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THE FINANCIAL SERVICES ACT – CURRENT ISSUES

by

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1. **INTRODUCTION**

1.1 **Background**

"The basic question .... is whether we can continue to maintain the existing framework, merely plastering over the cracks, or whether we should undertake major structural rebuilding".

Sir David Walker announcing the 1991 SIB Retail Review? No, Professor "Jim" Gower in his 1982 interim discussion document!

In fact, it is now over 10 years since Professor Gower was commissioned to carry out a review of investor protection, a review which resulted in the Financial Services Act 1986 which eventually came into full effect in August 1988.

Gower's review was against a regulatory environment centred on the Prevention of Fraud (Investments) Act 1958, which had been created piecemeal over the years in reaction to circumstances. There was inconsistent treatment of, for example, unit trusts and unit linked endowments, there was also considerable criticism of the DTI and its lack of supervision of the "dealers in securities" which it had licensed. In short, there was a proliferation of regulations which, nevertheless, left large loopholes.

For example, there was no regulation of insurance advisers other than those registered under the Insurance Brokers (Registration) Act 1977. This act prevented unregistered advisers calling themselves "insurance brokers" but otherwise had no control over them whatsoever. Registration required a minimum financial backing to be demonstrated and imposed a code of conduct. However, the code was by no means primarily concerned with life assurance and did nothing to prevent, for example, the acceptance of overriding commissions.

The full effect of the Financial Services Act has now been felt for over 3 years. It may fairly be said to have had a significant and beneficial impact on the control of unacceptable activities in many areas of the market. Nevertheless, the fact that the opening paragraph could have been thought to refer to the Act today so far as it relates to the marketing of life assurance is indicative of the less than satisfactory outcome so far in some areas of our market.

1.2 **Structure of the Paper**

This paper does not attempt to cover comprehensively either the past history of the Financial Services Act nor all the outstanding issues. It is, rather, a series of lightly connected essays on topics which are of particular current concern to actuaries, both as actuaries and more generally as managers of life assurance operations.

It will look at what the effects of the Act's introduction have been so far on our markets, and it will try to clarify why the Act has failed so far in certain areas and make suggestions for improvement.

On both disclosure of the effect of expense and measurement of persistency, I set out in some detail the mechanics of one possible approach. I would be grateful if, at the discussion at Staple Inn, those with experience in these areas could add to the general pool of knowledge by outlining briefly their own approach.

Chapters 2 and 3 are respectively a glossary of abbreviations and jargon and a selective chronology of the development and implementation of the Act. My intention with both has been to provide a background for those lacking in either experience or memory.
The glossary also avoids the need to interrupt the flow of the subsequent chapters for explanations to the uninitiated.

In the paper I have referred to three other papers. All were presented to the Staple Inn Actuarial Society but were otherwise unpublished.

1.3 Apologia

Rarely a week has gone by since the White Paper leading up to the Act was published without some reasonably significant piece of paper or statement being released. I do not anticipate that the period between this paper going to press and the date of discussion will be any different and I can therefore only apologise for those areas of the paper which may already be out of date by the time we all sit down at Staple Inn. In particular, I have been unable to wait for the expected simultaneous SIB and LAUTRO discussion documents on product disclosure.

The opinions expressed in this paper are, of course, mine and mine alone and not necessarily those of my employer. Nevertheless, I hope that they will provide some food for thought and the foundations for sound debate both at Staple Inn and more widely thereafter. Throughout the paper, I have highlighted by posing questions those points which I think particularly lend themselves to discussion.

Finally, the cynicism is also mine and mine alone and derives, at least in part, from having overseen the expenditure of a considerable amount of valuable systems resources to implement a disclosure regime which replaced one which had been put in place less than two years previously. Moreover, one which, before it was even fully in place, I knew would have to be replaced by yet another regime within a similar timescale!

1.4 Acknowledgements

My thanks are due to Val Ansell for achieving the impossible in deciphering my handwriting and stoically processing my copious revisions. I am also grateful to those of my friends and colleagues who have made helpful comments on earlier drafts of the paper and prevented me from exposing my ignorance even more than will prove to be the case.
2. **A FINANCIAL SERVICES ACT GLOSSARY**

Unusually this glossary is not alphabetic. It also occupies a place in the main body of the paper. This is because the entries are intended to be read sequentially to give those unfamiliar with FSA a rapid introduction to the subject. Of course, Moule and Bannon (1987) did it much more thoroughly.

Practitioners may skip to the next chapter with the assurance that they are unlikely to have missed anything that they do not already know.

- **FSA** The Financial Services Act 1986 - a law (and the framework for much regulation) aimed at protecting the investor.

- **SIB** The Securities and Investment Board - the designated agency for issuing and enforcing regulations under FSA.

- **SRO** Self-Regulating Organisations - membership of which is the main way of being authorised to transact investment business.

- **Providers** Life Assurance and Unit Trust Companies.

- **LAUTRO** The Life Assurance and Unit Trust Regulatory Organisation - most providers join this SRO. LAUTRO issues rules which these companies must follow.

- **Tied Agent** Those giving financial advice but selling the products of only one Provider.

- **IFA** Independent Financial Adviser - anyone giving financial advice and arranging life assurance and unit trust products and not the representative of one company.

- **Polarisation** One of the main pillars of life assurance and unit trust marketing regulation. All those giving financial advice must be either Tied or an IFA.

- **Best Advice** Another pillar of regulation is that both types of Adviser must give "best" advice. For IFAs this means that the type of product(s) and its/their term, premium, etc must meet the client's needs. Further, they must recommend only the product from the Provider who, in their opinion, offers the "best" value.

For Tied Agents, the first half of the above definition suffices to define "best" advice. Nevertheless, long gone are the days when Universal Life was all a direct salesman ever needed.

- **Know Your Client** In order to be able to give best advice, yet another regulatory pillar requires the Adviser to have enquired fully into the client's financial circumstances, including any existing investments, income and expenditure and financial priorities. This is usually done by completing or, for existing clients, updating "Factfinds".
| **Factfind** | Several pages of fairly convoluted questions to prise from the client all that an Adviser needs to know to be able to recommend the appropriate investment product. Of course, clients do not have to answer all the questions but, if they don't, "best" advice is purely relative. |
| **Fee Based** | Most IFAs earn a commission (from the Provider of the product they arrange for their client - note that legally the IFA is the agent of the client, whereas in a tied sale the salesperson is the agent of the Provider). However, some (solicitors, and consulting actuaries are obvious examples) will either take no commission in exchange for improved rates for the client and instead make a time-spent charge or, more simply, offset any commission earned against their fee. |
| **Appointed Representative** | Like the Bank of England, exempt from the need to be authorised under FSA. Some would say that many behave like it, too, although being generally somewhat less solvent than their illustrious co-exemptee! ARs, as they are universally known, are in reality only exempt from the need for authorisation by the fact that the company whom they represent (and I shall assume that this is a Provider in what follows - although ARs of IFAs or other authorised organisations can and do exist) is fully responsible for ensuring their actions conform with all the regulations to which it is itself subject. |
| **Company Representative** | CRs are either of ARs or directly of a Provider. Whereas an AR can be, and usually is, a corporate body, CRs are always individuals, employed or self-employed, salaried or, usually, commissioned. |
| **Introducer** | CRs not allowed to give financial advice themselves, merely, as their name suggests, to introduce clients to other CRs, ARs, IFAs or Providers. |
| **Direct Authorisation** | Rather than join an SRO, Providers, IFAs and others can choose to be directly authorised by SIB. In particular, several large IFAs chose this route, probably to steer clear of the possible taint of association with the inevitable scandal at FIMBRA. With hindsight, they chose correctly (Barlow Clowes, Dunsdale, Levitt, FIMBRA's precarious financial position, etc). However, who knows whether FIMBRA might not have been a stronger and wiser body if this route (and the RPB route) had not been permitted. |
| **FIMBRA** | The Financial Intermediaries, Managers and Brokers Regulatory Association - the SRO for IFAs. Several times FIMBRA has had to be assisted financially by Life Offices, most recently as it was in danger of not being able to meet all its liabilities under the ICS. |
| **IMAG** | Independent Marketing Assistance Group. A voluntary association originally set up to assist smaller IFAs to survive the implementation of FSA. Later to act as a convenient |
vehicle by which Providers could give FIMBRA financial support.

