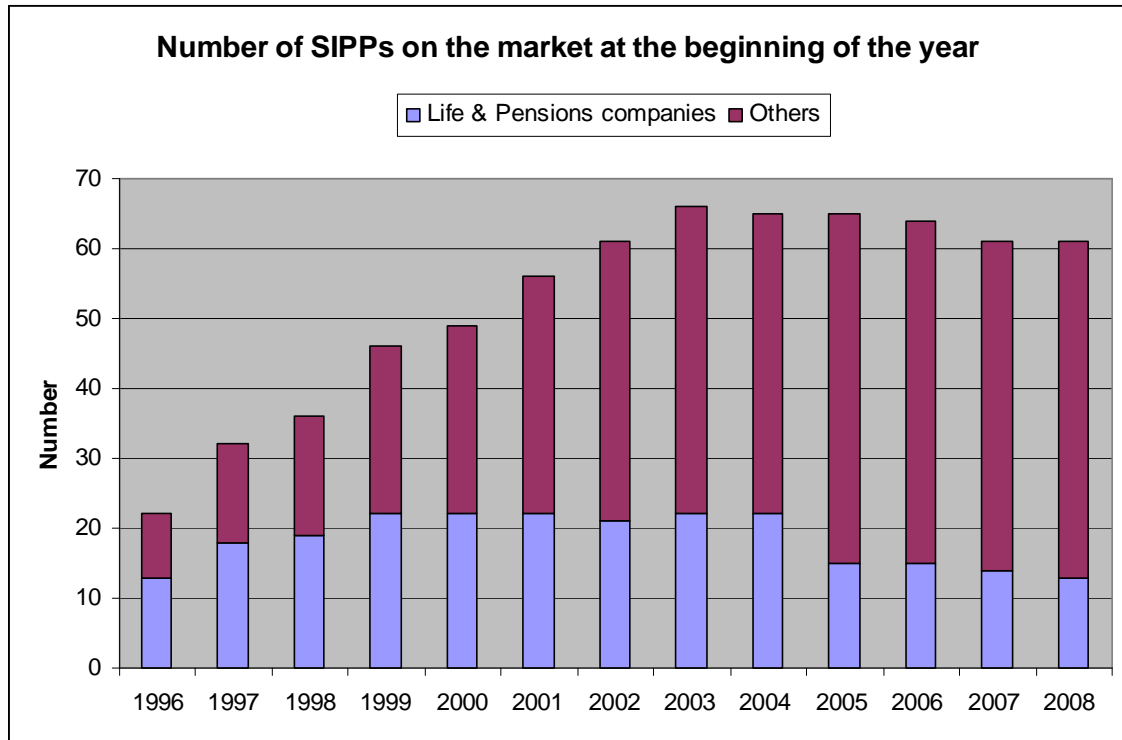
The third reason for the increase in GPP business is related to the requirement in the stakeholder regulations for employers with five or more employees to set up stakeholder arrangements if they did not have existing pension arrangements of an acceptable standard. This may have prompted a number of employers to set up GPP arrangements although this involved the employer making a commitment to a contribution of at least 3% of the employees' earnings in order to be exempt from the requirement to set up stakeholder arrangements. Under a designated stakeholder scheme an employer is not obliged to make contributions. As with SHP contracts in employer designated schemes, the data on the total contributions to GPPs is not separated between employer contributions and employee contributions.

#### *Self-invested personal pensions*

In the mid-1990s the government clarified the rules governing the assets which could be held in a SIPP and more importantly relaxed the compulsory annuity rules allowing 'income drawdown' which enabled the fund to remain invested on retirement instead of it being converted into an annuity. Conversion to an annuity could be deferred until age 75. These changes made SIPP products more attractive and the number of products on the market rose rapidly as shown in Figure 5.12 below. The market proved particularly attractive to unit trust companies, fund management companies and some larger IFAs which increasingly entered the market. In terms of market offerings, the products of these new entrants have outnumbered those of the traditional insurance

companies. SIPP products have been targeted at higher income earners and those with substantial funds to invest, including funds already in existing personal pension plans. The SIPP is promoted as an ideal tax efficient and flexible investment vehicle for the discerning investor.

Figure 5.12



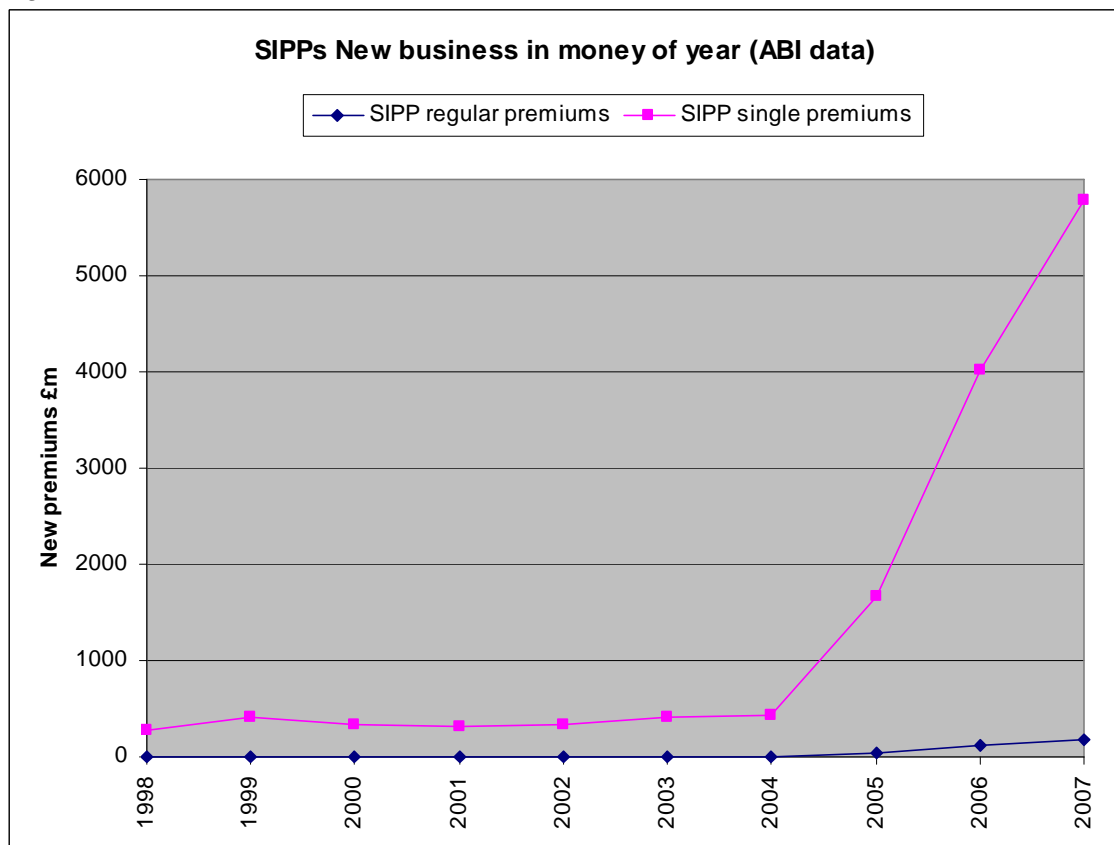
Sources: *Money£acts*, *Pensions Management*

The degree of differentiation between the SIPP products of providers is much wider than that between other retail pension products. There are two basic types: the full SIPP and the hybrid SIPP. The full SIPP, which is primarily offered by the non-insurance companies, provides complete freedom of investment within the tax rules. The hybrid SIPP, which tends to be provided by insurance companies, requires some of the funds to be invested in the providers own funds. Within both SIPP types there are often wide differences between providers in product features such as the minimum investment and the level of investment advice offered; and the structure and level of charges also varied considerably. The various services are often disaggregated so that the provider out-sources the administration and/or the investment management service.

The demand for SIPPs is more difficult to establish than with other pension products. The ABI data covers only insurance companies. The publications *Money Management*

and *Pensions Management* conduct surveys of providers requesting information but not all providers respond and some decline to provide commercially sensitive information about sales levels. Sufficient data is available however to illustrate the trend, which is a substantial increase in demand in recent years, particularly from 2005 onwards. Figure 5.13 below shows the ABI new business data for the insurance companies. Table 5.5 shows the number of SIPPs in force and the assets under management in those SIPPs for a panel of 25 non-insurance companies.

Figure 5.13



Source: ABI

Table 5.5 Panel of 25 non-insurance companies

	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Mar 2007
Number of SIPPs in force at each date	28,641	35,154	42,270	82,664	112,003
Assets under management at each date £m	5,073	6,769	10,429	19,162	29,105

Source: *Pensions Management* surveys

The data from *Pensions Management* and *Money Management* surveys reveals that around 70% to 80% of the money flowing into SIPPs came from transfers by customers from existing pension schemes. The SIPP has been advertised as an ideal vehicle for pension savers to take control of poorly performing pension assets or to consolidate the funds from a number of pension plans which they may have accumulated.

The SIPP product was given a substantial boost by major changes in the tax rules governing pensions ('Pensions simplification') introduced on 6 April 2006 ('A-day'). The changes included a further widening of the permitted asset classes and a further relaxation of the annuity rules. These changes were advertised by producers and distributors as an opportunity for pension savers; and savers were advised to review their pension provision in advance of A-day in any event. The general consensus among industry participants and observers is that A-day and the publicity in the run up to A-day had a substantial impact on SIPP sales. A further boost to transfers is expected when government allows so-called 'protected rights' transfers, cash built up from NIC rebates from contracting out of SERPS, to be held within SIPPs from October 2008.

A number of articles in the specialist press suggest another reason for the surge in SIPPs: generous commission (may be 10% or more) on offer to IFAs from providers for large fund transfers. In September 2007 the FSA issued a newsletter to Financial Advisers reminding them of the need to compare the charges of different products in the light of the customer's needs. Firms should be able to demonstrate that a particular consumer genuinely requires the investment flexibility and control offered by a SIPP. An SHP or PP might well satisfy the customer's needs potentially at lower cost. The FSA announced that it would be undertaking further work including visits to firms in 2008. But some press commentators argue that the FSA should have started this work when SIPP sales accelerated in 2005.

A related issue is that until April 2007 SIPPs were not uniformly regulated by the FSA. SIPPs provided by insurance companies were fully regulated but SIPPs provided by fund managers were only regulated in respect of assets which fell within the statutory definition of investments, which did not include commercial property. So SIPPs provided by non-insurance companies were less regulated than those provided by insurance companies. From April 2007, all SIPPs were brought within the same regulatory environment.

It is possible that the SIPP surge contains yet another mis-selling episode driven by changes to pension regulations creating new incentives for consumers and new opportunities for market participants, coupled with high commission to distributors and the absence of effective regulatory constraints.

*The churn in pension funds*

The data on SHPs and SIPPs business referred to above suggest that an increasing amount of pensions business involved transfers of funds between providers and between products. The ABI does not routinely publish details of the amount of new business which constitutes transfers. Insurance companies like to celebrate their success in winning new business but they are more reluctant to publish information about business they have lost. In September 2007 the ABI did publish some data on the degree of churn in 2006. The total premium receipts from personal pension business and occupational pension business transacted by insurance companies amounted to £79.9bn. Of this amount, £72.7bn (91%) consisted of transfers from one provider to another. The ABI report reveals that the percentage of transfers had risen steadily to 91% from 41% in 1996.

ABI statistics also contain some information on transfers at product level, as shown in Table 5.6 below. For individual initiated stakeholder business, this data is not entirely consistent with the report the ABI made in November 2002 that in the first 18 months 68% of individually initiated SHP business consisted of transfers.

Table 5.6 Single premium new business consisting of transfers

Percentage	2000	2001	2002	2003	2004
Individually initiated SHPs	n/a	54	62	64	69
Employer sponsored SHPs	n/a	26	44	43	33
PPs	44	47	54	57	52
GPPs	49	52	52	49	41
Weighted average	45	48	55	58	55

Source: ABI

Another source of data is the companies' individual returns to the FSA which have been collated by Standard & Poor's in their Synthesys Life database. This database

includes all insurance companies but not other companies competing in the SIPP market. The companies' returns show separately the amount of claims paid in respect of surrenders of policies (i.e. transfers) and claims paid on maturity (to convert to annuities). Table 5.7 below shows the ratio of surrenders to new single premiums for all lines of pension business together. This shows a rise in 2001, probably associated with transfers prompted by the new stakeholder products and a substantial rise in 2006, probably associated with the surge in SIPP sales. This data suggests a net transfer of funds outside the realm of the insurance companies for 2006 and 2007.

Table 5.7 Ratio of surrenders to new single premiums

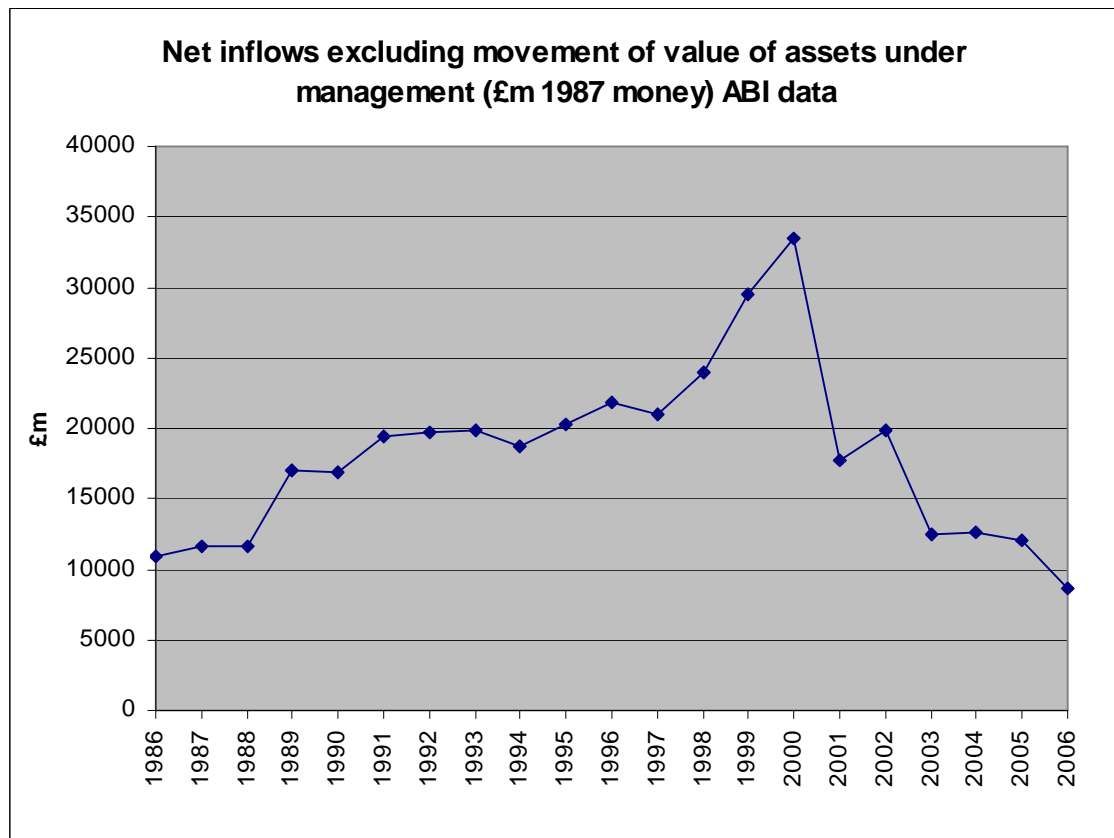
	2000	2001	2002	2003	2004	2005	2006	2007
Ratio	0.58	0.91	0.77	0.79	0.85	0.80	1.18	1.36

Source: Synthesys Life database

Transfers of funds between providers have been an integral part of pensions business since the Fowler reforms of the mid 1980s. Pension savers can transfer the value of their funds from their OPS into a PP and they can transfer their PP funds between providers. Such switching is a normal and healthy part of a competitive industry. But the increase in the percentage of transfers over the years, and the level of transfers reported in some of the statistics raises the question of whether some of this churn is initiated to generate fee income for intermediaries with consequential dead-weight costs for consumers. In its Financial Risks Outlook of 2008, the FSA identified the trend of increasing transfers as a risk to consumers.

The problem for the life and pensions industry can be seen from the trend of net inflows into the industry shown in Figure 5.14 below. To compile this chart (from ABI data) I have taken the total premium receipts of all the business streams (i.e. life, personal pensions and occupation pensions business), added investment income receipts and deducted benefits paid, interest paid, taxation, commission and management expenses. I have not included movement of the value funds under management. The cost of capital is not included: I have not deducted dividends paid to shareholders. Transfers are included in both premium receipts and benefits paid so the net inflows constitute the new business money coming into the industry, mainly from customers but also from any business won from non-insurance companies (i.e. non-members of the ABI).

Figure 5.14



Source: ABI

The rise in net inflows between 1988 and 1991 was caused by the pension boom which followed the Fowler reforms. The rise from 1997 to 2000 comes from additional business won from the occupation pensions industry: this consists of transfers from OPSs into GPPs and includes a rise in the business conducted by insurance companies for the occupational pensions industry. Since 2000 there has been a sharp fall in the net inflows into the industry and in real terms growth in the industry has fallen below the level of the mid-1980s. It appears therefore that with the decline in the net inflows into the industry, competition has become a matter of winning transfer business from competitors.

*The impact of regulation on the development and sale of personal pensions*

The government's stakeholder pensions initiative, and in particular its price cap together with the regulator's advice contained in RU64, had a significant impact on the PP market. These interventions by government and the regulator forced providers to reconsider their products and particularly the level of charges. Initially these interventions exerted a downward pressure on charges until producers were confident

enough to distinguish their PP offerings from the SHP product. GPPs were to some extent affected by the stakeholder initiative and RU64 but it was easier for providers and distributors to distinguish GPP products from SHP products if the employer sponsored a GPP and made a contribution. The stakeholder initiative failed to meet its primary objective of increasing pension saving among lower to middle income earners but it did exert a downward pressure on PP charges generally.

The increased regulation of OPSs introduced in the mid 1990s following the Maxwell scandal had the effect of changing the balance of advantage between the OPS and GPP for small to medium enterprises leading to an increase in GPP business for life and pensions companies. This helped providers cope with the pressure on charges exerted by the increased disclosure requirements introduced in 1995 and the subsequent stakeholder initiative. The GPP provided some economies of scale.

The government's tax simplification initiative introduced on A-Day, 6 April 2006, and the publicity in the run up to A-Day led to increased pensions business and to consumer interest in the SIPP product. Providers and distributors seized upon this initiative to promote pensions provision generally but competition between producers became more a matter of capturing transfer business than increasing the level of contributions by pension savers. Changes to pension regulations may have led to increased churn in pension funds to the disadvantage of consumers.

#### *Other factors affecting the market*

The period 1997 to 2007 was one of continuous economic growth, stable inflation and interest rates, rising house prices and steadily rising real earnings. There was a sharp fall in the stock market in the years 2000 to 2002 which reduced consumer confidence and presented problems for providers in meeting regulatory solvency requirements. But stock markets started to recover in 2003 and there was also a rapid rise in house prices in the period 2002 to 2004. Overall, the economic conditions in the period 1997 to 2007 were favourable for the life and pensions industry. The fall in inflows into the industry since 2000 was however not reversed in 2003 and competition shifted to transfer business with implications for the health of the industry going forward.

Technological innovation had an impact in this period, particularly in the development of so called 'platforms' which consist of 'wraps' and 'fund supermarkets' and contain a variety of administrative and analytical tools. Platforms are IT based services used by



investors, or more usually by their advisers, to administer investments. The adviser opens an account for the client on a platform which then enables the placement of money in tax efficient 'wrappers' such as pension plans or ISAs. The money can then be invested in any of the range of funds to which the platform provides access. Platforms contain tools to analyse the portfolio, to assess risk exposure and to make asset allocation decisions. They also enable an adviser to analyse the investments held across the adviser's client base and to assess and compare charges. Advisers can also assess their own remuneration through the platform.

The platform or the wrap part of a platform is a new way of delivering the services contained within the traditional PP or GPP product. The longstanding PP or GPP product consists of administration and investments management services. The administration includes the collection of tax rebates on contributions, custodial services for the assets, the provision of statements and valuations; the investment management services include access to a range of funds. Wraps enable those services to be provided in a more efficient way, and particularly provide more direct access for the customer and the adviser to investment funds.

The terminology in use in the industry can be confusing. The terms 'platform', 'wrap', 'wrapper' and 'fund supermarket' are often used interchangeably but can mean different things depending on the provider. A SIPP product is sometimes referred to as a wrapper. In essence, what is being referred to is a bundle of services which differ from provider to provider. Providers include insurance companies, fund managers and technology companies.

The development of platforms has provided new issues for the FSA which is considering the matter as part of its ongoing Retail Distribution Review. In the meantime, the FSA issued a factsheet to intermediaries in June 2007 which contained guidance on the use of platforms. The factsheet said that platforms can create conflicts of interest which need to be managed. "For example, a firm's desire to make an administrative cost saving should not lead to customers being recommended to use a platform when this will not be in their interests." This guidance was followed by the newsletter of September 2007 referred to above in the context of SIPPs, which said that firms should be able to demonstrate that a particular consumer requires the investment flexibility and control offered by a SIPP. This guidance needs to be seen in

the context of the evidence cited above which shows that there is an increasing amount of churn in the pension fund business.

The development of platforms, wraps and SIPPs present some difficult and important issues of public policy. The FSA has a statutory duty to protect consumers. It does not have a statutory duty to promote competition but in achieving the objective of protecting consumers it must not impede or distort competition unnecessarily. The OFT is guardian of competition policy. The OFT can intervene if it felt that competition was being impeded or distorted unnecessarily and make a report to the Treasury. But the FSA's primary duty is to protect consumers and this duty is bound to be implemented having regard to the political context following the Northern Rock crisis. Neither the FSA nor the Treasury will want to take any risk of adverse public criticism from any future crisis. It may well be therefore that competition issues will take second place and that there will in the near future be more regulation than is operationally necessary, impeding innovation and competition.

The point is that platforms are an innovation which potentially could improve competition to the benefit of consumers. Platforms could make the various services offered in a traditional packaged pension product more transparent to consumers, reducing the information asymmetry which has been a feature of pension products in the past. In a competitive environment, a customer would be able to compare the quality and price of services provided by different intermediaries and then make a choice. Intermediaries would then have an incentive to improve the quality of their offerings and maintain competitive prices. Consumers may still be at a disadvantage in being ill-informed on financial matters and they may still require some protection but competition could reduce the degree of regulatory intervention required. There is a risk however that in the political climate following Northern Rock there will be an increase in regulation which could frustrate innovation with longer term disadvantage to consumers. From the intermediaries' point of view, they have to consider not only their own business interests and their competitive positioning in their market but also the likely reaction of the regulators in any particular case. The risk is that whatever competitive offering the intermediary creates the FSA might take the view in a particular case that a customer had been disadvantaged and might impose sanctions on the intermediary. This risk is bound to affect the strategic decisions of intermediaries and therefore the development of the pension products and services.

#### **5.4 Summary: The impact of regulation on the development of products**

A personal pension product is a bundle of services for a retail consumer. It meets the needs of an individual to save during working life to accumulate a fund to spend during retirement. The individual needs:

- advice on the level of contributions in the context of their income, personal circumstances and aspirations,
- advice on and access to investments,
- advice on and access to products which convert the accumulated fund into a retirement income, and
- risk management services to cover both financial risks and life risks (for example, the possibilities of early death or greater than average longevity).

In a competitive environment one might expect the financial services industry to design a wide range of products and services to meet these needs, products with increasing value for money for the consumer if competition is effective. But the provision of tax relief on contributions to specified personal pension arrangements, and the complex rules which inevitably accompany such fiscal incentives to prevent abuse, change the nature of the product development process. Tax breaks enhance the marketability of products which comply with the rules, crowding out other possibilities. Product development is then limited to products which comply with the tax rules, and this in turn makes development of those products largely dependent on changes to tax rules. The provision of tax incentives shifts control of product development from the market place to the government.

This phenomenon is seen throughout the last twenty years in:

- the Conservative personal pension initiative which created new types of product available to a new groups of consumers and which promoted a boom in pensions sales, regrettably not in the interests of many consumers,
- the changes to the annuity rules to allow income drawdowns which permitted the development of the SIPP product,
- the Labour government stakeholder initiative which created a new product which did not sell well to its target market but which put pressure on charges to consumers of other pension products through the link made between the stakeholder rules and conduct of business regulation, and

- the pension simplification initiative which allowed existing pension funds to be consolidated more easily promoting SIPPs and transfer business.

As the product is defined by regulation, the degree of differentiation in product features between products on the market over much of the last twenty years has inevitably been limited. The main variable has been in the range of investment funds available.

In a competitive environment one might expect that the price charged to consumers for the product will be driven down to the marginal cost of production and distribution. Prior to the introduction of investor protection regulation in 1988, the price was not apparent to the consumer: money was taken from the contributions and from the investment fund without any disclosure. Regulations introduced in 1988 created for sellers a duty of care to the consumer, thereby making the seller the agent of the consumer. But regulations did not require the agent to disclose his/her remuneration or the total price charged for the product. When full disclosure was required in 1995, it was difficult for the information to be provided in a way which was meaningful to the consumer and in a way which assisted the consumer compare products on the market. Charging structures were complex. Government then moved to price caps, but as shown in Section 5.3 above, producers have manoeuvred around the rules to some degree with their PP, GPP and SIPP products. It is fair to say that charges and agent remuneration are now much more transparent than they used to be but the charging structure of some products, especially SIPPs, are still complex making it difficult for consumers to compare prices.

If the seller has a duty of care to the consumer and is the agent of the consumer, then the agent has the duty to advise their client not only on the suitability of the product but also on whether it is competitively priced. But agents face conflicts of interest: they are also agents of the producer and the price includes their own remuneration. This issue has been at the heart of the debate between the industry and the regulators for the last twenty years but it remains unresolved. There has been some movement towards fee based advice where the adviser is truly independent, but most sellers in the field retain their conflicts of interest. In today's tight market place, there is still a temptation for advisers to churn their clients' funds to obtain remuneration. The regulations introduced since 1988 have not therefore solved a problem that was inherent in the market before that date.

Ideally, consumers will be price conscious and sellers will compete on price, but limited financial literacy among many consumers makes this ideal difficult to realise in practice. Regulation may therefore be necessary to protect consumers. But the regulations introduced and maintained since 1988 have institutionalised the problem, the conflict of interest facing the seller. Regulations which directly addressed the underlying problem might have had a more beneficial outcome.

In summary therefore:

- Regulation has defined the product which has meant that differentiation between the offerings of different companies has been limited; and changes to regulation are required to enable product innovation.
- Regulation may impede technological innovation such as that seen in platforms and wraps.
- Regulation has determined the customers who are eligible or who are targeted to purchase the product.
- Government has promoted the product with advertising and fiscal incentives.
- Regulation initially did not prevent the price being concealed from the consumer; later regulation required the price to be disclosed and also attempted to control the price.
- There has been limited competition in this market on product quality and price.

Having examined the impact of regulation on products, I turn in the next chapter to the impact of regulation on the distribution channels for those products.

## **CHAPTER 6: THE IMPACT OF REGULATION ON THE EVOLUTION OF DISTRIBUTION CHANNELS**

### **6.1 Overview of this chapter**

In the last chapter I examined the impact of regulation on the development and sale of pension products. I now examine the closely related issue of the distribution of those products. I address the response of market participants to the key events summarised in Section 4.13 above as they relate to the issue of distribution.

In particular, I look at the effect of the polarisation rule which prohibited one particular business model. I examine the effect that this rule had on the strategic decision-making of the various market participants: the independent brokers, the banks and building societies and the life and pensions companies. I chart the evolution of distribution channels in terms of the proportion of new business coming in through each of the channels provided by the market participants and show that the market became dominated by just one channel. I assess the impact that the polarisation rule and other regulations had on the emergence of this dominant channel. I also assess the impact of the abolition of the polarisation rule (depolarisation) in 2005.

I again split the period into two phases: 1987 to 1997 and 1997 to 2007 corresponding to the periods of the Conservative and Labour governments.

The sources of data are shown in Appendix A and a selection of contemporaneous commentary is in Appendix B.

### **6.2 The evolution of distribution channels 1987 to 1997**

#### *The polarisation rule and associated regulatory rules*

As described in Section 4.6 above, the new regulatory rules which came into effect in April 1988 required a seller of investment products (including personal pensions) to be either an independent financial adviser (IFA) providing advice on (and access to) all the products on the market, or a representative of just one producer selling only that producer's products. It was not permitted for a seller to offer products from a limited range or panel of producers. The polarisation rule remained in existence until June 2005.

All distributors had to be members of a self-regulatory organisation (SRO) or supervised by a member of an SRO. Fimbra was set up for IFAs and Lautro for

producers. Representatives of producers were supervised by the producer to whom they were tied, and thereby came under the regulatory regime. Members of an SRO had to pay fees to cover the SRO's administrative costs and the costs of investor compensation schemes; they had to provide their own professional indemnity insurance; and they were responsible for costs of the training and supervision of their staff and representatives.

The other regulatory rules which were relevant in the context of the development of distribution channels were:

- the Lautro Maximum Commissions Agreement (MCA) and the limited disclosure rules associated with it; the abolition of the MCA with effect from January 1990; and the new disclosure rules which came into effect in January 1995 after various intermediate manifestations;
- the conduct of business rules which were increasingly enforced from 1994 onwards, including the requirement to review a substantial number of sales and to increase training of sales people; and particularly the deadline of July 1997 for sales people to pass the FPC (Financial Planning Certificate) examination.

*The implications of the polarisation rule and associated regulatory rules for market participants*

Before the new rules came into effect, insurance companies distributed their retail products through three main channels:

- Independent brokers; this channel was preferred by the traditional (often mutual) insurance company such as Standard Life.
- The producer's own direct sales force (DSF); this was the method used by the newer (sometimes called 'unit-linked') insurance companies such as Allied Dunbar.
- The producer's own home sales force; this was used by some of the traditional insurance companies such as Prudential ('the man from the Pru') which collected small premiums in cash.

The regulatory changes introduced in the mid-1980s allowed other financial institutions such as banks, building societies, unit trust companies and fund managers to enter the markets previously reserved for the insurance companies.

The new regulations required existing market participants and potential entrants to make some decisions about the position they wished to take in the retail investment

markets and to take the necessary action following these decisions. These decisions had to be taken in the context of the government's initiative to expand the personal pensions market, as described in Sections 4.4 and 5.2 above.

The independent brokers were faced with a difficult choice. Many such brokers were small firms which sold products from a limited panel of insurers, a business model which was no longer permitted. These firms had to decide if they wished to remain independent, otherwise they needed to be taken on as a representative of just one insurance company. If brokers wished to remain independent they had to expand their operations to cover the whole market and to register with Fimbra, incurring the costs of regulation and bearing the risks that regulation entailed. As a representative, the producer would take the lead in ensuring compliance with regulations. In making a decision, a broker had to take a view on the business opportunities of the expanding pensions market and on the impact of the Lautro MCA rules. As an independent, the broker's commission would be controlled by the MCA, but as a representative there was no such regulatory control.

Each of the new entrant banks and building societies had to decide if they wished to set up their own production operations. As a distributor, a bank or building society had to decide either to become an IFA or to tie their branch network to just one producer. One option denied to these new entrants by the polarisation rule was the opportunity to use their branch networks as investment supermarkets, selling a selected range of products from different companies. In this respect the smaller building societies had similar issues to those of the smaller brokers; and whether large or small, banks and building societies had to take a view on the potential of the new pensions market and the impact of the Lautro MCA rules.

For their part, the incumbent insurance companies had to decide whether to remain with their preferred distribution channel, to expand that channel, or to diversify into different channels. The producer was not restricted by the polarisation rule directly. A producer could distribute either through IFAs, or through their own DSF, or by signing up banks and building societies on a tied agent basis; or they could choose two of these channels or all three, or indeed they could develop other channels such as direct advertising.

In making decisions, market participants had to take into account the expected and actual behaviour of other market participants, particularly competitors and companies



with whom they had or could have a business relationship (such as that between a producer and distributor). They also had to take into account the responses of the regulators and changing regulatory requirements particularly following the OFT interventions. The discourse at the time reveals considerable uncertainty and anxiety in the marketplace which persisted from 1987 onwards.

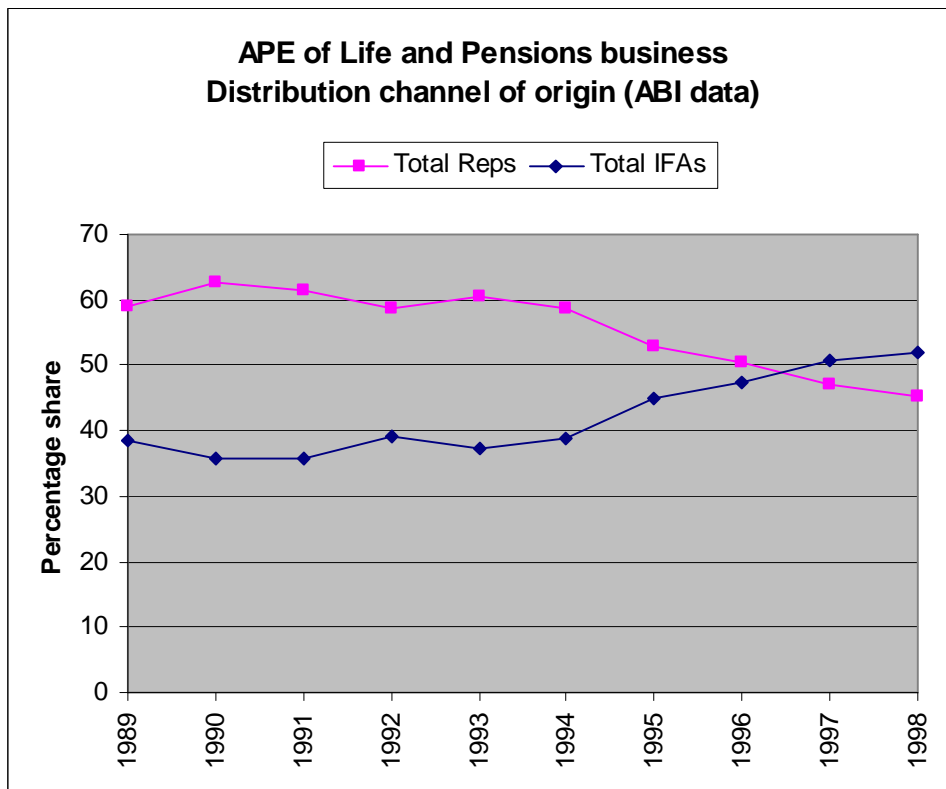
I now describe the evolution of the distribution channels in the market for life and pensions products and then assess the impact that regulation had on that evolution. My focus is on the distribution of personal pensions products but it needs to be recognised that the distribution channels for these products was shared with other products, notably life insurance and endowment policies (collectively called 'life business').

#### *The evolution of distribution channels 1987 to 1997*

Figure 6.1 below shows the distribution channels of origin of new retail life and pensions business combined for the period 1989 to 1998. This figure shows the percentage of new business coming in through the two polarised channels, Representatives and IFAs respectively. At the start of the period representatives secured 60% of new business against IFAs of 40%. By the end of the period the proportions had equalised. There is small amount of direct selling business (less than 3% which is ignored for clarity).

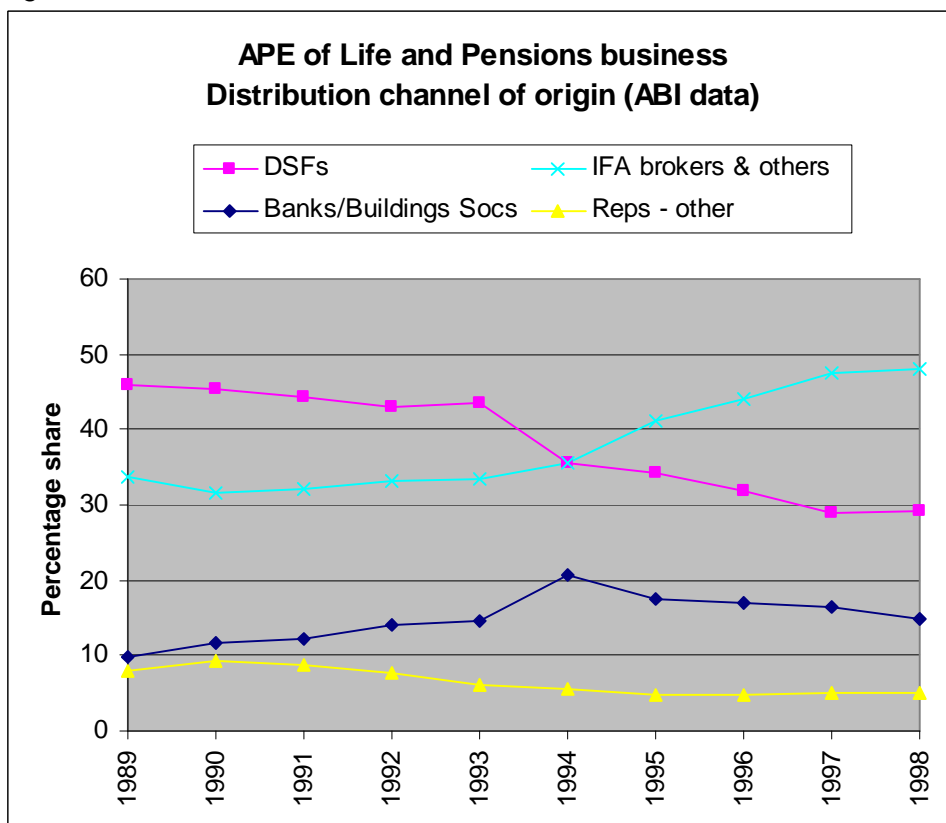
Each of the two polarised channels contains different participants. Representatives include producers' DSFs, tied banks and buildings societies and other tied agents such as former independent brokers. IFAs include independent brokers and other agents such as solicitors and accountants, together with banks and buildings societies which polarised as IFAs. Figure 6.2 shows the division of business between these participants. At the start of the period producers' DSFs took the largest share but by 1994 IFAs had caught up and then proceeded to overtake DSFs. The banks and building societies did not start the period from a zero base as they had traditionally placed insurance business with producers. By 1994 the banks and buildings societies had doubled their market share but this then began to tail off. The share of banks and buildings societies includes that from companies operating as tied agents to a single producer and from companies polarised as IFAs. Figure 6.3 shows the division between these two options. The tied option proved far more popular.