**RPB**  
Recognised Professional Body. Individuals and firms may be regulated by their professions (yet another route to authorisation under FSA). Includes actuaries, solicitors, accountants and insurance brokers.

**IBRC**  
The Insurance Brokers Registration Council - the RPB for insurance brokers. Those regulated by this route must do no more than 49% of their business in the life assurance market, being mainly general insurance brokerages.

**ICS**  
Investors’ Compensation Scheme - the final part of FSA to be put in place, it will recompense private investors up to £48,000 in the event of financial loss as a result of the negligence or criminal activities of authorised persons. There is no limit on the total number of individuals who may be compensated as a result of the actions of one authorised person. The first few million pounds of compensation (e.g. in FIMBRA’s case £19m) is met from the SRO of the authorised person with, if necessary, any excess coming from all the other SROs collectively.

Businesses regulated via RPBs are not party to the ICS although the professions have their own schemes and the Professional Indemnity Cover of individual firms also play a part.

**LOA**  
The Life Offices Association - the former trade association of the life industry. The life arm of the former BIA which became the ABI. For many years its commission scales were respected but gradually breakaway offices paying higher rates led to the scale’s demise.

**ASLO**  
Association of Scottish Life Offices - the Gaelic for LOA.

**ABI**  
Association of British Insurers - the Life Insurance Council of which now carries out the old LOA/ASLO role with the exception of commission control.

**ROLAC**  
Registry Of Life Assurance Commissions. A pre-FSA attempt to stem the increase in commissions in the market. Doomed to failure without regulatory backing, its proposed commissions scales nevertheless became the basis for the LAUTRO MCA.

**MCA**  
Maximum Commissions Agreement. Commission payable to IFAs post 1.7.88 which exceeded the MCA scales had to be disclosed in full monetary terms. Commissions at or under the MCA level merely had to be acknowledged as such. Brainchild of MIBOC.

**MIB(OC)**  
Marketing of Investments Board (Organising Committee) - MIB was originally envisaged as one of two bodies to regulate investor protection, SIB being the other. It only got as far as MIBOC before being merged with SIB, thank goodness.
Product Particulars

Information given by a Provider, his agent or an IFA, which sets out the main benefits, obligations and risks of the product purchased. LAUTRO rules originally required them to be given both at the point of sale (this was usually done by handing out a brochure and a product illustration, the latter including the required projection of the first five years surrender values) and accompanying the cancellation notice. See Chapter 5 for subsequent developments.

Cancellation Notice

Document required to be posted to the investor which gives him a number of days, usually 14, to change his mind. Effectively replaced, with a few very minor exceptions, the old Statutory Notice under the Insurance Companies Regulations 1981.

A tear-off slip is provided for those wishing to cancel. However, it is not unknown for those returning this slip to do so because they mistakenly thought it was a necessary step to put the policy in force! Note to Regulators - most "investors" are not sophisticated - or even particularly literate.

RIY

Reduction in Yield - the effect of charges (on unit-linked business) or expenses (on with-profits business) expressed as a percentage point reduction in the investment return. Now appears in product particulars. See Chapter 5 for (much) more.

TPN3

Temporary Practice Note issued by the Institute and Faculty of Actuaries. Sets out guidance as to how Appointed Actuaries should carry out the attribution of expenses to with-profits business when their advice is sought.

The expenses so determined would be for use in RIY calculations (see Chapter 6).

CAMIFA

Campaign for Independent Financial Advice. A grouping of offices who undertook not to recruit tied agents. It gradually broke apart as, one by one, the big building societies decided to abandon independent advice (having found that most of their customers were not bothered about what type of advice they got).

IFAP

A wider grouping of offices, mostly active in both the tied and independent market who contribute to a central fund to publicise independent advice (P = Promotions).

IMRO, AFBD and TSA

The other three original SROs, covering fund managers, futures dealers and stockbrokers respectively. The latter two subsequently merged to form the Securities and Futures Authority (SFA).

OFT

Office of Fair Trading - personified by its high-profile Director-General, Sir Gordon Borrie, the office has wide powers including a statutory role to advise the Secretary of State for Trade and Industry whether or not it considers
<table>
<thead>
<tr>
<th>The pink papers</th>
<th>SIB or SRO rules to be anti-competitive. The Secretary of State must in turn take account of the OFT’s advice when approving rulebooks.</th>
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<tbody>
<tr>
<td></td>
<td>&quot;Money Marketing&quot;, &quot;Financial Adviser&quot; and &quot;Money Week&quot; (which is white!). Weekly &quot;tabloid&quot; newspapers for insurance intermediaries providing detailed news and comment on the market.</td>
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### A FINANCIAL SERVICES ACT CHRONOLOGY

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Event</th>
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<tbody>
<tr>
<td>1981</td>
<td>July</td>
<td>Gower commissioned to review investor protection</td>
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<tr>
<td>1982</td>
<td>January</td>
<td>Gower published discussion document</td>
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<tr>
<td>1983</td>
<td>January</td>
<td>LOA/ASLO commission agreement breaks down</td>
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<td></td>
<td>September</td>
<td>ROLAC launched</td>
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<td>1984</td>
<td>January</td>
<td>Gower publishes main part of his report, concluding that there should be comprehensive new legislation</td>
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<td></td>
<td>July</td>
<td>House of Commons debates Gower report, general consensus in favour of subject to main regulator being self-standing and not the DTI.</td>
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<td>1985</td>
<td>January</td>
<td>Financial Services white paper published</td>
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<td></td>
<td>March</td>
<td>Sir Kenneth Berrill named Chairman of the proposed main new regulatory body. Gower publishes the second part of his report, a description of the White Paper proposals. He wants only SIB and not MIB and is disappointed at the rejection of statutory control of commission.</td>
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<td>1986</td>
<td>November</td>
<td>Royal Assent</td>
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<td>1987</td>
<td>May</td>
<td>Peat Marwick commissioned by SIB to review expense disclosure</td>
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<td></td>
<td>August</td>
<td>Draft LAUTRO rulebook released</td>
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<td></td>
<td>December</td>
<td>'P-day' (26th). All applications for authorisation should have been submitted.</td>
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<td>1988</td>
<td>April</td>
<td>OFT report on LAUTRO rules rejects concept of MCA</td>
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<td>'A-day' (29th) - FSA comes into force</td>
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<td>Polarisation relaxed to permit tied banks to write execution only unit trust business of other LAUTRO members</td>
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<td></td>
<td>May</td>
<td>Peat Marwick report that consumers would prefer cash disclosure of expenses, but recommends RIY nevertheless</td>
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<td>Barlow Clowes collapses</td>
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<td>June</td>
<td>David Walker replaces Kenneth Berrill at SIB amidst rumours of Government dissatisfaction at the intricate web of regulation SIB had created.</td>
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<td></td>
<td>July</td>
<td>Cancellation and Illustration rules take force (1st)</td>
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<td></td>
<td>August</td>
<td>ICS comes into force (27th)</td>
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<tr>
<td></td>
<td>December</td>
<td>SIB publishes &quot;Life Assurance and Unit Trust Disclosure - the regime for 1990&quot; - its recommendations were fairly similar to those finally put in place 19 months later, with the exception that</td>
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expenses were to be disclosed as a percentage of premium (despite Peat's report) and, for with profits, was initially to be on industry standard bases.

1989 May
MCA partially withdrawn. Commission exceeding MCA to be disclosed as percentage of premium with cancellation notice.

SIB Consultative Paper No. 23 - revised the December proposals by introducing the Buyers Guide concept, permitting disclosure of expenses in the form of a table of specimen values and returning to RIY.

June
CAMIFA folds and IFAP set up

July
CII launch Financial Planning Certificate as an attempt to achieve a recognised qualification for both tied and independent advisers

August
SIB Consultative Paper No. 27 - with profits expenses now to start on office specific basis but not until April 1990. Unit-linked disclosure also not now needed until then. With-profits disclosure to be agreed by Appointed Actuary and later contrasted with actual in With Profits Guide. First draft of With Profits Guide requirements very similar to final version. The main exception being the requirement, eventually dropped (why?) to disclose proportion of sample payouts represented by terminal bonus.

November
FIMBRA compulsory Personal Indemnity insurance scheme fails to be accepted by membership. Lord Elton subsequently resigns as chairman and (1991) the intended underwriters threaten legal action to recover costs of £2m.

SIB Consultative Paper No. 30 - "Life Assurance and Unit Trust Disclosure - Outstanding Matters". Dealt mainly with differential pricing. Would permit this both within the tied agent sector and between that sector and IFAs. Disclosure of expenses would have to take this into account as would illustrations (see 8.4). The date for final implementation of the new disclosure regime was put back to 1st July 1991.

1990 January
MCA ceases. All commission now disclosed.

Buyers Guides begin to be used.

March
Institute and Faculty of Actuaries publishes TPN3.

Tied agent Garston Amherst goes down owing £20m in client monies it should never have had.

April
Second OFT report finds disclosure still unacceptable.

SIB's "10 Principles" come into force (30th April), the first stage of David Walker's intended simplification.

May
DTI supports OFT view.

SIB Consultative Paper No. 40 - Oonagh McDonald's report "Training and Competence in the Financial Services Industry" which recommended that SIB agree standards of competence with
the SRO's and RPB's. Achievement of these standards should be
tested for new entrants but existing practitioners could be exempt
('grandfathering'). Testing could be by an external body (e.g. CII)
or via accredited in-house arrangements.

June
DTI writes to regulators, ABI etc with some rather odd ideas
about expense disclosure that seem to ignore both Borrie and all
SIB's previous deliberations.

July
Effect of charges and expenses disclosed as reduction in yield with
cancellation notice.

August
(31st) Final date for publication of With-Profits Guides.
SIB sets up its "quality of information" working group.

September
DTI supports OFT view on disclosure and requests SIB to
undertake a review within 18 months.

November
LAUTRO announces changes to standard illustration expense
assumptions (more realistic, although larger offices would prefer a
mean rather than a median level). Also suggest no more "actual
charges" projections in magazines for unit-linked business,
subsequently dropped after finding little support either amongst
life assurers (how else do we find out how our competitors are
pricing?) or journalists.

1991
January
David Walker knighted in New Year's honours.

April
SIB publishes the scope of its "Retail Review", requesting view on,
amongst other things, multi-ties.

AFBD merger with TSA.

September
(1st) LAUTRO members required to ensure that ARs and CRs do
not indulge in unauthorised investment business. The rule will not
be breached, however, if the member can demonstrate that it
reasonably attempted to ensure compliance.

SIB pronounces against multi-ties in a discussion paper on
polarisation and other issues (see Chapter 10).

Natwest announces that it, the last IFA bank, is to tie to its own yet
to be founded subsidiary in 1993.

October
Sir Kenneth Clucas commissioned by SIB to produce a report on
regulatory boundaries.

SIB and LAUTRO expected to produce simultaneous discussion
paper on expense disclosure.

December
(6th) Final opportunity to comment on proposal papers.

1992
1st Quarter
Proposals and draft regulations expected from SIB.
4. SINS OF COMMISSION

4.1 Disclosure of IFA Commission

Gower, writing after the collapse of the LOA/ASLO commissions agreement and at the
time when breakaway offices were beginning to introduce overriding commission for
volume, thought that there was no alternative to some statutory control of commission
scales both for IFAs and Tied Agents.

Of disclosure, he perceptively wrote "what the client really needs to know is not the
amount of commission payable on the policy sold, but that payable in respect of every
policy that the salesman is entitled to sell".

Even more perceptively, he wrote "the objections (to commission control) on anti-
competitive grounds seems .... misconceived .... it can never be to the advantage of the
public to permit insurance companies to compete with one another .... by escalating
their commission rates".

Shortly after the FSA was implemented, some of Gower's worst dreams rapidly came
true. Sir Gordon Borrie's OFT objected to the MCA on anti-competitive grounds. It
was removed and replaced by commission disclosure at such a stage and in such a form
as to ensure that few policyholders understood its implications and even fewer were
realistically able to do anything about it.

The result was that commission rates to IFAs rose, on average by perhaps 30% but with
instances of much higher rates. Offices initially tried to make the higher rates
conditional on volume but the larger IFAs recognised their position of strength and
were able to obtain the higher rates without significantly compromising best advice.

The rates were, however, really only rising towards the levels which had been agreed
with and paid to Appointed Representatives since A-day.

Commission disclosure is now very much in the melting pot again, as the OFT also
objected to the regime introduced in 1990. Amongst the aspects that could be debated
are:

- should it be at the point of sale?
- if so, just for the product being recommended or also for alternatives?
- should it be mandatory for IFAs only or also for Tied Agents?
- should it be as a percentage of premium, in cash or some other way?

Gower also said that disclosure (and he meant in cash terms) would "probably lead to
far fewer sales of life assurance since a client would often be shocked to find how much
the salesman would earn on the one sale to him - not realising that that may have
followed many abortive and unrewarded attempts to sell to others". He might have
added that this could have led to individuals negotiating levels down. This would lead,
no doubt, to much reduced earnings and the survival of only the fittest. The tied market
would benefit unless the commission disclosure playing fields were levelled.

4.2 Why Disclosure?

Commission disclosure for IFAs in whatever form is perceived to meet several needs.
Firstly it satisfies the right of the individual to know what his agent, the IFA, is going to
earn from the transaction. However, one could argue that it is not necessary to thrust this information down clients' throats. FSA brought with it the requirement for an IFA to disclose commission if asked and the Buyers Guide informs the client of his right to ask.

The second need is to ensure competition between advisers; the public "shopping around" to find the best deal (in terms of the lowest commission rate and hence best rate for a given product).