Figure 6.1



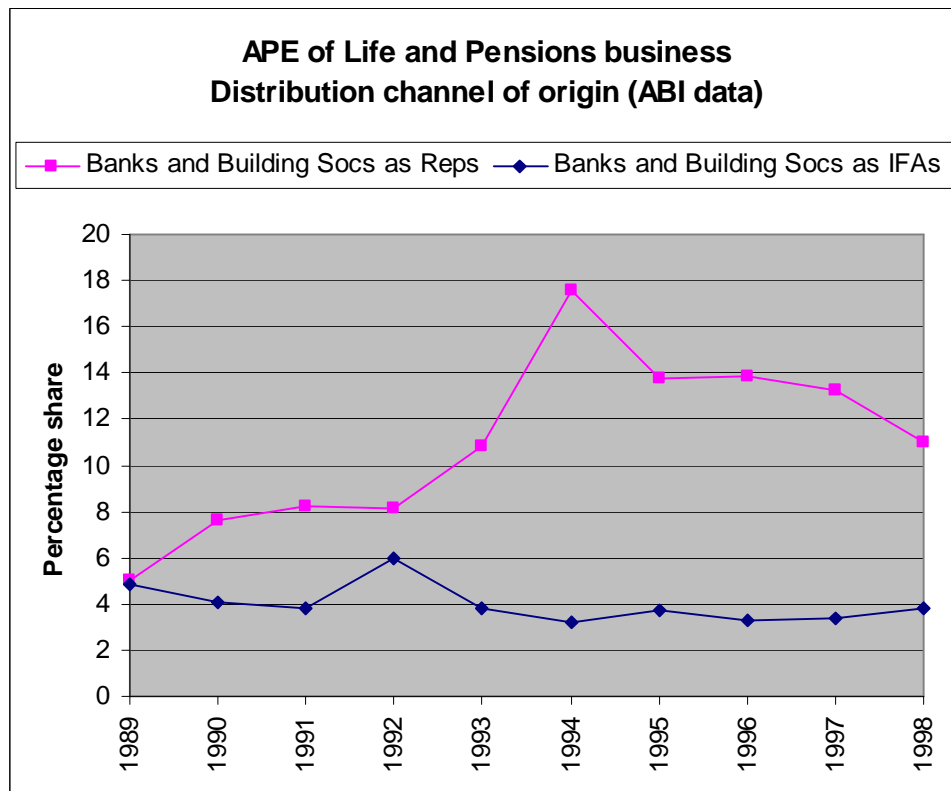
Source: ABI

Figure 6.2



Source: ABI

Figure 6.3

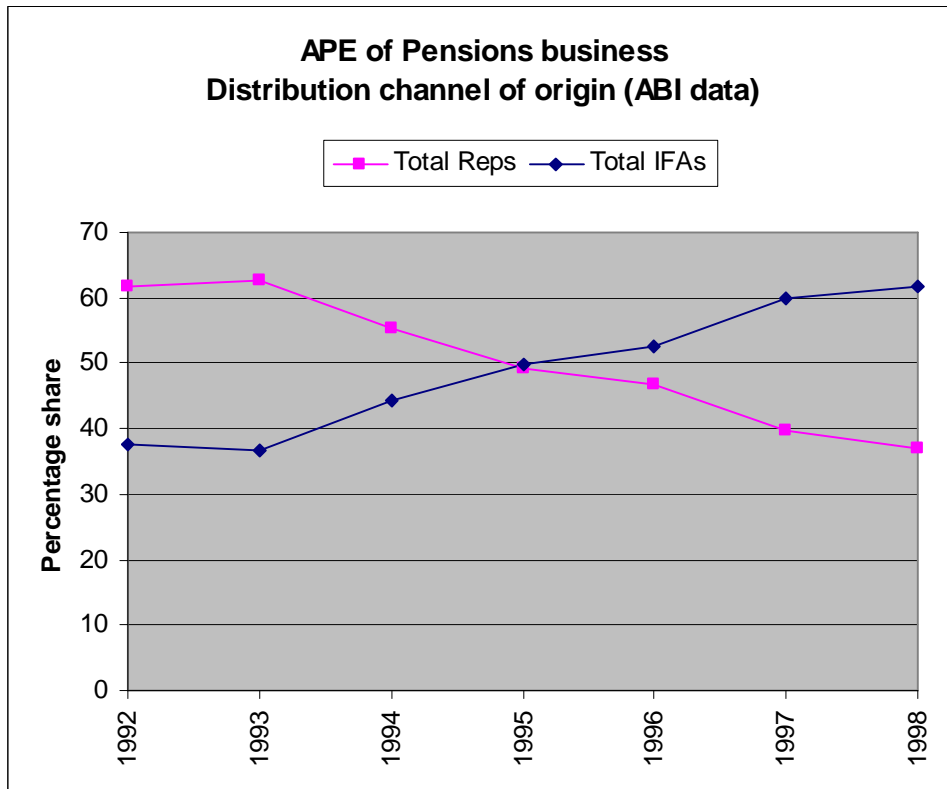


Source: ABI

Figures 6.4 to 6.6 below show the data just for retail pensions business. The data for life and pensions business is not separated for years before 1992 so these charts show only the position from that date. The competition for pensions business turns out to be a contest between IFA brokers and producers' DSFs, with the banks and building societies winning less than 10% share of the market. By the end of the period, IFAs were becoming dominant with 60% of new pensions business.

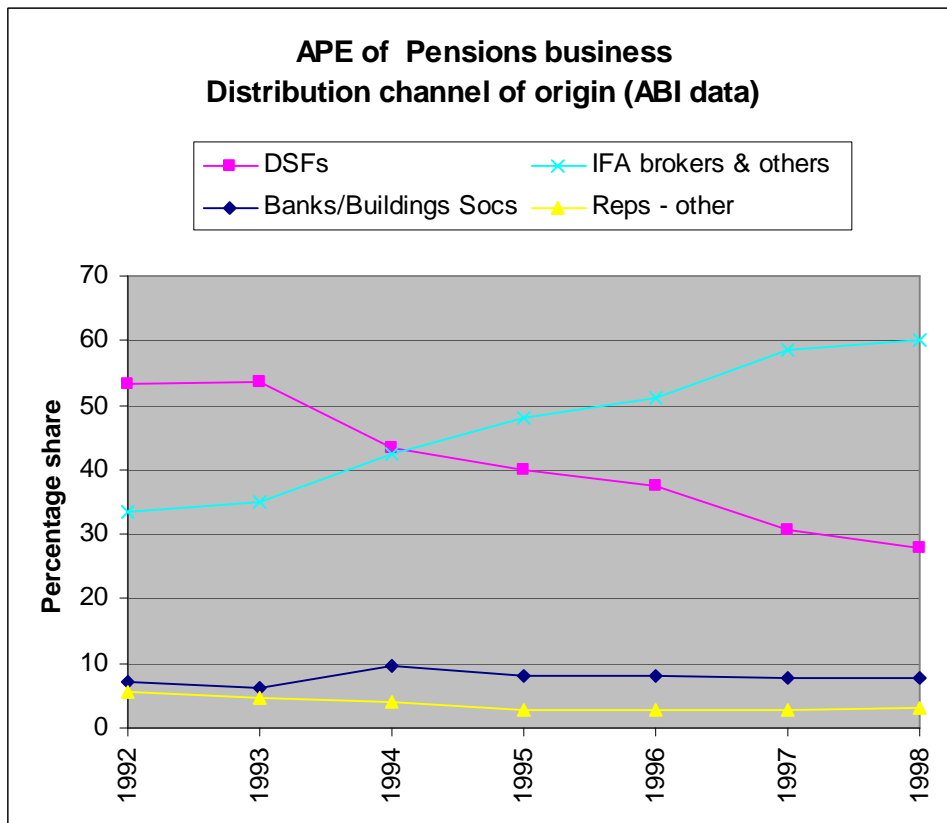
The pattern revealed by these charts was not expected by market participants and observers at the time. Much of the discourse in the early part of this period was about the threat to the existence of IFAs from the new regulatory and competitive environments but this sector proved to be much more resilient than expected. It was also expected that the banks and buildings societies would obtain a much higher proportion of the business but the much heralded bancassurance movement in the UK failed to materialise. I now examine the evolution of the distribution system in more detail and from the perspective of the main participants.

Figure 6.4



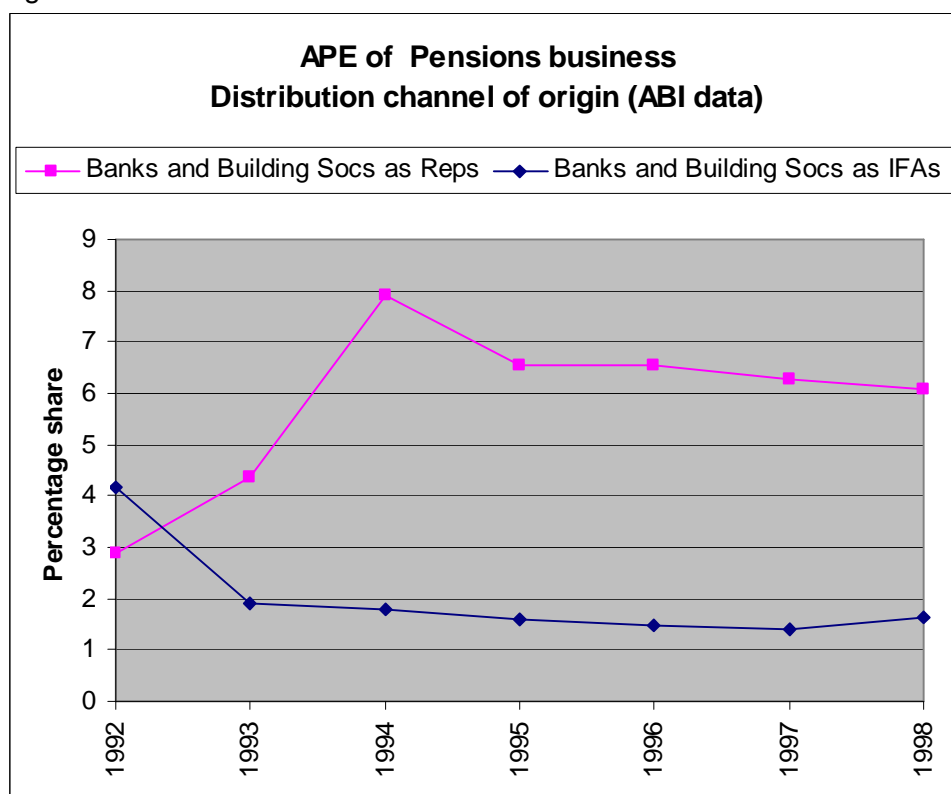
Source: ABI

Figure 6.5



Source: ABI

Figure 6.6



Source: ABI

*Independent brokers*

The number of firms of independent brokers selling life assurance and pensions before the new regulatory regime came into effect is unknown. In April 1988 Fimbra had enrolled 5,725 members with a further 4,800 applications pending, giving a potential membership of 10,500. The Economist reported in November 1988 that 950 firms had withdrawn their applications and a further 1000 had been advised by Fimbra not to proceed. By May 1989 Fimbra membership had reached 8,910 firms but this had fallen to 8,083 by January 1990. These data confirm the general impression reported in the professional press that many small brokers had given up their independence and tied themselves to just one producer. The fact that this exodus generally only involved the smaller firms is confirmed by the data in figures 6.2 and 6.5 above which shows that representatives, other than DSFs and banks and buildings societies, captured less than 10% of all retail life and pensions business and less than 5% of pensions business.

Nevertheless there was at the time considerable concern about the future of the IFA sector among the group of producers which relied on independent brokers for their sales. One group of insurance companies formed the 'Independent Market Assistance

Group' to support IFAs and another group formed 'The Campaign for Independent Financial Advice (CAMIFA)' to promote the benefits of the IFAs services. Although the threat to the IFA sector was perhaps overstated, the perceptions of insurance companies when coupled with the perceptions of what happened in the bank and buildings society sector undoubtedly affected the strategic decisions of insurance companies. I return to this after examining what the banks and buildings societies did.

### *Banks and building societies*

The banks and building societies fought against the polarisation rule on the grounds that it was anti-competitive and discriminated against them. Their campaign did not however move the regulators or the government so they had to decide which way to polarise their branch networks. They did manage to get one concession from the regulators which was that if they tied their branches they could retain an IFA subsidiary to receive referrals from the branches but the IFA could not sell an in-house product unless it was demonstrably better than the best on the market (the 'better than best rule'). This concession did not however help with the main issue of how to use the main branch network.

Barclays, Lloyds and TSB had already formed life and pensions subsidiaries (under concessions granted by the Bank of England and the DTI) and tied their branches to those subsidiaries. Midland followed, forming a life and pensions subsidiary as a joint venture with an existing life and pensions company, Commercial Union. NatWest and the three Scottish Banks decided to set their branches up as IFAs but the Bank of Scotland soon changed its mind and tied to Standard Life. Later, RBS formed a joint venture with Scottish Equitable and NatWest set up its own life and pensions subsidiary in partnership with Clerical Medical.

Among the large building societies, Abbey National initially tied to Friends Provident but later it acquired Scottish Mutual which sold through IFAs and it also set up another life and pensions subsidiary to tie to its branch network. Many other large societies decided initially to set their branches up as IFAs but soon changed their minds. Halifax, C&G, Nationwide, Woolwich, Alliance & Leicester and Leeds all changed their minds and tied. Later, Halifax, Nationwide, Woolwich and Leeds set up their own life and pensions subsidiaries. Britannia acquired a number of small life and pension companies and amalgamated them to form its own production operation. Most other

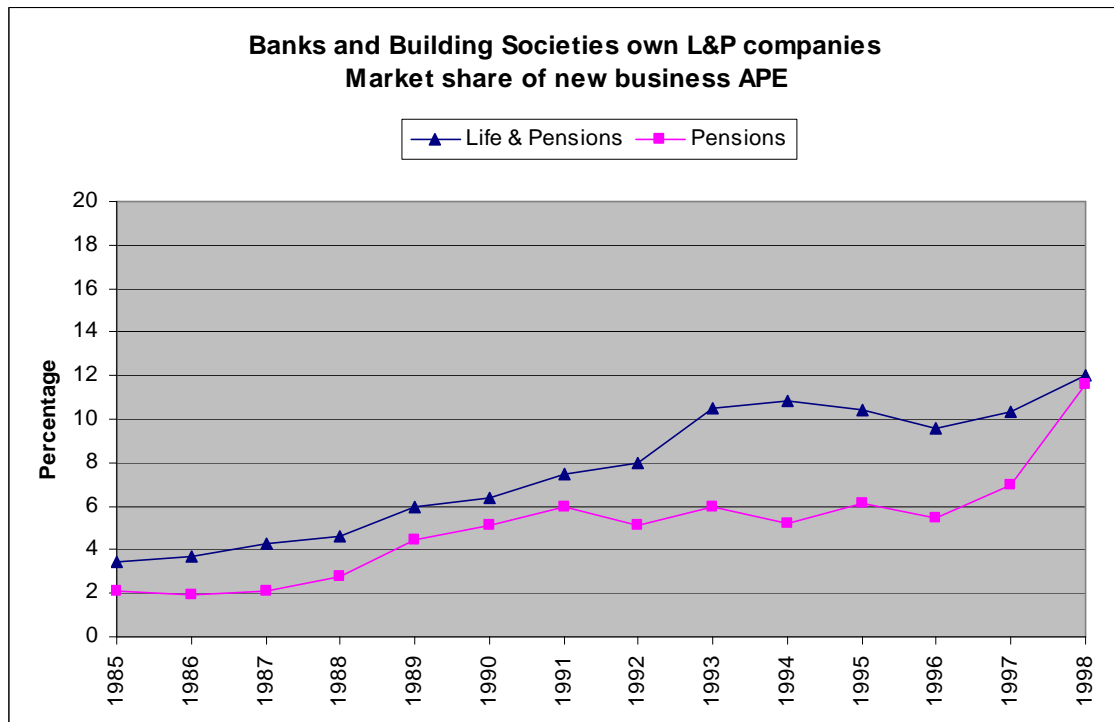
building societies found themselves a tie to an existing life and pensions company leaving very few IFA polarised societies.

The reasons why most building societies tied to existing life and pensions companies were reported at the time to be related to the cost of staff training and the regulatory risks of attempting to offer independent advice to the standard expected by the conduct of business regulations across a large dispersed branch network. Remuneration as a representative was also higher than that as an IFA.

Banks and building societies were also courted by life and pensions companies anxious to secure distribution outlets and many banks and building societies also intended to learn the business so that they too could set up or acquire their own life and pensions subsidiaries, a route which many subsequently followed. Llewellyn (1996) reported a survey of senior bankers. The immediate catalyst for the shift into manufacture (as opposed to distribution) was polarisation. The motives were both defensive and strategic: defensive because the products of the insurance companies had become more akin to savings than insurance and this was encroaching on their traditional territory; strategic because demographic change and the pressure on state pensions were seen as favourable to the development of savings and pensions products.

Figure 6.7 below shows the market share of in-house life and pensions companies owned by banks and building societies which distribute products through the corresponding branch network. It does not include the market shares of IFA distributors acquired by the banks (Clerical Medical and Scottish Mutual). The data set used to produce this chart includes some OPS business but this does not distort the picture except for the year 1998 which is exceptional due to a high level of OPS business won by NatWest Life. The market share falls back to 1997 levels in 1999. The chart shows that the banks and buildings societies managed to grow a steadily rising market share, but this by no means broke into the heart of business of the incumbent life and pensions companies.

Figure 6.7



Source: Synthesys Life database

#### *The incumbent life and pensions producers*

Before the new regulatory regime came into effect in 1988, the majority of life and pensions companies fell into one of two strategic groups. Firstly there was the group of traditional (often mutual) life assurance companies, many tracing their roots back to the nineteenth century, selling mainly with-profits products through independent brokers. Secondly there was the group of newer unit-linked companies that had been established since the 1960s selling products through their own direct sales forces. There were some major exceptions, notably Equitable Life, a mutual with its own direct sales force which targeted professional customers.

Each of the two main groups inevitably saw the personal pension boom and the new regulatory regime in their own terms. The traditional with-profits companies sought to protect the independent sector while the newer unit-linked companies sought to develop their DSFs to take advantage of the new selling opportunities. The traditional companies had been under threat from the newer companies for some years, and polarisation was originally a counter to that threat, preventing members of DSFs from passing themselves off as independent advisers. Polarisation was also seen as a defence against the banks and buildings societies as new entrants. The insurance



companies had the power on the regulatory bodies to maintain the line on this policy in the face of opposition from the banks and building societies.

The group of traditional companies was however a fragile coalition and some companies started to break ranks, signing up independent brokers and building societies as tied agents. This then led to what was described at the time as a 'scramble' to sign up distribution outlets. Reports appeared in the press and professional journals that some companies were offering commissions well above the MCA levels to secure brokers and buildings societies. As mention in Section 5.2 above, the abolition of the MCA led to a rise in commissions payable to IFAs but representatives retained a lead over IFAs as shown by the Lautro data in Table 6.1 below for the average commission as a percentage of the maximum:

Table 6.1 Commission as a percentage of MCA

	March 1990	November 1991	August 1993
IFAs	123%	126%	128%
Representatives	134%	144%	146%

Source: Lautro data

From a producer's point of view, once a bank or building society had signed up as a representative for a competitor, that bank or building society was no longer a potential sales outlet. So once it became apparent that some producers were signing up outlets, all companies had to engage in the competition to sign up the remaining outlets.

At one point, many traditional companies started to develop their own DSFs to ensure that they did not lose out in the emerging personal pension boom. But the DSF route proved problematic. Staff turnover was very high, creating recruitment and training costs. This was exacerbated by the increasing enforcement by the regulators of the conduct of business rules, which involved suspending and/or retraining staff. The final straw for many was the regulator's deadline of July 1997 for all sales people to have passed the FPC examination, which proved a challenge for many in DSFs.

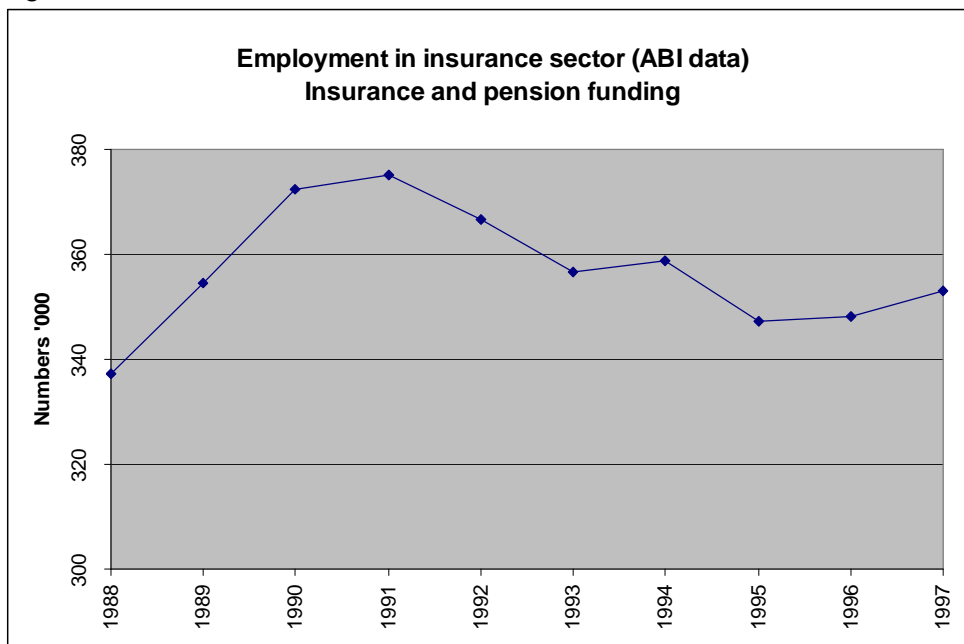
The IFA sector proved to be much more successful than DSFs in meeting the regulatory and commercial challenges. There was some consolidation in the sector but also IFA networks emerged to provide central services such as regulatory compliance and marketing support. As can be seen from Figures 6.2 and 6.5 above, IFAs overtook DSFs in terms of market share in 1994 and then began to open up a substantial lead,

particularly in pensions. Many producers, after toying with DSFs and strategies to increase their tied network, shifted their emphasis back to the IFA sector.

The companies which had always operated through DSFs initially increased their salesforces to compete in the new pensions market but they too ran into problems of recruitment, training and compliance with the conduct of business regulations. Many had to scale down their operations significantly as consumer demand fell away in 1994 and 1995 and as regulatory enforcement increased.

More generally, the life and pensions industry increased its capacity during the boom years which proved to be a problem later. This can be seen in the data in Figure 6.8 below for the total employment in the sector. Employment rose by 11% between 1988 and 1991 before falling back. But by the mid 1990s the industry was still carrying excess capacity which was a factor in the consolidation which started in the late 1990s (which is covered in detail in Chapter 8 below).

Figure 6.8



Source: ABI

#### *The impact of regulation on the evolution of distribution channels*

There is no doubt that the polarisation rule introduced in 1988 had a profound and lasting effect on the development of distribution channels. This new rule made one business model, the multi-tied distribution agency, unlawful. The prohibition of this

business model had an immediate impact on two groups: firstly the independent brokers which were using it, forcing those brokers to change their way of doing business; and secondly, the banks and building societies as new entrants to the life and pensions market, forcing these companies to adopt different strategies from those they might otherwise have preferred for their branch networks.

Once a bank or building society had decided against the IFA route, only the single tied agency remained for the branch network. Without the polarisation rule, some banks and building societies might still have chosen to sign exclusively for one producer, but others might have opted to set up a multi-agency, a business model some were already using to place insurance business. The existence of multi-agencies would have allowed producers to compete for the attention of those agencies on an ongoing basis. In a polarised world however, once banks and building societies decided against IFA status, producers could only compete to sign exclusive deals. Polarisation therefore substantially restricted the potential competition.

As Llewellyn (1996) reported, polarisation was also a catalyst for the large banks and building societies to set up their own life and pensions operations. For these companies, the strategic decision effectively became one of choosing between signing a distribution arrangement with one producer or setting up (or buying) a life and pensions operation. Had the multi-agency been an option, it might have been preferred by some banks and building societies.

The polarisation rule was not the only piece of regulation that affected the evolution of the distribution channels. The polarisation rule operated alongside the government's promotion of personal pensions and the other regulatory issues of the time, namely the MCA and its abolition, the disclosure rules in their numerous changing manifestations, and the enforcement action taken by the regulators. While the polarisation rule was the most significant in its impact on the development of distribution channels, the other regulations had a moderating influence. The pension boom increased the urgency for the signing of distribution agency arrangements. When the MCA was in force, producers were prevented from bidding up commission levels to secure the loyalty of IFAs which had the effect of shifting available marketing effort and budgets towards securing tied agencies. This in turn led to a differential opening up between commission levels payable to IFAs and representatives. The delay in enforcing full disclosure to consumers allowed these commission levels to be concealed, facilitating

the competition for distribution outlets and dulling the incentives for competition on price. The enforcement activity when it came had a disproportionate affect on DSFs, resulting in a reduction in the market share of this channel.

The general consensus of regulators, market participants and observers was that the life and pensions market in the period 1987 to 1997 became driven by competition for distribution outlets rather than competition on the quality and price of products.

### **6.3 The evolution of distribution channels 1997 to 2007**

#### *Introduction*

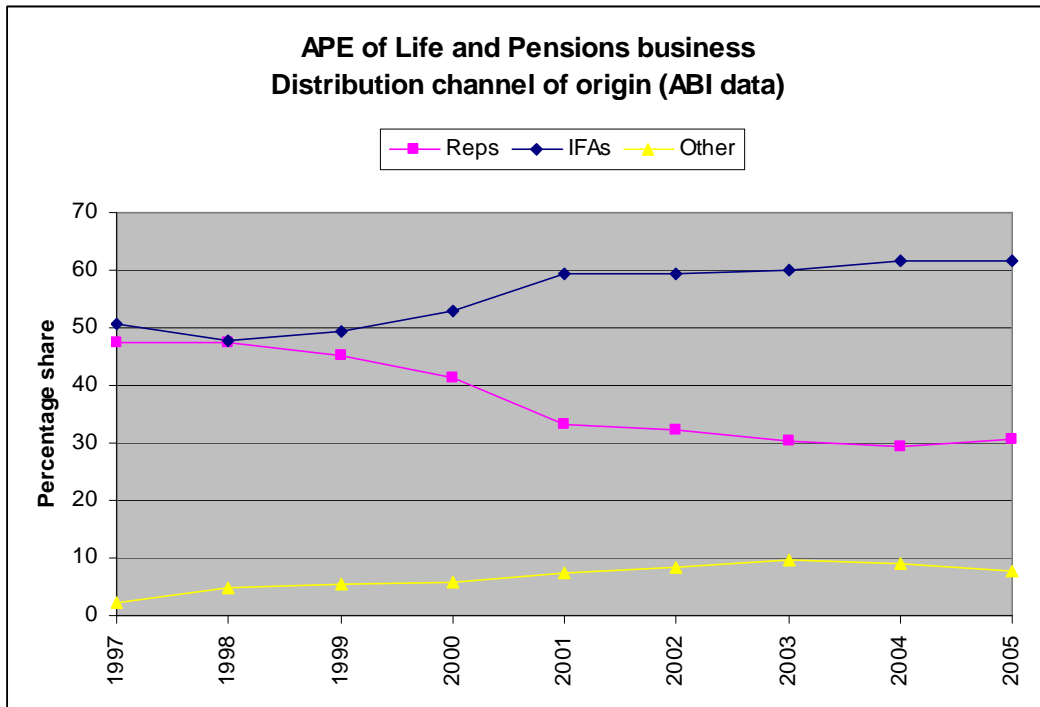
In Section 6.2 above I analysed the evolution of distribution channels up to 1997. By this date, independent brokers were taking 60% of new pensions business; incumbent insurance companies with DSFs were taking 30%, leaving less than 10% for the new entrant banks and building societies through their branch networks. Some banks and building societies had opened or acquired their own production operations to tie to their branch networks; by 1997 they had achieved a market share of pension production of 7%. Under the influence of the polarisation rule, producers were competing for distribution channels rather than on product quality and price.

In this section I describe and analyse the evolution of distribution channels from 1997 onwards. I examine the strategic responses of independent brokers, banks and buildings societies, and the long standing insurance companies to the various regulatory changes in this period. I assess the impact of regulations, particularly the requirement for all salesmen and advisers to pass the FPC examination, the stakeholder charging cap and depolarisation in June 2005.

#### *The evolution of distribution channels 1997 – 2007*

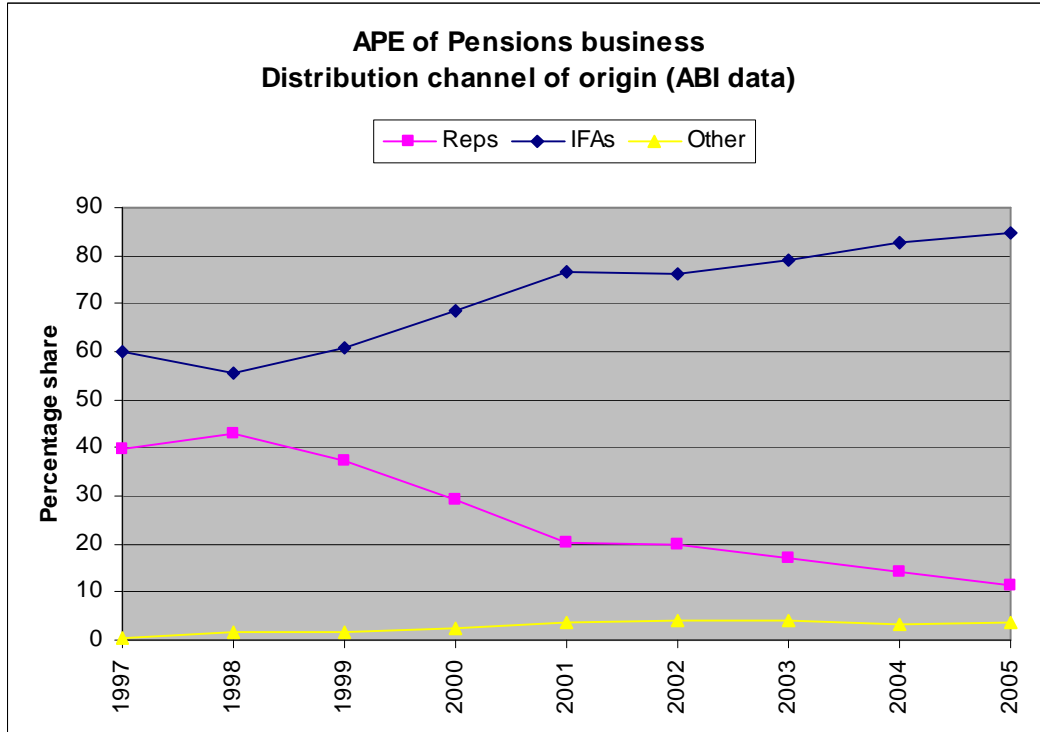
Figure 6.9 below shows the channel of origin of new life and pensions business combined from 1997 onwards, distinguishing between representatives, IFAs and other channels. Figure 6.10 shows the data for retail pensions business alone. IFAs increased their dominance of distribution. By 2005 IFAs were taking over 60% of all life and pensions business and over 80% of pensions business. The ABI data for this period no longer splits the share of representatives between producers' DSFs and branches of banks and building societies but clearly, by 2005, very little new pensions business was being secured through either DSFs or branches of banks and building societies.

Figure 6.9



Source: ABI

Figure 6.10



Source: ABI

A number of major changes can be observed in the structure of distribution channels and the structure of the industry from the mid-1990s onwards:

- 'Networks' arise to support IFAs.
- Producers take equity stakes in large IFAs.
- Traditional insurance companies distributing wholly or mainly through IFAs are taken over by banks and larger insurance companies (Halifax/Clerical Medical, Lloyds TSB/Scottish Widows, Abbey/Scottish Provident, Prudential/Scottish Amicable, Axa/Sun Life); others merge (Commerical Union/General Accident/Norwich Union).
- DSFs almost disappear, including the long standing home service sales forces.
- A number of life and pensions funds close to new business and some are taken over by newly formed closed fund consolidation companies Resolution and Pearl.

Further change then takes place in anticipation of and as a result of depolarisation in June 2005.

These changes need to be seen in the context of a more general consolidation in the industry which is examined in detail in Chapter 8. The changes take place also in the context of a wider consolidation in the financial services sector, which includes mergers of banks.

I now examine these changes from the perspective of the each of the participants in the market and then look at the most recent developments following depolarisation.

#### *Independent brokers*

IFAs faced a number of major challenges from the mid-1990s onwards. Their revenues came under threat from the new disclosure regulations in 1995 and from the charge cap announced in 1999 and effective from 2001. At the same time regulatory compliance costs increased from the requirement to review cases following the mis-selling scandal and from the increased enforcement of conduct of business rules including increased training requirements for advisers.

These pressures led to some consolidation in the sector but IFAs generally are very protective of their independence. The solution was the 'network' which provided compliance and other support services to small IFA firms achieving economies of scale. There are different models in use but the main one involves the partners in an

IFA firm becoming representatives of a network company for regulatory purposes while they remain in business on their own account. The network company then takes responsibility for regulatory compliance allowing the adviser to focus on the client relationship. The network company also provides a number of other services such as staff recruitment and training, business development and marketing. Networks started to emerge after the introduction of conduct of business regulation in 1988 but the numbers of IFA firms in networks increased substantially after 2000 so that by 2003 around 60% of all IFA firms were members of networks. The number of IFA firms in business remained fairly stable at around 11,000 to 12,000 over the period 1999 to 2005 (Matrix/Mintel data).

Some producers started to take equity stakes in networks and larger IFA firms providing much needed capital. This investment was inhibited by the polarisation rule: if a producer held 10% or more of an IFA, that IFA could not sell the products of the producer unless those products were demonstrably 'better than the best' on the market. Nevertheless some producers took controlling stakes in some firms prior to depolarisation. They were careful however to say that they were taking these stakes as investments and not to control distribution. Scottish Equitable, Friends Provident, Norwich Union, Skandia, and AMP were all active in acquiring such stakes. Some of the banks such as Barclays, RBS and HSBC already had IFA arms under the concession they won from the regulators when they tied their branch networks.

IFAs also embraced new technology to reduce costs and improve their services, but managing the regulatory burden was a major factor in the success of this sector. In the competition with producers' DSFs, IFAs were helped by the failure of the DSFs to find solutions to their challenges.

#### *Producers with DSFs*

Table 6.2 shows the companies relying wholly or mainly on DSFs to distribute their products together with data on the size of their DSFs where figures are available. The data shows the steady decline of DSFs over the period 1997 to 2004.

Table 6.2 Companies distributing wholly or mainly through DSFs in 1997

	L&P APE £m 1997	Ownership	Size of Direct sales force							
			1997	1998	1999	2000	2001	2002	2003	2004
<b>Home service specialists</b>										
Britannic	38	Independent	1600	2100			194	180	0	0
Co-operative	96	Mutual					3551	3348	3149	?
Pearl	90	AMP					800	800	0	0
Prudential	485	Independent	6000		3000	1800	0	0	60	83
Royal London	39	Mutual					693	326	108	0
<b>Unit linked companies</b>										
Abbey Life	84	Lloyds TSB			1350	0	0	0	0	0
Allied Dunbar	239	Zurich				4000	3489	3221	3000	2496
J Rothschild	87	Quoted/HBOS					1121	1101	1124	1131
<b>Others distributing mainly through DSFs</b>										
Equitable Life	662	Mutual				450	0	0	0	0
NFU	20	Mutual					91	120	125	104
Sun Life of Canada	57	Mutual				2000	0	0	0	0
Wesleyan	16	Mutual					170	170	40	60

Sources: Company reports and *Money Management*



The largest company by value, Equitable Life, closed for new business in December 2000 after failing to maintain sufficient reserves to meet obligations created by guaranteed annuity options in its contracts. The case of the second largest, Prudential, is presented in Figure 6.11 below. This is a story of a well controlled strategic withdrawal from selling through DSFs. The reason given for the change of strategy was that DSFs had become uneconomic largely as a result of regulatory pressure. The switch to IFAs was achieved by the acquisition of Scottish Amicable.

Figure 6.11 A change of strategy

### **Prudential**

In 1998 the company celebrated its 150<sup>th</sup> birthday. The Chairman recorded that Prudential became the largest insurer in the UK in 1879 with the sale of life insurance to working people. In 1998, it was still the largest insurer in the UK, but was now a more diversified and international business. Nevertheless, just over 50% of UK sales by value were made through its direct sales force. Most of its retail pension sales were through this channel.

In its strategic review in 1995, the company was concerned about the productivity of its direct sales force. An agent with over one year's experience was doing on average 12 sales appointments a week producing only two life and pensions proposals. There was a need to substantially increase productivity. The problem was with the way the company sold to and serviced the client base – one by one. Prudential began to consider marketing in bulk using its corporate connections and resolved to diversify its distribution channels. Its strategy was also to increase its product range and to grow its client base, especially in upmarket segments. Prudential made a major advance with this strategy in 1997 by buying Scottish Amicable, which distributed its products mainly through IFAs.

At this time the company was also under considerable pressure from the regulators over the mis-selling review, and like all companies in the field, it had to get its direct sales force representatives through the examinations for the Financial Planning Certificate. In its report for 1997, the company recorded that sales through the direct sales force were held back by the need for retraining and the implementation of recommendations from the regulator. The company reduced its direct sales force from around 6000 agents in 1997 to around 3000 by March 1999. Further action was then required to meet the challenge of the governments 1% charging cap. By December 2000 it had 1800 agents in the field and in mid 2001 it closed the direct sales force altogether, apart from a small number to service customers with more complex needs. Direct sales forces had become uneconomic. The man from the Pru was given a quiet funeral. In the new 1% charging environment there was a need to develop lower cost distribution channels.

Source: company reports and announcements

While Prudential made a successful change in its distribution strategy, Britannic Assurance was forced to close as is shown in Figure 6.12 below. It is ironic that Britannic committed itself to targeting the same customer group as the government with its stakeholder pension initiative but that regulation made its chosen strategy uneconomic.

Figure 6.12 A change of strategy

### **Britannic Assurance**

Founded in 1866, Britannic was one of the original 'industrial branch' (home service) insurers. It remained independent until 2005 when it merged with closed fund consolidator Resolution Life.

In a strategic review in 1995 Britannic identified its strength as its relationship with around one million households and two million customers in social groups C, D and E. This relationship was founded on the personal service provided by its agents who visited customers in their homes. The company had remained true to its roots. The strategic review recognised however that the company needed to restructure its operations, to introduce new technology and to ensure cost effectiveness. The company also had to retrain its agents to meet increased regulatory standards and to improve its compliance processes.

In a statement in September 1997, the Chairman thought that there was considerable room for growth in the company's market segment which some competitors had chosen to abandon. He noted that the new Labour government was committed to promoting value for money savings especially among the lower income group, the company's core customer group, and he looked forward to learning more about the government's proposals. Providing expert advice and sales service at home by its fully qualified sales staff remained at the heart of Britannic's focus.

In its annual report for the year 1997, Britannic celebrated the success of its restructuring programme. It had made a significant investment in training its sales force to enable them to acquire the Financial Planning Certificate. By the middle of 1998, the company expected to have around 2100 fully qualified agents in the field.

But the strategy ran into serious problems. In its report for the year 2000, the company noted that pressure from the market, regulators and government legislation was driving products towards the '1% world'. This charging structure discriminated against small regular payments business. Further, the increasing requirements of regulation had added to the costs of training and made the sale process longer and more complex. Britannic therefore concluded that it did not make economic sense to continue delivering a proactive sales service through a direct sales force. The company outsourced its cash premium collection and began to reduce its sales force to a core of 100 advisers who would provide a service for existing customers seeking to increase payments or to reinvest maturities. An additional 100 strong sales force would conduct worksite marketing of their stakeholder pension product. Britannic would henceforth focus on developing IFA and tied agent channels. The main sales force was closed in May 2001.

But this change of strategy was not enough. The fall in equity markets required further action to maintain the company's minimum capital requirement. The company closed Britannic Assurance to new business in early 2003 and disposed of its residual direct sales force. There was no bonus for policyholders and no dividend for shareholders for 2002. The following year the company closed Britannic Retirement Solutions, a new business it had started in March 2000. In its report for year 2003, Britannic identified itself as a forward looking financial services group specialising in asset management and the administration of closed life funds. In 2005, Britannic merged with Resolution Life.

Source: company reports and announcements

Another home service specialist, Pearl Assurance, was also forced to close and was subsequently taken over by a consolidator which renamed itself 'Pearl'. Royal London followed Prudential with a strategic withdrawal from selling through DSFs, buying Scottish Life which distributed wholly through IFAs. This left only Co-operative Insurance in this sector.

The case of unit-linked specialist Abbey Life (owned by Lloyds TSB) is in Figure 6.13 below and that of Allied Dunbar is in Figure 6.14.

Figure 6.13 A change of strategy

#### **Lloyds TSB/Abbey Life**

Lloyds TSB owned the unit-linked specialist Abbey Life which sold its products through a direct sales force. Lloyds TSB had a second life and pensions company Lloyds TSB Life, formed in 1998 from Black Horse Life, TSB Life and TSB Pensions, which sold products through the branch network.

Towards the end of the 1990s, the APE of life and pensions sales was static at around £80m for Abbey Life and £120m for Lloyds TSB Life. The company reduced its charges for existing retail pension customers in advance of the launch of stakeholder pensions requiring a provision of £80m in 1999 to add to the existing provision of £100m for mis-selling and £150m for the cost of guaranteed annuities. The prospects were not good. Early in 2000 Lloyds TSB bought Scottish Widows which distributed mainly through IFAs with an APE of around £240m. Abbey Life was immediately closed to new business, with the new business capability (the direct sales force of 1350 self-employed agents and 165 managers) sold to Allied Dunbar. The CEO said that the distribution of life, pensions and investment products through self-employed sales force no longer fits the group strategy. Lloyds TSB Life was merged with Scottish Widows, with life and pensions products being sold through the branch network under the Scottish Widows brand.

Source: company reports and announcements

Figure 6.14 A change of strategy

#### **Zurich Financial Services/Allied Dunbar**

Zurich owned the unit-linked specialist Allied Dunbar which sold its products through its direct sales force. After taking over Abbey Life's salesforce in 2000 Allied Dunbar had around 4000 sales agents, the largest direct sales force in the UK. Zurich also owned Eagle Star and Sterling which distributed mainly through IFAs.

Zurich's strategic review followed the announcement by the regulator in November 2000 of the end of polarisation which permitted the introduction of multi-tied distribution networks. Zurich's concept was to turn the Allied Dunbar/Abbey Life sales force into a multi-tied distribution network. It began in 2001 by re-branding the sales force as 'Zurich Advice Network'. Zurich was suffering adverse publicity from reports about the retraining and retesting of the sales force following visits from the regulator; and the company was continually being teased by references to 'Allied Crowbar' as Allied Dunbar was known in the trade for its hard selling techniques. After much delay in implementing depolarisation, Zurich Advice Network, now known as 'Openwork' was finally launched in June 2005. All the production activity in Allied Dunbar, Eagle Star and Sterling was brought together within Zurich Assurance but the Sterling brand was retained for investment products.

Openwork was launched as a free standing distribution company selling the products of a range of producers: Scottish Equitable for pension products, Prudential for annuities and Zurich for protection and Zurich/Sterling for investments; and a panel of 40 producers for mortgages. Zurich owns 25% of Openwork; 67.5% is owned by the selling agents and 7.5% by Openwork employees. In April 2007 Openwork had 2500 advisers in the field. Zurich Assurance continues to sell through IFAs as well as through Openwork.

Source: company reports and announcements

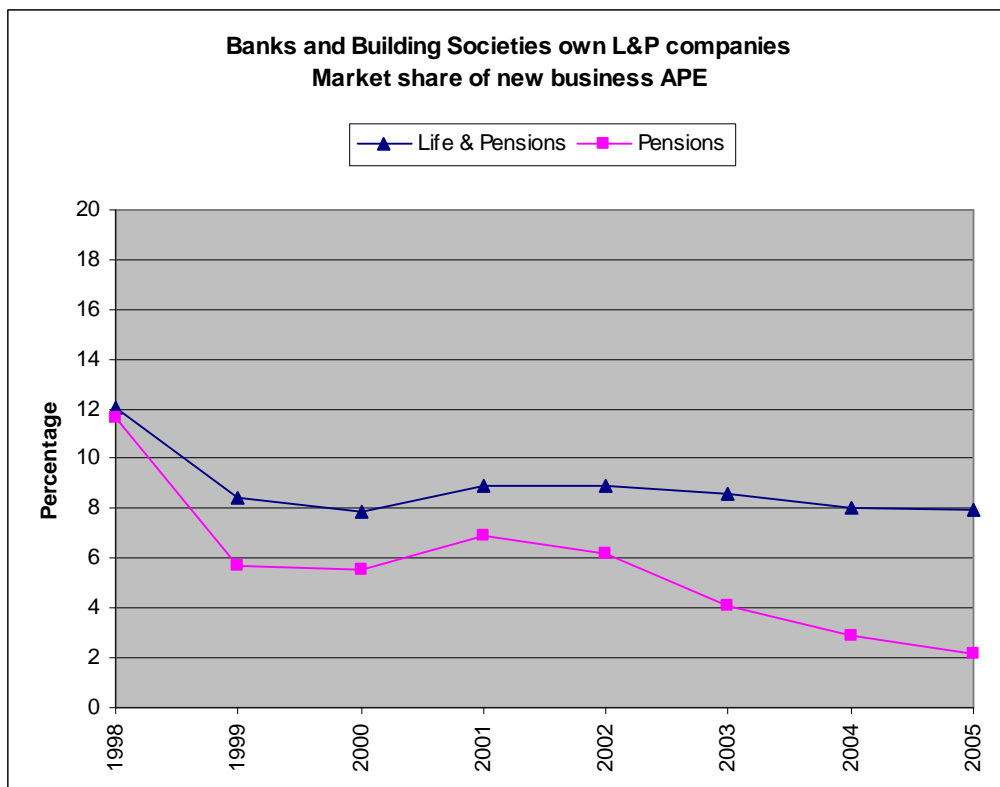
Lloyds TSB purchased IFA distributor Scottish Widows and closed Abbey Life, selling its DSF to Allied Dunbar. Zurich, the owner of Allied Dunbar adopted a different strategy, reinventing the newly enlarged DSF as a free standing multi-agency distributor in anticipation of depolarisation. These strategic changes left only J Rothschild Assurance (renamed St James Place) in this sector. This company specialises in high net worth individuals.

Of the other companies relying on DSFs, Sun Life of Canada closed to new business leaving only niche players NFU and Wesleyan. Of the producers which used DSFs as part of a multi-channel distribution strategy, some such as Legal & General, Axa Sun and Friends Provident closed their DSFs and others such as Norwich Union and Standard Life reduced their DSFs in size.

*Banks and building societies*

Figure 6.15 below shows the market share of in-house life and pensions companies owned by banks and building societies which distribute products through the corresponding branch network.

Figure 6.15



Source: Synthesys Life database

This chart does not include the market shares of IFA distributors acquired by the banks (Scottish Widows, Clerical Medical, Scottish Mutual and Scottish Provident). The data set includes some OPS business but this does not distort the picture except for the year 1998 which is exceptional due to a high level of OPS business won by NatWest Life. The chart shows that the pensions business which the banks and building societies were able to grow has now shrunk to a negligible level. The top ten retail pensions companies are all traditional life and pensions companies, led by Standard Life, Scottish Equitable and Norwich Union. The banks only enter the top ten by acquisition in the form of Scottish Widows (acquired by Lloyds TSB in 2000) and Clerical Medical (acquired by Halifax in 1996).

Lloyds TSB has already been mentioned above in the context of its disposal of Abbey Life and its acquisition of IFA distributor Scottish Widows. The branch network continues to be used to distribute products but now under the Scottish Widows brand name. Halifax retained its own in-house life and pensions company, Halifax Life, to sell through its branch network after acquiring Clerical Medical, which continues to sell wholly through IFAs. Abbey National (now Abbey) acquired IFA distributor Scottish Provident in 2001 which merged with its existing IFA distributor Scottish Mutual to form a new operation named 'Abbey for Intermediaries' to focus on the IFA channel. Abbey's own in house producer, Abbey National Life, continued to sell through the branch network. However, in 2006 Abbey sold all its life and pensions production operations to Resolution Life with a distribution agreement to sell the products through the Abbey branches and through IFAs. Britannia Life closed to new business in 1998 and Barclays closed its retail pensions businesses Barclays Life and Woolwich Life in 2003. Alliance and Leicester Life was absorbed into Legal & General, also in 2003.

#### *Closed fund consolidators*

In the tougher regulatory and competitive environment from the mid-1990s onwards an increasing number of life and pensions companies closed to new business and went into run off. This produced a new challenge for the companies concerned, which were geared towards increasing new business and growing funds under management. Managing a closed fund required a different approach. This provided an opportunity for the entry of other companies into the industry.

Pearl Group was formed in 2005 to acquire the closed life funds of Pearl Assurance, NPI and London Life from Australian financial services company AMP. Pearl Group is

owned and financed by Sun Capital Partners and TDR Capital. Sun Capital Partners describes itself as a specialist provider of capital and management with particular expertise in the long term restructuring of out of favour industries. TDR Capital describes itself as a highly selective private equity investment firm with a track record of investing in businesses that have delivered excellent returns for its investors. In acquiring AMP's interests Pearl Group became responsible for around £25bn in funds belonging to around 3.6m customers.

Resolution Life was formed in 2004 to buy and run closed life funds. It was backed by capital from leading institutional investors, including pension funds and investment trusts, led by clients of Fleming Family & Partners. In 2004 it bought the UK life operations of Royal & SunAlliance which had closed to new business. It then added the funds of Swiss Life UK, merging them with the Royal & SunAlliance funds and rebranding them as Phoenix. Resolution then added the closed funds of Britannic Assurance which in turn included the closed funds of Britannia Life and Century Life. In 2006 it changed its strategy somewhat by buying the live operations of Abbey including Scottish Mutual and Scottish Provident. In November 2007 Resolution accepted a cash offer from Pearl and Royal London Mutual. In recommending the offer to shareholders, Chairman Clive Cowdery noted that Resolution had acquired Royal & SunAlliance at 65% of embedded value (EV), Swiss Life at 76% EV, Britannic at 88% of EV and Abbey at 97% of EV. Resolution was now exiting the closed fund market at 120% of EV in selling out to Pearl.

Reinsurance company Swiss Re also entered the closed funds market in 2004 acquiring Windsor Life which included a number of smaller closed funds and Deutsche Bank bought Abbey Life from Lloyds TSB.

### *Depolarisation*

Against the background of the change in the industry outlined above, depolarisation when it finally arrived in June 2005 did not have as much impact as had been expected within the industry when the FSA first announced the intention to abolish polarisation in November 2000. The world had moved on. In particular, there had been a significant consolidation in, and exit from, the market.

As mentioned above, Zurich had anticipated depolarisation in establishing the multi-tied distributor Openwork. Barclays closed its own production operations and set up a multi-

tie distributor selling the products of six of the top ten life and pensions companies. HSBC set up a multi-tie to distribute the products of number of fund management companies. The other leading banks remained single tied. A number of IFA networks set up multi-tie sections and some producers took equity stakes in IFAs. Some small producers such as St James Place filled gaps in their product range with products from other producers. The structure of the industry therefore became more complex, but the changes did little to reduce the dominance of independent brokers in distribution. ABI data shows that brokers still took 80% of new pensions business in 2007.

This outcome needs to be seen in the context of a much changed competitive environment. By 2007 the emphasis had changed from winning new contributions from customers to managing existing funds. This is evidenced by the increasing competition for transfer business referred to in Section 5.3 above and by the closure of funds to new members followed by the consolidation of those funds into the fund management operations of Resolution, Pearl and others. Also, the producers which remain in the business of winning new contributions from customers have concentrated their efforts on the wealthier clients, abandoning lower to middle income earners. It may be concluded that the deregulation introduced by depolarisation was too little too late to allow the emergence of an active mass market distribution channel to retail pension consumers through branches of banks and building societies.

Depolarisation proved to be a disappointment to the regulator. The FSA had hoped that the increased disclosure requirements accompanying the change would lead to benefits for consumers. But an investigation into the effects of the new disclosure rules commissioned from consultants showed that there was little evidence of any significant benefits. The FSA then put its efforts into a new Retail Distribution Review to finally fix what its chairman Callum McCarthy described as a broken business model (McCarthy, 2006).

#### *The impact of regulation on the evolution of distribution channels*

A number of government and regulatory initiatives had a major impact on the evolution of distribution channels since the mid-1990s:

- the mis-selling review,
- the increased enforcement of conduct of business rules,
- the increased training requirements and the necessity for all sales staff and advisers to pass the FPC examination,

- the increased disclosure of commissions and charges,
- the introduction of a charge cap through the stakeholder initiative and RU64 announcement,
- the announcement of the abolition of polarisation and the very long delay in its implementation.

The mis-selling review, increased enforcement of conduct of business rules and increased training requirements all increased compliance burdens on distributors putting upward pressure on costs. The increased disclosure of commission and charges and the stakeholder price cap put downward pressure on prices. This put severe pressure on margins. In the competition for distribution between IFAs and DSFs which had emerged by the mid-1990s, IFAs proved to be more resilient and ultimately more successful. The banks and building societies started this period as a poor third, and the distribution of retail pension products through branch networks never had much of a chance to grow.

Depolarisation did reshape distribution channels to some degree but it did not have the effect that might have been seen had it been implemented a decade earlier.

The development of new technology might have been expected to lead to the emergence of new internet based distribution channels direct to the consumer. New IT has had an impact with the emergence of platforms and wraps, as described in Section 5.3 above, but again this development is targeted the wealthier customer and his/her adviser. Mass market selling of retail pensions through the internet is inhibited by the requirements of the conduct of business rules. Government responded by attempting to make stakeholder products sufficiently simple to enable them to be sold with light touch regulation. But while these products are available on the internet, the volumes of sales have been very low and certainly insufficient to make adequate pension provision for many lower to middle income earners.

#### **6.4 Summary: The impact of regulation on the evolution of distribution channels**

In a competitive environment one might expect distribution channels to emerge which met the needs of consumers and provided competitive advantage to the distributors. In the late 1980s there were three groups capable of delivering this outcome: the life and pensions companies with their direct sales forces, the independent brokers with their local offices and the banks and building societies with their branch networks. But the



polarisation rule substantially changed the competitive environment making unlawful one business model which could have had a number of variants. This had a major impact on the brokers and particularly on the new entrant banks and building societies. Coupled with other regulations, the maximum commission agreement and the disclosure regulations, polarisation led to competition between producers to secure distribution outlets. Later regulations, the mis-selling review and the increased enforcement of conduct of business rules, the training requirement and the stakeholder charging cap, all put distributors' margins under severe pressure. In the competition, the brokers won at the expense of DSFs and branches of banks and building societies. Deregulation, when it came in 2005, was too little too late. The industry had undergone major consolidation and restructuring. The retail pension market had become dominated by one distribution channel, the IFA.

One cannot say what might have emerged without polarisation and the accompanying conduct of business regulation. But one can say that the polarisation rule prevented the possibility of branches of banks and buildings societies becoming product supermarkets selling a range of producers' products to the mass market. There is no doubt that almost 20 years of polarisation irrevocably shaped the distribution system so that depolarisation had a limited impact. It is also fair to say that the stringent conduct of business rules (know your customer, best advice) made it difficult for distributors to make best use of new technology. Selling in this market normally requires face to face contact between the consumer and an adviser so selling through the internet is limited.

Having examined in the last two chapters the impact of regulation on product development and distribution I now move on to another critical issue for producers, namely their costs.

## **CHAPTER 7: THE IMPACT OF REGULATION ON PRODUCERS' COSTS**

### **7.1 Overview of this chapter**

In the previous two chapters I examined the impact of regulation on the development of products and distribution channels in the retail pensions market. In this chapter I look at producers' costs and assess the impact of regulation on those costs, specifically the costs of acquiring new business.

I begin by describing the nature of companies' costs and the common business model in use in the retail pensions market. I then present a model for the costs of acquiring new business in this market. I identify three regulatory events which can be hypothesised to have affected costs. Two of these events have already been considered to some degree by the regulators so I concentrate on the third event, namely the introduction of the stakeholder pension price cap in 2001 and the associated regulatory rules introduced in 1999. Using the *Synthesis Life* database of all 357 insurance companies in business in the period 1998 to 2002, together with other data, I test the hypotheses that regulations caused a reduction in costs in 1999 and/or 2001. Finally, I draw conclusions on the impact of regulation on the costs to companies of acquiring new business.

### **7.2 The nature of companies' costs**

A retail pension product is a set of services delivered to the consumer over a long period of time. For the customer, the process starts with making contact with an IFA or company representative followed by the signing of a contract with a provider; it continues through the saving phase, then onto the period when a pension is drawn, and ends with the customer's death.

The retail pensions industry services the customer's needs over this period, but not all companies offer all the services required. During the period examined in this study, almost all companies in the market have been engaged in signing up new customers and managing customers' savings. Fewer firms have offered annuities and income drawdown products, and the numbers of those companies have fallen over the period since the mid-1980s. More recently, there has been a tendency for companies to outsource some functions, as described in Section 5.3 above in connection with the development of SIPPs, platforms and wraps. Also, increasing numbers of companies have withdrawn from the business of acquiring new customers, concentrating on

managing existing funds and servicing the needs of existing customers. But for the majority of the period under review, companies have adopted a common business model for the services required to take customers up to the point of purchasing an annuity or drawdown product. This model is shown in Figure 7.1 below. This depicts the three key processes operated by companies:

- the acquisition of new business
- the management of continuing business, and
- the management of the long term fund.

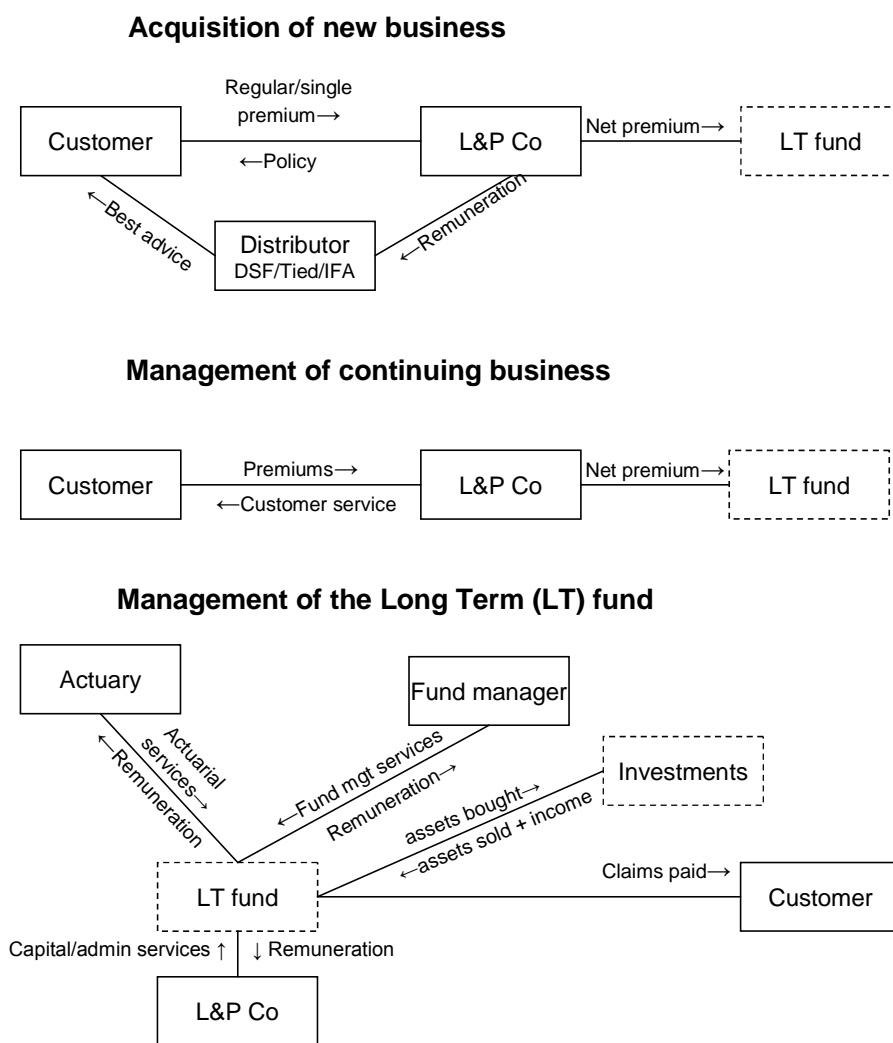


Figure 7.1 Business model for pensions business (compiled by the author)

### *Acquiring new business*

Acquiring new business involves designing appropriate products, marketing and distributing those products in the competitive market place, giving advice to customers and signing up new contracts, and the consequent administration. The output of the provider is a number of new policies issued. The costs to the provider in achieving this output are primarily labour, the salaries of staff (including consequential overheads) and the commission paid to intermediaries. Over the period since the mid-1980s there have been increasing costs for IT, with corresponding reductions in labour costs for administration. There are some fixed costs which need to be recovered but the bulk of the costs are direct costs which vary primarily with the numbers of new policies issued in any time period.

### *Managing continuing business*

This involves managing the relationship with the customer, collecting premiums and tax rebates, maintaining records, producing statements for the customer and dealing with customer's questions. The costs for this activity relate mainly to the firms' own staff and to the IT systems. The level of costs will be determined by the number of customers on the books at any time.

### *Managing the long term fund*

This consists of managing the collective investments of customers and maximising the return on those investments. This activity involves costs for the companies' own staff plus the costs of specialist services (e.g. actuaries and investment managers) bought in by the companies. There is also a significant cost for financial capital to cover the residual risks in the fund. The level of costs is determined by the size and nature of the fund. With-profit funds involve greater risks for the company than unit-linked funds and are more expensive to finance. The level of finance available to cover risks will determine the amount of new business the firm can afford to write.

### *The potential impact of regulation on costs*

Each of the three processes outlined above is subject to the regulations described in Chapter 4. The process of product design and development is heavily influenced by government policy on pensions. The acquisition of new business and the relationship between the firm and the customer is heavily regulated by the conduct of business

rules. The management of the long term fund is covered by the prudential regulations which require minimum levels of financial capital.

It can be expected therefore that regulation will increase costs above the level which would otherwise be incurred. But some regulations (disclosure of charges, stakeholder pension charging caps) are also intended to put pressure on companies to reduce their charges to customers which will squeeze margins and create incentives for reducing costs. There are therefore two opposing forces and the question is how regulation has actually affected costs over the period of this enquiry.

In Chapters 5 and 6 I examined the impact of regulation on the development and distribution of products. I concluded that the retail pensions market which has evolved today is largely a result of government pension policy and conduct of business regulation rather than of other environmental or competitive factors. The activities examined in Chapters 5 and 6 were mainly those contained in the process of acquiring new business described above. I therefore focus the study of the impact of regulation on costs on this process of new business acquisition. The impact of regulation on the management of the long term fund is an important issue, but beyond the scope of this thesis.

### **7.3 A model for the costs of the acquisition of new business**

The total costs to a company of acquiring new business will be the sum of:

- the initial costs of designing and marketing new products,
- the initial costs of setting up or obtaining access to distribution channels and
- the variable costs of selling and issuing each new policy, which will include the costs of contact with potential customers who do not sign a contract.

For each new policy issued there will be a minimum cost to serve plus the administrative cost of creating the new account. But the sales costs of each new policy will also vary with the premium secured by the new contract. Commission to intermediaries and commission or bonuses to sales staff are to some extent related to premium receipts. The cost of acquiring each new policy will therefore vary to some degree with the level of premiums.

Different pension products will have different base costs. A stakeholder pension with its simplified rules will involve less adviser/salesperson time than a standard personal

pension product. Group pension products involve some economies of scale and the base unit cost of each contract will be less than the standard personal pension. Pension contracts involving regular payments are likely to involve more adviser time than contracts involving only a single payment as the customer is making a longer term commitment.

Finally, the unit cost of a new contract may depend on the distribution channel through which it is sold. As indicated in Section 6.2 above, there was a period in the early 1990s when commissions payable to tied agents were higher than those payable to IFAs.

A basic model of the total costs of acquisition for a company will therefore be as follows:

$$Y = a + b_1X_1 + b_2X_2 + \dots + z_1D_1$$

Where:

Y is the total acquisition cost for a time period;

a is the initial costs of product design, marketing and securing distribution outlets incurred;

$b_1, b_2$  etc is the unit cost of a product line and  $X_1, X_2$  etc is the number of contracts issued in that line in the time period (regular premium contracts and single premium contracts for a particular product can be treated as separate product lines as each will have different unit costs);

$D_1$  is a dummy variable taking the value 0 when the company sells mainly through IFAs, and the value 1 when the company sells mainly through DSF/tied agents;  $z_1$  is the coefficient of this variable.

The above model does not cater for different unit costs for different levels of premium within a particular product line so a more sophisticated model would be:

$$Y = a + b_{1S}X_{1S} + b_{1L}X_{1L} + b_{2S}X_{2S} + b_{2L}X_{2L} \dots + z_1D_1$$

Here each product line is divided into two tranches, one involving the smaller (S) premiums and the other involving larger (L) premiums. Smaller premium business is defined as cases where the premium per policy is less than £x, and larger premium business involves cases where the premium per policy is more than £x; x is determined

at an appropriate level having regard to the distribution of premiums per policy in the data set.

#### **7.4 The regulatory events likely to influence the costs of acquisition of new business**

From the analysis of the regulatory events in Chapter 4 and the assessment of the impact of those events in Chapters 5 and 6, three key events can be identified which can be hypothesised to have had a significant impact on the costs of acquisition of new business:

- the abolition of the Maximum Commissions Agreement (MCA) with effect from January 1990,
- the new disclosure rules introduced in January 1995, and
- the regulator's announcement in RU64 in March 1999 in advance of the stakeholder pensions initiative implemented in April 2001.

Apart from these specific events, the compliance and administrative burdens placed upon companies have increased significantly, especially after the discovery of the pension mis-selling scandal and the increased enforcement activity that followed. The pressures on companies increased gradually over a period. There were important deadlines such as July 1997 for advisers and sales people to pass the required examination but generally the increase in the compliance burden cannot be associated with any one single event.

##### *The abolition of the MCA*

I have already referred in Section 6.2 above to the evidence gathered by the regulator Lautro on commission levels and for convenience I reproduce the table here:

Table 7.1 Commission as a percentage of the MCA

	March 1990	November 1991	August 1993
IFAs	123%	126%	128%
Representatives	134%	144%	146%

Source: Lautro data

The conclusion of the regulator, widely supported by the commentary in the journals at the time, was that the abolition of the MCA, in the context of the government inspired personal pension boom and the introduction of the polarisation rule, led to a significant

increase in distribution costs for providers, costs which were passed onto consumers in the form of higher (undisclosed) charges.

#### *The new disclosure rules*

The regulator, the PIA, undertook annual surveys of insurance companies in the years following 1995 to assess the impact of the disclosure rule on commission levels and charges to customers. The PIA required companies to provide data on their commissions to IFAs (or equivalent cost of advice in the case of representatives), total charges to customers and their projected surrender and maturity values on a range of life and pensions products including a standard 25 year personal pension plan with premiums of £60 per month. These surveys found that following the introduction of the new disclosure rules in 1995 there was little change in the level of IFA commission or equivalent representatives' costs until 1999 which the PIA thought was likely to be due to the RU64 notice.

The data for a 25 year personal pension plan with premiums of £60 per month is shown in Table 7.2 below. This shows the average IFA commission and the equivalent cost of representatives as a percentage of the first year's premium, i.e. on an annual premium of £720, a level of 70% indicates a commission or cost of £504.

Table 7.2 Costs as a percentage of first year premium

	1995	1996	1997	1998	1999
IFA initial commission	72	75	71	74	70
IFA indemnity commission	66	66	66	67	56
Tied agent cost of advice	86	87	88	87	62
DSF cost of advice	80	89	77	75	72

Source: PIA data

IFA's initial commission is paid in instalments over the first few years of the contract. If the customer stops paying premiums then the commission stops but previous payments are not recoverable. Indemnity commission is a discounted lump sum paid at the time of the contract but is part repayable if the policy lapses.

The conclusion of the regulator, again supported by commentary in the professional journals, was that the disclosure rules had not had a significant effect on sales costs and only a gradual reduction in charges to customers. The implication of this finding is



that the increase in compliance costs following the increase in enforcement activity by the regulator did not increase sales costs. These additional cost pressures may have therefore been adsorbed by the distribution industry by increased efficiency, for example, in the IFA distribution system by the development of the networks referred to in Section 6.3 above.

#### *The stakeholder pension initiative*

The last PIA survey which included commission and advice costs was published in March 2000 and contained the 1999 data. The FSA now publishes league tables of pension providers so that consumers can compare the total charges of the various market offerings. These tables do not however contain data similar to the PIA reports on the cost of IFA commission or the cost of advice of representatives. No systematic study has been reported on the effect of the RU64 announcement and the introduction of stakeholder pensions on the acquisition costs of new business.

### **7.5 Testing the hypotheses**

Apart from the surveys undertaken by the regulators, the best source of data on the acquisition costs of new business is contained in the companies' annual returns to the regulator. This data is collated by Standard & Poor's in their Synthesys Life database.

Each company reports the commission paid for the acquisition of new business and the management costs of new business. Unfortunately this is not divided between life and pensions business until 2005. But data is available for the numbers of new policies and the premiums receivable for new policies, separated into life and pensions business, and the data also distinguishes between regular premium business and single premium business. There is one added complication in that some companies sell overseas products through branches of their UK companies so in these cases some of the reported costs relate to overseas business. But data is also available on the numbers and premiums of overseas business and in practice the level of business is small compared with UK business.

Using regression analysis employing the type of model shown in Section 7.3 above, it is possible to infer the unit costs of pensions business distinguishing between regular premium and single premium business. It is not possible to break this down further into the various lines of pensions business such as personal pensions, group personal

pensions and stakeholder pensions but data is available on the business mix at the industry level (from ABI data) from which conclusions may be drawn.

As no previous study has been reported into the events in 1999 and 2001 relating to stakeholder pensions, I focus my study on these two events. I take a period starting one year before the first event to one year after the second event, i.e. 1998 to 2002, to enable comparisons to be made between the situations before, during and after the regulations were announced and implemented.

## **7.6 The period 1998 to 2002**

### *Descriptive statistics*

The database consists of 357 insurance companies. Some companies are not active and some do not engage in retail business. Some companies report costs but no business and vice versa. Some companies report new policies but no premiums and vice versa. Deleting these lines from the database leaves 208 companies. Some groups of companies have more than one active insurance subsidiary and these are treated in the database as separate entities.

The sample for the study covers almost the whole of the active UK retail pensions market. Some companies have occupational pension scheme business as well as retail business but these companies can be identified by the fact that their average premiums per policy are very much higher than the median of the dataset as a whole. The model described in Section 7.3 above distinguishes the larger premium business, and this is described in more detail below. Some companies sell only life products, others only pensions and some sell both. A small proportion of companies sell overseas. Some companies sell only regular premium business, some only single premium business, and some both categories.

Table 7.3 below shows more detail of the data including the mix of life, pensions and overseas business, and regular versus single premium business. In terms of numbers of new policies, life business substantially exceeds pension business. For premiums, single premium business substantially exceeds regular premium business. Overseas business is negligible in total, but some companies have large premiums. In terms of trends, the percentage of regular life sales falls and the percentage of single life sales increases. Otherwise the business mix is fairly stable.

Table 7.3 Descriptive statistics: life, pensions and overseas business

	1998	1999	2000	2001	2002
Number of companies	208	208	208	208	208
Total acquisition costs £m	5762	6554	6438	7206	7016
% commission in costs	43	46	47	53	52
Total new regular premiums £m	4379	4506	4138	5239	5015
Total new regular policies millions	6.79	6.55	5.96	6.92	6.98
Industry average premium per policy £	645	688	694	758	719
Total new single premiums £m	47,592	63,451	83,082	67,482	71,521
Total new single policies millions	5.91	7.66	8.99	12.14	11.73
Industry average premium per policy £	8055	8282	9245	5558	6097
Business mix in terms of numbers %					
Regular life	41	35	30	25	27
Regular pensions	10	9	8	9	8
Regular overseas	2	2	2	2	2
Single life	40	47	53	57	55
Single pensions	5	5	5	5	6
Single overseas	1	2	2	2	2
Business mix in terms of premiums %					
Regular life	3	3	2	2	2
Regular pensions	5	4	3	5	4
Regular overseas	0	0	0	0	1
Single life	35	35	29	35	32
Single pensions	54	56	64	54	58
Single overseas	3	3	2	3	3

Source: Synthesys Life

Between companies in the database there is inevitably a wide variation in the numbers of new policies issued in each business category and in the premiums received. There is also a variation in the average premium per policy for each company. The distribution of average premiums per policy in the dataset is shown in Table 7.4 and Figure 7.2 below using the 1998 data as an example. The histograms are based upon the median in the data set. There are a significant number of observations exceeding twice the median. For life business, both regular and single premium, 89% of the

observations are less than three times the median. For pensions business, just under 80% of observations are within three times the median but for those observations above that level, many are very large indeed, representing occupational pensions business. Also, there is greater variance between these larger observations than between observations at lower premium per policy levels. The data set contains heteroscedasticity. The model outlined in Section 7.3 above caters for this by identifying the larger premiums per policy as separate business streams.

It is necessary to decide on a cut off point to categorise observations as belonging to one of the two tranches, smaller premium business and larger premium business. To some extent the decision is an arbitrary one. The distinction between the smaller premiums and the larger premiums needs to be made relative to the business line concerned. Generally, pension premiums are larger than life premiums. As I am examining trends from one year to the next, it is also important to be consistent. From an examination of all the data, a level of three times the median seems to be a sensible starting point.

The percentage of observations regarded as large is shown in Table 7.4 below and the cut off level is marked on each of the charts. In running the regression, I test for the effect of changing the cut off point to twice the median and to four times the median. The results are presented below and I conclude that a choice of three times the median is a reasonable one.

The reason for using the median as the measure rather than the mean is that the median is less sensitive to a small number of large observations. Also, the standard deviation is not a good measure of the dispersion as the distributions are not normal.

Table 7.4 Distribution of company average premiums per policy (1998 data)

	Regular life		Regular pensions		Regular overseas		Single life		Single pensions		Single overseas	
	1	Frequency	1	Frequency	1	Frequency	1	Frequency	1	Frequency	1	Frequency
	90	9	375	4	200	2	2500	25	6500	15	7000	4
	180	14	750	24	400	4	5000	17	13000	20	14000	3
	270	32	1125	14	600	2	7500	7	19500	19	21000	3
Median	360	21	1500	14	800	4	10000	10	26000	9	28000	2
	450	14	1875	7	1000	3	12500	12	32500	13	35000	2
	540	13	2250	8	1200	0	15000	5	39000	5	42000	0
	630	11	2625	7	1400	1	17500	10	45500	0	49000	1
2x median	720	7	3000	3	1600	0	20000	3	52000	2	56000	1
	810	3	3375	1	1800	1	22500	7	58500	6	63000	1
	900	1	3750	2	2000	2	25000	2	65000	1	70000	2
	990	2	4125	5	2200	0	27500	5	71500	3	77000	0
3xmedian	1080	1	4500	0	2400	0	30000	7	78000	5	84000	1
4xmedian	1440	6	6000	5	3200	1	40000	7	104000	4	112000	1
5xmedian	1800	1	7500	1	4000	1	50000	2	130000	2	140000	1
	More	9	More	17	More	2	More	4	More	24	More	2
Observations		144		112		23		123		128		24
Number>3x median		16		23		4		13		30		4
% of observations		11		21		17		11		23		17

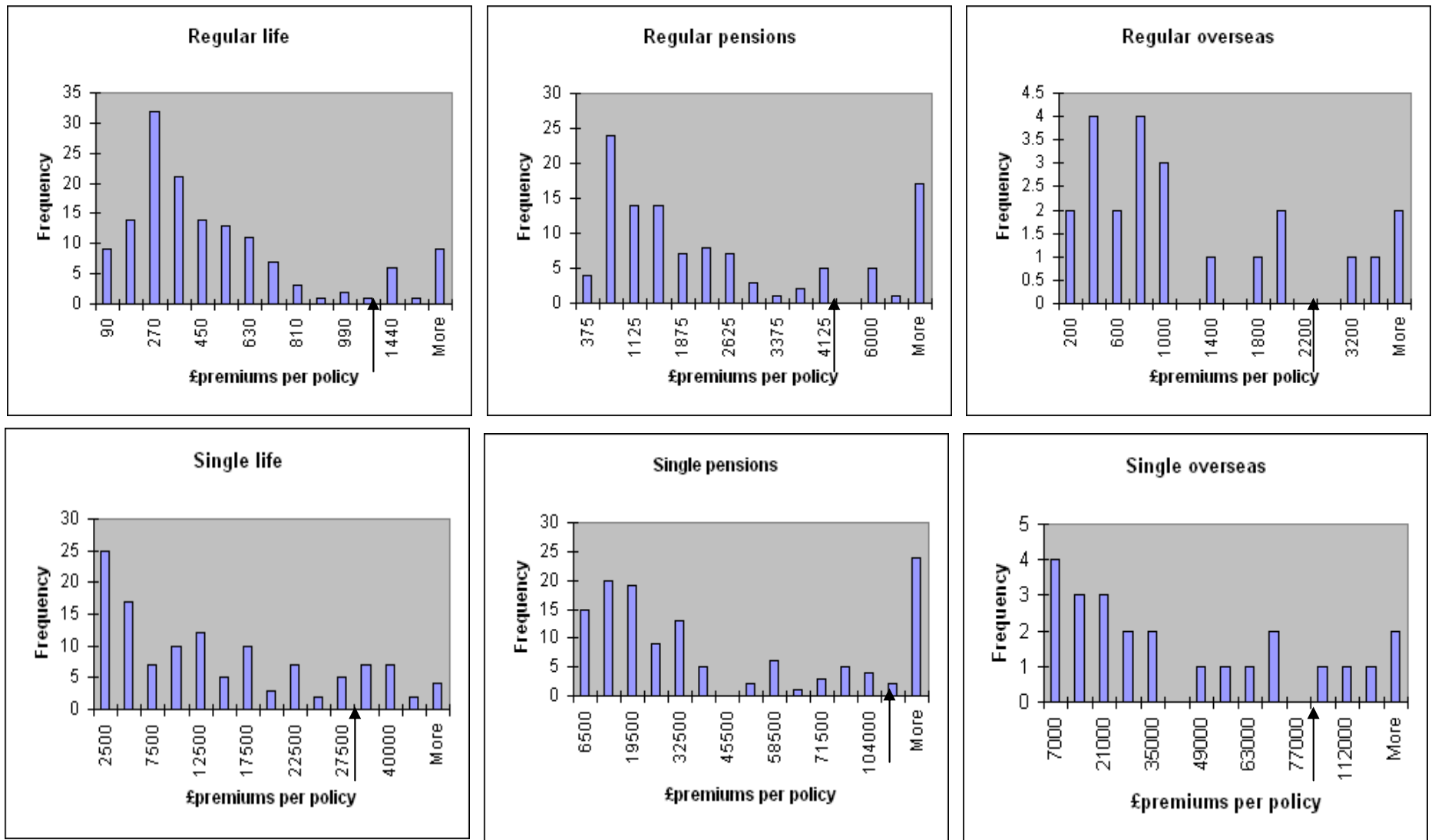


Figure 7.2 Histograms showing distribution of company average premiums per policy for 1998

### *Inferential statistics*

The results of the regression are shown in Table 7.5 below. One company, Standard Life, has a substantial effect on the results because of its market share. Standard Life's share, in terms of numbers of new policies, of regular premium pension business was 21.6% in 1998 rising to 38.1% in 2002; for single premium pension business the company's share was 20.1% in 1998, falling slightly in the following year but rising to 32% by 2002. Standard Life also wrote much of the overseas business: its share of regular premium business in 1998 was 24.9% in 1998 falling to 18.2% in 2002. I have therefore run the regression again excluding Standard Life as a special case.