A third need, at least as far as the regulators are concerned, is to ensure that an IFA is not influenced by commission rates in making his recommendations. Presumably this temptation could manifest itself either in the form of recommending, for example, a whole life policy when a term assurance would suffice or in the form of recommending the products of one company over another in the face of generally accepted best advice.

Imagine the following dialogue:

"Well, Mr Smith", says James of James & Co. "We have agreed that you need £100,000 life cover. On a five year renewable term assurance this would cost you £15 per month increasing every five years from ABC Life, which has the lowest rate. ABC Life will pay me £45. On a level term assurance for 20 years, for which DEF Life is the cheapest at £25 per month, I would earn £60. However, I recommend a whole life policy for the following reasons .... You could get such a policy from GHI Life for £X per month, in which case I would earn £90 but I recommend JKL Life because .... even though the policy costs £X+Y pounds per month and I will get £100. I could have recommended MNO Life's product then I would have earned £120, however the premium to you would be £X+Y+Z per month".

"Thank you, Mr James" replies the client "but Williams & Co down the road have already said that they can get me a JKL Life policy for £X-Y per month by only taking £50 commission themselves. I will place the business with you if you can get the policy for £X-Y-Z pounds by only taking commission of £25".

While this dialogue may well be what the regulators would want to see happening, the sheer cost of logistical difficulties of putting together all the above information would tend to render it totally impractical. And no mention was made of renewal commission.

In any case, the British public has not been brought up to haggle. It prefers to buy from the Marks & Spencers of this world who can be trusted to deliver quality goods at a reasonable price. It relies on the authorities, supported by investigative journalism, to ensure that it is protected from the unscrupulous.

In my opinion, the regulators are tilting at windmills if they seriously expect the British public to carry out much self policing of this or any other area.

I would suggest that the three needs outlined earlier can best be met by, respectively,

- encouraging a greater public awareness of the right to quiz an IFA about his commission
- continued efforts by consumer organisations and the financial press to encourage prospective investors who possess the bazaar mentality to shop around and make deals
- a reliance on retrospective inspection by the regulator to ensure that best advice has not been swayed by commission levels.
Do you agree? And would you also agree that it makes sense to continue to disclose the levels of commission paid to IFAs with the product particulars (which usually accompany the cancellation notice), if only to ensure that those who do successfully negotiate lower commission levels have indeed received the contingent benefit thereof.

This would also serve to confirm to the clients of IFAs operating on a fee basis that no commission has, mistakenly or otherwise, been paid.

4.3 **Tied Agents**

Should there also be disclosure of commission for tied agents?

Of the reasons advanced for IFA disclosure, certainly the "right to know" and the company bias issues do not apply in the tied case. However, the competitive and product bias reasons do still apply, so it could be argued that there are grounds for disclosure.

Life offices claim that as tied agents are remunerated in many ways - salary, cars, exotic holidays, etc - as well as commission, it is not possible to relate the remuneration to any particular sale. I suspect, however, that it could be done if it had to be, by spreading the estimated value of the indirect benefits over the direct benefits.

However, it may not be necessary as both of the remaining reasons for disclosure would in fact be satisfied by disclosing only the direct elements of remuneration. In other words, those elements which the agent is able to influence by the type and size of product sold or to give up to improve the benefits for the purchaser.

So for tied agents, too, a threelfold regime could also be proposed.

- the right to ask an agent how he is remunerated and the amount of any direct benefit from the particular sale
- encouragement of the public to negotiate improved terms
- continued monitoring of advice given to ensure absence of product bias.

But it is not going too far to introduce a right for a third party to know how much an employer pays his employee (IFAs would not think so in this context)?

Moreover, would not status and total cost disclosure be as effective, with any bargain hunters negotiating on total cost, rather than remuneration foregone?

4.4 **Up at the Front**

We need look no further for evidence of the turmoil in the market place than to letters that have been appearing in the pink papers lately from IFAs actually asking for less commission up front.

Their request, for a return to commission as a percentage of each premium paid, is not because they are so flush with cash that they don't know what to do with it. Rather, it is because of a belief, true in my opinion, that indemnity commission was at the root of many of the more or less well publicised collapses of intermediaries, both independent and tied in the last few years.

FSA encouraged the bidding up of commission rates. First, in order to tie appointed representatives. Then, after the MCA ended, to keep IFA business. It's amazing how
legislative change concentrates the corporate mind on an issue, particularly in a market oversupplied with cash-rich providers all chasing the holy Grail of secured distribution. Polarisation also encouraged the granting of "golden hellos" to agents prepared to tie.

Unfortunately, FSA came towards the end of a boom period for the life insurance industry, which had been fuelled by a number of developments over the past few years, including:

1) The seemingly never ending growth in house prices.

2) The movement from repayment mortgages to endowment mortgages, fuelled by the building societies’ thirst for commission.

3) The personal pensions market.

Rose-tinted spectacles at intermediaries and life offices alike caused a failure to recognise that the end was nigh. Warning signs such as the ridiculous multiples of earnings to which house prices had climbed and the fact that saturation levels would soon be reached for both "switch" mortgage endowment business and the new personal pensions were ignored. Golden hellos were advanced, often without security, on the basis of new business growth continuing at levels experienced in the recent past.

This would not have been so bad in itself, had many of those new tied agents not believed their own figures and over-committed themselves in the expectation of being able to service the loan from new business production.

Then came the recession. Suddenly proposal flow was down, not up. Lapses and surrenders were up too, as interest rate hikes led to the need to economise and jobs began to go (particularly impacting the PPP market). Net income declined even further because of the gearing effect of commission clawback, salesmen got desperate, the quality of business fell and lapse rates got even worse - a vicious cycle.

With new business down and clawbacks up, it suddenly got difficult for the profligate tied agent to pay the rent on his new offices. Then the Life Office began to ask for repayment of that part of its development loan not now supported from production levels.

The temptation to use client money, whether legally controlled or not, then proved too much for a few. Sometimes this was done with the all too often dashed hope that it could be repaid without the clients ever being aware of its clandestine use. Then came the downfall and the client losses.

Mostly, though, the only losers were the intermediary himself, possibly his family if he has staked his house as well, and the life office who often stood little chance of recovering its loans or unearned commission.

4.5 Confession and Absolution

However, just as it is not money itself but rather the love of money that is the proverbial root of all evil, so it is the mishandling of indemnity commission that is the problem rather than indemnity commission itself. Sensible management of indemnity commission by agents, with proper reserves being kept against future clawbacks, and expenditure being kept within reasonable limits and based on conservative new business projections, would have avoided many of the problems experienced.
Recent LAUTRO rules require Appointed Representatives to maintain adequate records so that Life Offices may keep themselves appraised of the AR's financial position. This may improve matters, although see 10.1(c) for some doubts about this.

So it could be argued that indemnity commission should continue as the main form of remuneration of both IFA's and Tied Agents. After all a commission structure which pays a larger amount upfront, accompanied by smaller subsequent payments, could be said to be the 'right' shape of commission as it compensates the agent for the work that he does at the time that he does it.

Any further adverse publicity on the subject may, however, be the last straw that breaks the patience of our regulators or legislators. For example, the amount of commission payable in the first year could be limited to 25% of the annual premium. Is this likely?