Excluding Standard Life significantly increases the adjusted  $R^2$  in 1998 and 1999, but reduces it slightly in 2001 and 2002. Overall, the t statistics are more significant without Standard Life, and for small regular business, all the results are significant.

In both sets of results there are some unusual coefficients for the overseas business, particularly regular business in the large tranche, where the coefficients are usually negative. In this category there are far fewer observations and some large data items will have a disproportionate effect on the results.

Changing the cut off point between the small and the large premium per policy tranches does not affect the adjusted  $R^2$  substantially. Across the five years, the average adjusted  $R^2$  for a cut off at three times the median is 0.73 (0.77 excluding Standard Life). At twice the median the average is 0.74 (0.75 excluding Standard Life); for four times the median the average is 0.70 (0.76 excluding Standard Life). As the cut off is changed, the coefficients move around and at both twice the median and four times the median, more unit cost coefficients turn negative; and at four times the median, the number of significant positive unit costs falls so this level is too high. In terms of the patterns in the data there is no real difference between three times the median and two times the median. I conclude therefore that setting the cut off at three times the median is reasonable.

Table 7.5 Regression results 1998 - 2002

\* p<0.05 \*\* p<0.01 \*\*\* p<0.001

	1998		1999		2000		2001		2002	
<b>All companies</b>										
Observations	208		208		208		208		208	
Adjusted R Squared	0.72		0.59		0.78		0.76		0.80	
	Coeff	t stat	Coeff	t stat	Coeff	t stat	Coeff	t stat	Coeff	t stat
Intercept £m	13	2.2 *	30	4.1 ***	17	3.1 **	27	3.6 ***	22	3.0 **
Reg Life Small £	365	7.4 ***	349	5.5 ***	168	3.1 **	376	6.5 ***	652	10.7 ***
Reg Pensions Small £	695	1.6	552	2.0 *	1885	6.7 ***	272	1.8	88	0.3
Reg Overseas Small £	-153	-0.3	208	0.4	3689	6.5 ***	2323	8.9 ***	3088	8.1 ***
Single Life Small £	44	2.4 *	76	3.9 ***	57	6.4 ***	75	8.3 ***	43	4.1 ***
Single Pensions Small £	591	0.6	1056	2.0 *	1704	4.3 ***	715	2.0 *	1008	1.8
Single Overseas Small £	885	2.3 *	354	2.3 *	0	0.0	522	3.6 ***	-505	-1.9
Reg Life Large £	1872	1.4	-1704	-1.3	763	1.0	1747	1.0	3305	1.5
Reg Pensions Large £	10978	7.6 ***	10126	5.9 ***	3299	1.4	-1234	-0.5	2168	0.7
Reg Overseas Large £	-366516	-3.3 ***	3091	0.2	-8206	-7.4 ***	-34892	-0.1	-37350	-5.4 ***
Single Life Large £	792	1.2	-25	0.0	1837	3.7 ***	-49	0.0	-1995	-2.0 *
Single Pensions Large £	5408	0.8	-473	-0.1	19534	1.5	64394	2.0 *	26110	1.4
Single Overseas Large £	985544	2.2 *	-123776	-4.1 ***	26662	0.7	136484	2.6 *	-5762417	-1.5
Distribution dummy £m	-8	-1.3	-23	-2.9 **	-15	-2.5 *	-22	-2.8 **	-21	-2.7 **
<b>Excluding Standard Life</b>										
Observations	207		207		207		207		207	
Adjusted R squared	0.82		0.73		0.79		0.72		0.77	
	Coeff	t stat	Coeff	t stat	Coeff	t stat	Coeff	t stat	Coeff	t stat
Intercept £m	3	0.6	14	2.4 *	14	2.7 **	23	3.1 **	14	2.0 *
Reg Life Small £	160	3.9 ***	168	3.3 **	144	2.8 **	346	6.0 ***	605	10.4 ***
Reg Pensions Small £	2788	7.6 ***	3164	10.1 ***	2597	8.7 ***	565	3.1 **	710	2.0 *
Reg Overseas Small £	1679	4.3 ***	1394	3.5 ***	4443	8.1 ***	2380	9.2 ***	3214	8.9 ***
Single Life Small £	41	3.0 **	48	3.2 **	51	5.9 ***	72	8.0 ***	33	3.2 ***
Single Pensions Small £	463	0.7	1091	2.6 **	580	1.3	1012	2.7 **	1593	3.0 **
Single Overseas Small £	1282	4.4 ***	339	2.8 **	-138	-0.9	533	3.8 ***	-479	-1.9
Reg Life Large £	1689	1.6	-600	-0.6	-926	-1.2	1712	1.0	3257	1.6
Reg Pensions Large £	10303	9.5 ***	10939	8.2 ***	4635	2.1 *	-906	-0.4	3275	1.2
Reg Overseas Large £	-148581	-1.7	-21647	-1.6	7154	2.3 *	-75732	-0.2	-36538	-5.6 ***
Single Life Large £	720	1.5	122	0.2	1511	3.2 **	6	0.0	-2406	-2.6 **
Single Pensions Large £	5000	1.0	4326	0.8	27503	2.2 *	66761	2.1 *	25637	1.4
Single Overseas Large £	114692	0.3	-119028	-5.0 ***	23767	0.7	82076	1.5	-5066598	-1.4
Distribution dummy £m	-1	-0.2	-12	-1.9	-12	-2.2 *	-19	-2.4 *	-15	-2.0 *



### *Interpretation of regression results*

The purpose of this regression analysis is to establish the unit costs of acquisition of new business for pension products. The coefficients of the independent variables, except for the distribution dummy, represent those costs. Table 7.6 below summarises the coefficients which are statistically significant for each line of pension business.

Table 7.6 Unit costs (£ per policy)

All companies (n=208)

	1998	1999	2000	2001	2002
Reg Pensions small		552 *	1885 ***		
Single Pensions small		1056 *	1704 ***	715 *	
Reg Pensions large	10,978 ***	10,126 ***			
Single Pensions large				64,394 *	

Excluding Standard Life (n=207)

	1998	1999	2000	2001	2002
Reg Pensions small	2788 ***	3164 ***	2597 ***	565 **	710 *
Single Pensions small		1091 **		1012 **	1593 **
Reg Pensions large	10,303 ***	10,939 ***	4635 *		
Single Pensions large			27,503 *	66,761 *	

In the case of the data set excluding Standard Life there is a clear pattern for the smaller tranche of pensions business. In the case of regular premium business, there is a sharp fall in unit costs in 2001, which is the year in which stakeholder pensions were introduced. The figures for single premiums do not suggest any fall in unit costs for this line of business.

In both sets of regression results, the coefficient of the distribution dummy variable is often significant and consistently negative, suggesting that representatives have lower costs than IFAs. But the difference across the whole data set is never greater than £23m which in the context of total acquisition costs of between £5,700m and £7,200m is not large.

### *Standard Life*

Throughout the period 1998 to 2002, Standard Life was the volume leader in pensions by a large margin, as shown in Table 7.7 below. Its nearest rival in 1998 was Equitable Life which issued less than a quarter of the new regular premium policies and less than a half of single premium policies compared with Standard Life. But Equitable Life had

much higher premiums per policy and in fact brought in more money than Standard Life. By 2002 Equitable Life had ceased competing for new customers and in terms of numbers its place was taken by Scottish Equitable. But Scottish Equitable issued less than a quarter of the new regular premium policies and less than a sixth of new single premium policies compared with Standard Life. Throughout the period Standard Life had lower premiums per policy than its nearest six rivals.

In 2005 Standard Life appointed a new head of its UK Life and Pensions business. Trevor Matthews was reported in the Financial Times on 1 August 2005 as expressing disbelief that Standard Life was paying commission of up to £220 on a stakeholder pension with premiums of £1000 per annum. With the government charge cap the maximum they could pass onto the customer was £15; and they had their own account set up costs to meet as well. It was clear that Standard Life had been attracting large volumes of low value business. Matthews immediately began to change the strategy to target higher margin business which was essential in the run up to the company's demutualisation and floatation in 2006.

It is understandable that Standard Life's figures distort the regression and it is appropriate therefore to consider this company separately from the rest of the industry.

Table 7.7 Pension business levels of market leaders

	Number Regular premium policies	Number Single premium policies	Regular Premium per policy £	Single Premium per policy £
<b>1998</b>				
Standard Life	280,302	125,544	842	13,456
Equitable Life	65,630	54,364	5,501	31,403
L&G	53,521	24,113	1,863	38,105
Scottish Equitable	48,038	19,451	4,093	76,412
Norwich Union	40,795	30,718	1,918	32,469
Prudential	36,826	48,045	4,738	22,358
Scottish Widows	33,126	23,157	2,756	30,679
<b>2002</b>				
Standard Life	539,940	360,028	1,081	13,199
Equitable Life	1,840	12,171	15,242	26,723
L&G	96,203	24,172	1,884	51,326
Scottish Equitable	120,963	55,632	2,567	33,106
Norwich Union	18,507	22,651	3,236	39,173
Prudential	831	46,332	157,191	30,139
Scottish Widows	99,581	70,986	1,894	22,817

Source: Synthesys Life

*The business mix within the pension streams*

The Synthesys Life database does not contain sufficient data to enable a breakdown of the unit costs into separate product lines, i.e. into personal pensions (PP), group personal pensions (GPP), self invested personal pensions (SIPP) and stakeholder pensions (SHP, or ESHP when sponsored by an employer). As each of these lines of business can have different unit costs, any change in the business mix over time will affect the unit costs generated by the regression analysis. Data is available at industry level for the business mix from the ABI, and this is shown in Table 7.8 below. This table shows the percentage of new policies issued in each product class. This data does not include any occupational pensions business so the figures will be comparable to the smaller tranche identified in the regression.

Table 7.8 Pensions business mix 1998 - 2002

%	1998	1999	2000	2001	2002
<b>Regular premium pension policies issued</b>					
PP	66	62	51	19	16
GPP	34	38	49	41	35
SIPP	0	0	0	0	0
SHP	0	0	0	16	26
ESHP	0	0	0	25	22
	100	100	100	100	100
<b>Single premium pension policies issued</b>					
PP	80	74	63	48	39
GPP	20	25	36	38	30
SIPP	1	1	1	1	1
SHP	0	0	0	11	24
ESHP	0	0	0	3	6
	100	100	100	100	100

Source: ABI

The significant change in business mix revealed by this data is the fall in the numbers of PP policies issued in 2001 and the appearance of SHP business. This is particularly marked in the case of regular premium business. The substantial fall in numbers of new regular PP policies in favour of SHP policies corresponds to the fall in unit costs observed from the regression analysis for regular pension business in the small tranche.

There were two events which were hypothesised to affect the acquisition costs of new business: the issue of RU64 by the PIA in March 1999 and the commencement of

stakeholder pensions in April 2001. The last survey of companies conducted by the PIA into commission levels and equivalent advice costs reported a fall in costs in 1999. It appears, however, from the data on unit costs from the regression analysis that this fall in costs did not have any practical effect until 2001 when stakeholder pension regime came into effect. The data supplied by companies to the PIA for 1999 may have contained an element of forward projection. The fall in unit costs can be attributed directly to the issue of stakeholder pension policies in 2001.

*The effect of changing levels of premiums per policy on unit costs*

If average levels of premiums per policy fell in 2001 this could in part account for the reduction in unit costs. Acquisition costs are not directly proportional to premium levels but there is some correlation as higher premiums tend to attract higher remuneration to advisers and sales people. However, the data shows a steady rising level of average premiums. Table 7.9 below shows the mean and the median for premiums per policy in the smaller tranche.

Table 7.9 Pension premiums – per policy

£	1998	1999	2000	2001	2002
<b>Regular premium pensions – smaller tranche</b>					
Mean	1641	1776	1919	2519	3147
Median	1248	1299	1487	1953	2360
<b>Single premium pensions – smaller tranche</b>					
Mean	27,693	30,992	35,475	32,980	33,540
Median	18,213	21,735	27,083	25,982	27,828

The rise in average levels of premiums per policy in 2001 and 2002 for regular premium business makes the reduction in unit costs that much more significant.

*The effect of increasing levels of transfer business on unit costs*

In Section 5.3 above I identified the increasing levels of transfer business between companies and in Figure 5.14 I showed the trend in net inflows into the industry. The rise in net inflows between 1997 and 2000 and the sharp fall in 2001 are attributable to changes in the level of OPS business which will not affect the results shown in the smaller tranche. The increase generally of transfer business may have had an effect on the unit costs of single premium business where this transfer activity is recorded but it will not affect regular premium business.

*A comparison with the data for 2005-2007*

From 2005 companies were required by the FSA to show costs separately for life, pensions and overseas business. Establishing the unit costs of pensions business is therefore more straightforward for 2005 onwards. It is useful to examine the data for this period firstly as a test of the regression methodology and secondly to see if there are any major changes in unit costs since 2002.

Table 7.10 below shows the regression results. There were only 79 companies active in the retail pensions business in this period. By 2007 the market for new business had become concentrated: the top five groups took 54% of new business in APE terms and the top eleven took 90% in APE terms. The market share of Standard Life in terms of numbers has now fallen, and in fact the company was overtaken in 2007 as market leader on this measure by Friends Provident. Excluding Standard Life or Friends Provident from the data makes no significant difference to the results.

The adjusted R<sup>2</sup> figures are of a similar order of magnitude to the period 1998 to 2002, and the coefficients are generally significant except for single premium business in the large tranche. The coefficient of the distribution dummy variable again comes out as a small negative number.

Table 7.10 Regression results for 2005 - 2007

<b>Pensions only</b>	2005		2006		2007	
Observations	79		79		79	
Adjusted R squared	0.87		0.72		0.59	
	coeff	t stat	coeff	t stat	coeff	t stat
Intercept £m	3	0.6	21	2.6 **	24	2.9 **
Regular small £	1169	9.8 ***	1194	6.7 ***	763	3.2 **
Single small £	1089	6.1 ***	527	2.2 *	636	2.9 **
Regular large £	25898	6.9 ***	9764	1.1	33742	3.6 ***
Single large £	2366	1.3	1640	0.9	-267	0.0
Distribution dummy £m	-5	-0.8	-22	-2.5 *	-26	-2.7 **

\* p<0.05 \*\* p<0.01 \*\*\* p<0.001

For regular premium business in the small tranche, the unit costs are of the same order of magnitude as the figures for 2001 and 2002 (£565 and £710 respectively), suggesting that costs have not returned to the levels prior to 2001. After accounting for inflation, there appears to have been a rise in unit costs in 2005 and 2006 followed by a

fall. For single premium business in the small tranche, there appears to be a fall in unit costs in 2006.

The change in business mix since 2002 is given in Table 7.11 below. In regular premium business, the proportion of individually sponsored SHP policies fell in 2005 and there has been a steady rise in GPP business since 2003. SIPP business begins to appear in 2005.

Table 7.11 Pensions business mix 2003 - 2007

%	2003	2004	2005	2006	2007
Regular premium pension policies issued					
PP	13	9	8	6	13
GPP	34	40	46	51	49
SIPP	0	0	2	4	3
SHP	23	23	14	15	12
ESHP	30	28	29	23	23
	100	100	100	100	100
Single premium pension policies issued					
PP	38	36	29	27	30
GPP	29	24	27	20	20
SIPP	1	1	5	10	11
SHP	26	28	21	22	19
ESHP	6	11	18	21	20
	100	100	100	100	100

Source: ABI

A number of other factors, described in Sections 5.3 and 6.3 above, could account for the movement in unit costs suggested by the regression results for 2005 to 2007:

- Companies increasingly differentiated their PP products from SHP products, paying additional commissions on PPs to allow for the cost of advice.
- The SHP price cap increased from 1% to 1.5% in 2005 allowing additional commission to be paid to advisers.
- Platforms and wraps were making an increasing impact allowing for reductions in administration costs.
- Distribution was depolarised in June 2005 and pension tax regulations were simplified on A day in 2006.

The increase in commission payable will increase acquisition costs but the increase in the use of platforms and wraps, and new technology generally will allow reductions in costs. Depolarisation and A day are probably neutral in cost terms. More generally in

the market place, the increased competition for transfer business will exert a downward pressure on costs of single premium business. Overall therefore a downward trend in costs is understandable.

I am not testing a hypothesis that regulation in the period 2005 to 2007 has affected costs so I do not come to any final judgement on these issues. The purpose of examining the years 2005 to 2007 is to see if there is anything arising which throws doubt on the regression methodology or the conclusions drawn for the years 1998 to 2002. I conclude that the regression results for 2005 to 2007 are consistent with the earlier period allowing for known changes which can be expected to affect the coefficients of the independent variables. I conclude also that there is nothing in the results for 2005 to 2007 which raises doubts about the main conclusion that the introduction of SHPs in 2001 led to a significant reduction in costs.

#### **7.7 Summary: the impact of regulation on costs**

The study presented above for the years 1998 to 2002 shows that costs fell under the influence of the government's stakeholder price cap coupled with the regulators requirement in RU64 that higher cost non-stakeholder products needed to be justified. The fall in costs did not take place until stakeholder pensions were available for sale in 2001 but the RU64 requirement was an essential part of the regulatory strategy. Companies were not obliged to produce the SHP and few of those that did produce it marketed it actively. The RU64 requirement extended the influence of the SHP price cap to other products. Under the influence of price constraints companies had to reduce remuneration to intermediaries. Companies did however adjust later, differentiating their PP offerings from the SHP offerings and intermediary remuneration moved back up again but not to the same levels as before the stakeholder initiative.

The regulator's data for the years 1990 to 1993 shows that commission levels to IFAs and representatives rose after the abolition of the Maximum Commission Agreement. This shows that while this agreement was in place, it did depress commission levels. The MCA was a cost cap while the SHP regulations introduced a price cap. But both types of cap have had the effect of reducing the remuneration of advisers and sales people. In contrast, the evidence suggests that disclosure regulations have had a more limited effect in practice on cost levels.

The increasing compliance burden of regulation on companies especially since 1994 has inevitably increased the costs of competing for new business in the retail pensions market. Companies have attempted to mitigate the effects of these costs pressures by introducing new technology, seeking economies of scale, and in the case of IFAs, setting up networks to share the regulatory burden. But the pressure on costs, the pressure on prices and the increased competition for reducing levels of new money from customers has led to increased consolidation in the industry, which is examined in more detail in the next chapter.



## **CHAPTER 8: THE IMPACT OF REGULATION ON INDUSTRY STRUCTURE**

### **8.1 Overview of this chapter**

In the last three chapters I assessed the impact of regulation on the development of products, the evolution of distribution channels and the costs of acquisition of new business. I have been focusing on the core competitive activity in the retail pensions market: the design, marketing and distribution of pension products to customers and the costs of this activity. I now turn to consider the impact of regulation on the industry structure. I examine the number and market shares of the producers in this market, the changes in industry concentration over the period 1985 to 2007, the pattern of entry and exit, and merger and acquisition. I then look at the possible drivers of the changes observed and assess the impact that regulation has had, as one of those drivers.

### **8.2 Definitions and source of data**

I define a 'market participant' as a producer which is competing for new customers in the retail pensions market. Such companies will also be seeking to sell new policies to existing customers and these new contracts count as new business; but to be a market participant, the company needs to be open to new customers. A company which 'closes to new business' is not a market participant on this definition. Such a company may give new contracts to existing customers seeking to enhance their existing pension account, but I do not count such companies as active in the competitive market place. So when Equitable Life closed its doors in December 2000 it ceased to be a market participant although it remained a live insurance company to service its existing customer base.

Some producers have more than one registered insurance company. It was common for example for companies to distinguish 'with-profits' business from 'unit-linked' business using two separate companies. From a competitive perspective this is of no significance: the company appears as one for marketing purposes. I have therefore amalgamated the results of insurance companies operating under the same brand name. Where however following a merger or acquisition, a group operates two companies under different brand names, I treat these brands separately. So when Halifax acquired Clerical Medical in 1996, it continued to sell under the Halifax name through its branches and maintained Clerical Medical to sell through IFAs. There are therefore two distinct market participants. On the other hand, when Lloyds TSB acquired Scottish Widows in 2000, it closed its existing Abbey Life and Lloyds TSB

operations to sell exclusively under the Scottish Widows brand. Lloyds TSB then had only one market participant.

I take as the measure of market share the industry's own measure, namely the Annual Premium Equivalent (APE). The APE is the full amount of the first year's premium for regular premium contracts signed in the accounting year plus 10% of the single premiums for single premium contracts signed in the accounting year.

The data for this study is derived from the annual regulatory returns of all insurance companies operating in the market. This data is consolidated by Standard and Poor's in its Synthesys Life database. The data includes the records of new business premiums secured for pensions business, showing regular premium and single premium contracts separately. The data does however include some occupation pension scheme (OPS) business which is a separate market from the retail pensions market. In the case of most companies in the dataset, the volumes of OPS business are such that they do not significantly affect the calculation of the concentration indices. But in some cases the volumes are very large indeed and I have therefore identified the largest data items from other sources such as the company's own reports and accounts. For example, in 1995 Barclays set up Barclays Global Investors Pensions Management Ltd as a pension fund manager specialising in index linked funds. It retained its retail arm, Barclays Life, until that closed to new business in 2003. The fund management company received new single premiums of £23 billion in 2007. This company is included in the dataset but as it is not operating in the retail pensions market I have excluded it. Similarly, where I have been able to identify other pension fund management specialists I have excluded them also.

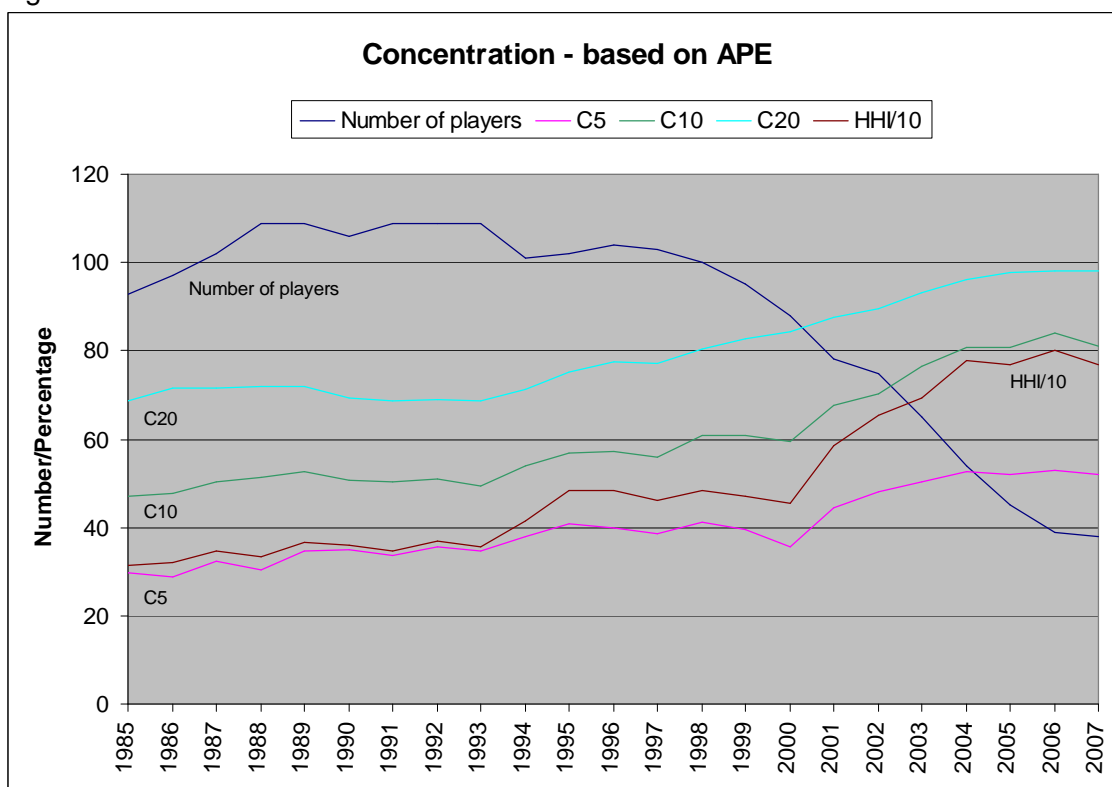
As the dataset includes only insurance companies, it excludes some other financial institutions competing in the retail pensions market. This is however only significant in the SIPP market which is described in Section 5.4 above. I deal with this issue in the text below.

### **8.3 Changes in industry concentration 1985 to 2007**

#### *The number of players and the concentration indices*

Figure 8.1 below shows the number of players in the market, the market share of the top five (C5), the top ten (C10) and the top 20 (C20) and the Herfindal index (HHI, divided by 10 to fit onto the same scale on the chart).

Figure 8.1



Source: Synthesis Life database

There were 93 market participants in 1985 which rose to 109 in 1988. The number of participants started to decline in 1996 and by 2007 there were only 38 companies open for new customers. All the concentration indices have risen steadily over the period so that by 2007 the top five participants took over 50% of new business and the top 10 around 80% of new business. The top 20 take 98% of business so that almost half the participants have no significant new business at all.

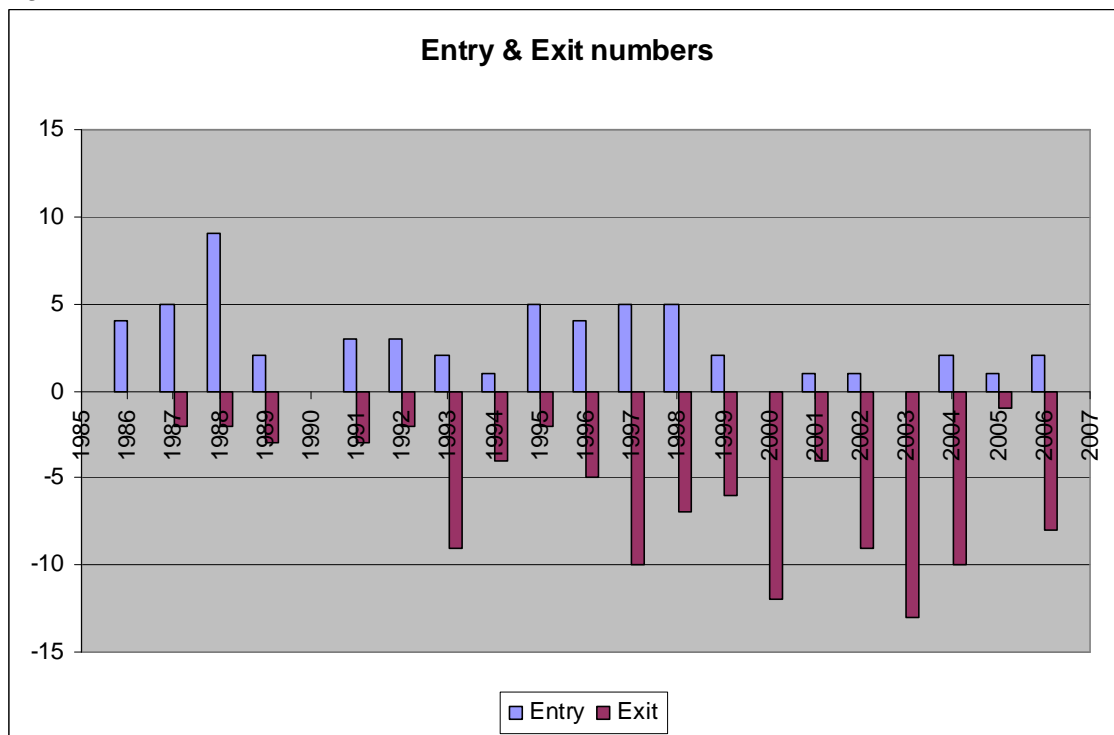
#### *The pattern of entry and exit*

The numbers of companies entering the market and the numbers leaving each year are shown in Figure 8.2 below.

There was a short burst of new entrants in the period 1986 to 1988 and thereafter a steady number of entries up to 1999. But from 1997 onwards there is a much more substantial exit. Some companies simply closed to new business and went into run off. Others participants went for merger or take over, consolidating business into one company and dispensing with some brand names. Of the top 50 brand names in 1985, only 15 remain in 2007. Many companies with long histories are no longer open for new business or have lost their identity in mergers: Equitable Life (1762), Commercial

Union (1861), General Accident (1885), Royal (1845), Britannic (1866), National Provident (1835) and so on.

Figure 8.2



Source: Synthesys Life database

Considering that the pension product is by its very nature a long term one, this is a significant change for this market and for customers. For example, a customer taking out a new pension contract in 1988 with Royal Insurance will have received notice in 1996 of a merger with Sun Alliance to form the company Royal & Sun Alliance. Then in 1998 the customer will have received notice of merger of some funds, some of which went ahead and others which did not. Then in 2002 Royal & Sun Alliance closed to new business and in 2004 the closed funds were taken over by Resolution Life being rebranded as Phoenix. More recently, Resolution has been taken over by Pearl.

#### *The new entrants*

The banks and building societies were active entrants after 1986. Barclays, Lloyds and TSB had already set up life and pensions subsidiaries. Midland and National & Provincial set up production operations in partnership with existing insurance companies. Royal Bank of Scotland set up a joint venture with Scottish Equitable. Other banks and building societies initially entered into distribution agreements with producers but then terminated their agreements to set up their own life subsidiaries.

These included Halifax (1995) and Abbey National (1993) which also acquired Scottish Mutual. NatWest initially set up its branches as independent financial advisers but in 1993 it set up its own life subsidiary. Britannia entered by acquisition of a number of small incumbent producers. Nationwide, Woolwich and Leeds also set up life and pensions subsidiaries.

In addition to the banks and building societies a number of other institutions entered. Unit trusts and Friendly societies were represented, along with Marks and Spencer Financial Services and Virgin. Foreign insurers also took an interest. Aegon became a major player through its acquisition of Scottish Equitable in 1993.

#### *The exits, mergers and takeovers*

Until 1994 there were only a two casualties, companies which failed and were rescued by take over. In addition, there were a small number of takeovers, such as Britannia's acquisitions which account for the peak of exits in 1993.

From 1996 onwards, the number of exits and mergers exceeds the number of new entrants. For each year from 1996 to 2002 there was at least one major merger: Royal Insurance and Sun Alliance (1996), Halifax and Clerical Medical (1996), Prudential and Scottish Amicable (1997), General Accident and Commercial Union (1998), Britannic and Britannia (1999), CGU and Norwich Union (2000), Lloyds and Scottish Widows (2000), Abbey National and Scottish Provident (2001), GE and National Mutual (2002).

From 1999 onwards an increasing number of companies closed to new business, starting with Abbey Life in 1999 and Equitable Life in 2000. This brought a new type of company into the industry, the manager of closed funds, represented by Resolution Life and Pearl.

#### *Other changes in the nature of the participants*

Accompanying consolidation was a phase of demutualisation. The older mutual companies converted to Public Limited Companies, usually prior to merger. The last major demutualisation was Standard Life in 2006, which remains independent.

Some consolidation results from bank mergers. The merger of Lloyds and TSB brought together Black Horse Life and TSB Life which were merged. The merger of Barclays and Woolwich led to the merger of their respective life and pensions companies and their subsequent closure to new business.

### *Market participants not in the dataset*

As a general rule, entrants to the retail pensions market have constituted an insurance company through which to do business and such companies are in the dataset. The exception is the case of SIPP business where there are significant numbers of non-insurance companies competing for business. In Figure 5.12 in Section 5.3 above I show the number of companies offering SIPP products identifying separately insurance companies and others. There have been up to 50 non-insurance companies competing for this business, but not all have been successful.

Table 8.1 below shows the share of SIPP business as a percentage of the total retail pensions business (in APE terms using ABI data).

Table 8.1 Market share of SIPP business

APE £m	2003	2004	2005	2006	2007
SIPPs	42	45	198	518	760
Total pensions	2864	2859	3263	4811	5458
%SIPP	1.5	1.6	6.1	10.8	13.9

Source: ABI

Up to and including 2004, the level of SIPP business was small and will not affect the concentration indices to any significant extent. From 2005 however, SIPP business takes an increasing share of the market. It is difficult to establish the relative market shares of the various participants in this business as there is no wholly reliable source of information. But the surveys conducted by *Pensions Management* give some indication of the market share held by non-insurance companies. In the latest survey of July 2007, 33 companies reported the level of assets under management in their SIPP products. Of these 33, only five were insurance companies included in the Sythesys Life database but these companies held 62% of the assets under management. This suggests that the non-insurance companies have not yet obtained a dominant share of the SIPP market, and given the level of SIPP business as a percentage of total pensions business, these non-insurance companies have yet to take a significant stake in the retail pensions market overall. But the expansion of SIPP business in the last few years is a significant development which could change the nature of the market.

*The nature of the leading producers in 2008*

The top eleven groups and their brands are shown in Table 8.2 below.

Table 8.2 The top eleven groups and their brands in 2008

<b>Group</b>	<b>Active brands</b>	<b>Brands incorporated</b>
Aegon	Scottish Equitable	Guardian
Aviva	Norwich Union	Commercial Union, General Accident
Axa	Axa	Equity & Law, Sun Life, Winterthur
Friends Provident	Friends Provident	London & Manchester
HBOS	Clerical Medical Halifax Life St James Place	
Legal & General	Legal & General	
Lloyds TSB	Scottish Widows	Black Horse, TSB
Old Mutual	Skandia	
Prudential	Prudential	Scottish Amicable
Royal London Mutual	Royal London Scottish Life	Refuge, United Friendly
Standard Life	Standard Life	

Source: Synthesys Life database

Of the 14 active brands, only two are new businesses since 1985: Halifax Life and St James Place. Halifax Life was the in-house life and pensions company started by Halifax in 1995 after it terminated its distribution agreement with Standard Life. St James Place was started in 1992 as a new life and pensions company, J Rothschild Assurance, selling through a direct sales force. HBOS acquired a controlling stake in the company in 2000 and adopted its current name in 2002. The company now concentrates on high net worth individuals.

The only other new brand since 1985 is Axa, created out of two existing brands Equity & Law and Sun Life. The company traded as Axa Equity & Law for some years, then as Axa Sun Life until the Axa name became better known.

Three of the longest standing major players Legal & General, Prudential and Standard Life have consolidated their position by growth and/or acquisition and have been joined by Aviva, formed by merger of three big names. Scottish Equitable has also grown under the ownership of Aegon. Royal London has successfully incorporated a number of companies selling through direct sales forces and has entered the IFA channel by acquisition of Scottish Life. Friends Provident has grown organically and by acquisition

but is the weakest of the top class, a potential target for take over. Only two banks are represented in the top eleven but largely by acquisition.

Overall therefore, the top players in the market today are primarily the survivors of the market of twenty years ago. The major change apart from the substantial reduction in number of producers is the disappearance of the mutual company. The only mutual in the top class is Royal London.

#### **8.4 The drivers of the observed changes in industry concentration**

The increase in the number of participants up to 1988 can be explained by the relaxation of regulatory entry barriers, the promotion by government of personal pensions and the ensuing pension boom. In the years up to 1994 the new entrants and the incumbents were positioning themselves in the new market and responding to the increased competition for distribution outlets as described in Section 6.2 above. Competition in the industry became more a matter of securing distribution outlets than a matter of product quality and price. The polarisation rule has been identified as a major influence on strategic decision-making of companies in this period. More banks and building societies may have entered the market as producers than would have done without polarisation. The distribution network which evolved by the mid-1990s had been shaped largely by the requirements of polarisation.

In the competitive environment promoted by the pension boom, the industry developed new capacity, not only through the branches of banks and building societies but also by the expansion of direct sales forces (DSFs). As shown in Figure 6.8 in Section 6.2, employment in the insurance industry increased significantly after 1988 before falling back to some degree after 1991.

The years 1994 and 1995 were difficult for the industry and mark a turning point. Confidence among savers had diminished following the recession and stagnation in the equity market. The pension mis-selling scandal erupted. Regulators became more active in the enforcement of conduct of business rules, increasing training and competence requirements for staff and finally resolving the long running disclosure issue. New business premium income fell substantially in 1994 and 1995, leaving companies carrying the cost of what had clearly become excess capacity.

Pressures on costs rose steadily after 1994 from regulatory activity and this was joined by pressure on prices in 2001 with the stakeholder price cap which in turn put pressure



on margins. The fall of one of the market leaders, Equitable Life, in 2000 was a major shock for the industry and led to a tightening by the regulator of the prudential regulations, requiring companies to hold increased financial capital. This caught Standard Life forcing it to divest its life fund of a substantial amount of equity investment to reduce risk and regulatory pressure led to the company's decision to demutualise. The weakness of equity markets between 2000 and 2002 added to the regulatory pressure, with solvency margins reducing to dangerously low levels in some companies.

In this context, the consolidation of the industry which took place after the mid-1990s can be understood. A number of commercial drivers for consolidation can be identified:

- As described in Section 6.3 above, the banks and buildings societies failed to grow a significant market share through their branches and they were losing in the competition to IFAs. It was inevitable therefore that the larger banks and buildings societies would turn their attention to the task of acquiring insurance companies distributing through the IFA channel.
- Companies such as Prudential with large DSFs recognised the need to change their strategy which also involved an entry into the market for the acquisition of a company distributing through IFAs.
- The industry had accumulated excess capacity by the mid-1990s which had to be shed.
- The pressure on margins which increased during the late 1990s and early 2000s forced weaker players to close to new business or to put themselves in the market for take over.
- The pressure on solvency levels in the early 2000s added to the difficulties of the weaker players making them even more vulnerable to closure or take over.
- As shown in Figure 5.14 in Section 5.3 above, the net inflows into the industry started to fall after 2002 (ignoring the peak up to 2000 caused by OPS business). This reduction in net inflows reflects a reduction in new money invested by customers, i.e. reduced demand, which increased the competitive pressures on market participants.

The consolidation in this industry needs to be seen in the context of change in the financial services industry in general where there has been increased competition, consolidation and globalisation. But the retail pensions market is to some extent insulated from the wider pressures of change by being domestic and highly specialised.

The pressures on insurance companies are more indirect, through the strategic decisions of their parent companies which operate in the wider context.