Might lending to support new entrants to the financial advisory market then revert to the banks where it more properly belongs? Would this not actually be a welcome relief for the industry?
5. PRODUCT DISCLOSURE

5.1 Why?

The OFT and the consumer lobby would argue that the public have a right to know how the policies that they are buying will operate. In particular, they should be aware of how much of their premium or investment return is being deducted to meet the Life Office's expenses. This will enable them to compare the merits of competing suppliers and compare the merits of different investment media both within the ambit of the FSA and more widely (e.g. deposit accounts).

Regrettably, as with commission, very few potential purchasers will in practice take the effort to shop around and compare technical details. Most people buy their insurance either from an IFA or direct salesman whom they trust, either as an individual or because he represents a company with a well known name, or as a virtually compulsory adjunct to a mortgage.

Perhaps the most that we can hope is that, given a little prompting, a reasonable proportion of prospective purchasers should be able to understand something about the investment they are about to make, particularly about its downside potential with regard to both market fluctuations and front end costs.

5.2 What and when?

FSA originally required written "product particulars" to be given to proposers both at the point of sale and again, on the guilty until proved innocent approach, with the cancellation notice. In 1990, this changed to a requirement that salesmen ensure that their client is informed of and understands the salient points of the contract being sold, reinforced by full written particulars no later than the delivery of the cancellation notice.

In theory, the current regime requires salesmen to give such warnings as "... down as well as up ...", "... business not guaranteed ...", "... on early surrender may not get back ..." - which adequately warn of the downside risk. The OFT is not satisfied. Its faith that agents will deliver verbal warnings is virtually non-existent and it wants to see written product particulars handed over at the point of sale.

However, the problem with the current product particulars is that the majority of people never read them due to their length and turgid style, whether delivered at the point of sale or not.

LAUTRO are known to be considering a three tier approach consisting of:

1. "Key" information (one or two sides of "clearly expressed" product description) with a "signpost" to,

2. "Important" information, mainly similar to the current product particulars but slightly simplified, again with a signpost as to how to obtain, if required,

3. "Useful" information - with profits guides, details of all unit linked funds available to switch into, etc.

Key information must be delivered prior to the signing of a proposal form. Whilst it could be presented in isolation, it is likely to form part of the product brochure often used as part of the sales process.
"Important" information can be delivered at any time between the delivery of the key information and the sending of the cancellation notice. Offices are likely either to choose to deliver it all with the cancellation notice as now, or to deliver as much as possible at the point of sale (e.g. in the brochure) with only those elements which relate specifically to the product sold (e.g. term, premium, etc) accompanying the cancellation notice.

As a consumer, I would prefer the latter approach, as I would have any information that I needed to make my choice prior to doing so. Further, I would receive only a small package with my cancellation notice which I might be sufficiently motivated to read and maybe comprehend, something unlikely to occur with the current package.

The ever-suspicious OFT might still doubt, as in their hearts might some Life Office Managers, that the brochure and verbal warnings would be delivered by their agents every time despite instruction to the contrary - and so want the "important" information additionally to be sent directly from the provider to the consumer.

Which view do you take? And do you support the LAUTRO proposals in general?

5.3 Expense Disclosure

The proposed "key" information will include disclosure of the effect of expenses and of the surrender values available at the end of each of the first 5 years. This would be in the form of specimen tables and is merely bringing forward to the point of sale information already provided in product particulars.

Those drafting the new practices may also be tempted to require that the "important" information confirms both these values for the specific product purchased. Given that the purpose of these disclosures is as an aid to choice-making before a sale is completed, the value of later confirmation is fairly limited (the mistrust argument again). The number of purchasers who would ever bother to compare actual values with those that they were expecting, having studied the specimen tables, will be fairly minimal, I should think.

Is there, therefore, really a need for reiteration?

5.4 The "Effect" of Charges and Expenses

The far from transparent way in which Life Offices recover their expenses from both unit linked business (e.g. capital units) and, particularly, with profits business means that it is rarely possible for consumers, or indeed professional advisers, to make the comparisons that they should.

Comparing projected surrender values with premiums paid (making suitable allowance for the cost of life cover) for the first five years is one way of demonstrating the "effect" of the charges or expenses on the policy in the short term. Their impact over the long term is less obvious and can only be reasonably compared by condensation to one number.

My own view is that disclosure in these two forms is sufficient for both the professional adviser and the vast majority of those consumers who would wish to make comparisons. All that is required is to make this information available earlier, as outlined in 5.2, and, if possible, to present it in the form more easily comprehended (see 5.6 for a suggestion).
RIY was the vehicle eventually chosen by SIB for the disclosure of the long term effect of expenses, with profits products being included by relying upon the Appointed Actuary's assessment and allocation of the costs attributable to that business. Chapter 6 considers this process in more detail.

Experience has revealed certain inconsistencies in the LAUTRO rules for calculating RIY that make comparisons between different products unreliable especially between unit linked and with profits. One problem is that the fund-related management charge (e.g. 0.75% per annum) grows in line with the underlying investment return (e.g. 7% per annum) whereas other monthly charges on unit linked business or general administration expenses on with profits business are specifically excluded from the need to increase in line with inflation. As the unit linked management charge often is intended to meet some or all of the ongoing administration expenses as well, this clearly puts the unit-linked policy at a disadvantage.

The obvious solution would be to allow for inflation in all charges. However, the unique structure of with-profits business allows smaller numbers of older, low premium policies to have their costs subsidised by more recent business in substantial volumes. It may therefore not be correct to take full account of inflation.

Another problem relates to shareholders' profits in proprietary companies. Unit-linked business effectively includes them as they are expected to emerge from the expense loadings, but they escape mention for with-profits business. Should they be out in both cases or - as the mutuals would no doubt wish - in?

Finally, some strange results can emerge when developing new unit-linked contracts. Two charging structures which are identical under normal profit-test assumptions can have surprisingly different RIYs. This is due to the higher interest rates and the lapse assumptions used in the former process. Will this lead to RIY driving the pattern of charges, I wonder?

5.5 Alternatives to RIY

The Consumer Lobby also claims, not without some justification, that the typical purchaser does not understand the concept of RIY. Easier to understand concepts, such as percentage of premium or reduction in projected maturity value, have therefore been mooted as alternatives.

Unfortunately, both of the alternatives tend to lead to values which would look unreasonably large in the eyes of the average purchaser.

Of course, these approaches would also show the expenses associated with, say, a building society share account in an unfavourable light, assuming that the charge was taken as the difference between the building society's earnings, after costs, from their mortgage portfolio and other investments and the gross rate of interest payable on such accounts. The impact of the charge generally would become more significant as the time for which the money was assumed to remain in the account lengthened.

Whatever methods are finally adopted, we must avoid ones which portray life assurance as being unduly expensive if held for the full term. However, neither should we hide from the public the fact that life assurance can prove to have been an expensive investment if terminated early.

An approach that would no doubt satisfy even the most ardent consumerist would be to disclose expenses, particularly those of acquisition, as a cash amount. They would no doubt argue that the prospect of some intending purchasers being dissuaded as a result would encourage the industry to reduce the cost of acquisition and serve to drive the
less efficient providers from the marketplace - both debatably of benefit to the public although not to the industry.

One way of making these disclosures would be to tabulate the expenses expected to be incurred in each year in a similar format to that currently used for the disclosure of IFA commission. For example:

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenses (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>400</td>
</tr>
<tr>
<td>2-3</td>
<td>200</td>
</tr>
<tr>
<td>4-25</td>
<td>20</td>
</tr>
</tbody>
</table>

Expenses of 1% of the accrued fund would also be incurred.

Expenses are expressed in "today's" money and in practice may be higher as a result of inflation.

Charges not immediately falling into either cash amounts or fund percentages can easily be made to do so by the application of the same actuarial wizardry as is currently used in RIY calculations.

This information would be given for a specimen policy at the point of sale and would be accompanied by a reduction in yield figure. The RIY would still be necessary to facilitate a comparison of the expense structure.

I have no doubt that this explicit form of disclosure would be of greater service to a larger number of prospective purchasers than any of the other methods mentioned above. However, I am also certain that our industry would not be able to espouse such openness unless its introduction could be harmonised with similar disclosures (especially of early termination penalties) for other investment products. After all, are we not at one with the consumer movement in attempting to dissuade short term investors from taking on long term commitments?

5.6 RIY Revisited

There has been much comment in the financial press that reduction in yield is not understood by consumers. Judging by the quality of some of the criticism, it is not understood by all of the financial press either! So, if it is to remain, how can it be rendered more "user friendly"?

In this context, it is interesting to examine the precedent set by the Consumer Credit Act. This introduced the concept of APR (Annual Percentage Rate) under which all the different charges relating to borrowing are contracted down to one single figure. Whilst few borrowers understand how APR is calculated, many more of those who wish to compare the cost of different sources of, say, mortgage or credit card finance, are aware that the APR is the figure to use for this purpose.

I would therefore like to suggest that reduction in yield is renamed APC - Annual (or Average) Percentage Charge. This, I think, will bring home to many more consumers the fact that it is a device for consolidating and spreading all types of charges into one single figure across the whole policy term.

If this figure were to feature prominently in point of sale disclosure material and in direct marketing advertisements, just as APR does in similar material in the lending arena, I believe that the public could begin to accept this measure in due course.
Commission can also be disclosed in this format, enabling it to be in the 'same currency' as expense disclosure for comparison. This is one of the OFT's demands (see 5.7).

A great aid to the acceptance of APC would be if it could be introduced not just across all products regulated by the Financial Services Act, but also across bank accounts, National Savings Certificates and other competing media. For media with no fixed investment term, specimen values would have to be given for an assortment of terms, for example 1, 2, 5, 10 and 25 years.

I hope that the DTI will take note.

Is there any support for this idea? And can anyone suggest a succinct definition of APC which the public will understand?

5.7 An OFT Held View

It is perhaps worth ending this chapter with a summary of the OFT's list of "requirements": Then at least the SIB/LAUTRO proposals can be examined against them to see if they satisfy Sir Gordon or not.

1) IFA commission and expense disclosure to be in the same "currency" to facilitate comparison.

2) Expense disclosure to be at the point of sale.

3) Commission disclosure to be at the point of sale and to be volunteered by the IFA.

4) Percentage of premium commission disclosure is insufficient to keep commission levels down or to encourage rebating.

Of course, the OFT has made no secret that it would not be unhappy if this led to a world consisting of tied agents or fee-based IFAs only. Are their commission and disclosure requirements actually their means to this end?
6. **ATTRIBUTION OF EXPENSES**

As far as I am aware, there has been no attempt so far to set down a practical guide to the implementation of TPN3 and the LAUTRO disclosure rules for participating business. So here goes!

The method that I will describe is equally applicable whether one is calculating RIYs for the year gone by (for Table 4 of the With Profits Guide) or for the year to come (for Product Particulars). The only difference is that in one case the incurred expenses and new business volumes are known and in the other they are only estimated.

When making estimates on which to base projected RIYs for Product Particulars, it must be remembered that there will be a price to pay if low RIYs have resulted from the selection of an over-optimistic base. That price will be a lack of credibility in future years in your projected RIYs because of the comparison with your actual experience which will have to be made in a future issue of your With Profits Guide.

Perhaps one should have two new business estimates. One for motivational purposes and another, perhaps more pragmatic, for RIY calculations only!

**Step One** The starting place should be the expenses for the year, either incurred or projected depending upon the purpose of the analysis.

Where there are several subsidiary companies under one marketing group umbrella (e.g. unit linked, unit trust, etc), separately identify and remove all expenses that may fairly be attributed to them (but only so much as will appear in the DTI returns).

**Step Two** Hopefully, the remaining expenses will have been subdivided by your accountancy colleagues into at least such groupings as main class, term, personal pension, group business, etc. The methods that they will have used or, which you will have to use for this subdivision will include:

- direct attribution (e.g. full commissions)
- time spent (e.g. administration department salaries, computer CPU time, etc)
- proportionate (e.g. personnel department - to salaries)

The methods, of course, are similar to those used in expense analysis for product pricing.

**Step Three** If you are really lucky, your accountancy colleagues will also have split the expenses within each subdivision into various types (e.g. initial commission, renewal commission, acquisition expenses, servicing expenses, investment management expenses, etc). If not, you will also have to do this.

**Step Four** It is then necessary to ensure that the expenses to be used total to those shown or expected to be shown in the DTI returns. There are several reasons why this might not be so and TPN3 gives guidance to some cases. So add back:

1. Interest subsidies on cheap or interest-free loans
2. Loans written off, e.g. to Appointed Representatives
3. Share purchase in excess of fair valuation (Appointed Representatives again or, perish the thought, IFAs!)

4. Rent on premises owned and occupied by the Company

5. Investment and property management costs, excluding dealing and routine property management costs, which may internally have been offset against the investment return.

Please feel free to suggest others during the discussion.

Internal accounts may also spread the cost of large developments; premises, computer systems, etc over a number of years. TPN3 allows this to be reflected in the figures used for RIY calculations but also requires you to look backwards and spread into the current year an appropriate proportion of any similar capital expenditures in the previous three. So spreading may not be worth it in terms of improving the figures if heavy capital expenditure has taken place recently. And anyway, think carefully whether you or your successor will welcome the imposition when the future arrives.

**Step Five**

This is an interesting one. Some practitioners hold that a proportion of current expenditure, particularly of a large capital nature, may rightly be attributed to the estate and not to the current generation of policyholders alone. Put simply, the company has been "saving up" for, for example, a new computer system and does not intend to reduce bonus rates as a result of finally buying one. As disclosure is primarily aimed at those about to purchase a policy from the company, and this expenditure will not directly affect them, the argument goes that these amounts should be excluded.

The phrase "subject to any system of experience pooling inherent in the company's .... surplus distribution policies" from a paragraph of TPN3 is sufficient grounds, in many minds, to permit this. What do you think?

**Step Six**

Having allocated the added-back or excluded expenses to the appropriate class of business and type of expense, it is then necessary to determine or estimate the amount of new and existing business (both in terms of annual premium income and numbers of policies) for each type of policy within any class for which an RIY is required for at least one type of policy in that class. Also estimate the accumulated fund value for each of those classes.

At this stage, you might consider whether a proportion of the free reserves should be attributed to each class or whether, following a similar argument as that outlined in Step 5, a proportion of the investment management costs should be allocated to the estate and not to policyholders at all.

**Step Eight**

It will be necessary ultimately to arrive at a formula to enable yield reductions to be calculated for a variety of terms and premium sizes. This is true whether the RIY is to be calculated individually in each case (for product particular purposes) or merely for production of a table of selected values.

A possible method is to express both initial and subsequent administration expenses on a per policy basis, acquisition expenses as a
percentage of indemnity commission, renewal commission in its actual form and investment management expenses as a percentage of the fund.