### **8.5 Summary: the impact of regulation on the changes in industry structure**

Government pensions policy and regulation were the direct antecedents of the increase in numbers of participants and the increase in capacity of the industry in the period up to the mid-1990s. The expansion of the industry was however commercially unsustainable and in this sense the subsequent consolidation was a natural consequence of earlier public policy. The turning point came in the mid-1990s with the fall in demand along with the start of the mis-selling review and the fear of the effects of the disclosure of product details and charges. Regulation subsequently played a leading part in creating the conditions which made consolidation necessary by increasing compliance costs and reducing prices which put pressure on margins, making some businesses unviable. The tightening of prudential regulation in the early 2000s added to the difficulties of the weaker producers.

Regulation can also be seen as an antecedent of the commercial conditions which gave rise to the acquisition by some larger groups of insurance companies distributing through IFAs. Polarisation shaped the distribution network which became dominated by IFAs. The competition to sign up distributors became competition to buy up producers with established links to IFAs.

The fall in demand from consumers since 2003 may also have regulatory component. The pensions mis-selling scandal, followed by endowment mortgage mis-selling, the fall of Equitable Life and the adverse publicity accompanying these events may have damaged consumer confidence in the industry. Such events contain a large element of regulatory failure, the failure of regulation to be effective in its objective of protecting consumers. It may also be argued that the effective control of product development by government through fiscal and other regulations stifled product innovation; and conduct of business rules are likely to have affected innovation in the marketing and sale of pension products using new technology. It may be argued that lack of innovation leads to lack of interest among consumers and a fall in demand.

Regulation has therefore had a direct and indirect impact on the consolidation in the market. Today, the retail pensions market is dominated by eleven groups of companies which control almost 90% of new business. Around 80% of this business is obtained

through one distribution channel. Consumer demand in the market is now no higher in real terms than in the mid-1980s despite the widely recognised need for increased pension provision. Given purely social, economic and technological drivers, with some more subtle regulations to protect consumers, we might imagine an industry which is very different from the one we see today. I develop this theme in the next chapter.

## **CHAPTER 9: EVALUATION OF PUBLIC POLICY TOWARDS THE UK RETAIL PENSIONS MARKET**

### **9.1 Overview of this chapter**

In preceding chapters I have traced the changing regulatory environment of the UK retail pensions market since the mid-1980s and I have shown how regulation has affected product development, pricing, demand, distribution, costs and industry structure. I begin this chapter by summarising and expanding the evidence presented to show the current state of the market in 2008, including the consumer dimension. I assess the state of health of the market and the prospects for the industry and its consumers; and I summarise the argument showing how regulation has led to or contributed to this outcome. I then turn to the evaluation of public policy towards the market. I set out the criteria for the evaluation, returning to the literature review in Chapter 2. I then evaluate the three strands of public policy identified in Chapter 4 in terms of those criteria and in the light of the market outcome.

### **9.2 The UK retail pensions market in 2008**

#### *Product availability, differentiation and pricing*

A consumer in the retail pensions market today has a choice between a stakeholder pension (SHP) and a personal pension (PP). If the consumer is an employee, the consumer may be able to access these products through the employer in the form of an employer sponsored SHP (ESHP) or a group personal pension (GPP). From the consumers' point of view the products available through the employer are essentially the same as those he/she is able to access personally, except that the employer may make a contribution. A consumer may also be able to access these products through an affinity group such as a Trade Union. For the wealthier investor or the consumer wishing to consolidate existing pension plans there is in addition a self-invested personal pension (SIPP) product.

The monthly trade magazine *MoneyFacts* lists the products available, their features and their charges. Product features are tabulated: minimum and maximum age, minimum contributions and options to increase premiums, allocation rates, transfer penalties, fund choice, death benefit and other options such as the ability to take premium holidays.

In January 2008, 18 SHP products were listed. Inevitably there was limited differentiation between them given that these products have to satisfy regulatory and fiscal criteria. The smaller companies tend to offer very limited choice of funds while the market leaders do offer the consumer a range of funds but with a maximum. Charges do not exceed the stakeholder cap (1.5% annual management charge) but vary depending on a number of factors such the amount of commission taken by the adviser (to enable advisers to offer a choice of fee based advice or commission rebating), the funds chosen or the size of the fund.

In January 2008, 23 PP products were listed from 20 companies. Inevitably the structure of each product is essentially the same given that they must comply with fiscal criteria but there is a greater variation in product features than in the case of SHPs. Variations are found particularly in the minimum contributions, the range of funds on offer and the commission options. Charges vary for the same reasons as SHPs but the variation is greater, and some companies charge up to 3.6% annual management charge.

In January 2008, 64 SIPP products were listed with a much greater variation in product features and price than PPs.

The SHP is almost a commodity product, and PP products are not much more differentiated. There is a brand element however in that each product is associated with a well known name. Producers and advisers also attempt to build brand value through the funds on offer, for example, by running profiles on the leading fund managers and their track records. Whatever the evidence that over time fund managers do not beat the market average, providers and advisers attempt to persuade investors that the funds recommended will outperform others. This branding is particularly evident in the SIPP market.

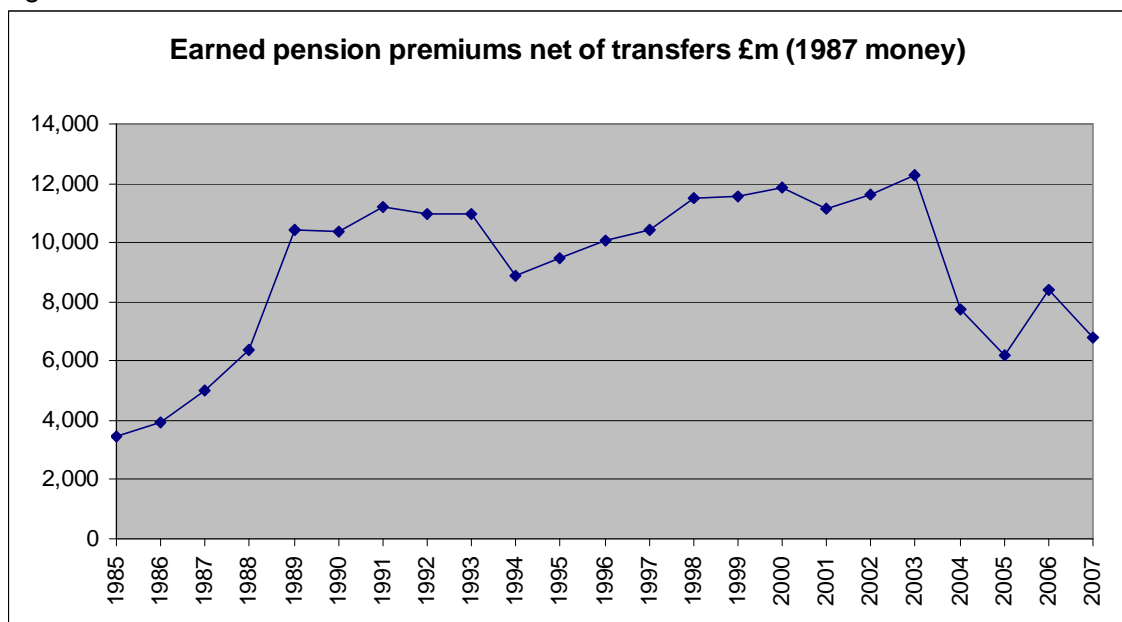
#### *Consumer demand*

Figure 9.1 below shows the earned pension premiums of insurance companies (i.e. the actual amounts paid by customers into regular premium and single premium personal pensions) less amounts repaid by way of transfers to other pension schemes. Earned premiums will include transfers in and amounts repaid include transfers out, so the net is the amount received by the insurance company sector. I have excluded the companies dealing solely with occupational pension schemes but the data will still

include some OPS business for those companies doing both retail and OPS business. This will affect the figures to some degree from 1997 onwards when there was an increase in OPS business. The rise after 1997 is probably due to OPS business and the consequent fall in 2004 for retail pension business is not as sharp as it appears in the chart.

The chart in Figure 9.1 does not include premiums received by non-insurance companies, mainly for SIPPs business. Table 5.5 in Section 5.3 above shows a significant increase in 2003. I concluded in Section 8.3 that non-insurance companies have yet to obtain a significant market share from insurance companies but part of fall in 2004 in Figure 9.1 is due to entry of these companies. For this reason also, the fall in retail pension business in 2004 is not quite as sharp as appears, but the contribution of the non-insurance companies will not affect the picture by very much.

Figure 9.1



Source: Synthesys Life database

The rise in demand after 1985 can be attributed to the government's promotion of personal pensions but the sharp rise in 1989 is not due wholly to new contributions by consumers as it includes transfers from occupational pension schemes (in respect of those opting out) and also transfers from the National Insurance Fund (for those opting out of SERPS). Nevertheless, until 2004, the insurance industry has enjoyed a sustained demand for its products. The fall in demand since 2004 appears therefore to be significant.

This picture of falling demand is also confirmed by other data on contributions. Government data on pension contributions aggregates personal pension schemes and money purchase occupational schemes but it does not include mainstream defined benefit OPSs. Table 9.1 below shows that contributions fell steadily after 2003 with a rise in 2006-7 perhaps due to the effect of pensions simplification on A-day on 6 April 2006.

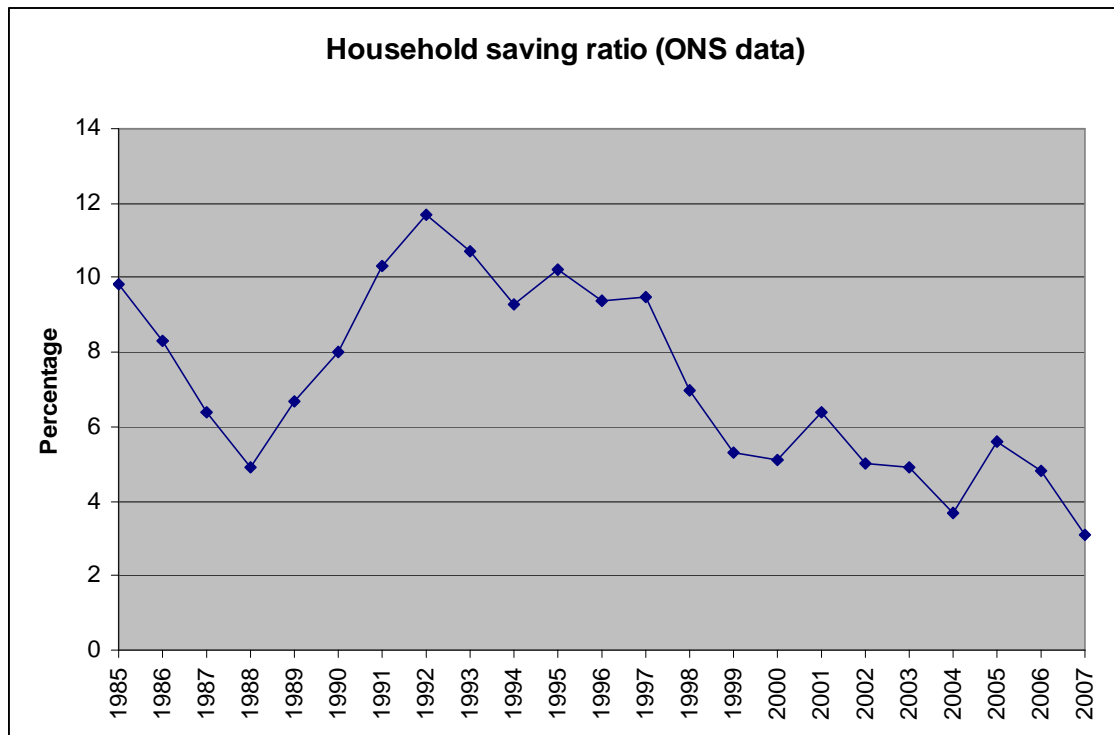
Table 9.1 Contributions to personal pension and money purchase schemes

Includes employees and employers contributions and tax refunds						
	2001-2	2002-3	2003-4	2004-5	2005-6	2006-7
£m (2001 money)	12,000	13,189	13,000	12,875	12,808	15,825

Source: HMRC data

Data from the Office of National Statistics (ONS) in Figure 9.2 below shows that the savings ratio has fallen significantly since 1997. The rise in the savings ratio after 1988 corresponds to the rise in pension contributions but there is a sharp fall in 1998 and a steady decline thereafter.

Figure 9.2



Source: ONS

The evidence up to 2007 suggests therefore that the industry is facing a significant downturn in demand in terms of new contributions from consumers. More recent events in the financial markets are unlikely to have helped companies restore their fortunes. The market has now moved from competing for new contributions from consumers towards competition for the management of existing funds, as evidenced by the increased volumes of transfer business.

#### *Distribution and market segmentation*

Over 80% by value of new retail pensions business is now secured by independent brokers. These brokers have increasingly targeted above average earners since the mid-1990s. Data quoted by Sandler (2002, p76) shows that in 1996 only around 4% of IFA customers were in socio-economic groups A and B. This rose to 23% in 2001 and was estimated to rise to 40% in 2003. The demise of the direct sales force, and particularly the home sales force has also increasingly disenfranchised lower to middle income consumers. This is referred to in Sandler's report and also by the FSA in its consultation document CP121 on polarisation (FSA, 2002).

Burton *et al* (2005) examine the decline of the home service industry. Companies such as Prudential, Pearl, Co-operative Insurance, Royal London, Refuge, Britannic and others operated successfully within the cash economy, tailoring their systems to match. This was also an early example of relationship marketing. The regular call from the agent encouraged saving and introduced a discipline to continue saving. By the mid-1980s a significant number of these companies were still active. But during the 1990s these companies increasingly found this business unprofitable, in large part due to the increased regulatory burden. One of the unintended consequences of regulation, according to Burton *et al*, has been the demise of the home service industry. This has left lower income consumers increasingly marginalised.

Although the number of producers has fallen rapidly to just eleven players controlling 90% of the market, the number of independent brokers remains substantial at around 12,000 firms supported by a range of networking arrangements. There is still plenty of choice of adviser for consumers but increasingly only for the wealthier individuals and above average earners.

The dominance of the independent broker in the relationship with the client has institutionalised the phenomenon observed during the pension boom of 1988 to 1992:



competition in this market for producers is more a matter of securing distribution outlets than about product quality and price. Producers meet brokers' needs first.

### *Costs*

The data in Table 7.10 in Section 7.6 above suggests that in 2007 the average cost of setting up a new regular pension plan was around £750 and the cost of a single premium contribution around £650. This is entirely understandable in terms of the work required. The sales process can take several hours of the time of a trained adviser and the producer has set up costs as well. Also, not every prospect turns into a remunerated sale and many regular premium policies lapse before the up-front costs have been recovered so adviser remuneration has to be set at a higher level than it would otherwise need to be. For single premium contributions, there are still handsome rewards for the adviser bringing in the larger contributions which boosts average costs. There are economies of scale in GPP and ESHP products which means that the average cost of an personal pension initiated by an individual must be even higher than the figures shown.

The other main costs of managing personal pension plans are those of maintaining the customer relationship and of managing the investment fund. No one single measure captures the total cost of pension plans in terms of output. In the industry, ratios of costs to premiums and costs to funds under management are in common use. Data on funds under management from both ABI and Synthesys Life sources does not distinguish life, retail pensions and occupational pension funds so the cost ratio in respect of retail pension funds under management cannot be presented. Data is however available to enable a calculation to be made of the ratio of costs to premiums earned. Table 9.2 below shows the total costs (excluding the cost of capital) for the top 11 groups as a fraction of the premiums earned in the year 2007 (i.e. the regular and single premiums paid by customers but not reduced by amounts repaid).

The median is 0.09, i.e. 9% of all premiums collected by insurance companies (including transfers in) goes in costs.

Table 9.2 Ratio of total costs to premiums earned: the top eleven

Year 2007	Ratio of total cost to premiums earned
Aegon Scottish Equitable	0.07
Aviva Norwich Union	0.09
Axa	0.09
Friends Provident	0.21
HBOS Clerical Medical	0.14
HBOS Halifax Life	0.08
HBOS St James Place	0.08
Legal & General	0.05
Lloyds TSB Scottish Widows	0.10
Old Mutual Skandia	0.06
Prudential	0.10
Royal London/Scottish Life	0.08
Standard Life	0.09

Source: Synthesys Life database

### *Producer margins*

Producers now almost invariably set their charges to customers in terms of an annual management charge on the funds managed. Their margin is therefore the difference between this charge and the total costs. In its second report, the Turner Pensions Commission calculated that at the current stakeholder charge rate of 1.5% per annum for the first 10 years and 1% thereafter, only 17% of individuals currently not contributing to a pension fund are profitable for insurance companies to serve. The median earner aged 40 is marginally unprofitable (Turner, 2005, p110). To create a margin therefore, producers must either target above average earners or find a justification for a charge in excess of 1.5%. The charges made by companies for retail pensions products compares unfavourably with the charges levied by occupational pension funds which are typically less than 0.3% (Turner, 2005). Producer margins are therefore under constant media scrutiny.

### *The closed fund industry*

The exit of companies from the market and the closure of funds to new business have led to a new type of company entering the market, the closed fund consolidator. The leading consolidators are shown in Table 9.3 below with the amount of funds under management (both life and pension funds) at the end of 2007.

Table 9.3 The leading consolidators

At end of 2007	Closed funds under management £billion
Resolution Life	43.7
Swiss Re	19.2
Pearl	18.7
Deutsche Bank	11.7

Source: Synthesys Life database

The Financial Services Consumer Panel, an official body set up by the FSA to represent consumers interests, estimated that in 2007 there was a total of around £190 billion in closed funds belonging to around 11 million consumers. In a report in September 2007 the Consumer Panel suggested that around 8 million of these consumers cannot obtain essential advice about what they should do with their investments because they cannot afford to pay for fee-based advice, while commission-based advisers are reluctant to take them on "for fear of future reprisals from the FSA" (Financial Services Consumer Panel, 2007).

From a consumer perspective also, the frequent change of ownership of their investments without their consent is unsatisfactory. The investments in question are long term in nature and in the past brand continuity has been important to the industry in maintaining customer confidence and loyalty. Many insurance companies traced their histories back to the 19<sup>th</sup> century. A consumer taking out a pension policy in their 20s could be sure that the company would be around to pay their pension when they retired and until they died. In an era when marketing is about building long term relationships with customers to retain their loyalty, the direction the life and pensions industry has taken in the last decade is against the trend.

*The health of the market, and prospects for market participants and consumers*

From the survey above, the UK retail pensions market today can be characterised as consisting of

- largely commoditised products (with the exception of SIPPs),
- offered at a price well in excess of charges levied by occupational pension funds,
- by a small number of companies,
- increasingly to wealthier individuals and higher income earners,
- through one dominant channel.

As identified in Chapter 5, there is limited competition on product quality and price in this market.

From a producer perspective, margins are under pressure and under public scrutiny. Real demand is falling. The industry is no longer held in the esteem it once was. It is significant that during the debate on the future of pension provision led by Turner, the industry (through the ABI) made representations on the role that the industry could play in a future national pension savings scheme. The ABI proposals were rejected by government. Insurance companies will be able to tender for administrative services and fund management services from the newly created government agency which will run the new scheme but the industry will not have a leading role. The industry is no longer able to serve the needs of the mass market.

At the same time, the industry remains under regulatory pressure. The industry's business model is described by FSA chairman Callum McCarthy as 'bust' (McCarthy, 2006). His contention is that we have a system which serves the interests of neither the producer of the services nor the consumer of the services. It is doubtful whether it services the intermediary either. The present distribution system is distinguished by a focus on volume rather than quality (McCarthy, 2006). The FSA has instituted a Retail Distribution Review to solve the problem. Companies are under pressure to 'treat customers fairly'. From the companies' perspective however, the regulatory regime is complex and expensive. Companies face a conflict between conduct of business regulation managed by the FSA and product regulation managed by the Treasury.

Interestingly, before McCarthy made his speech on 16 September 2006, the *Financial Adviser* carried an article on 2 March 2006 headed "Top bosses flock to IFA crisis talks". There was concern among many in the IFA world that the business model was in trouble because it had been based on a belief among product providers that they can design policies to sell to IFAs who are then tasked with selling them to the public. A more sustainable model would be to allow the client to buy the services of an adviser who recommends the most appropriate *solution* not *products*. This article reflected two common themes in the professional journals. The first theme is that producers see IFAs and not end consumers as their customers, which often means that products do not serve the needs of consumers. The second theme is that a client with cash or spare income to invest should normally be advised to pay off debt first before thinking of an investment product. Such advice will however not be of benefit to either the

adviser or the producer. The dissatisfaction with the business model expressed by the regulator is also shared by many in the industry.

From a consumer perspective, the astute and better off will look after themselves and they will be courted by advisers and producers. But the prospects for the mass market consumer are uncertain. The insurance industry no longer offers the service that it once did and the implementation of the new government pension scheme is still some way off. Existing funds are increasingly being managed by companies with which consumers did not enter into contracts and most consumers are unable to obtain advice on their options.

For McCarthy, the consumer suffers from product bias, provider bias and churn. Providers still manage demand by adjusting commissions to intermediaries leading to consumers buying unsuitable products. Consumers also suffer from unnecessary costs when induced to switch from one product or provider to another without any clear benefit (McCarthy, 2006). The FSA's survey data on the level of persistency of regular premium pensions policies (the percentage of policies still receiving contributions from the policyholder after one, two, three and four years) shows significant falls in persistency since the 1990s. In particular, the four year persistency of policies sold through IFAs has fallen from 70.5% for policies sold in 1993 to 42.3% for policies sold in 2003 (FSA, 2007). Some of this is due to churn and some to policyholders ceasing to make contributions.

The evidence therefore points towards a market that is far from healthy in the sense that it is not fulfilling the needs of market participants and consumers. The future prospects for both market participants and consumers are uncertain.

#### *Regulation as the determinant or an antecedent of the market outcome*

In preceding chapters I have assessed the impact of regulation on the market and concluded that regulation rather than economic, social or technological conditions has been the main determinant or antecedent governing the evolution of the market since the mid-1980s. Over the last 20 years government and/or regulators have had effective control over product design through fiscal rules, over product distribution through the polarisation rule and over consumer demand through fiscal incentives. More recently the government has had substantial influence over product price through stakeholder and associated regulations. Compliance obligations have steadily increased costs for

market participants. The consolidation of the industry seen over the last decade has direct and indirect regulatory antecedents. The market we have today is therefore largely a product of regulation.

Economic, social and technological factors have had some impact. Demand has been affected by the economic cycle and by the performance of the stock market. This was particularly apparent after the recession in the early 1990s. Demand has fallen in recent years along with the general fall in the savings ratio. But economic factors cannot account for the market outcome now observed. The UK stock markets have risen steadily over the period since the mid-1980s. Interest rates and inflation have been very stable since the mid-1990s accompanied by consistent economic growth, a steady rise in real earnings and a steady fall in unemployment. Until events in credit markets in 2007 started to reverse the trend, the UK has enjoyed a long period of growth and stability.

The public debate on the need for pension provision should be positive for the industry. Technology has been harnessed by the industry to improve efficiency and to manage the cost pressures; and more recently technology has begun to affect product development with the emergence of platforms and wraps. But technology has not rendered products obsolete or required radical product redesign as in some industries.

Consolidation has been a feature of the wider financial services industry. Globalisation has affected the financial services industry but the UK retail pensions industry has been protected to a large extent by being domestic. UK products are not sold overseas and overseas products are not sold in the UK. Overall, government pensions policy, conduct of business regulation and product regulation (and to some extent prudential regulation) have had a much greater impact on the evolution of the market than any economic, social or technological factor.

This assessment of the state of the market in 2008 and the proximate causes of the outcome observed leads naturally to an assessment of the public policy towards the market in question.

### **9.3 The evaluation of public policy towards the retail pensions market**

#### *The criteria for the evaluation*

In Chapter 2 I reviewed the literature on the evaluation of regulation. I referred to the increasing use by government and regulators of cost-benefit analysis and regulatory impact assessment. These techniques are useful in assisting decision-making but are limited in their ability to address some of the longer term questions, particularly questions involving the adaptive and behavioural responses of market participants, the impact of cumulative changes in regulation over time and the interaction of different regulatory regimes.

In this thesis I set out to address some of these more difficult questions. I set myself the question: what was the impact of regulation on the UK retail pensions market? In chapters 4 to 8 I chartered the changing regulatory environment of this market and answered the question in terms of some of the key institutional market features. In section 9.2 above I summarised the current state of the market, the position reached after 20 years of regulation.

Having understood the impact that regulation has had in practice on the dynamics and evolution of the market, I now turn to questions about the regulation itself. We may ask a set of related questions about any line of regulatory intervention in the market:

- Was there a clear rationale for intervention?
- Were the objectives of the intervention realistic?
- Were the mechanisms and instruments of the intervention well designed and did they deliver the objectives?
- Were the risks of the intervention identified, were mitigating actions put in place and were they successful?
- Were the adaptive and behavioural responses of market participants and consumers accurately assessed?
- Were the cumulative effects of a series of interventions identified?
- Were the potential interactions between different lines of intervention identified?
- Were there any unforeseen or unintended consequences?
- Overall, did the intervention lead to an improvement in the operation of the market with attendant economic and social benefits?

### *The evaluation of the three strands of public policy*

In Section 4.13 I identified three strands of public policy towards the retail pensions market:

- pensions policy
- investor protection policy
- competition policy.

I now examine each of these three strands addressing the questions listed above. I then turn to the interaction between the three strands.

#### **9.4 The evaluation of pensions policy**

##### *Personal pensions*

Norman Fowler's preface to his consultative document on pensions in 1984 (described in Section 4.4 above) began "This government believes in people having a choice. This paper is about one important aspect of choice – giving people more choice in the way they save for old age ..." The government of the day was pursuing an ideological agenda of individual freedom over government and corporate control. Personal share ownership (especially of privatised companies) and increasing home ownership were also part of that agenda. Government was also concerned about the long term cost of SERPS to the state and wanted to promote pension saving.

There was therefore a clear rationale for an expansion of the existing personal pensions market but the mechanisms chosen (opting out, fiscal incentives, aggressive government advertising and reliance on a new investor protection regime) had substantial risks. These risks were identified at the time:

- Employees would be persuaded by aggressive sales people on commission to opt out of their OPS into a PP, against their interests.
- PP plans presented substantial financial risks to employees compared with the guaranteed benefits of final salary OPSs.
- Opting out of SERPS would only benefit younger people.
- People in PP plans would suffer much larger administration costs than those in an OPS.

As can be seen from Section 5.2 above, the policy was very successful in one sense. Large numbers of people set up PPs and substantial amounts of money flowed into



insurance companies. But as described in Section 4.4, the risks soon became manifest. Government was surprised by the result. On 28 February 1994 the *Financial Times* carried an article containing off the record comments from civil servants: 'The reality is that this was a duff product from day one'. Government became 'mesmerised' by the allure of personal pensions as a way to extend choice, increase individual investment and reduce the cost of the state pension scheme. Government ignored the operational risks and was surprised by the result of the forces it had unleashed.

A major review followed taking eight years to complete resulting in £11.8 billion in compensation and £2 billion in administrative costs. The compensation and costs were charged mainly to the companies' life funds and were therefore borne largely by the greater body of policyholders. The review therefore consisted mainly of the reallocation of money within the funds. This can be regarded as of no collective benefit so the administration costs of £2 billion were dead-weight costs. More generally, the transfer of money from OPSs and the National Insurance Fund into PP funds can be regarded as having no collective benefit and the cost of making those transfers are dead-weight costs also. It is significant that in recent years a number of insurance companies have ceased taking national insurance rebates in relation to SERPS/S2P opt outs and put their customers back into S2P on the basis that they would be better off in the state scheme.

It may be argued that the policy did result in an increase in pension saving, as evidenced by Figure 9.1 above which shows that throughout the 1990s there was a sustained inflow of pension contributions to the insurance companies. But this flow seems now to have come to an end. The problem for consumers is that much of the increased saving of the 1990s now vests in closed funds in relation to which many consumers cannot get independent advice on their options. Just as important is the question of the cost to consumers of the policy. Data from the regulators shown in Table 6.1 in Section 6.2 above show that commission cost rose substantially after the abolition of the maximum commissions agreement and these costs were passed onto consumers. Although costs subsequently fell under regulatory pressure, Table 9.2 above shows that even at the much reduced levels of 2007, costs still absorb on average 9% of actual contributions. The annual management charges on funds in PP plans is well in excess of the charge on funds in OPSs.

Overall therefore, it cannot be concluded that the personal pensions policy achieved its objectives. Arguably, the disadvantages to consumers and providers exceeded the advantages. Also, a later government found the need for further action to promote pension saving.

#### *Stakeholder pensions*

This policy also had a clear rationale: to increase pension saving among the lower to middle income group and to reduce the costs to consumers. The evidence presented in Section 5.3 above shows that the initiative did not reach its target group effectively. The policy did, however, lead to a reduction in costs of personal pension plans generally as shown in Section 7.6 above. But this in turn led to a lack of interest among providers. While many providers still offer the stakeholder product, they do not market it actively.

In contrast to the earlier personal pensions initiative, stakeholder pensions had no significant risks to consumers as the market was heavily regulated. It may be argued however that the market was too heavily regulated to provide any incentives to companies to actively market the product to its target group. The policy also introduced a conflict between its product regulation and existing conduct of business regulation which created problems for both companies and the FSA.

Overall therefore the policy failed to meet its primary objective of increasing saving among the target group which meant that further action was required in the form of the national scheme which followed the Turner reports.

#### *Tax policy on pensions*

A common feature of the personal pensions policies of both Conservative and Labour governments has been the provision of tax relief on contributions. Providers and advisers advertise this feature: personal pensions are 'tax efficient'. The price of tax relief on contributions to the saver is that the contributions are locked into a fund which can only be accessed on retirement in the form of a taxable annuity or income drawdown product. Providers and advisers do not generally provide potential clients with a comparison of the situation which would pertain if the contributions were saved directly into a fund outside the tax regime.

Figure 9.3 below shows an illustrative example. In the first scenario a saver buys a stakeholder pension plan which invests contributions in a managed fund. In the second

scenario the investor puts the same contributions directly into the managed fund outside the pensions tax regime. The saver is marginally better off in the second scenario.

Figure 9.3 An illustrative example

**Tax relief on pensions – a gift from the Chancellor?**

A woman aged 40 wishes to save for her retirement at age 65. She will save £1000 each year. We assume a tax rate of 20% during working life and during retirement and a real growth rate on funds of 5% per annum before the annual management charge.

Scenario 1. Our saver chooses a stakeholder pension plan charging 1% per annum on funds under management. At the beginning of year 1 she pays £1000 to which is added the tax rebate of £200. This contribution goes into a managed fund and grows by 5% to £1260 at the end of year 1 which after a 1% charge of £13 provides a fund of £1247. After 25 years the fund has grown to £51,600. From this fund a tax free lump sum of 25% may be taken: £12,900. The balance of must be turned into a taxable annuity. A woman aged 65 has an average life expectancy of 20 years. From annuity tables the present value of an income of £1 per annum for 20 years at 5% discount rate is £12.46. A fund of £38,700 therefore yields an annuity of £3,106 and after tax an annual income of £2,485. Assume that the lump sum is turned into a life annuity which is tax free. This yields an income of £1,035 per annum. The total annual income enjoyed by our saver will therefore be £3,520.

Scenario 2. Our saver puts £1000 each year directly into a managed fund. This means that she does not receive a tax rebate on the contribution. But the cost of the fund is less than the stakeholder pension as there is much less administration for the provider. Assume the annual management charge is 0.75%. After 25 years a fund of £44,664 accumulates. This can be turned into a tax free life annuity of £3,585 per annum.

In this example I have made some simplifying assumptions. I have ignored the charge levied by the insurance company for providing the annuity and taking the longevity risk. I have also ignored the fact that in practice insurance companies quote lower annuity rates on life annuities than compulsory pension annuities because of the moral hazard risk – only people in good health with long life expectancy will buy a life annuity. I have also ignored the marginal tax on the deemed income element of the life annuity. The point however is that the tax relief on contributions is clawed back from tax levied on the pension so that the saver is actually no better off.

In practice, many people do gain a benefit from tax relief on contributions because their tax rate in working life is higher than their rate in retirement. But the benefit is not as high as is generally believed.

The advantage to government of this tax regime is that it provides an incentive to saving as people generally believe the pension product offers substantial tax advantages. Also, providing tax relief enables government to secure the savings from

being spent by the saver before retirement, thereby reducing the risk to the state of providing income benefits. The disadvantage of this regime is that it raises the cost of administration of pension funds as data and money has to be passed between government and provider on an annual basis throughout the life of the customer. Also, as I have demonstrated in Chapter 5, the tax regulations accompanying the provision of tax rebates effectively transfer control of product development from providers to government. Innovation can only take place by changes to the tax rules.

This latter point is worth further exploration. It is generally argued by consumer groups that people should be advised to pay off debt, particularly credit card debt, before buying investment products. The more difficult issue is whether people would be better off paying off mortgage debt before investing in a personal pension. If the tax benefit of the pension plan is marginal and the rate of growth of the pension fund after charges is likely to be less than the rate of interest on the mortgage then it would be advantageous to pay off the mortgage early and then save for the pension. This line of thinking leads to some interesting possibilities for product innovation by financial services companies. Can products and services be devised which allow people to manage their finances more comprehensively to deal with their needs for house purchase, pension, school fees or whatever. In this context, the tax regime on pensions can be seen as a major barrier to long term innovation in personal financial planning.

This leads to another point and to a problem. The retail pensions industry may not possess the capability to innovate as it has been used to depending on government for changes to the tax rules. Regulatory control over a long period is bound to change the mindset of strategists in the industry.

### *Conclusion*

On the basis of the state of the market outlined in Section 9.2 and the evaluation set out above, government pensions policy over the last 20 years cannot be regarded as having met the core social and economic objective of enabling and encouraging people, especially those on lower than average incomes, to provide for their retirement in a cost effective way. The mechanisms chosen to deliver the policy objectives were not effective and carried more risk than potential benefits. Neither providers nor consumers behaved in the way which was expected. The outcomes were unexpected. Overall, the intervention in the market by government over the 20 year period did little to promote a sustainable retail pensions market.

Government itself has been dissatisfied with the result and commissioned Adair Turner to carry out an extensive review which concluded in 2006. Government is now implementing the recommendations in the form of a new scheme to be introduced in 2012. This new scheme carries substantial risks. Already the implementation date has been put back by two years to reduce the risk of operational failure (process and technology) in government. The scheme requires an extensive compliance regime as it depends upon employers to collect and pay over contributions. The main employers affected will be those without existing pension schemes: small to medium enterprises which are already struggling to meet the compliance burdens of tax, national insurance and employment regulation. Whether the new scheme meets its objectives remains to be seen.

## **9.5 The evaluation of investor protection policy**

### *The review of investor protection*

In his report of 1984 on investor protection (described in Section 4.5 above), Professor Jim Gower set out his philosophy for a new investor protection regime: regulation should be the minimum necessary to protect reasonable people from being made fools of. He was responding to a number of scandals where investors lost money by both fraud and incompetence. A new regime was considered necessary to support another government policy, that of opening the financial markets to increased competition. Government saw regulation to protect investors as a necessary element in the healthy development of financial services. All should know that they are doing business within a system where fraudulent or dishonest conduct is prohibited and where high standards are expected and obtained.

But, as a lawyer, Gower was also keen to remove what he saw as irrationality in existing regulation, the failure to treat like with like. He was particularly troubled by the privileges enjoyed by insurance companies which were able to market what were really investments as insurance contracts, obtaining competitive advantage over other forms of investment such as unit trusts. His other main concern from the point of view of the retail consumer was the effect of hard selling by insurance companies and the risk that people would be persuaded to invest in products against their interests.

The rationale for regulation was therefore clear and the objectives generally accepted by all concerned. Implicit in the debate is the recognition that consumers of financial services are at a disadvantage from lack of expertise and information.

But as described in Chapters 4 and 6, the mechanisms proposed to deliver the investor protection objectives were highly contentious and the debate over some of the issues still continues today in the form of the FSA's *Retail Distribution Review*. Some of the issues have been resolved such as the debate about self-regulation versus state regulation although there are some commentators who question whether the FSA is too big and diverse to be effective. But a number of related issues have dominated the regulatory discourse over the 20 year period concerning:

- the conflicts of interest facing advisers/salespeople,
- the training and competence of advisers/salespeople,
- the method of remuneration for advisers/salespeople,
- the disclosure of information to the consumer, and
- the regulatory control over the distribution business model.

#### *Advisers and salespeople, and disclosure*

In a recent report, the Law Commission (2007, p220) identified confusion within the UK law of agency about the position of intermediaries in insurance contracts. Sometimes the intermediary is regarded as the agent of the insurance company and sometimes the agent of the consumer. Normally, however, the agent is remunerated with commission by the insurance company. On general agency principles, it would be expected that an intermediary who was agent for the consumer should account to the consumer for the commission received from the insurance company. But under common practice in the industry this was not done and has only changed following specific disclosure regulations. Employees and appointed representatives of the insurance company are normally regarded as agents of the insurance company. This issue is material in insurance contracts generally as the position of the agent determines the responsibility for errors and omissions in the insurance proposal.

The investor protection regulations introduced in 1988, and still effective today, build upon the general law of agency by requiring all intermediaries, employees and representatives to give 'best advice' to customers. All advisers and salespeople owe a duty of care to the consumer even though they may also be agents of the insurance company. This rule created a fundamental conflict of interest for all advisers and

salespeople and compounded the problem that the Law Commission now seeks to resolve.

Also, this rule assumed that advisers and salespeople were trained and competent to discharge the duty imposed upon them, but as described in section 4.8 above, this proved to be optimistic. The regulator was required to undertake substantial remedial action to improve standards. Although professional standards have improved substantially since the 1980s, the appropriate qualifications for financial advisers are still an issue today.

Alongside these issues there was a debate which ran until 1995 about the requirement for advisers and salespeople to disclose their remuneration. More recently, the debate has shifted toward the question of whether it is appropriate for independent advisers to be remunerated by commission from the insurance company at all and whether instead they should be paid by fee by the consumer.

The investor protection regime put in place in 1988 failed, therefore, to address some fundamental issues in the insurance market. Regulators since then have not resolved the issues. The regime did not meet its objectives in the mis-selling episode and the subsequent tightening and enforcement of the rules has led, alongside the stakeholder price cap, to many consumers being unable to access advice. Government has attempted through the stakeholder initiative to mitigate the unintended effects of the investor protection regime by moving to product regulation but this has created a conflict between two different approaches to investor protection.

#### *Regulatory control over the distribution business model*

Polarisation was a key part of the regulatory regime introduced in 1988 and despite constant criticism within the industry and from observers it endured until 2005. The stated rationale of polarisation was investor protection, to prevent consumers being confused about the status of the person with whom they were dealing in relation to a potential purchase. However, as described in section 4.6, the polarisation rule had its origins in the history of the industry and was very much associated with attempts to maintain maximum commission agreements. Polarisation was seen by the banks and buildings societies as an attempt by dominant insurance companies to protect incumbents' interests and prevent effective entry.

The rationale for polarisation was, therefore, never very clear. Surveys conducted by regulators and by consumer groups showed that consumers were very slow to understand the difference between IFAs and representatives. Even as late as January 2001 the FSA reported that research evidence suggested that about 20% of consumers did not understand what type of adviser they were dealing with and qualitative survey evidence suggests that the proportion may be higher. Over 30% of bank consumers thought that their bank was offering independent advice even though almost all banks were tied representatives (FSA, 2001). If consumer protection and clarifying the status of intermediaries and salespeople were the objectives of polarisation, this objective was not very successful.

The impact of polarisation was not foreseen by anyone at the time it was introduced. The way that polarisation shaped distribution, as described in Chapter 6, was not anticipated by regulators or by market participants. The emergence of a dominant IFA channel was a surprise. The risks of the policy were not therefore understood by the regulator.

With hindsight therefore, the polarisation rule cannot be regarded as a well thought out policy or as an effective mechanism for investor protection. With foresight, it could be argued that there was never any justification for the prohibition of a business model, the multi-tied agency. The OFT expressed concern about the rule at the time but it was over-ruled by the DTI. The rule was anti-competitive but the advantages to the investor were never clear enough to justify restricting competition in this way.

Depolarisation followed a further report from the OFT but it was impending EU regulation that made polarisation unsustainable. The FSA also put forward other reasons for depolarisation which are listed in Section 4.12. In particular, research commissioned by the FSA showed that competition in the market operated, via the commission system, to secure IFA distribution power for product providers which was detrimental to consumers. This was a direct acknowledgement that polarisation had led to an IFA dominated distribution channel and in this sense polarisation did not operate to protect consumers.

The FSA had other objectives from depolarisation. It hoped that increased disclosure requirements would have benefits for consumers but research commissioned by the FSA after implementation suggested that the benefits were limited. The outgoing CEO of the FSA, John Tiner, regretted that the FSA had not held firm on the question of



commission and conflicts of interest (Tiner, 2007). The evidence presented in Section 6.3 above showed that when depolarisation finally arrived in June 2005 it did not have the impact which was expected. The world had moved on. Depolarisation was too little, too late.

The failure of depolarisation to meet its objectives led the FSA to institute a more far reaching review, the *Retail Distribution Review* (RDR) which at the time of writing is ongoing. In its latest publication in April 2008, which is an interim report on feedback received on a consultation paper issued in June 2007, the FSA states that the aim of the RDR is for more consumers to have sufficient confidence in the market to want to use its products and services more often. To achieve this, the FSA says, we need an industry that more clearly acts in the best interests of its customers and treats them fairly. The FSA will produce a further statement in October 2008 together with conclusions based upon further economic analysis of their current ideas. Following feedback on their earlier paper, the FSA's current ideas are that the landscape will consist of three components:

- Advice – there would be only one type of adviser and a step-change in the standards required of advisers; all advisers would be independent operating remuneration without product provider input;
- Sales – the starting point is that sales are strictly non-advised;
- Money Guidance – a newly proposed information and guidance service, which follows from a review commissioned by the Treasury on generic advice in financial services (FSA, 2008).

The FSA will provide in due course the mechanisms for implementing its conclusions but whatever those mechanisms are the question will be whether they are likely to be successful in delivering the objectives. Given that two previous attempts to engineer distribution channels by regulation have failed to meet investor protection objectives, why is it thought that this latest attempt will succeed? Why does the regulator think that it can design and successfully implement, even with the cooperation of market participants, a distribution system for retail investment products? Previous experience shows that regulation of distribution has had a profound effect on the evolution of distribution channels, but that effect was neither expected nor desirable. How will the FSA control market forces and the strategic behaviour of market participants to ensure that the market does evolve in the way that it desires?

## *Conclusion*

On the basis of the state of the market outlined in Section 9.2 and the evaluation above, investor protection policy cannot be judged to have been successful in this market in meeting its objectives without unintended consequences. The policy did not work at all before 1994 and thereafter, although it largely prevented scandal, it increased costs for market participants which had the unintended effects (along with stakeholder regulations) of preventing less well off consumers from obtaining advice.

The mechanisms chosen to deliver the objectives failed to deal with the conflict facing intermediaries and regulation made this problem worse by creating a conflict of interest for salespeople. Polarisation substantially distorted competition leading to an unintended outcome which did not benefit consumers.

### **9.6 The evaluation of competition policy**

In the regulatory regime introduced in 1988, competition policy took second place to investor protection policy. The rationale was that it was appropriate to restrict competition in the interests of investor protection, but that the restriction of competition should go no further than that required to deliver investor protection. In Gower's words, regulation should be the minimum necessary to prevent reasonable people being made fools of.

This principle is reproduced in the legislation which now governs the FSA. The FSA's primary objective is to secure the appropriate degree of protection for consumers. But in delivering this objective FSA is obliged to ensure that it does not impede or distort competition unnecessarily.

The Director General of Fair Trading (DGFT) is the guardian of competition policy. He has the power and the duty to examine the regulatory rules and to make reports to the Treasury if he feels that competition is being restricted or distorted unnecessarily. In the early days of the new investor protection regime, there was considerable conflict between the OFT and the regulators, as described in Section 4.7 above. It was recognised that self-regulation could lead to the creation of restrictive practices. The OFT, under the forceful leadership of Gordon Borrie, succeeded in changing many of the regulations to promote competition. The DGFT did not however manage to remove the polarisation rule.

The DGFT's report on polarisation in 1999 did contribute to the eventual demise of polarisation but the DGFT did not comment adversely on the proposals for depolarisation. So far the DGFT has not commented on the latest proposals emerging from the RDR. Clearly, the RDR is an attempt to restrict competition, to restrict the basis on which intermediaries and salespeople may operate in the market place. Under present law, this is permissible if it is necessary to protect investors. If, however, competition policy took an equal place alongside investor protection policy the outcome may be different. If, for example, the regulator was under an obligation to promote competition as a means of securing an appropriate level of investor protection, then a different approach could be adopted. The approach could be one of creating the right incentives and preventing conflicts of interest in the market place rather than attempting to define permitted and non-permitted roles in that market place. The emphasis could be on promoting competition on product quality and price which has been notably absent from this market.

As an example of this, I referred in Section 5.3 above to the development of platforms and wraps which are a market innovation and which have potential to improve competition in terms of product quality and price. But the guidance issued by the regulator carries the risk of impeding this development. The alternative approach would be to encourage this innovation as a mechanism of improving competition to the advantage of consumers.

In conclusion, the secondary place of competition policy to investor protection policy in the retail pension market may not be helpful to consumers in the longer term.

### **9.7 The interaction between the three policy strands**

Each of the three strands of policy emerged separately in the 1980s. At a late stage the government linked its pensions policy to investor protection policy to answer one of the criticisms of pensions policy, the risk to consumers from hard selling techniques. Subsequently competition policy became engaged with investor protection policy. It is clear then that the three strands of policy interacted together to determine the development of products and the evolution of distribution channels as described in Sections 5.2 and 6.2 above. These three strands also operated together to lead to an increase in distribution costs and to an increase in the number of participants in the market, as described in Sections 7.4 and 8.3 above.

Pensions policy created a new market but this market was constrained by investor protection rules and subject to controversy over the restriction of competition. The professional journals at the time showed considerable uncertainty and anxiety in the market place. Companies did not want to lose out in the pensions boom but the frequent changes to the regulations (particularly the maximum commissions agreement and disclosure rules) along with the unknown impact of polarisation led to uncertainty and to what was described as a 'scramble' to sign up distribution channels. After the abolition of the MCA, distribution cost rose significantly. Investor protection policy failed to prevent the mis-selling scandal which emerged.

The interaction between the different strands of policy can also be seen in later events. The government's stakeholder pensions policy created a new type of regulation, product regulation, which conflicted with the existing conduct of business rules. The government wanted to kite-mark its stakeholder pensions as safe for investors but the FSA's research suggested that consumers could still be subject to detriment. The FSA was not prepared to take the risk that it would be held to account for failing to meet its statutory objective of providing the appropriate degree of investor protection.

Stakeholder pensions policy also had a major impact on the market through its price cap and the interaction with investor protection regulation through the RU64 requirement which extended the influence of the price cap to other products, as described in Section 7.7. This in turn put pressure on companies' margins, already under pressure from increasing investor protection compliance requirements. This then contributed to companies withdrawing from the market and to a wave of consolidation as described in Section 8.4 above. By this time the IFA distribution channel had become dominant. Competition in the market place had reduced substantially over a number of years.

The evolution of the UK retail pension market has therefore been heavily influenced by the interaction of three strands of government policy. These interactions have not been assessed and understood by government and regulators and the outcomes have, therefore, been unexpected and unintended.

## **9.8 The overall evaluation of public policy**

In terms of the criteria set out in Section 9.3 above, government pensions policy and investor protection policy over the last 20 years do not score very favourably. At the highest level, the rationale for intervention is clear and the objectives meritorious. Few would argue with the objectives of promoting pension saving or providing a reasonable level of investor protection without unduly distorting competition. But the mechanisms chosen to deliver the objectives were poorly designed and government often ignored the risks. This is not the application of hindsight. In pensions policy, the risks of the opt-outs together with fiscal incentives were highlighted at the time. In investor protection policy, Gower's proposals were criticised for their emphasis on the rationality of the rules at the expense of a thorough analysis of the objectives of regulation, its economic costs and the likelihood of the regulatory apparatus achieving its objectives. Regulation failed to deal with the conflict of interest facing intermediaries and made matters worse by creating a conflict for salespeople. Polarisation never had a robust rationale or justification for its significant distortion of competition.

It was inevitable, therefore, that the regulations introduced would have unforeseen and unintended consequences. With hindsight, we can now see how fiscal policy controlled product development and how polarisation determined the development of distribution channels. We can see the influence of regulation on producers' costs and margins and the contribution this made to the consolidation in the industry. We can see the cumulative effects on the market of a series of interventions over time and the way that different lines of policy interacted with each other. The outcome we see today is primarily the result of a complex set of government and regulatory interventions over a long period of time, along with the normal environmental change seen in any market. The outcome of those interventions cannot have been foreseen, which raises the question whether such direct and extensive intervention is wise. The example of the UK retail pensions market shows that government cannot control the forces in the market and direct them towards a chosen outcome.

Competition policy emerges with a more favourable judgement than pensions or investor protection policy. The main criticism is that it has taken second place. This leads to a prescription: raising the profile of competition policy and working with the competitive forces in the market is likely to be more successful than any attempt at direct control.

## 9.9 A counterfactual

It is useful to end this analysis by constructing a counterfactual and to consider what might have been if public policy towards the market had been rather different. The basis for creating the counterfactual is that government intervention in the market should have a clear rationale, realistic objectives and mechanisms for implementation which are likely to be effective. Risks should be assessed and managed. I use the results of the evaluation with hindsight to construct the counterfactual. This leads to the following public policies:

### Pensions policy

- No tax relief or other fiscal incentive is given on an individual's contributions to a pension product.
- No tax is charged on the use of the capital accumulated for spending in retirement on the grounds that such capital will have been accumulated out of taxed income and it is therefore inappropriate to tax it again. This approach is already reflected in the taxation of purchased life annuities other than compulsory pension annuities.
- Government does not attempt to design, specify or promote any pension products and there is no control on the prices charged for such products.
- Employment law does not provide an employee with a right to opt out of an employer's pension scheme: terms of employment are matters for the employer and employee.
- The problems with the funding of SERPS and S2P are resolved without providing national insurance rebates for investment in a personal pension scheme.

### Investor protection policy

- Brokers and salespeople are solely the agents of the producers.
- There is no control over distribution channels.
- Prudential regulations continue to operate to require companies handling customers' money to be authorised and to hold appropriate levels of capital.
- Regulations also require people dealing with the public to be authorised to ensure appropriate levels of probity and competence.
- A compensation scheme and Ombudsman service is provided, funded by levy on the industry, to compensate customers subject to dishonest conduct or incompetence.

- Conduct of business regulation is similar to that found in other markets, i.e. products should be of merchandisable quality, should be correctly described and should contain 'health and safety' warnings where appropriate.
- Government should promote public education in financial matters and support generic financial advice.

#### Competition policy

- This policy should have equal standing with pensions and investor protection policy.
- The policy should focus on promoting competition on product quality and price.

The immediate consequences of these policies will be as follows:

- Product development is not controlled by government so innovation is not constrained.
- Risks to consumers, which arise partly from the complexity caused by fiscal rules and the right to opt out of occupational schemes, are reduced.
- Demand for pension products is not affected by fiscal incentives.
- There will no government inspired pension selling boom and associated mis-selling scandal.
- Brokers and salespeople do not face conflicts of interest in dealing with customers.
- The consumer retains the responsibility for purchasing decisions.
- Banks and building societies, and other financial institutions, can enter the market without any constraints on their distribution strategies.

The outcome of these policies, if they had been pursued since the mid 1980s, cannot be predicted but we can see that many of the problems created by the regulations actually adopted would not have arisen. We can also imagine the opportunities which would have been provided to producers and distributors for innovation. For example, there is the possibility of products being designed which combine house purchase and retirement saving. One innovation in banking has been the off-set mortgage where the interest charged on the mortgage is reduced if the customer holds money in savings accounts. If the current fiscal rules which prevent people accessing their pension savings did not exist, there is a potential for the off-setting concept to be extended to retirement savings. There is then the possibility for more innovative products and services to enable customers to manage their debt alongside their short term and long term savings.

The absence of tax rules surrounding pension products would also have had a second effect in the competitive environment. Banks and building societies have been less dependent on tax incentives than the insurance companies. The insurance companies' core life and pension products have all been developed on the back of tax breaks. Alongside the absence of the constraint introduced by the polarisation rule, the absence of tax rules on retirement savings would provide greater opportunities for banks and building societies to compete with insurance companies. The distribution network and the industry structure could therefore have been very different from what is observed today.

The absence of tax rules has two possible downsides. The first is that removing tax relief would reduce incentives for retirement savings leading to more people requiring state assistance. The second is that people may spend their savings before retirement or run out of money in retirement and thereby become a burden on the state. Pension policy recognises the need for a state pension and for a minimum income for all in retirement provided by national insurance contributions. The problem, recognised in the Turner reports, is that the current state pension is inadequate and that the means tested benefits provided to those without other sources of income create a disincentive to personal savings. This needs to be solved in any event. Removing tax relief on contributions provides a source of funds to enhance the state pension. Providing incomes over that level then becomes solely the responsibility of the citizen.

The absence of detailed conduct of business rules requiring brokers and salespeople to offer 'best advice' and to produce detailed documentation substantially reduces the compliance burden and therefore the cost of products. In a more competitive environment there is the possibility of these savings being passed onto consumers.

It may be argued that the absence of an obligation on brokers and salespeople to offer consumers 'best advice' would lead to more people being sold unsuitable products. But one of the reasons that people need advice is the complexity of the tax system and the fact that a contribution into a personal pension is irrevocable: the money is tied up until retirement. Also, the counterfactual assumes that some investor protection is still required but without creating conflicts of interest. Under the counterfactual, consumers are unlikely to be at any greater risk than they face under the current regime.



In summary therefore, the counterfactual demonstrates that there was a very real alternative to the policies actually adopted and that the outcomes from this counterfactual could well have been more beneficial to the market and to consumers.

### **9.10 Conclusions**

In this chapter I have summarised the evidence presented in this thesis to provide a picture of the market as it exists in 2008. I have assessed the state of health of this market and its prospects for market participants and consumers. I have summarised the argument showing how regulation has been the main determinant of the outcome observed. I have set out criteria for the evaluation of public policy towards the market. I presented an evaluation showing that the policies did not achieve their objectives and led to unforeseen and unintended effects. Finally I presented a counterfactual showing the possibility of a different outcome from different policies.

In the next chapter I summarise the key findings of the research presented in this thesis and draw together the main conclusions. I also consider the wider implications of these findings for the regulation of competitive markets.

## **CHAPTER 10: SUMMARY AND CONCLUSIONS**

### **10.1 Overview of this chapter**

In this chapter I summarise my empirical results. I then consider the implications of those results for the theory of regulated competition and for the methodology for evaluating public policy. I finalise the model used in this study. I then assess the contribution of this thesis and outline an agenda for future research.

### **10.2 Summary of empirical results**

I began with the question: what was the impact of regulation on the UK retail pensions market. The answer, from the empirical evidence for the period 1985 to 2007, is as follows:

#### *Products, prices and demand*

Regulation, and particularly fiscal rules, effectively transferred control of product development from market participants to government. Regulation limited product differentiation. Changes to regulation were necessary to allow significant product innovation and regulation may impede technological innovation. In the early periods, new fiscal incentives and government advertising substantially increased demand. Towards the end of the period, demand fell and this may have a regulatory component. In later periods, regulation exerted significant influence on product price.

#### *Distribution*

Regulation substantially distorted the competitive environment and led to the emergence of one dominant channel, the independent financial adviser. Regulation restricted the way banks and building societies were allowed to compete using their branch networks and as a result, these companies did not obtain a significant market share of distribution. Competition between insurance companies in the market was a matter of securing distribution outlets and there was limited competition on product quality and price.

#### *Costs*

Regulation increased the costs of marketing and distribution through increasing compliance obligations. Other regulations put downward pressure on prices leading to pressure on producers' margins. This led to a reduction in the remuneration of advisers and made it more difficult for some consumers to obtain advice.

### *Industry structure*

Regulation initially led to an expansion of the industry but as this was unsustainable, contraction followed, driven also by increasing pressures on margins, increased capital requirements and falling demand. Regulation led directly or indirectly to a substantial exit and merger in the industry, increasing producer concentration.

### *The market outcome and the evaluation of public policy*

The outcome of 20 years of regulation is a market which is far from healthy with uncertain prospects for both market participants and consumers. Insurance companies have suffered damage to their reputations; they no longer have the same level of confidence and loyalty among government and consumers that they once did. Lower to middle income consumers have effectively been frozen out of the market. The evaluation of public policy shows that it failed to meet its objectives and led to unforeseen and unintended consequences. Alternative policies could have led to more beneficial outcomes for market participants and consumers.

## **10.3 Towards a more general theory of regulated competition**

### *The impact of regulation on competitive markets*

This thesis contributes to a line of literature concerning the economic regulation of competitive markets and the effect that regulation has on those markets. Most of the reported studies on this theme relate to the regulations introduced in the US in the 1930s and the wave of deregulation that followed in the 1970s and 1980s. This thesis looks at a market in a different era and a different context. It is useful, therefore, to compare the context and the results of my study with those in the literature on the US experience of regulation.

In terms of the context, the rationale for regulation and the mechanisms chosen were very different. The regulations introduced in the US in the 1930s were a response to the Great Depression and reflected a loss of public confidence in competition. The objective was microeconomic stabilisation and the regulatory mechanisms chosen were overt price and entry controls in a number of key industries (Viotor, 1994). In the market I study, the rationale for intervention starting in the 1980s was to promote pension saving and to protect investors. Government initially displayed a confidence in competition. The regulation of the UK retail pensions market was accompanied by a

removal of restrictions on entry into financial services generally. Government made a point of not attempting to control price (although that was reversed by a later government). The mechanisms chosen included new fiscal incentives to promote personal pensions, control over the marketing and sale of products and control over distribution channels.

While the context is different there is a good deal of similarity in the outcomes. Vietor (1991, 1994) finds in his studies of airlines and banking that regulation affected various dimensions of the market and the strategic decision-making of market participants. Regulation shapes markets in a variety of ways, many unintended. Naturally, as the regulations directly controlled product price and entry, those two market factors were determined by regulation. But regulation also affected product quality and service levels and penetrated to the operational core of the firms. In the airlines industry, route structure and fleet composition, the essential plant and operating method of the business, were artefacts of public policy. In banking, regulations controlled inputs as well as outputs, fundamentally affecting banks' risk positions. This ultimately led to the failure of many Savings and Loan institutions in the US (Benston, 1985). In my study, regulation substantially affected the process of product development and the nature of competition in the market. It influenced the strategic decision-making of market participants. Products and service to customers and producer costs and margins were all affected. Many companies fell by the wayside. Most of the outcomes were unintended and undesirable.

Vietor (1994) finds that the regulatory system in the US became unsustainable because it was divorced from economic and technological realities. The regulators became grid-locked by procedure and were unable to respond rapidly enough to market change. In my study, we can see regulatory paralysis in the seven years it took to resolve the disclosure issue, in the eight years to complete the mis-selling review and the five years it took after the decision on polarisation to implement new rules (which did not in any event settle the issues).

We can conclude, firstly, that regulation affects the operation of the market and strategic decision-making of participants. Of course, regulation is intended to have an effect on the market and on participants. In neoclassical economic theory, regulation is rationalised as a response to a market failure, a failure of the market to deliver Pareto optimum outcomes. Regulation is intended to overcome that market failure. But

empirical studies show that regulation may not solve the perceived problem and may create other problems.

We can conclude, secondly, that regulators find it difficult to keep up with the pace of change in a competitive marketplace, bound as they are by political and legal process. Any regulatory regime is likely therefore to date very rapidly, unless it is of such a nature as to prevent innovation and change in the market making any innovation dependent on regulatory change. We can see this with product development in the UK retail pensions market.

It follows that any regulatory intervention in a competitive market needs to have clear (and perhaps limited) objectives, an understanding of how the mechanisms will work in practice and how they will be kept up to date. For example, prudential regulation of financial institutions by a regulator has more chance of success than other regulations which interfere to one degree or another in the relationship between buyers and sellers in the market. Ensuring the probity and financial stability of companies in financial services are clear goals and the relationships between large institutions and a regulator are potentially manageable however imperfectly. Individual relationships between market participants and consumers are potentially unmanageable by a regulator. There are too many different situations to define and control, and those situations are constantly changing. This suggests that consumer protection is better provided through enabling law (laws governing contracts, property rights and liability for negligence) which provides options for consumers or consumer activists rather than relying solely on regulators.

#### *Market failure as the rationale for regulation*

The failure of regulation in many situations leads to the question whether the normal rationale for intervention in terms of market failure needs to be revisited. The market failure theory can be used to suggest that any market failure should lead to regulation. The alternative view of the Austrian economic school does not start from the concept of perfect markets and Pareto optimum outcomes. Markets are regarded as imperfect and dynamic so intervention by government finds less justification. A presumption against regulation rather than for regulation may in current circumstances lead to less but better justified and better designed interventions and more beneficial outcomes. This suggests that regulation should only be sanctioned when it can reasonably be

expected that it will improve some operation of the market and where the intervention does not create unmanageable risks.

#### *A model of regulated competition*

With the results from the empirical study and with reference to studies in the literature we can now finalise the provisional model shown in Figure 3.3 in Chapter 3.

The introduction by government of regulation and regulatory change is preceded by the identification of the rationale and objectives of regulation, by the design of the mechanisms of intervention and by a risk assessment. Although not considered specifically in this thesis, there is a corresponding assessment by market participants of the regulatory environment alongside the usual assessment of the competitive environment of the market. This is an input to strategic decision-making. We may also add the outputs for government/regulators, for market participants and for consumers. The result is shown in Figure 10.1 below.

From the point of view of the public policy maker, this model now shows the connection between the government input, and the outputs for government, market participants and consumers. Successful interventions are preceded by a careful consideration of the rationale, objectives, mechanism design and risks. The design and the risk assessment are aided by an understanding of the way in which regulation affects strategic decision-making of market participants and the dimensions of the market and the way that the market works to deliver outcomes.

This model can also be used by market participants. In this thesis I have focused on the public policy perspective but equally important is the company perspective (and indeed the consumer perspective). For the company operating in a heavily regulated marketplace strategic decision-making is much more complex than for those operating in less regulated environments. Success in these circumstances requires an understanding of the dynamics of regulation as well as the normal competitive dynamics of the market.

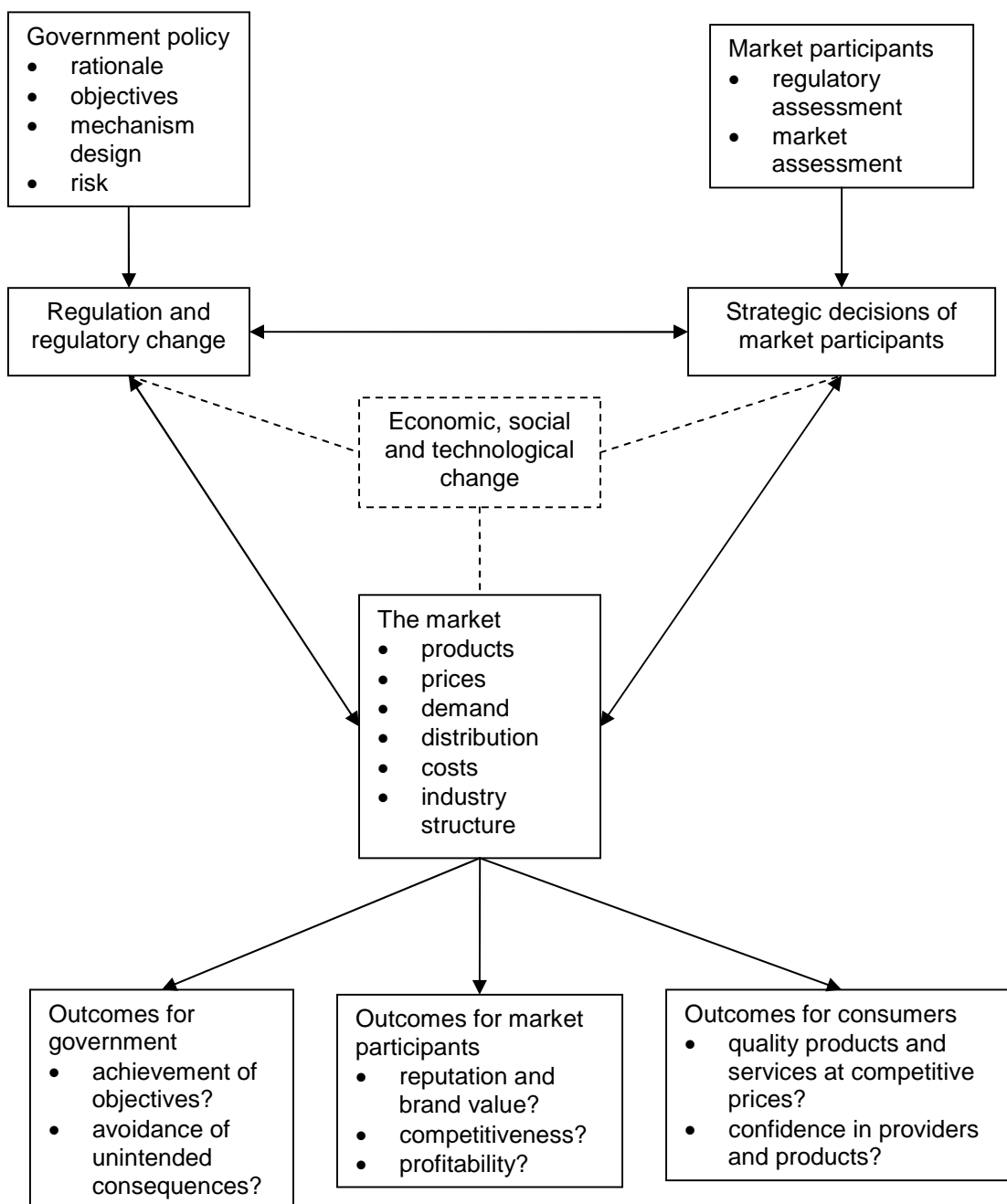


Figure 10.1 A model of regulated competition

#### **10.4 Towards a methodology for the evaluation of public policy**

As well as contributing to the literature on the regulation of competitive markets, this thesis also contributes to a related line of literature concerning the methodology for the evaluation of public policy. In Chapter 3 I described how I developed a framework to analyse the regulation of the market and a model to enable an assessment to be made of the impact of regulation on the market. From an understanding of how regulation actually works in the market and by developing the criteria for evaluation I showed how an *ex post* evaluation can be carried out to lead to clear and defensible conclusions. This methodology was used in this study to evaluate three separate but related lines of regulation and the interaction of these three lines over an extended period of time. This in turn led to the development of the model now shown in Figure 10.1 above.

The framework and the model developed in this thesis can be used for an *ex ante* evaluation of proposed regulation alongside current cost-benefit analysis and regulatory impact analysis. While the latter techniques currently in use cover the short to medium term, the framework and model concentrate thinking about the longer term impact. The framework and model can then be used for an *ex post* evaluation of regulations which have been in place over a number of years.

#### **10.5 The contribution of this thesis and the agenda future research**

##### *The contribution*

The primary contribution of this thesis is to the literature on regulation and the evaluation of public policy as outlined in Sections 10.3 and 10.4 above. The distinctive feature of this thesis is its longitudinal approach. There are few such studies in the literature. The longitudinal approach provides different insights from the more normal comparative studies. This study also contributes to another literature, on business history. The story of the UK insurance companies over the last 20 years is an interesting one given the long history of the industry and an important one given the size of the funds it manages. The rapid decline of the industry over the last ten years, including the failure of Equitable Life founded in 1762, is a significant phenomenon.

##### *The political dimension*

This study takes an economic approach. It recognises the political dimension of regulation but does not investigate the politics of government decision-making. I referred to the political dimension in Section 2.8 when concluding the literature review.



Economic analysis is just one of the sources of argument for the political discourse. This study shows that ideology is a factor in decision-making, as can be seen in Norman Fowler's pensions policy and in the Labour government 'stakeholder' concept. Political decisions are also reactions to events, such as the tightening of prudential regulation after the collapse of Equitable Life, and more recently after Northern Rock. There is therefore a complementary study to be undertaken into the political decision-making processes which led to the regulations in question. Against the background of the economic analysis, the question is how regulations came to be introduced, and were maintained for so long, which were recognised at the time as unlikely to achieve their objectives and as containing unacceptable risks.

#### *The regulation of other retail financial services markets*

This study of the regulation of the UK retail pensions market leads naturally to the study of the regulation of other retail financial markets and to questions about the regulation of financial institutions which is brought into sharp relief by the failures of Equitable Life and Northern Rock. One important question is about the role of government and the extent to which it should take responsibility for consumer protection; and consequently, the degree to which the citizen should be responsible for their own decisions. An example will illustrate the current trend. A recent piece of promotional material issued by the Bradford and Bingley in relation to a Legal and General product says "You must attend a financial review with a Legal & General adviser. Eligibility for the Fixed Rate Savings Bond is dependent on the adviser's assessment that the investment is appropriate to your needs. The adviser will decide whether and how much you will be able to contribute to the Fixed Rate Savings Bond." So on this product, and undoubtedly on many investment products on the market, the responsibility is taken away from the citizen. There is therefore a need for research into the consumer dimension of regulation and the consequences of increasing government control.

#### *The approach to regulation*

The question of individual responsibility is taken up in the much broader context of regulation in general, including social regulation, in a paper by the Better Regulation Commission (2006). The BRC paper refers to the growing disquiet about the management of risk in society and what is seen by many as the rising tide of regulation. There is a sense that the current public debate around risk places an over-

reliance on government to manage all risks, at the cost of eroded personal responsibility. My study contributes to one angle on this issue: consumer protection regulations do not necessarily succeed in protecting consumers and lead to unintended consequences. Consumers might therefore be better off managing more of their own risks.

#### *The European Union dimension*

In this thesis I have referred only in passing to the European Union dimension. The market I studied has been very much a domestic one but increasingly EU regulations are beginning to affect it. The FSA incorporates the EU requirements into its regulations so I have not studied the EU regulations specifically. The EU dimension is, however, becoming more important and is a theme for research in its own right.

#### *The strategic management perspective*

In this thesis I have adopted the public policy perspective and not the strategic management perspective. A complementary study would therefore involve consideration of the issues from the point of view of the strategic manager in industry. This would assist decision-makers in industry manage the substantial regulatory risks that they carry.

#### *The future of pensions provision*

The UK government is now embarking on a major project to promote pension provision especially among those who have no current pension savings. This has significant implications for the future of the retail pensions market. The government has rejected the proposals of insurance companies and decided to set up a government agency to run the new scheme, outsourcing some services to bidders from the private sector. The role that companies in the current market will have in this initiative is uncertain, as is the future of the market itself. Equally important is the question about the government scheme and its prospects for success. There is a substantial research agenda here.

#### *The efficiency of insurance companies*

In my summary of my empirical findings in Section 10.2 above I referred to the lack of competition in the UK retail pensions market on product quality and price. If the normal competitive forces are absent in this market, there is a question about the efficiency of the insurance companies in the market. The efficiency of financial institutions is an

active area of research and is reported in journals such as the *Journal of Banking and Finance*. There is an unresolved issue about the modelling of insurance companies and in particular about the measurement of output. While it is recognised that the number of policies issued is the correct measure of output, many studies regard numbers of policies as a poor measure and introduce proxies including the premiums received (Gardner and Grace, 1993), addition to reserves (Yuengert, 1993) and incurred benefit payments and addition to reserves (Cummins and Zi, 1998). In my study of costs in Chapter 7 I successfully used numbers of policies as the output, albeit in a model which was used to estimate unit costs. But with this starting point and the data I have on the insurance companies, there is a potential contribution to literature from a broader study of the efficiency of the UK insurance companies.

### *Summary*

In summary therefore, this thesis contributes to knowledge in a number of ways: to the understanding of the impact of regulation, to the development of methodologies for evaluating public policy and to the history of the UK insurance industry. This thesis also leads to a number of areas for future research and future potential contributions as outlined above.

## APPENDIX A: PRINCIPAL SOURCES OF EMPIRICAL DATA

### Government and regulators

Department/author	Date	Title
Better Regulation Task Force (BRTF)	Mar 2005	Regulation – Less is More: Reducing Burdens, Improving outcomes. A BRTF report to the Prime Minister
Better Regulation Task Force (BRTF)	Dec 2005	Routes to Better Regulation: A guide to alternatives to classic regulation
Better Regulation Commission (BRC)	Oct 2006	Risk, Responsibility and Regulation: Whose risk is it anyway?
DSS	Jul 1984	Personal Pensions: A consultative document
DSS	Jun 1985	Reform of social security (Green paper)
DSS	Dec 1985	Reform of social security (White paper)
DTI	Jan 1985	Financial Services in the UK: A new framework for investor protection
DWP/Inland Revenue	Feb 2002	Modernising annuities
DWP/HMT/Inland Revenue	Dec 2002	Simplicity, security and choice: working and saving for retirement
DWP	May 2006	Security in retirement: towards a new pensions system
DWP	Oct 2006	Security in retirement: towards a new pensions system Summary of responses to the consultation
DWP	Dec 2006	Personal accounts: a new way to save
FSA	Jan 2001	Reforming polarisation: First steps (CP80)
FSA	Jun 2001	Treating customers fairly after the point of sale
FSA/Baird	Oct 2001	Review of the regulation of Equitable Life
FSA	Jan 2002	Reforming polarisation: Making the market work for consumers (CP121)
FSA/Charles River Associates Ltd	Jan 2002	Polarisation: research into the effect of commission based remuneration on advice
FSA/Gap Gemini	Jan 2002	Polarisation research: IFA use of panels
FSA	Jun 2002	Treating customers fairly: Progress report
FSA	Jun 2002	£11.8 billion compensation for pensions and FSAVC reviews (Press Release)
FSA	Jan 2003	Reforming polarisation: Removing the barriers to choice (CP166)
FSA	Aug 2003	Capital for life insurers (CP195)
FSA/McCarthy	Dec 2003	FSA calls on banks to treat their customers fairly (Press release/speech)
FSA	Jul 2004	Treating customers fairly – progress and next steps
FSA/Tiner	Sep 2004	FSA Enforcement conference (speech)
FSA/TNS Financial and Professional Services	Jun 2005	Treating customers fairly: the consumers' view (CR38)

## Government and regulators continued

Department/author	Date	Title
FSA	Jul 2005	Treating customers fairly – building on progress
FSA	Apr 2006	The regulation of personal pension schemes including SIPPs (CP06/5)
FSA	Mar 2006 Nov 2007	Surveys of the persistency of life and pensions policies
FSA	Jul 2006	Treating customers fairly – towards fair outcomes for consumers
FSA	Sep 2006	The responsibilities of providers and distributors for the fair treatment of customers
FSA/McCarthy	Sep 2006	Is the present business model bust? (speech)
FSA/Tiner	Jul 2007	Reflections of a soon to be former regulator (speech)
FSA/CRA International	May 2007	An empirical investigation into the effects of the menu
FSA	Jun 2007	A Review of Retail Distribution (DP07/1)
FSA	Jun 2007	Platforms: using fund supermarkets and wraps (Factsheet)
FSA	Jun 2007	Platforms: the role of wraps and fund supermarkets (DP07/2)
FSA	Sep 2007	Financial Advisers Newsletter including advice on SIPPs
FSA	Sep 2007	The responsibilities of providers, distributors and platform providers for the fair treatment of customers where a platform is used in the supply of a product (DP07/2)
FSA/Financial Services Consumer Panel	Sept 2007	Are customers in closed life funds being treated fairly?
FSA	2008	Financial Risks Outlook
FSA/Dan Waters	Jan 2008	MiFID – Threats and Opportunities (Speech)
FSA	Mar 2008	Platforms and more principles-based regulation (FS08/1)
FSA	Apr 2008	Retail Distribution Review – Interim report
GAD	1995	Occupational Pension Schemes: tenth survey
GAD	2000	Occupational Pension Schemes: eleventh survey
GAD	2004	Occupational Pension Schemes: twelfth survey
GAD	2005	Occupational Pension Schemes: thirteenth survey
Gower	Jan 1982	Review of Investor Protection: A discussion document
Gower	Jan 1984	Review of Investor Protection: Report
HMT/Inland Revenue	Dec 2002	Simplifying the taxation of pensions: increasing choice and flexibility for all
HMT/Inland Revenue	Dec 2003	Simplifying the taxation of pensions: the Government's proposals

## Government and regulators continued

Department/author	Date	Title
House of Commons Treasury Committee	2004	Restoring confidence in long-term savings
Lautro/Jebens	1997	Lautro: A Pioneer Regulator
Legislation	1985	Social Security Act 1985
Legislation	1986	Social Security Act 1986
Legislation	1986	Financial Services Act 1986
Legislation	2000	Financial Services and Markets Act 2000
OFT	Mar 1987	SIB: A report by the DGFT to the Secretary of State for Trade and Industry
OFT	Mar 1988	Lautro: A report by the DGFT to the Secretary of State for Trade and Industry
OFT	Apr 1990	The disclosure of information about life insurance products and commissions paid to IFAs: A report by the DGFT to the Secretary of State for Trade and Industry
OFT	Mar 1993	The marketing and sale of investment-linked insurance products: A report by the DGFT to the Chancellor of the Exchequer
OFT	Mar 1993	Fair trading and life insurance savings products: A report by DGFT
OFT	Aug 1999	The rules on the polarisation of investment advice: A report by the DGFT to the Chancellor of the Exchequer
PIA	Feb 1999 Mar 2000	Disclosure reports
PIA	Mar 1999	Advice on personal pensions in advance of the introduction of stakeholder pensions (RU64)
PIA	Oct 1999 Nov 2000 Sep 2001	Surveys of the persistency of life and pensions policies
Penrose	Mar 2004	Report of the Equitable Life inquiry
Sandler	Jul 2004	Medium and Long-Term Retail Savings in the UK
Turner/Pensions Commission	2004	Pensions: Challenges and Choices. The first report of the Pensions Commission
Turner/Pensions Commission	2005	A New Settlement for the Twenty-First Century. The second report of the Pensions Commission
Turner/Pensions Commission	2006	Implementing an integrated package of pension reforms: The final report of the Pensions Commission

## Principal databases

ABI: Statistics and new business results (based on quarterly data provided by members)

Standard & Poor's: Synthesys Life database (based on companies annual regulatory returns)

## Principal publications (accessed through Factiva by keyword search or British Library archives)

Financial Adviser (1987 to 2007 on Factiva from 1994)