Should your expenses be analysed in a different way, for example you may have claims expenses separated from other servicing, you may have proceeded differently. Do tell!

Appendix 1 shows how the expenses are "divided" by the new business to obtain a range of parameters and how these parameters fit into a formula to arrive at basic RIYs.

Where there is non-profit business within a class, the method will automatically attribute some of the expenses to this business.

**Step Nine**

It is then really only necessary to make adjustments for the peculiarities of the business.

The most important of these are likely to be the policy fees or improvement for magnitude scales which apply to different lines of business. Appendix 2 shows how this could be handled.

Adjustments will also be necessary where it has been the practice to cross-subsidise one class with another, for example life with pensions or long term with short. Don't forget that whilst such changes will reduce the yield reductions for one type of business, there must be a corresponding increase in the total expenses allocated to some others.

**Step Ten**

Pat yourself on the back and pour yourself a drink. No one else will!

Confirmation that others followed this general approach - or differed radically - would be welcome.
7. **THE WITH PROFITS GUIDE**

7.1 **What was wanted?**

A Life Office with-profits fund has often been likened to a black box. In go premiums and investment income, out comes claims, expenses, tax and, with proprietary companies, shareholders' profits too.

Prior to the With Profits Guide, anyone who wanted to find out what was going on inside the black box had access only to published past performance statistics and to the office's DTI returns. From the latter, anybody with a little knowledge of the business could calculate a few liability/asset ratios and attempt to use these to assess the relative solvency and efficiency of offices and hence their relative ability to maintain current payout levels.

However, simple ratios are misleading for a variety of reasons as Ljeskovac, Nisbet and Ross (1987) showed. Liability valuation bases vary and the presence of a significant volume of unit linked business can render a fair comparison inadequate as can abnormally rapid new business growth.

An independent actuary could make a reasonable attempt at a consistent valuation and interpretation of results across several offices. But no-one else could nor, given the relative inaccessibility of DTI returns, would be likely to try.

So, in its December 1989 paper "Life Assurance and Unit Trust Disclosure - The Regime for 1990", SIB first introduced the concept of the With Profits Guide (or booklet as it was then called). Its purpose was stated as being to enable intermediaries, commentators and interested investors to make a valid comparison between Life Office with-profits funds and, incidentally, to dissuade intermediaries from using the newly introduced disclosure of the effect of expenses as their sole discriminator (which, given its eventual timing, it was never likely to become!).

7.2 **What we got**

The first Guides saw the light of day on 31 August 1990. One or two offices got them out early for publicity value and if anyone was late they successfully kept it quiet.

Apart from one or two offices apparently ignoring LAUTRO guidance and producing Guides full of colour photographs - of city types at computer terminals and multi-million pound property developments - they were all much of a muchness with fairly non-committal prose where freedom of expression was allowed.

Some other offices appear to have rather liberally interpreted the permission to avoid disclosing the effect of expenses or other figures for years prior to 1990 due to "non-availability". I suspect that this relaxation was intended to cater for those with profits funds founded within the last 5 years and not for when the office concerned simply felt it was too much hard work to recreate past data!

7.3 **Examination questions**

The preparation of a With Profits Guide in accordance with the LAUTRO rules actually required the answering of one or two interesting questions on the philosophy and management of with profits funds - shades of subject 8! The following were, in my opinion, the most difficult.
1. The identification of the main factors likely to influence bonus rates. Offices to "relate the factors to each other, so far as is possible".

2. A description of the factors influencing solvency margins, "for example, the bases of valuations and the effects of the business mix". Further, "this description must also explain how those factors affect the margins".

3. The office's policy for ensuring fairness of treatment at maturity or early surrender when declaring bonuses and, with regard to terminal bonus, "identifying ... the factors which might lead to any change".

4. An outline of the method used to attribute expenses to the with profits business with an indication of "the effect of changes in growth and composition of any new business".

5. An explanation of how the level of expenses is affected by the nature of the with profits business and of the assets in which the with profits fund is invested.

7.4 Examiner's Report

I have taken the 1990 With Profits Guides of 8 leading offices and examined how well they dealt with the five questions above.

1. Only three offices really took the opportunity in Section C of their Guides of giving a reasonably simple explanation of how a with profits fund worked. Most identified that the investment return was the most important element but at least three made no mention at all of how it might be impacted by taxation and inflation and how these two factors would have, probably opposite, effects on expenses.

2. There were again three offices, not the same three, who gave reasonable answers to this question. Regarding the effect of a change in valuation bases, the others may have argued that as their bases had not changed over the past five years, there was no need to explain how a change might impact upon solvency margins. This ignores the possibility that a policyholder might witness a change sometime in the next 25, however. Changes in new business happen to all offices and whilst five offices in all mentioned changes that had occurred, two of them regrettably failed to mention what the impact on solvency had been.

3. Although LAUTRO found this question poorly answered in general, I found that four out of my eight offices did specifically mention the treatment of early surrenders. In a couple of cases offices even mentioned that early surrenders would not benefit either fully or at all from terminal bonus. Only one of the eight offices attempted to identify circumstances in which terminal bonus would change ("a dramatic change in investment conditions"). Perhaps even that could have been more precisely defined for the lay reader. All the others, without exception, felt it adequate to say that the rate was not guaranteed and could be varied at any time - hardly helpful!

4. "Composition of business" was interpreted by one office as meaning whether premiums were annual or single and by two others as meaning individual business versus group business. In most cases, too little was said about the relative expenses of the classes named to enable users of the Guide to standardise when making comparisons. Most offices rose to the challenge of explaining how different types of investments would have different management costs, although I expect they all felt, as I did, that this was somewhat irrelevant for the purpose of the exercise, investment expenses being nowhere separately
identified and in most cases being fairly trivial relative to the overall expenses of management.

5. A number of offices were fairly weak in explaining precisely how their expenses were attributed to with profits business, the stronger ones talking about direct attribution, timesheet analyses and various methods of proportioning. Five rose reasonably to the challenge of explaining the impact of new business growth, in several cases supporting this with percentage growth figures over the period.

Of the eight booklets, I think there was probably only one which made a reasonable attempt at answering all the questions. Another two or three deserve an honourable mention. There were one or two who, in those immortal words, appeared not to have fully read the questions. As to my own office, "could try harder" would be my assessment!

7.5 A Footnote from the Fens

At the other extreme, Norwich Union's Guide demonstrates that our President is prepared to practise what he preaches. Their Guide mentions both the results of internal bonus reserve valuations, giving the proportions of the fund which are necessary to meet guaranteed benefits, to pay future bonuses and to cover tax and also that proportion which is "free". It also gives the rates of return that are necessary to be earned over the next five years to maintain current payouts on 10 and 25 year endowments (although whether this is on the fund as a whole after allowing for non-profit liabilities and maintenance of free asset ratio or on some notional with-profits asset share only is not stated).

Is this the way forward for the future, as Hugh Scurfield suggested in his Address? Or is the present content of the Guide sufficient?

7.6 Telling it as it is

How honest should we be? For example, we all know that a keen eye is kept on an office's position in certain magazines past performance "league tables" when setting levels of terminal bonus. But was there so much as a mention in passing of this? No, all the talk was of asset shares and other concepts of the theoretical world.

I repeat the question, this time not rhetorically. How honest should we be?

7.7 A little knowledge....

Do the contents of the With Profits Guide, particularly the objective elements as laid down in the regulations, adequately meet the original requirements of SIB as mentioned in 7.1?