Financial Times (1983 to 2006 all available on Factiva)

Money£acts (1998 to 2008 paper only)

Money Management (1987 to 2008 on Factiva from 2001)

Pensions Management (1997 to 2008 on Factiva from 2002)

## ABI papers

Nov 2002	Stakeholder pensions – closing the savings gap?
2003	ABI response to HMT consultation on Sandler products
Jun 2003	Pensions: Defining the liability
Aug 2003	Stakeholder pensions – time for change
Sep 2003	The future of the pensions annuity market
May 2004	Cost-benefit analysis: Making a reality of better regulation
Jan 2005	Challenges and choices: ABI response to the first report of the Pensions Commission
Feb 2005	Financial advice: how should we pay for it?
Feb 2005	Study of intermediary remuneration: A report for the ABI by Charles River Associates Ltd
Sep 2006	Making a success of Personal Accounts: The ABI's response to the pensions White Paper
Oct 2006	How to evaluate alternative proposals for Personal Account Pensions: An economic framework to compare NPSS and industry models. A report by Oxera

## Company sources: annual report and accounts

Allied Dunbar Assurance Plc  
Axa Equity & Law Life Assurance Society Plc  
Aviva Plc (Norwich Union)  
Barclays Plc (Barclays Global Pensions Management Ltd)  
Britannic Assurance Plc  
Equitable Life Assurance Society  
Friends Provident Life Office/Friends Provident Plc  
Legal & General Group Plc  
Lloyds TSB Group Plc (Abbey Life, Scottish Widows)  
Prudential Plc  
Scottish Amicable Life Assurance Society  
Standard Life Assurance Company/Standard Life Plc

## Academic sources

Author	Date	Title
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Blake, David	2003	Pension Schemes and Pension Funds in the UK (Oxford)
Ennew, Christine; Watkins, Trevor; Wright, Mike	1990	Marketing Financial Services (Heinemann, Oxford)
Franklin, Peter; Woodhead, Caroline	1980	The UK Life Assurance Industry (Croom Helm, London)
Laing, Angus W	1994	'Distribution of Life Assurance and Investment Products: The Scottish Mutual Life Assurance Industry' in International Journal of Bank Marketing Vol 12 Part 4 pp 25-31
Llewellyn, David	1996	Universal Banking and the Public Interest: A British Perspective. In Saunders A and Walter I (Eds) Universal Banking: Financial System Design Reconsidered (Irwin, Chicago)
Shelton, David	1990	'The impact of the Financial Services Act on Investment Products' in International Journal of Bank Marketing Vol 8, Part 2, pp 12-16
Taylor, Michael	1997	The Regulatory Leviathan: Will super-SIB work? (CTA Financial, London)



**APPENDIX B: FRAMEWORK FOR ANALYSIS OF REGULATION**

Subject matter	Rationale and objectives	People	Key dates
<b>Pensions policy</b>			
Pensions policy under the Conservative government 1983 - 1989 (no change 1990 to 1997)	<ul style="list-style-type: none"> <li>• Reduce cost of SERPS to the State</li> <li>• Provide portability of pensions and remove impediments to job mobility</li> <li>• Increase individual freedom and choice</li> </ul>	Fowler	May83 Government/CPS proposals July84 Condoc "Personal Pensions" Feb85 Government reported to be intending to proceed May85 Government announces intention to proceed Jun85 Green paper Aut85 SSA 85 Dec85 Government White paper Jul86 SSA 86 <b>Apr87 Govt to promote PPs but not to control charges</b> Oct87 Start of FSAVCs Mar88 Govt adverts (chains and straight-jackets) Apr88 Start of opt-outs and AVCs <b>Jul88 Start of PPs</b> Apr89 Relaxation of PP investment rules Apr89 Deadline for backdating SERPS opt out

Subject matter	Rationale and objectives	People	Key dates
<b>Pensions policy continued</b>			
Pensions policy under the Labour government 1997 to date	<ul style="list-style-type: none"> <li>• Encouraging pension provision among lower-middle income earners</li> <li>• Reduce cost of personal pensions to consumers</li> <li>• Improve long term provision of pensions in the light of demographic change</li> <li>• Simplify tax rules to reduce costs</li> </ul>	Darling Brown Sandler Turner	1997 Stakeholder pensions in election manifesto Nov98 Stakeholder pensions to proceed <b>Mar99 PIA's RU64 issued</b> Jun99 Stakeholder pensions 1% price cap announced <b>Apr01 Start of stakeholder pensions</b> Jun01 Sandler commissioned Jul02 Sandler report Dec02 Turner commission established Dec02 Pensions simplification initiative launched Jun04 Govt relaxes price cap from 1% to 1.5% for first 10years Oct04 Turner report 1 Apr05 Sandler stakeholder products start Nov05 Turner report 2 <b>Apr06 'A' day for pensions simplification</b> May06 Government White paper on Turner recommendations Sep06 ABI response to White paper Dec 06 White paper on Turner rejecting ABI solution

Subject matter	Rationale and objectives	People	Key dates
<b>Investor protection policy</b>			
Investor protection policy 1981 - 1988	<ul style="list-style-type: none"> <li>• Respond to scandals</li> <li>• Rationalise the rules</li> <li>• Stop reasonable people being made fools of</li> </ul>	Gower	Jul81 Gower commissioned Jan82 Discussion Doc Jan84 Gower report Jan85 Government White Paper Dec85 Bill issued Nov86 Financial Services Act <b>Apr88 Start of new regulations</b>
Changes to investor protection policy 1998 - 2004	<ul style="list-style-type: none"> <li>• Respond to GAR problem</li> <li>• Improve governance of WP funds</li> <li>• Calculate minimum capital levels on more rational basis</li> <li>• Embed fairness to customers in companies strategic plans and move to risk based approach to regulation</li> </ul>		Oct98 First indications of problem with GARs Jul00 Equitable loses in Court on GARs Dec00 Equitable closes to new business Jun01 FSA's TCF initiative Jan03 Tiner waivers on current capital rules <b>Aug03 New FSA rules on capital requirements</b> Jan04 StandLife announces strategic review re demutualisation and sells £7.5bn in equities following new FSA capital rules <b>Jul04 Revised rules for realistic balance sheets</b>

Subject matter	Rationale and objectives	People	Key dates
<b>Structure of regulatory institutions and rules</b>			
Structure of regulatory institutions and rules under the Conservative govt 1986 - 1994	<ul style="list-style-type: none"> <li>• Find compromise between self-regulation and statutory regulation</li> <li>• Continue existing attempts at self regulation of commission levels and avoid disclosure of commissions and charges to consumers</li> </ul>	Berrill Walker Large	Mar86 SIB first issue of rules May87 SIB gets designatory status Oct87 SIB final rules published <b>Feb88 Lautro rules approved by SIB</b> Nov88 New simplified SIB rulebook Mar90 SIB publishes 10 principles Jul90 SIB publishes 40 core rules Mar92 Lautro and Fimbra to merge (to form PIA) Nov92 Pru (Newmarch) calls for end to self regulation <b>Jul94 PIA starts</b>
Structure of regulatory institutions and rules under the Labour govt 1997 - 2001	<ul style="list-style-type: none"> <li>• Respond to failure of self-regulation</li> </ul>	Brown Darling Davies	May97 Brown announces formation of new super regulatory agency which will also take over banking supervision from Bank of England <b>Oct97 FSA starts</b> Dec01 Merger of 10 agencies to form FSA operations

Subject matter	Rationale and objectives	People	Key dates
<b>Competition issues on the content of rules</b>			
MCA and disclosure of commission and charges	<ul style="list-style-type: none"> <li>• Stop regulators' rules restricting or distorting competition</li> <li>• Address conflicts of interest in the distribution system</li> </ul>	Borrie Carsberg	Mar88 OFT report against MCA/for disclosure <b>Jan90 MCA abolished, new disclosure rules in place</b> Apr90 OFT report against new disclosure rules Jun92 New SIB conduct of business rules Mar93 OFT report against new disclosure rules Jul93 Chancellor's decision on disclosure Nov93/May94 SIB new disclosure rules issued <b>Jan95 New disclosure rules implemented</b>
Polarisation and depolarisation	<ul style="list-style-type: none"> <li>• Stop regulators' rules restricting or distorting competition</li> <li>• Address conflicts of interest in the distribution system</li> <li>• Reform the distribution system</li> </ul>	Davies McCarthy Tiner	Jul88 SIB rules out change to polarisation rule May91 SIB review of polarisation Oct91 SIB rules out change to polarisation Nov95 PIA rules out re-opening the polarisation issue Aug99 OFT report against polarisation (and new EU rules make polarisation unviable) Nov00 FSA announces way forward on polarisation Jan01/Jan02 FSA consultations on polarisation Oct 02 FSA backed down on fee basis for IFAs Nov02 FSA decision on reform of polarisation Dec04 New rules issued <b>June05 New rules come into force</b> June06 Retail distribution review announced by FSA

Subject matter	Rationale and objectives	People	Key dates
<p><b>Interpretation and enforcement of the rules: 1987 - 2004</b></p>	<ul style="list-style-type: none"> <li>• Identify what "best advice" means in practice</li> <li>• Deal with the consequences of bad advice given to consumers</li> <li>• Improve the standard of competence and training of advisers</li> </ul>	<p>Large Bowe Davies</p>	<p>Jun87 Fimbra says that it is not possible to give a precise definition of "best advice"  Dec87 Further Fimbra guidance notes on best advice  May92 First indications of mis-selling problem: Lautro and Fimbra issue new guidance  Sum93 KPMG review  Dec93 SIB to review up to 500k PPs  Jan94 Start of fines, training and competence initiative  <b>Oct94 SIB plan for reviewing mis-selling cases</b>  Feb95 Companies start making provisions for mis-selling  Aug95 Final PIA rules on compensation  Jan97 Fresh drive by PIA (Bowe) to get faster progress  May 97 New govt drive to get cases moving  May97 New SIB plan and advert campaign  <b>Jul97 PIA deadline for FPC</b>  Mar98 FSA estimates cost of mis-selling at £1.1bn  Jul98 Pru provision is £1.1bn  Sep99 FSA action starts on mortgage endowments  Feb00 Pru increases provision to £2bn  Jun02 FSA says mis-selling review 98% complete  2004 TSC hearings on mis-selling</p>

## Contemporaneous observations and perceptions – on the regulations introduced

### Pensions policy under the Conservative government 1983 - 1989

21/1/84	FT	Portable pensions would not be guaranteed in terms of final salary... they would be marketed by all kinds of investment salesmen, this opening up an entirely new field of investor protection The CPS proposals seem to ignore the drawbacks ... and concentrate only on the advantages
30/1/84	Institute of Actuaries	The introduction of PPs ... would involve a very significant change of direction.... it is important that the likely consequences should be appreciated Employees in a defined contribution system are exposed to a wide range of financial risks We believe that the effect of pension schemes as a discouragement to changing jobs is considerably overstated. As the proposed [legislation] ... becomes effective, final salary schemes will no longer be seen as failing to protect the early leaver We fear that the proliferation of individual arrangements would add to administrative and selling costs.... Salesmen with a financial incentive to promote specific products would find it difficult to give unbiased independent advice...
1/2/84	Society of Pension Consultants	the presentation of the proposals for personal and portable pensions [is] highly misleading and deceptively attractive to individuals
2/2/84	CBI	The CPS proposals had not been thought through
3/2/84	IoD	pension schemes are a major obstacle to the distribution of wealth...
6/2/84	BSA	portable pensions are a risky area, because they would leave more gullible employees vulnerable to investment advisers
9/6/84	FT	the hard sell dangers under a PP system have not been considered
18/12/85	FT	the government's pension reform proposals offer unlimited opportunities for life companies
4/4/86	Schroder Financial Management	PPs are unlikely to provide benefits as good as SERPS except for young people. Even with a yield of 4% and 2% incentive, PPs will only be attractive to women under 30 and men under 37. On the basis of a 3% yield, PPs will only be attractive to women in their early 20s and men under 28.
24/3/88	Financial Adviser	The DHSS national advertising campaign, designed to promote the new company pension arrangements to small employers, has attracted criticism from life offices. The marketing manager of Standard Life said "Anyone reading this ad will be misled – it mixes up contracting out of Serps with setting up a pension scheme ...

Pensions policy under the Labour government 1997 - date

21/1/98	FT	Moving the government's stakeholder pensions outside the Financial Services Act would reduce the costs of pension selling ten fold, Legal and General said yesterday. "We charge an average of £600 per scheme to comply with 'know your customer' and 'best advice' ... referring customers to official kite marks would see the price drop to £60."
15/5/98	FT	Howard Davies, FSA Chairman, told a Treasury select committee that kitemarking – a kind of official seal of approval – made him very nervous as it could imply suitability for everyone. He indicated that he was happy with benchmarking in so far as it improved customers' understanding of costs, charges and commission rates.
24/6/98	FT	The existing regulation of pensions has failed ... according to the New Policy Institute, and independent think tank. Most people do not even read, let alone understand, the information provided on key product features that pension companies are required to provide, according to research by the Consumers Association published in the institute's report.
3/6/99	FT	The government stunned pension providers yesterday when it unveiled benchmark standards for stakeholder pensions and recommended that charges should be capped at 1%
24/5/00	FT	The FSA said it was minded to mandate the use of "selling trees" and make them a prescribed part of the regulatory regime for low cost stakeholder pensions... the challenge for the regulator, working within the stakeholder minimum standards, is to help people make the decision that is right for them, without imposing excessive costs.
11/7/02	Times Anatole Kaletsky	Imposing price controls on one of Britain's most successful and fastest growing industries would be a very retrograde step for a government supposedly committed to competition. The Sandler report is deeply worrying in the economic and political attitudes it embodies.
18/7/03	FT	Sir Howard Davies said "I have personal doubts over whether product regulation and price controls are the right way to go ..."



Investor protection policy 1981-1988

Jan 1984	Gower	<p>I have not attempted any sort of cost-benefit analysis, partly because I am not competent to undertake it and partly because I am sceptical about its practicability.</p> <p>Relative to the enormous volume and value of the total annual turnover of transactions relating to investments, the cost of a comprehensive regulatory system could only be miniscule.</p> <p>A few respondents to the Discussion Document accused me of having an excessive passion for logic and tidiness. I regard logic and tidiness as of importance only in so far as they contribute to a legal regime which can be understood, which will be regarded as fair by those it affects, and which, as a result, will be generally observed and can be effectively enforced.</p>
July 1984	Ross	<p>Article in Economic Affairs</p> <p>Gower's report is a reactionary document which could set back for years the progress made in removing financial regulation and restrictive practices in the financial sector. Gower misunderstands competition</p>
Sept 1984	White	<p>Article in The Modern Law Review</p> <p>[The report has an] emphasis on rationalising rules at the expense of a thoroughgoing examination of the purposes, objects and desirability of regulation, its economic cost and the likelihood of the proposed regulatory apparatus actually achieving its objectives.</p>
1988	Veljanowski	<p>Article in a publication by The Institute of Economic Affairs</p> <p>The conceptual failings of the Financial Services Act grew out of a total disregard for the economic realities of financial markets.</p> <p>What is striking about these developments is that the deregulation of the markets has led to a growth of new regulatory structure which has not been costed and some argue is oblivious to cost. The Gower report assumes that costs are minimal and then proceeds on the basis that this assumption is established fact.</p>

Changes to investor protection policy 1998 - 2004

2/10/98	FT	Life assurers face a bill of more than £5bn to meet extravagant promises made on pensions sold in the 1970s and 1980s, according to a report by a leading investment bank (BT Alex Brown).
10/4/99	FT	Assurers may face £14bn bill for pension guarantees (assessment by Standard and Poor's)
16/11/02	FT	Equitable's misfortunes have triggered tighter regulation for insurers and inflicted some damage on the reputation of the life assurance industry
Aug 2003	Money Management	Everything is changing. Even the FSA acknowledges that the old accounting rules can be perverse, requiring offices to make assumptions which do not reflect their likely experience and which can be damaging in that they force equity sales at the worst possible time.
25/3/04	FT	Callum McCarthy hit back at critics who accused the regulator of, in effect, forcing Standard Life into considering a demutualisation to meet new "realistic" solvency requirements. Standard Life shocked the life industry in January when it said it was considering demutualisation and admitted it had held talks with the FSA over how to calculate the group's solvency on a realistic basis. It later revealed that, to meet the new regime, it had sold £7.5bn of equities.

Structure of regulatory institutions and rules under the Conservative government 1986 - 1994

24/2/87	FT	The SIB rules on polarisation have been strongly criticised by banks
4/3/87	FT	Fimbra has written to DTI complaining that the SIB rules are too complex and will have the effect of destroying many small businesses
3/9/87	FT	One particular aspect of the regulations that needs much sharper definition is that of best advice
25/9/87	FT	the new framework ... will be more akin to a statutory system than was at first envisaged. City figures have come to distrust the SIB. The SIB has been widely criticised for the way in which it has forced each SRO to match its won rule-book almost line for line
13/2/88	FT	The FT suggests that several serious mistakes and misrepresentations have been made. ...the current activities of the SIB are out of all proportion to the scale of the scandals which gave rise to the Financial Services Act. The second problematic issue is self-regulation. The SIB turned out to be a statutory wolf in sheep's clothing. The third misjudgement was that of polarisation. Because the life assurance industry was so powerful on the SIB's board, it was able to block proposals for the disclosure of commissions and charges. Its alternative protection for investors was polarisation. But this seriously damaged the High Street selling potential of banks and building societies. The banks should have realised that they were not taking part in an even-handed consultative process but with a fight with the life industry.
2/4/88	FT Barry Riley	The sheer size and power of the life assurance business made it inevitable that it should be granted special status when the new regulatory framework for the investment industry began to be formulated in the mid 1980s
11/7/88	FT	Sir Kenneth Berrill ... was widely criticised in the City for what was said to be a rigid and bureaucratic approach to rule making
1990	Moran	Gower's proposal for overall control of regulation to be placed in the hands of a public body was rejected by the City. The single most important thread in the history of City regulation has been a determination to preserve its autonomy from the State.
21/2/91	FT Barry Riley	The chronic problems of Fimbra [its own financial position] have recurred because the evasive compromises made in areas like polarisation and commission disclosure are breaking down. ... A largely new 'profession' of IFAs was created supervised by Fimbra. The trouble was there was no consistent professional quality and in a crucial way IFAs were cut off from the protection of life offices. Instead of integrated regulation of the two main arms of retail distribution ... we had the split between Lautro and Fimbra.
1/10/92	FA editorial	The fudging must stop ... The paper [on the formation of the PIA] is another classic fudge in the mould to which the SIB and Lautro watchers have become all too accustomed. It says next to nothing for fear of upsetting one of the 30 vested interests which sit on its board.

Structure of regulatory institutions and rules under the Conservative government 1986 – 1994 (continued)

8/10/92	FT Barry Riley	The PIA is a mass of internal contradictions and will probably sink. After 6 years the notorious Financial Services Act is weaving an even more tangled web.
25/3/94	FT	Prudential refuses to join the PIA and will be regulated directly by the SIB
26/3/94	FT	Lloyds bank described the PIA proposals as seriously flawed
21/4/94	FT	A directly administered system of statutory regulation would overcome the conflicts of interest from the industry's involvement and produce a stable regulatory regime, the Halifax told MPs yesterday
1997	Jebens	Former CEO Lautro. Faults stemming from the Financial Services Act soon became apparent and these were exacerbated by the obstacles stemming from differences in goals, external pressures and cultures between the SIB and SROs.

Structure of regulatory institutions and rules under the Labour government 1997 - date

1997	Taylor	There has been no clear explanation of the government's motive in creating a Super SIB because there is no clear objective in mind. A regulatory authority with Super SIB's range of responsibilities has no precedent anywhere in the world. Such a leap in the dark should be preceded by comprehensive research. Why did the labour government change its mind? In November 1996 Alistair Darling said that "A blanket approach, the creation of a super-regulator won't do..." [Taylor's theory is that the decision on one regulator was tied in with making the Bank of England independent and responsible for interest rates – the decision was politically expedient]
22/5/97	FT	Dissent lingers over a unified regulator. Years of debate over the ideal structure for financial regulation were swept away on Tuesday by the government's sudden decision.... but the argument over whether it makes sense to place so many functions under same roof will not go away that easily.
24/5/97	FT	is it actually a good idea to have a single organisation looking after both the wholesale (professional) and the retail (private individuals) sides of the business?
4/6/97	FT Taylor	a single regulator will be exposed to reputational contagion every time a financial scandal occurs.... a single regulator places too much power in too few hands; it will be responsible for regulating a group of industries which collectively account for 19% of UK GDP
18/1/07	FinAdv	It is well known that the Treasury has not been happy for sometime with the way the FSA has been operating. Senior Treasury officials have realised, a bit too late, that the remit of the FSA is too wide... There is also the tension between the FSA and the OFT ...
13/11/07	FT	The lessons from Northern Rock. The Tripartite arrangement between the Treasury, the FSA and the Bank of England, for dealing with financial stability, is flawed. The main problem with the arrangement is that it puts the information about individual banks in a different agency (the FSA) from the agency with the liquid financial resources to provide short-term assistance to a troubled banks (the Bank of England).

Competition issues on the content of the rules: MCA and disclosure of commissions and charges

28/4/88	FT	The requirement to disclose commission will have a greater impact than any other single provision in the new structure of investor protection
24/5/90	FinAdv	ABI believes that the OFT proposals are based upon a misleading view of competition within the life assurance market
12/12/91	FT Barry Riley	We all know what we get when we pay peanuts. Yet the retail investment industry especially the life assurance sector has traditionally peddled the fantasy that advice is free. This has created the industry's self inflicted problem over disclosure. The gap between the public perceptions of what advice is worth and what it costs is vast. Life companies know that if the public gain a clear idea of the level of up front charges there could be a severe impact on sales.
16/1/92	FT	Law Society calls for SIB to ban commission on financial products
3/2/93	FT	The life insurance industry, stung by adverse publicity about high commissions ... is embarking on its first ever image advertising campaign. The life company members of the ABI are also rethinking their two year opposition to new rules requiring greater disclosure of charges.
19/3/93	FT editorial	OFT on target. The DGFT remarks that 'competition can take place most effectively when investors have access to information of the right type and extent, at the right time, and in an understandable format.' It is a measure of the failure of practitioner based regulation in the retail investment market that it should still be necessary to make such a self-evidently sensible declaration so long after the introduction of the 1986 Financial Services Act.
19/3/93	FinAdv	Demands from the OFT [for disclosure] were attacked by many figures in the industry. The ABI expresses regret and disappointment. The proposals are unnecessary and unfair and likely to discourage sales of new products
20/5/93	FinAdv	ABI attacks upfront disclosure for advisers
8/7/93	FT Barry Riley	Rename IFAs as multi-company salesmen and reserve the independent label for those who are truly independent and paid by the client
29/1/94	FT	Unfortunately commission disclosure is very much a partial solution. The wool will still be pulled over most investors' eyes since it is likely to result in the industry restructuring the way in which commission is paid.
15/10/94	FT	ABI Chief backs disclosure: commission disclosure will draw attention to the substantial differences between the operating costs of life offices. This should stimulate competition which will drive down costs. In general the industry's costs are too high for the product which is being sold.

Competition issues on the content of the rules: polarisation and depolarisation

4/8/99	FT	Both the FSA and the Treasury are believed to be unhappy with the result of the year-long OFT enquiry. The OFT has called for a limited relaxation of the so-called polarisation rules.
11/11/00	FT	The government and the FSA teamed up on Wednesday to announce their long awaited decision on [polarisation]. For the rest of the week, financial advisers, banks and consumer representatives spent their time shouting at each other.
18/11/00	FT Barry Riley	Polarisation is on its way out and not a moment too soon. After 13 years I can claim victory. All right, it involves only a rather obscure battle over the so-called polarisation rules that apply to the retailing of investment products. I fought a campaign in this column during 1987 and 1988 to resist its introduction, but nobody took any notice.
1/12/00	FT	Plans for a fanfare launch of stakeholder pensions in April are looking shaky following admissions from regulators that changes to financial advice rules would not be made in time. Without a relaxation of the polarisation rules, high street banks, seen by the government as the key to distributing stakeholders to the masses, will be able to sell only their own branded products. These are likely to be few and far between because many banks have been put off manufacturing their own schemes by the restricted margins on offer.
11/1/01	FT	Multi-tied agents will be allowed to sell ... stakeholder pensions from April 2001. The FSA published further draft rules...
19/6/02	FT	MPs call on FSA to modify depolarisation to assist IFAs. The MPs heard evidence from the Association of Independent Financial Advisers who put forward an alternative to the defined payment system.
3/7/02	FT	The European Council has passed its consumer protection rules on remote sales of financial services. A spokesman for the FSA said "Provision of financial advice across EU borders had been one of the main reasons reform of the UK's polarisation regime had been proposed.
24/7/02	FT	[Sir Howard Davies] acknowledged opposition from Ron Sandler and the IFA sector to the FSA's proposals for a defined payment system and said that the FSA would look positively at their suggestions.
31/10/02	FT	Stiff opposition forces FSA to ditch fee plans
Dec 2002	Money Management	Refers to a report by the Centre for Studies in Financial Innovation "The dominant commission based model of today operates an effective monopoly, keeping financial advice costs high (and opaque), preventing the emergence of a separate market for advice, concealing the commodity nature of most products, and biasing advice."
4/3/04	FinAdv	Proposals served up after five years.... It has taken 15 years of sometimes angry debate between product providers, regulators, government officials and IFAs to reach today's product outline.
5/8/04	FinAdv	Industry is divided as depolarisation arrives

Competition issues on the content of the rules: polarisation and depolarisation (continued)

3/8/06	FinAdv	Callum rules out polarisation. The City regulator has turned its back on a return to polarisation as a solution to the failures of its troubled depolarisation regime.
2/7/07	FSA Tiner	Reflections of a soon to be former regulator.... On reflection, I wish we had stuck to our guns in 2002 when we made similar proposals [IFAs to be remunerated by fee] in the infamous CP121 on depolarisation.



Interpretation and enforcement of the rules 1987-2004

18/6/87	FT	Fimbra has admitted that it is impossible to set down a precise definition of "best advice" ... this whole area of best advice is full of greyness. It is not codifiable. There would be a lot of guidance notes issued and Fimbra inspectors would develop their approach over time.
1/3/94	FT	The personal pensions time bomb – slow response by regulators is exposed (results of KPMG study)
14/4/94	FT	GMB plans court action against pension providers over mis-sold pensions
19/7/94	FT	Lautro to probe leak on Prudential. A particular cause of controversy will be the reference to a 'sharp telephone exchange' between Mr Mick Newmarch, CEO Prudential, and Mr Kit Jebens, CEO Lautro, after which Lautro agreed to drop a formal investigation and instead to carry out an informal inquiry. Last year, against a background of widespread public concern on possible pensions mis-selling, Prudential launched an advertising campaign intended to reassure customers that it had behaved properly in this area.
22/9/94	FT	The City's chief regulator [Andrew Large] has begun a series of meetings with top life insurance executives in an attempt to head off a damaging public split between the industry and its watchdog over the sale of personal pensions.
24/10/94	FT	The TUC will today warn insurance companies that they may face legal action if they fail to reach agreement with the SIB over a timetable for compensation arising from mis-sold personal pensions.
26/10/94	FT	Several leading life companies yesterday offered a cautious welcome to the SIB's two year plan to help victims of pension mis-selling. But Legal & General attacked the plan. Mr David Prosser, CEO, said: 'We believe that SIB is unfairly putting too great a burden of the costs of resolving the issue on the life assurance industry'.
2/2/95	FT	A group of IFAs will yesterday won the right to seek a judicial review of regulators' plans for reviewing PP business in order to identify and compensate the victims of bad advice. The High Court ruling is an embarrassing set back for regulators.
13/5/95	FT	SIB wins victory for compensation guide. Judges rule it had acted within its powers in setting guidelines to compensate victims of poor pensions advice. But the court ruled that the SIB acted unreasonably in requiring IFAs to review their files as it might jeopardise their ability to claim on their professional indemnity cover.
20/10/95	FT	Prudential not to be disciplined over sale of pensions. It will end a long and turbulent chapter in the relationship between the Pru and its financial regulators.
27/11/95	FT	Lack of progress in identifying the victims of poor personal pensions advice and compensating them has led the SIB to postpone its review of the situation until early next year.
8/12/95	FT	About three quarters of life assurance companies will not meet the first deadline set by the regulators...

Interpretation and enforcement of the rules 1987-2004 (continued)

18/4/96	FT	Both the PIA and the SIB are thought to have lost patience with complaints from life companies and advisers about the difficulty of carrying out the review. The PIA statistics show how little has been achieved ...
8/11/96	FT	Sir Andrew Large yesterday attacked the pension industry for taking too long to compensate victims of mis-selling...
16/11/96	FT	The SIB this week scrapped the unworkable system it introduced in 1993 to identify and compensate victims of personal pensions mis-selling. It also ditched the strict deadlines to assess cases it imposed on pension companies that same year. By these actions, the SIB effectively conceded that it had wasted three years of investors' time.
21/11/96	FT	Pensions review could take five more years ... experts have warned SIB
8/3/97	FT	Will the arguing ever end? The Pensions Scandal. Life offices now want to delay some compensation payments ...
11/3/97	FT	PIA criticised over mis-selling. Commons committee describes attempt to clear scandal as pathetic
14/3/97	FT	18,000 die awaiting mis-selling payout
9/5/97	FT	Labour urged to end pension mis-selling [by chairman NAPF]
3/7/97	FT	MP dismisses Prudential's pension denial as "bullshit". Prudential gave the Treasury select committee "the biggest load of bullshit in history" when it denied it had any part in the £11bn pensions mis-selling scandal, and MP said yesterday. The confrontation came as Prudential more than doubled its estimated bill for compensating victims of pension mis-selling from £450m to £1.1bn. The MPs were particularly incensed by the fact that Mick Newmarch, former CEO, offered the committee a "total reassurance" in February 1994 that Prudential was not guilty of mis-selling. Prudential is the worst offender in the pensions industry in terms of the number of people affected.
22/10/97	FT	SIB attacks Prudential over pensions review. SIB said it was "deeply concerned" by the "serious shortcomings" in the Prudential's pensions review.
1997	Jebens Former CEO Lautro	Suitability and best advice were given low priority under the common belief that life insurance per se was a benefit which justified a sale to any client in any circumstances. At the time a government advertising campaign was extolling the virtues of escaping the shackles of state provision and of providing for retirement through personal pensions. As a result, personal pensions were seen, perhaps naively, as a new and beneficial form of investment. Definitive guidance was issued in July 1992 which said that it should be assumed that it would not constitute best advice to recommend opting out of into a PP unless positive arguments in favour of such advice can be established. With hindsight it was unrealistic of Lautro to rely on the force of the July 1992 notice without an active enforcement back up of a special visit programme.

Interpretation and enforcement of the rules 1987-2004 (continued)

18/4/98	FT	The launch of a government backed TV campaign featuring an ostrich to encourage victims of pension mis-selling to claim compensation should make the pensions industry wince. It is ironic that television, which in the late 1980s was used to urge people to take out personal pensions, is now being used to whip up claims.
4/7/98	FT	The pensions scandal – innocent policyholders are being penalised [by compensation being charged to life funds]
21/11/98	FT	As the Consumers' Association remarked, this [compensation being charged to life funds] is tantamount to expecting one group of consumers to compensate another

## Contemporaneous observations and perceptions – on the impact of regulations introduced

### Product development, prices and consumer demand

18/7/85	FT	[Albany Life] believes there is a big market for life companies offering both personal pensions and small group schemes
24/10/86	FT	According to Greenwell Montague, when the new pensions legislation comes into effect heralding a move from SERPS to PPs, life companies can expect a large increase in personal pension income
4/6/87	FinAdv	Royal Life this week launched a nationwide sales campaign to promote personal pensions ... It marks the first commitment to personal pensions by a big insurance group since the NAPF said it would combat through publicity any attempt to take employees out of company pension schemes
4/6/87	FinAdv	The NAPF anticipates an onslaught of marketing by PP providers to be directed towards actual or potential members of OPSs, as well as the self-employed and others who cannot join a company scheme. The government's strategy encouraging freedom of choice is about to open the floodgates of marketing activity.
25/6/87	FinAdv	L&G and Pru have launched major marketing campaigns to meet the challenge of what the L&G termed "the privatisation of SERPS". L&G's whole marketing image is to link in the public's mind the new pension opportunities to the 'giveaway' aspect of the government's privatisations.
15/10/87	FinAdv	The IR finally relented on its ridiculous administrative demands for FSAVCs. As a result FSAVCs will trickle onto the market over the next six months for no other reason than the providers desire to offer a full range of products
4/1/88	FinAdv	FSAVCs find unexpected buyers. Teachers, civil servants and GPs are the most popular targets for FSAVCs according to a Financial Adviser survey.
14/4/88	FinAdv	The opening shots in the battle to win part of the lucrative pensions market from the insurance companies was fired last week by fund managers Murray Johnstone and Abbey National.
22/9/88	FinAdv	Pensions unit trust groups open their umbrella funds. This new product offers ... the opportunity for direct and highly specific stockmarket investment
13/10/88	FinAdv	The SIB has confirmed that unit trust groups cannot take a flat monetary charge on their umbrella fund PP policies. As a result a number of groups ... have now written to the OFT to voice their complaints about what they seen as unfair discrimination compared with life offices.
20/10/88	FinAdv	L&G results. Impressive increase in new business premiums for the first nine months of the year, including a massive increase in individual pensions business of 144%. The first clear indication of the impact of the new legislation on pension sales
16/2/89	FinAdv	ABI reports pensions boom. Sales of more than 1m personal pensions since their launch on 1 July contributed to record figures for pensions business last year.

Product development, prices and consumer demand (continued)

21/6/90	FinAdv	Lautro has produced conclusive proof that the abolition of the MCA has led to a steep rise in commission payments. Tied agents have done best under the new liberal regime but IFAs have also seen their commissions rise.
12/2/94	FT	Prudential will launch a single recurring premium pension aimed at the company's sales through IFAs. The new product will offer advisers several ways to chose how to take their commission. Several life companies are planning new product ranges with differing structures so that customers and IFAs can choose from a variety of commission arrangements once the disclosure provisions come into effect.
18/5/94	FT	Figures released by ABI suggest that PP sales have been hit by widespread concern over the possible mis-selling of PPs to people transferring a lump sum from a pension scheme run by a former employer.
15/9/94	FT	Commenting on factors behind the uncertainty and caution among customers, Mr Newmarch [CEO Prudential] highlighted two areas of regulatory activity. The first was the report from City regulators on compensating customers who have suffered from poor advice to transfer out of OPSs, which is due next month. The second means that from the start of next year life insurers have to volunteer more information to customers about policies and charges.
13/10/94	FT	CBI/Coopers survey. Life insurers expect a short term fall in business volumes once disclosure is introduced. Other issues worrying insurers are system capacity, staff availability and compensation claims resulting from mis-selling.
10/12/94	FT	Over the past few months, company after company has announced re-structuring of policies, cuts in costs, or changes in paying sales agents and advisers.
3/1/95	FT	Commission disclosure and charges disclosure are going to have a significant commercial impact, said Mr David Prosser, CEO L&G. The lack of hard information combined with the ending in 1989 of an industry wide MCA enabled life companies to pass on rising costs to consumers without driving customers away. This meant there was little effective competition.
6/7/95	FT	Trickle turns to a flow as SIPP's start to taste good. It is forecast that the market for SIPP's is set to grow
7/12/95	FT	Group personal pensions market tipped for growth [by Datamonitor]
Dec 1995	Money Management	Pensions Director Scottish Equitable. I think the GPP market is buoyant at the moment and it is likely to go from strength to strength once the market understands the changes involved in the Pensions Act
18/4/96	FT	Pensions ready to sail on the good ship GPP. Sales growth reported. The facilities are particularly beneficial to large firms with high staff turnaround and are also unconstrained by legislation impacting OPSs
Nov96	Money Management	The Pensions Act has created new demands for GPPs. New restrictions imposed on OPSs has served to highlight the benefits of GPPs

Product development, prices and consumer demand (continued)

June 98	Money Management	Standard Life attributes much of its regular premium growth to group pensions business and also to the popularity of its fair deal for all pensions contracts launched in 1995 under what was then the new disclosure regime. It was one of the first to abolish front end loading so that individuals were not punished for leaving the scheme early but enjoyed higher transfer values.
12/4/99	FT	Ernst & Young report. Most life companies will be unable to make money from stakeholder pensions without radically reducing their cost base. The introduction of stakeholder pensions may well have a much wider impact. The cost-effectiveness and ease of availability they offer may eventually force the industry to reduce its charges on the majority of PP contracts.
5/6/99	FT	... already the plans for stakeholder pensions have forced companies to lower what were complex and frequently very high charges.
23/7/99	FT	Mr Prosser (L&G) said a new model would be required involving stakeholder pensions being sold much more like GPPs focusing on affinity groups such as trade unions and selling in the workplace.
23/8/01	FinAdv	Stakeholder pensions far from rosy. GPPs are part of the answer. Although stakeholder was only launched in April 2001 the broad details of the legislation had been known for a couple of years. Employers could see that they were going to have to review their pension arrangements to ensure compliance .... many chose to introduce GPPs
6/9/01	FinAdv	Three years ago Bacon and Woodrow [actuaries] warned that all stakeholder would do is offer better value products or greater tax shelters to those who would save anyway; and that it would not cater for the government's target market
Dec 01	Money Management	Take up rates have been low among the target customer base of SMEs. Nevertheless the stakeholder pension initiative has had significant impact on the market. Many life companies have restructured their products to stakeholder format.
13/8/04	FT	TUC: Average contributions to stakeholder pensions have been skewed by a number of wealthy people taking advantage of tax breaks to buy policies for family members.
14/10/04	Times	L&G said that it would not sell individual Stakeholder pensions to workers on low incomes because of the limit set on charges
19/5/05	FinAdv	With the April 2006 A-Day looming, customer interest in Sipp has picked up dramatically. The response from providers has been sharp and swift with new players entering the Sipp market every month.
13/8/05	FinAdv	IFAs could be the main beneficiaries of A-Day. The biggest earner for IFAs is going to be when the client makes a one off single premium pension contribution and when they help them consolidate several pensions with different providers into a single pot. NU and L&G are among the life companies vying for advisers' business. Not entirely coincidentally, they have hiked commission payments in the run-up to A-Day.

Product development, prices and consumer demand (continued)

Jan 2006	Hargreaves Lansdown	A leading IFA, Peter Hargreaves in his 'Guide to Sipp and A-Day changes': We are convinced that Sipp will be <i>the</i> investments success story of 2006 ...
July 2006	Money Management	The rise [in new business] in 2005 is mainly due to increased business activity in the lead up to A day.
March 2007	Mintel	Changes to pensions legislation prompted product innovation among pensions providers. In the build up to A day [April 2006], pensions providers launched compatible products designed to operate under the new legislation. However, the majority of new product development activity seems to have been around SIPPs leading up to A-day.... Innovation in personal pensions has now been stifled by government plans to introduce the NPSS. Personal pensions and pensions providers are to a certain extent in limbo while they wait to find their place among the government's plans... Growing fondness for SIPP among consumers has encouraged SIPP providers to invest more in promoting the product ... There has been a plethora of SIPP advertising since it became the product of choice for consolidating a group of pensions with a single provider... The level of intermediary pensions advertising expenditure has risen rapidly over the last few years. Both pension providers and intermediaries were encouraging consumers to reassess their pension plans in the build up to A day.... In spite of the government, trade union and pension providers enthusiastically supporting the stakeholder pension at its launch, the level of take up among consumers for whom the product was designed has been too low to regard it as a success.
25/10/07	FinAdv	RU64 states that we should still explain why the product sold is at least as good as a stakeholder pension. Why? What is it that is so special about a stakeholder that we would have to compare it? The basic problem of a stakeholder plan is the fund choice. Whether it is clumpy managed funds with the turning speed of the Titanic or expensive mirror funds, it is difficult to see any value for the discerning investor. If I am trying to build a portfolio of funds for my customer I need access to the best funds in the market place. I cannot get them in stakeholder. [Article written by an IFA]
Nov 2007	Money Management	What has brought about the extraordinary leap in SIPP sales? ... The FSA commented "a number of press articles have suggested that some of the SIPP business has been driven by high rates of commission" .... An alert regulator, on top of the game, should have investigated at the start of the SIPP surge in 2005, and acted much sooner.
Jan 2008	Money Management	If individually the advantages of SIPPs do not yet appear compelling, for the SIPP surge it must be hats off to the men leading the marketing of SIPPs... it will be interesting to see what the FSA has to say about the sale of SIPPs when it produces its report, due in the middle of 2008.

Distribution

4/3/87	FT	Fimbra is supporting the SIB's conflict with the banks and buildings societies over polarisation. A group of 21 life assurance and unit trust managers has been created to help intermediaries survive the new legislation. The Independent Market Assistant Group will provide financial help and other assistance to enable intermediaries to meet regulatory costs.
16/4/88	FT Barry Riley	Perhaps the most worrying aspect of polarisation in the high street is the impact upon the may smaller building societies. Most have no aspirations to be independent intermediaries and unlike most of the big societies (but like Abbey National) they have signed up with various life offices as tied agents. There is some concern in the industry that large commissions are being paid to certain of these societies ...
26/5/88	FinAdv	Refers to report in Daily Telegraph that poorly performing life companies have been offering building societies over the top commissions in exchange for becoming tied agents
13/10/88	FinAdv	A group of traditional insurance companies set up campaign (CAMIFA) to promote the benefits of IFAs
5/11/88	Economist	Britain's life assurance industry is facing upheaval thanks to the Financial Services Act. The number of IFAs is dwindling. ... Small firms lack the resources and expertise to carry out enough research to convince regulators that their advice is objective. Many are switching to become tied.... Many life offices not in CAMIFA are bidding against each other to ties up agents. Some are offering commission equivalent to 170% of the max available to IFAs
1990	Ennew and others	The Financial Services Act has had the inevitable consequence of increasing the power of the company representative at the expense of the IFA. The great majority of banks and buildings societies have decided to sell the life, pensions and investment products of only one supplying company, because of very high training and admin costs of providing independent advice through a large branch network.... The polarisation rule has led to more insurance companies setting up DSFs... The IFA route is most important for the more complex products such as GPPs which require comprehensive knowledge and training... distribution has been a major marketing battleground in the last few years and insurance companies have assiduously courted building societies...



Distribution (continued)

1990	Shelton	... the relationship between life companies and unit trust companies, as manufacturers, and retail banks, building societies and insurance brokers, as retailers, has been completely altered by the Financial Services Act. As the practical implementation of the Act emerged it became increasingly clear that there existed certain attractions from the adoption of the tied route: only one product range and one life office to deal with, avoiding certain requirements of the Act, higher commission rates, marketing support. In view of these attractions many small insurance brokers and minor building societies took the straightforward decision to adopt the tied route... From late 1988 into 1989 most of the major building societies switched to tied status after discovering the relatively high costs (training and lower commissions) of the independent route.... Events suggest that [large mutual insurance companies] misjudged the market in 1987 and early 1988 [by committing to the IFA route and losing distribution through banks and buildings societies as these companies tied]. The large mutuals came late to the tied world and scrambled for the remaining large building societies. Small mutuals do not possess sufficient resources to develop DSFs or tied agent networks and have thus lost market share and distribution.
27/6/91	FinAdv	Half of all salesmen leave jobs... a survey by Life Insurance Marketing and Research Association. Figures supplied by 25 of the UK leading direct sales organisations. This suggests that direct salesmen are extremely itinerant ... average industry retention is 57%, top 91%, bottom 34%.
10/10/91	FinAdv	Three portents for the eventual demise of independent advice: Abbey National's bid for Scottish Mutual, NatWest's entry into the life business, Standard Life pulling out of WP endowments.
2/4/94	FT	...people do not readily sign 25 year contracts. They have to be persuaded, usually by salesmen on a one-to-one basis, during visits to homes and offices. This is extraordinarily expensive.
8/12/94	FinAdv	Crackdown could halve the independent sector. A combination of the adverse effects of the pensions transfer scandal, larger competence and training costs and hard disclosure will by 1997 lead to a drop in the UK total of IFAs, tied agents and direct sales staff to 70,000 from 120,000 according to Kit Jebens (PIA).
1994	Laing	[The Scottish mutual life companies] reacted late to the Financial Services Act ... they sought to modify the Act and restore the primacy of the IFA in the distribution process. Ultimately it was only in the face of mounting market pressures that this commitment was to change.
June95	Money Management	By being totally committed to the IFA market enables Skandia to make its products 100% tailored to IFAs needs. Both products and commission structures can be adapted entirely to suit the IFA market.
Dec96	Money Management	Standard and Poor's assessment. The trend in the late 1980s towards multi-distribution strategies was driven largely by uncertainty as to which channels would suffer least under the disclosure regime, together with an over emphasis on sales growth

Distribution (continued)

1996	Llewellyn	The immediate catalyst for the shift into manufacture [by banks] as opposed to distribution of insurance was polarisation.
23/7/99	FT	Mr Prosser (CEO L&G) said that a new model would be required involving stakeholder pensions being sold much more like group pensions products, focusing on affinity groups such as trade unions and selling in the workplace
9/3/01	FT	Stakeholder revolution has unintended consequences ... the launch of the low-cost pension is heralding the end of door-to-door assurance sales
18/1/03	FT	Peter McNamara (CEO Wesleyan). "The big problem is that if you are trying to get the products into middle and low income households you can't make it happen in the 1% world. There just isn't sufficient margin to do it". Wesleyan was one of the first life assurers to change its target customer from a predominantly blue-collar base making door-to-door collections to wealthier clients using a specialist sales force ...the mutual now sells most of its products to doctors, dentists and vets.

## Costs

29/1/94	FT	Unfortunately commission disclosure is very much a partial solution .... Instead of taking the commission upfront, IFAs are likely to be paid less initially, taking most of the commission spread over the first years of the life of a policy...
12/2/94	FT	An early sign of the sort of product innovation that is likely to be a feature of the life assurance sector over the coming months because of commission disclosure has been given by the Prudential. Prudential will launch a single recurring premium pension aimed at the sales through IFAs. The new product will offer advisers several ways to choose how they take their commission (from 0% to 5.2% of each contribution each year, and up to 20% up front as a lump sum payment in respect of the first five years' commission.... Several life companies are planning new product ranges with differing structures so that customers and IFAs can choose from a variety of commission arrangements once the disclosure provisions come into effect.
18/5/94	FT	Coopers and Lybrand report. The estimated average cost of acquiring new business as a percentage of APE range from 60% for banks and building societies to 89% for IFAs and 95% for DSFs.
12/11/94	FT	The task of cutting costs is not made any easier in the life and pensions sector as official regulators become more demanding and set tougher standards to ensure that sales agents are competent and properly trained. Mr Stephen Maran, chief executive of Lloyds Abbey Life, the life assurance group, believes such compliance costs are now seven or eight times higher than at the beginning of the decade. At the same time, regulation is increasing the need to cut expenses. From the beginning of next year, new rules will oblige sales agents to tell customers the costs of selling the policy, including any commission they are paid for making the sale. That will focus increased attention on charges imposed by the insurance companies. 'Commission disclosure and charges disclosure are going to have a significant commercial impact,' says Mr David Prosser, chief executive of Legal and General. Low inflation and interest rates are adding to the pressure to cut costs in the life industry. 'We estimate that you will be doing well to average a 10% investment return a year in the 1990s,' says Mr Scott of the Norwich Union. 'If your expenses are still 4%, that leaves just 6% for the investor and you have a big problem.'
22/11/94	FT	Allied Dunbar is to replace its range of pension policies with a single adaptable plan intended to give customers greater flexibility. The commissions which Allied Dunbar pays its sales force and IFAs will be trimmed and spread over a longer period of the policy instead of being taken entirely from the initial premiums. The move is a further sign of the way the life insurance industry is responding to the forthcoming new regulatory regime.

Costs (continued)

3/12/94	FT	Norwich Union is hastening the disappearance of its conventional with profits policies in favour of unitised with profits policies. While in terms of what the customer receives there may seem little difference between the two, unitised policies allow the insurer to introduce flexible commission arrangements which give IFAs and their customers more choice about how the charges are made.
27/1/95	FT	In anticipation of increased competition between independents, many are offering a menu of commission options.... in most cases the IFA can still take the full commission as before and share this with the client if he chooses as an incentive. Alternatively, he can take a lower initial commission and have the life company invest the balance on the client's behalf. One alternative to high initial commissions is to pay a level amount throughout the term of the policy of between 5% and 12% of the premium. Alternatively several companies including Skandia, Prudential and Norwich Union are offering commission based on a percentage of the policies' fund value. This minimises the initial charges to the client but as the fund size grows so will the level of commission.
22/7/95	FT	'Perhaps one reason why people are looking at buying policies without taking advice is that the cost of advice has gone up and up,' one regulator said. 'That trend has implications for investor protection. We need to look at whether the industry has over responded, and ask whether the selling process is proportionate to the risk to investors.' Several life companies have complained that making a sale is taking longer than ever. In particular, the process has slowed down since the beginning of this year when a regulatory regime requiring sales agents to give customers more information about policies and charges was introduced. The increasing time that must be spent on each sale has hit significant amounts of new business being sold by life insurance companies in the first half of this year.
11/1/96	FT	The Personal Investment Authority's initiative to simplify the way investment products have to be sold is good news. One year after the introduction of the new disclosure rules, it is clear that the process is ludicrously complicated. It can take a life assurance sales agent three hours to fill in 30 pages of questionnaire, irrespective of whether the customer wants a fundamental review of his finances or just to put some money into a unit trust. Part of that is due to the belt-and-braces approach of life assurers following the scandal over pensions mis-selling. But it is also the result of a plethora of new rules imposed in the name of investor protection.
June 96	Money Management	The chief effect of disclosure has not been to turn clients back from the turnstiles but to lengthen the average time and costs connected to a sale. The cost of bringing large scale sales forces into line with new compliance regimes has also proved prohibitive, with several providers either selling their sales operations en masse or making radical cuts in their size.

Costs (continued)

10/1/97	FT	Rules forcing life assurers to disclose their charges are sharpening competition and helping customers to get a better deal, the PIA said yesterday. The PIA said the most expensive companies had show the biggest improvements. But it warned that progress was modest and said companies with the cheapest charges had become slightly more expensive.
24/1/98	FT	The new disclosure regime hasn't made much difference ... Anyone buying a new investment needs to negotiate a minefield of high charges allied to potentially poor advice. That is the clear message of a depressing but useful report published this week by the PIA. ... The PIAs report shows that the average level of charges after falling only modestly in 1995 and 1996 did not change last year.
22/4/99	FT	This is likely to impose an unprecedented cost squeeze on the industry. "Most UK life assurance companies will be unable to make money from stakeholder pensions without radically changing their current business model. Their expense base is too high to support the proposed charges, " says Ernst & Young, the accounting firm. To compensate, companies may have to cut their sales and servicing costs, slash commissions, and seek economies of scale. "We are heading for a low margin, high volume world," says Andrew Black, pensions marketing manager at Standard Life. This is likely to mean that some life assurance companies cutting back commissions to pensions salesmen and independent financial advisers. Legal & General, one of the largest life assurers, expects to cut its upfront commission by about 75 per cent.
6/7/00	Fin Adv	6/7/00 UK: MAJOR INSURERS HELD BACK FROM GOING ONLINE. Major UK insurers are not fully exploiting the Internet due to a combination of product complexity, regulation and legacy issues. The survey by the Association of British Insurers found other barriers such as paper signatures, regulatory restrictions, security risks and the cost of online development. Some 96% of those with a website use it for providing information but less than half use it for direct selling.
25/11/04	Fin Adv	ABBEY may scrap the Scottish Provident and Scottish Mutual brands if the idea proves popular with advisers.

Industry structure

15/7/94	FT Barry Riley	Companies from outside the life assurance industry are now gearing themselves up to make their second attempt at grabbing an important share of the personal pensions business. In the past, however, they have failed to overcome the barrier of investor indifference. New hope for the non-lifers springs essentially from the so-called 'hard' disclosure of commissions and charges on life policies, which comes into effect next January. These non-life providers will also be seeking to exploit the poor image of inflexible products and mis-selling which has so badly damaged the life companies in recent months. When personal pensions legislation was introduced in the mid-1980s, the government went out of its way to ensure that the new pensions products would no longer be confined to the life assurance closed shop. It was expected that unit trust companies, building societies and banks would all participate in the exciting new markets, providing an important new layer of competition for the life companies. But it didn't work out like that. Although new entrants appeared, most providers of unit trust pensions, such as Fidelity or Midland Bank, eventually either pulled out or switched to life assurance vehicles. Only a handful, such as Gartmore, Invesco and NM Rothschild, are still in business with niche products. They found marketing difficult when they could not use the life assurance distribution channels. Lower charges made the non-life pensions products inherently attractive, but the market turned out not to be very price-sensitive - a consequence of the life industry's ability to conceal its costs.
18/3/99	FT	New pension providers fail to gain big market share. New entrants to the pensions market, such as Virgin and Marks and Spencer, are failing to make significant inroads into the sector despite their success in the savings and investments market. M&S had sold 4,000 personal pensions by the end of last year and Virgin 15,000, according to a Financial Times report published today. This compares with the 129,000 pensions sold by Scottish Widows, a traditional provider, last year.
22/4/99	FT	Barry Bond, an executive of the management consultancy OSI, expects the number of UK life assurers to shrink from 60 to as few as six over the next 10 years because of a tidal wave of mergers driven by a search for economies of scale. He believes companies will need a customer base of at least 500,000 savers to achieve viability in the stakeholder pension market. But are stakeholder participants ever going to make good profits from them? Ernst & Young is cautious. "Can a company that makes radical changes in both its mindset and its business model make money from stakeholder pensions? The answer is, maybe."

Industry structure (continued)

3/6/99	FT	The government stunned pension providers yesterday when it unveiled benchmark standards for stakeholder pensions and recommended that charges should be capped at 1 per cent. Smaller companies and financial advisers would be driven out of business by the government's planned minimum standards, said the industry. Traditional providers said they were furious and called for a rethink. "It is unreasonable," said Steven Cameron, pensions development manager at Scottish Equitable, who said high-level advice could not be provided at that cost. "Without advice, take-up will be extremely low and [the stakeholder] will not reach the audience the government is aiming at. It will only be the most financially strong, efficient providers that will be able to make any attempt to join this market."
18/6/99	FT	Stakeholder pensions will cut a swathe through the pensions industry, leading to a wave of consolidation as companies are forced to cut costs to compensate for lower margins. KPMG Consulting said it could take many years for pensions providers to recoup their costs for stakeholders, and many existing personal pension premiums could switch to rivals. The main problem is that the 1 per cent annual management charge being proposed by the government for stakeholders is much lower than for existing individual pensions products. There is also the fear that although stakeholders are aimed at people earning #9,000 to #18,500 a year, their actual impact could be much wider. "Stakeholder pensions will have a dramatic impact on margins across industry as a whole. Consumers will be more aware," said Keith Nicholson, head of KPMG's insurance practice. "Costs have got to be cut. Real economies will only come through consolidation."
23/10/00	FT	Life assurers generally agree that low-cost "stakeholder" pensions will not become profitable for providers until 2010, according to Cap Gemini Ernst & Young. The consultants predict that government-backed stakeholder pensions, which will be launched in April with annual charges capped at 1 per cent, will reshape the entire financial services landscape in just three years.

Impact on consumers

28/2/94	FT	A former civil servant said 'The reality is that this was a duff product from day one'. Former officials say ministers who pushed the legislation through were told from the outset that personal pensions were likely to be bad for taxpayers and a bad bargain for all but a limited group of potential customers.
15/7/94	FT	A good idea that fell to earth. The antics of sales agents and reports of regulators' efforts to curb them have taken their toll on sales. But the product may at last be reaching those to whom it is best suited
28/11/96	Fin Adv	Providers miss young, white-collar workers: Financial services industry targets over-40s & those in AB socio-economic groups & badly targets younger investors IBM Banking Finance & Securities Consulting says the UK financial services industry targets the over-40s and those in AB socio-economic groups despite the fact that younger investors have largely driven the savings and investment market's 80% growth over five years. The report says C1C2s and under-40s are badly targeted or ignored by the industry and that those new entrants which have found success have been those which segment the market and tailor products accordingly. The report says that trusted and recognised high street banks and building societies will continue to be the choice of investors unless products and services become more user-friendly.
26/9/04	Sunday Times	Tax relief masks dire pension returns. One in four pension funds has lost money over the last 10 years. Their performance is rescued only by the tax relief on investors contributions. Ros Altman said that financial services firms have been supported by an enormous subsidy from the taxpayer and this has taken away the incentive for fund manager to address poor performance. Hargreaves Lansdown said since the late 1980s many life companies have got away with foisting second rate funds, with high charges and poor management, onto unsuspecting investors.
2005	Various	Resolution Life, NU, ScotAm, StandLife, Axa, HSBC put SERPS opt outs back into S2P
2/3/06	Fin Adv	There was acknowledgement that advice businesses could not meet the need of the mass market, with one respondent saying "90 per cent of middle England consumers are expensive to service for a long-term relationship. Customers get promised ongoing services, but few businesses can afford to provide it."



## APPENDIX C: ECONOMIC TRENDS

### UK stock exchange indices

Figure C1

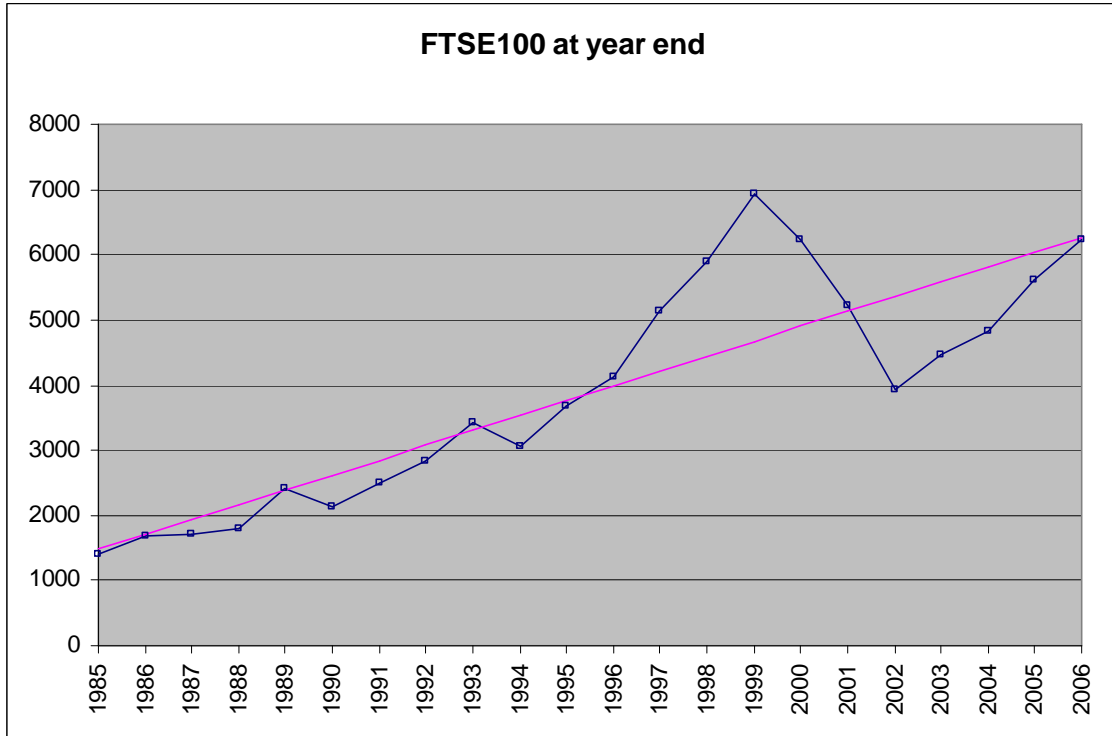
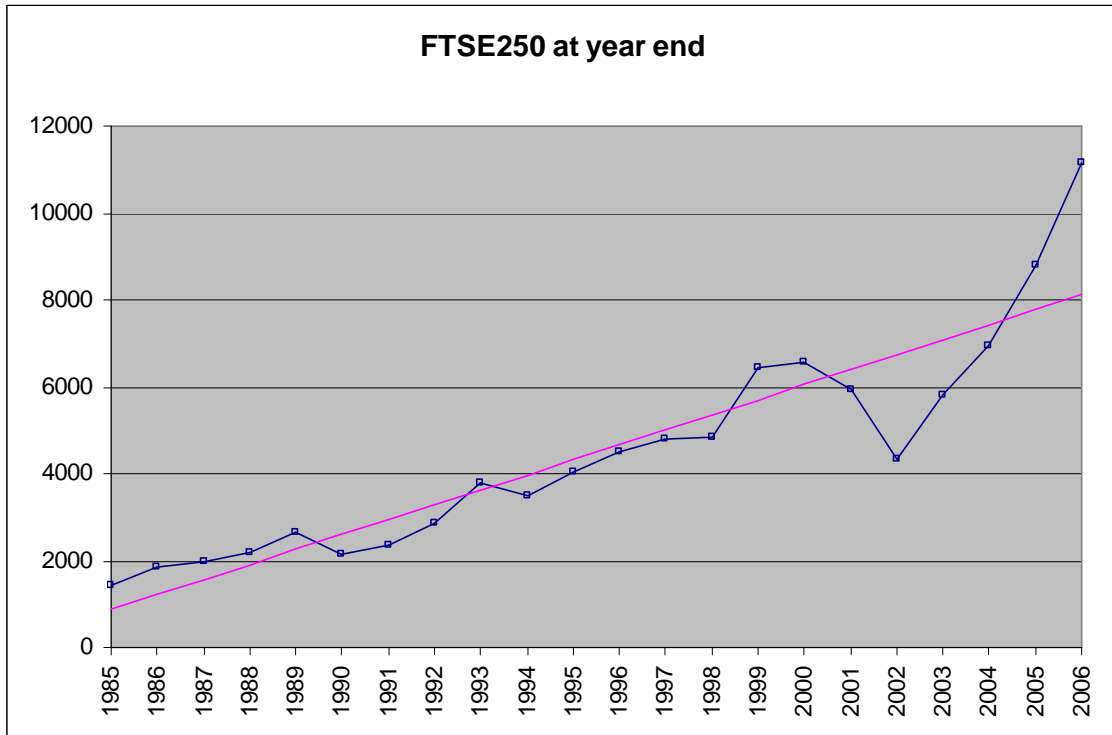
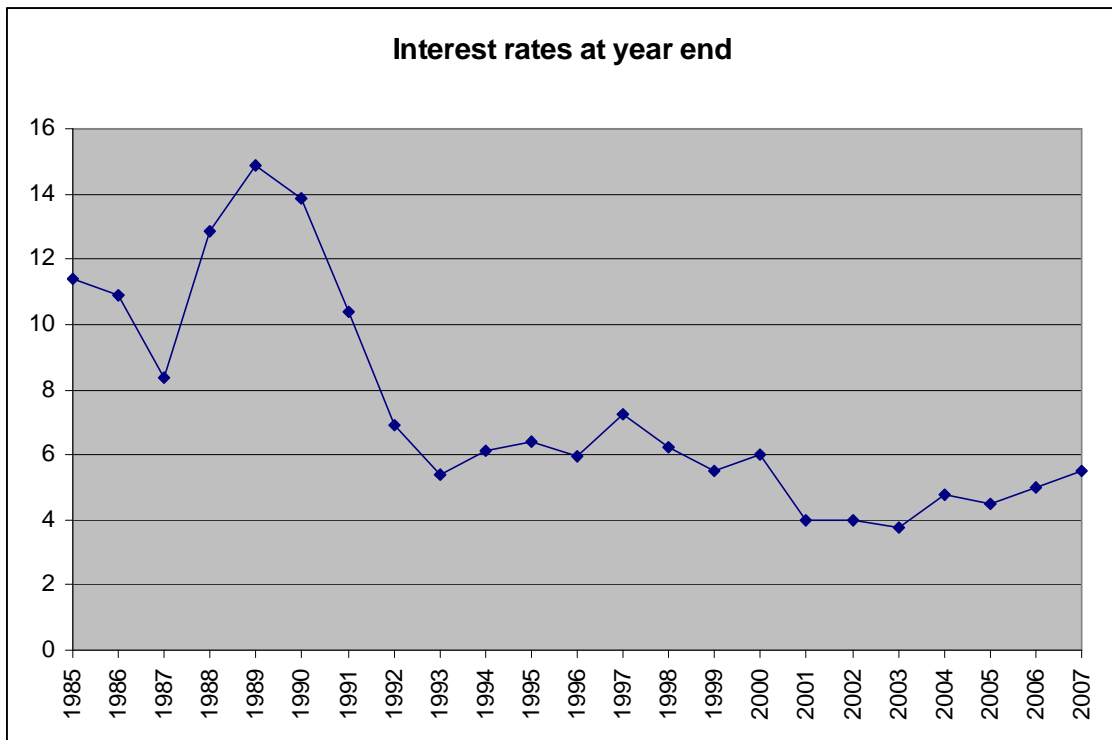


Figure C2



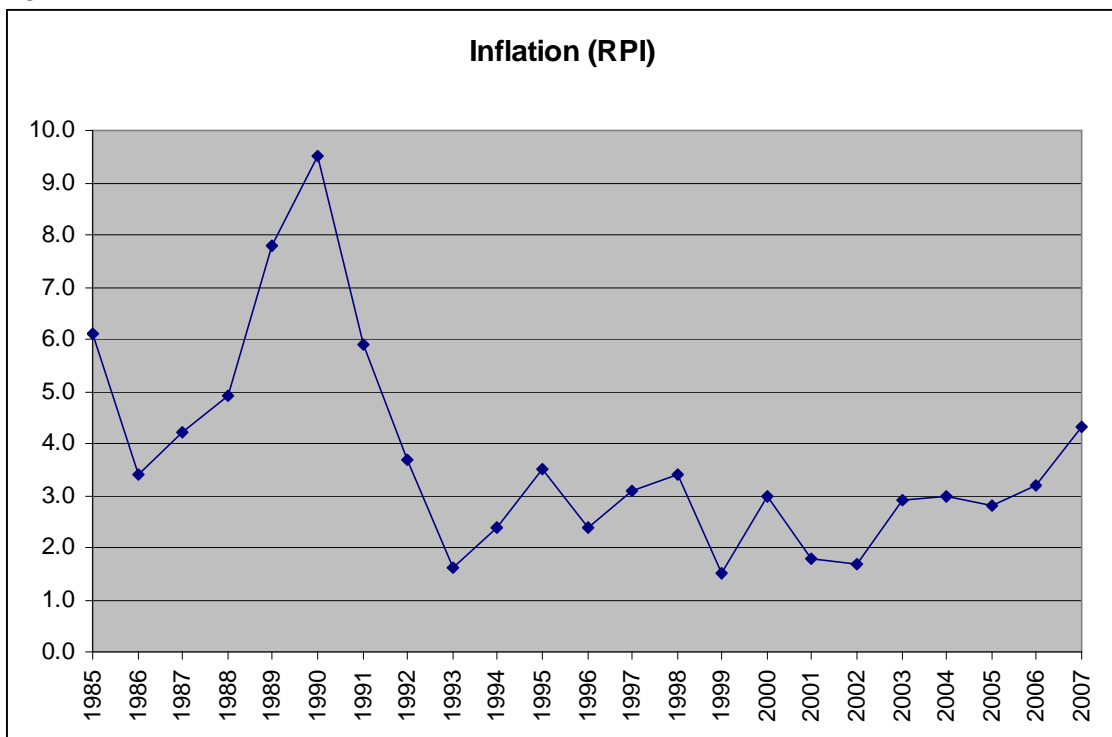
## Interest rates and inflation

Figure C3



Source: Bank of England – official rate

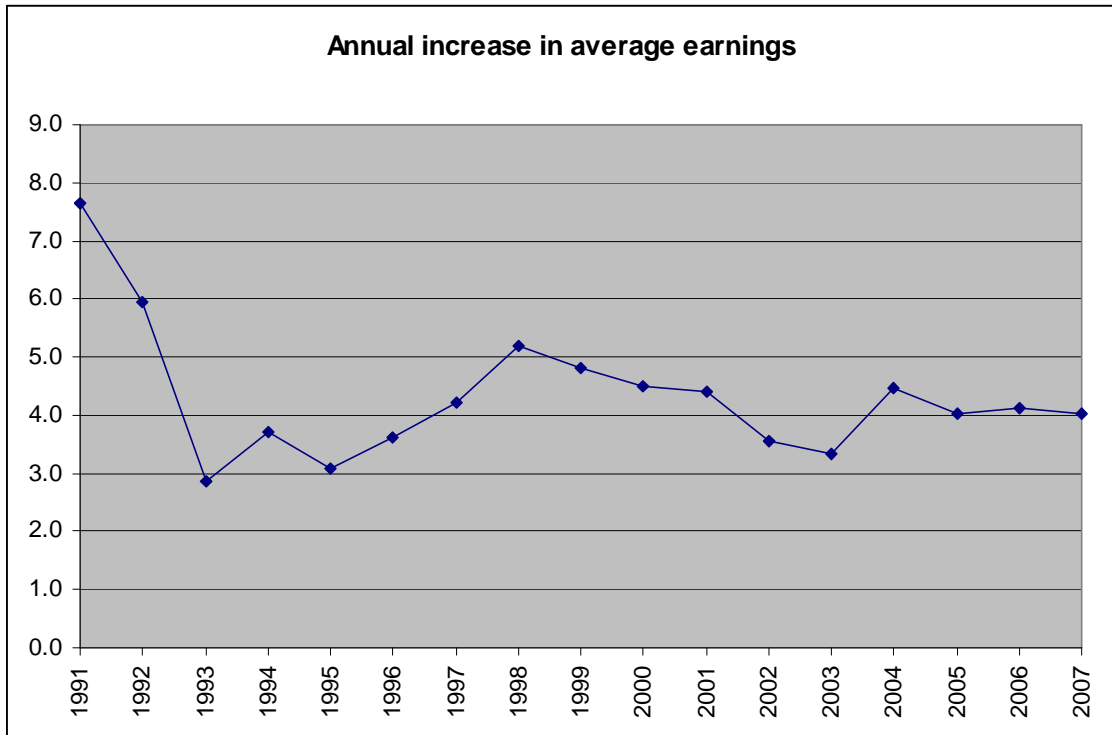
Figure C4



Source: ONS table RP04 series CZBH

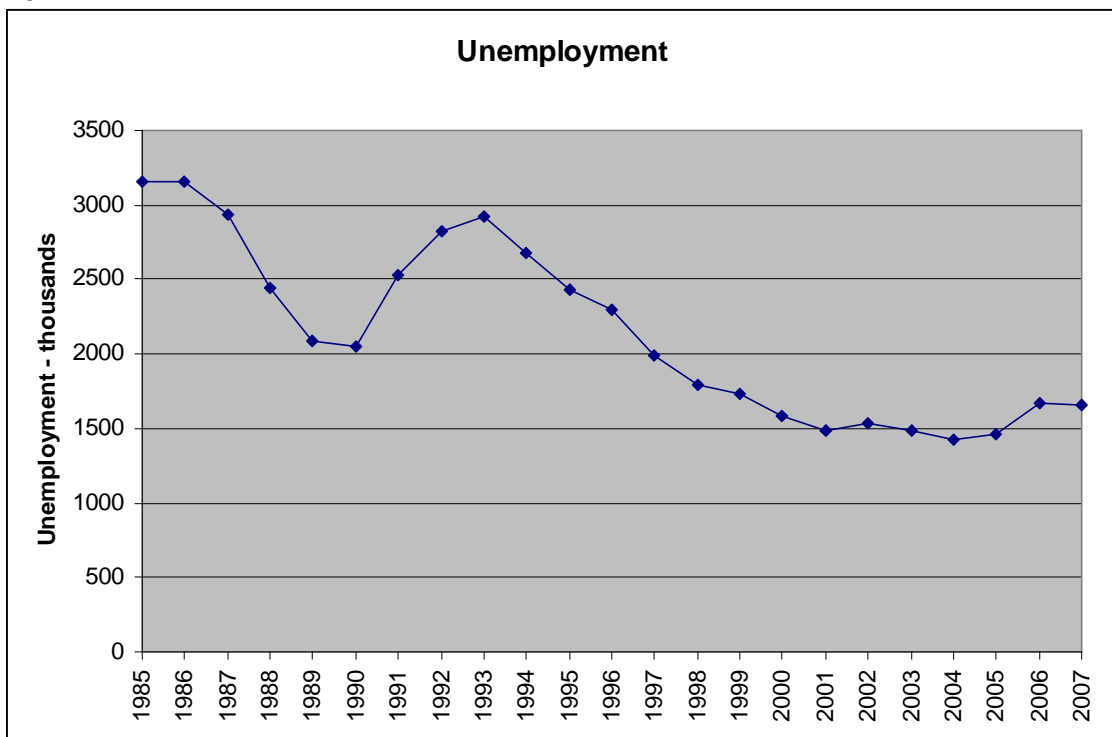
## Average earnings and unemployment

Figure C5



Source: ONS series LNMM

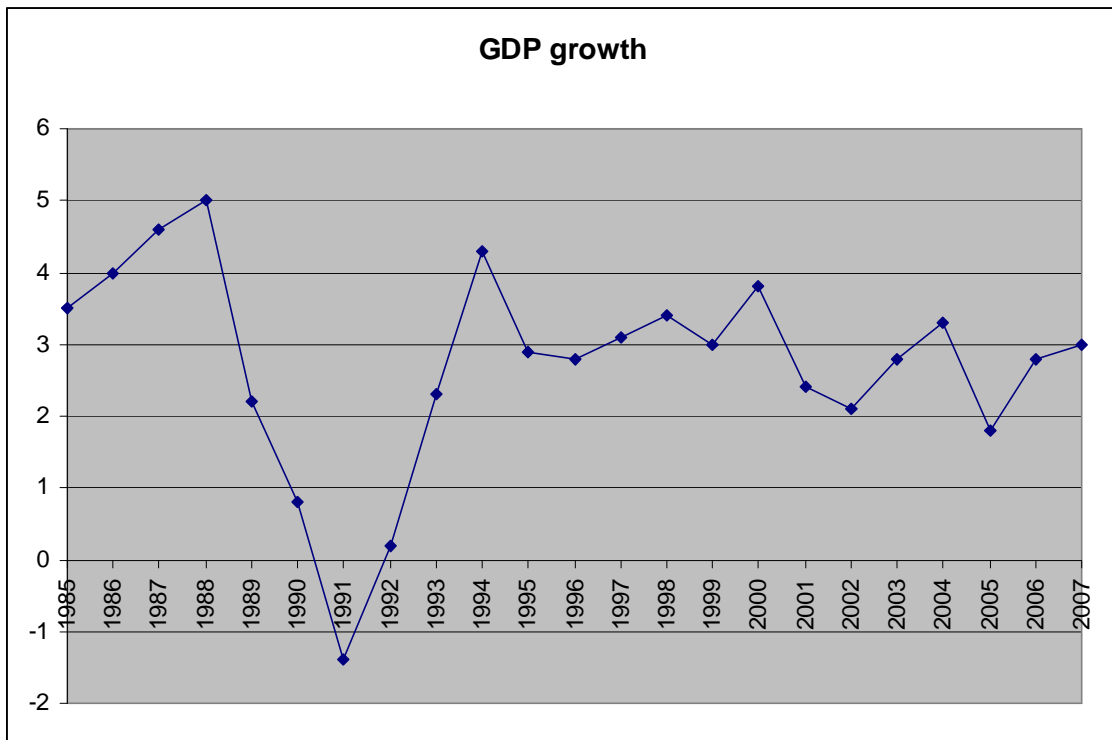
Figure C6



Source: ONS series MGSC

## Economic growth

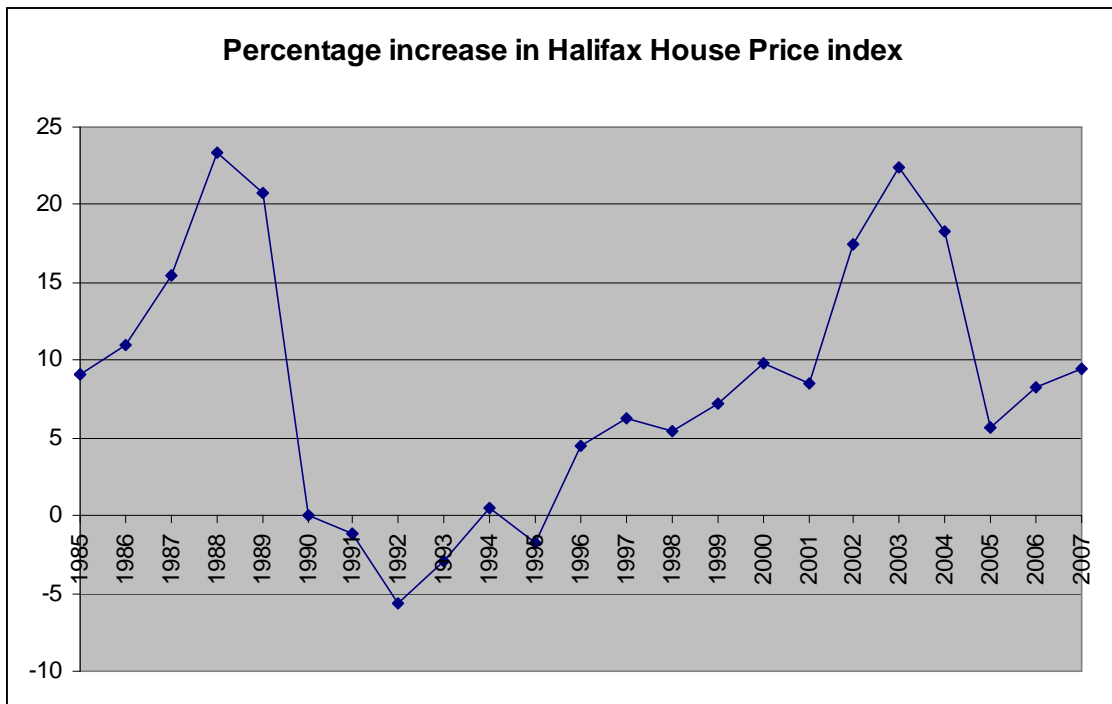
Figure C7



ONS Blue Book table 8.7 series YBEZ

## House price index

Figure C8



Source: HBOS

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