I am afraid that the answer has to be "no". Many of the numbers are plucked straight from the DTI returns, and, whilst this may make them more accessible to interested parties, it does nothing to remove the anomalies mentioned in 7.1.

The tables of assets can either be those relating solely to with profits business or those relating to the fund as a whole. Incidentally, I would be interested to hear how those who chose the former option hypothecated assets to the with profits fund. Some examples that I have seen have apparently hypothecated most if not all of the fixed interest assets to other business leaving virtually complete equity backing to the with profits business.
In my opinion, allowing alternative formats in this way is merely confusing and I have noted commentators blithely contrasting offices with the two formats and drawing judgement from them unaware of the fundamental differences.

Expenses are shown split between acquisition and renewal but there is no requirement whatever to show the new business achieved over the last five years in order that one may at least have some chance of deciding whether the acquisition expenses are reasonable relative to the results achieved.

Neither is there any requirement to give the mix of existing business between major categories. This would serve to help identify those cases where there was, for example, a heavy Group Pensions presence and partially explain the apparently relatively low administration costs per £ of liability.

Have we been less than fair to the With Profits Guides users, by failing to provide them with sufficient consistently-based information to draw firm conclusions - or have we been shrewd businessmen by pretending to go through the motions to satisfy the regulators, knowing all along that we would still be keeping most of our hand to ourselves?

Finally, one thing that we could do, and which I believe SIB and LAUTRO are considering enforcing once the overall future disclosure regime has been decided, is to make it more well known that With Profits Guides actually exist! It has been an anomaly of the current regulations that there is no requirement to make prospective policyholders, or anyone else, aware of the Guide.

7.8 To what use have they been put?

Probably the greatest use made so far of With Profits Guides has been in creating employment amongst financial journalists, consulting actuaries and others who have prepared huge tables or even computer disks from the individual reports. Admittedly, this does at least save the majority of us from having to go through cupboards full of the damn things!

What these tables reveal is, as we knew all along, that most of the major offices are fairly well solvent and have not unreasonable expense levels. Perhaps a few IFAs have been swayed one way or the other in the case of the more extreme offices - but I don't suppose that many offices who appeared relatively poorly in this regard would have been expecting much business from the independent sector anyway.

Perhaps the most useful table in the Guide is Table 4, showing the effect of expenses.

These, at least, are on a reasonably consistent basis between offices. This table is more interesting in the 1991 Guides, as it shows for the first time how close offices came in 1990 to eventually achieving the expense and new business levels necessary to make the RIYs predicted in their product particulars come true in practice.

The 1992 Guides will be even more interesting in this regard, as the offices will for the first time have had to predict the RIYs more than a year ahead, rather than with the benefit of at least a few months hindsight, as was the case for 1990 expenses.
8. **ILLUSTRATIONS**

8.1 **Impact of the LAUTRO Basis**

It was recognised by Short and Iqbal in 1986 that an illustration for a life contract with an investment element was serving two distinct purposes:

1. To give an indication of the benefits that were likely to emerge from the policy, and
2. To assist in the choice of the contract.

They went on to comment that far too much emphasis was being placed by intermediaries on 2, it serving in effect as an "instant selector" of life companies.

Taking heed of such warnings, LAUTRO ruled that all long term illustrations must be on industry-standard investment growth and expense assumptions, allowing only mortality to be office's own.

As all illustrations were essentially the same, IFA's and the press now looked for a substitute "simple" tool for selecting the "best" provider. Past performance became the obvious candidate.

In another of their perceptive comments, Short and Iqbal said "if the emphasis on marketing were to shift to past performance, it is very cost effective to declare large terminal bonuses which only cost very little particularly if they are duration related".

The emphasis has indeed shifted and the terminal bonus war has broken out. The market has recently seen increased payouts, particularly for 25 year endowment policies, in some cases far and away larger than asset share movements alone could justify.

One could argue that it was equally valid to "buy" new business this way as by ever higher commission payments or by increasing advertising spending.

It is certainly not the duty of a life company to draw IFAs' attention to the caveat that they themselves should tell their clients - "past performance is not necessarily a guide to future performance". Although, funnily enough, those offices less well placed in the tables seem to be doing precisely this.

Those offices with significant maturities - and it is surprising how much 1981 ten year endowment business is still in force (especially from "back-to-back" plans) - cite actuarial equity between policyholders to explain their lower payouts.

Precisely the same argument is advanced by those whose payouts have experienced significant recent increases. Can they too be right? Or is our professional name being once more taken in vain in the marketing cause?

8.2 **Some Problems with the LAUTRO Basis**

We have now been operating on the LAUTRO illustration basis for three years and, although it has been subject to many criticisms and suggestions for change, it remains as implemented in 1988.

In fairness LAUTRO were intending to introduce, in October this year, increases in the standard expense assumptions. These were to take into account inflation since 1988, increases in average commission rates and the changed tax basis. However, these
changes were put on ice when the SIB Retail Review was announced and are unlikely to see the light of day for some while yet.

Recommendations under the Retail Review with major systems implications for offices are unlikely to come into effect much before 1993. It did seem to me, therefore, that suspending these changes was perhaps a little unnecessary. Two changes within 18 months to 2 years would have been an unwelcome burden, although I suspect that most offices would be quick enough to make changes of similar magnitude if they changed bonus rates or introduced a new improved product.

LAUTRO's intended changes were also going to result in simplification in the projection basis on contracted-out personal pensions. Whilst it was always sensible to insist upon a "real rate of return" comparison when advising whether or not to contract-out for a particular year, it was always most impractical to have to continue to illustrate on that basis on in-force business. This was particularly the case where, as is common, the policyholder also has a voluntary contribution personal pension. Illustrating a normal projected cash sum on this and in "real" pounds on the contracted-out element taxes the understanding of even the most numerate policyholder.

The increased expense assumptions would also have some way to resolving the odd situation that currently prevails when trying to illustrate the likely date at which a unit-linked policy will achieve a certain value (e.g. to repay a loan). If the premium has been calculated using actual, higher expenses, the standard illustrations will often show the loan being repaid earlier than intended, sometimes sufficiently so for the date to have to be suppressed for fear of confusing the investor.

There are one or two minor quibbles about the current basis which were not addressed in the proposed changes and perhaps there is now still the opportunity for further consideration. For example, it is not possible to distinguish between the various forms of death return on a personal pension plan. A contract providing a return of fund on death has to be shown as having the same projected cash value as one offering only a return of premiums making it very difficult for the intermediary to illustrate the differences between them. It would not be beyond the powers of man or LAUTRO to devise a basis which, whilst a little more complicated than that currently in force, resolved this anomaly.

Finally, if 8.5% and 13% are the "right" growth rates for gross contracts, are 7% and 10.5% still right for fixed funds in the light of recent changes in the tax basis?

8.3 Own Expenses

Some offices, particularly those not paying commission, would wish to see the office's own charges or expenses used in illustrations rather than the LAUTRO standard.

Given that this would probably mean a return to the days when the illustration largely performed the selection of office for the intermediary, should these calls be welcomed or dismissed?

Much more detailed disclosure of expenses is, after all, now available for any serious intermediary to analyse and present to policyholders as (which indeed it is) just one of the factors in choosing an office.
8.4 **Differential pricing**

In late 1989, SIB issued a consultative paper which suggested that illustrations should perhaps differ for products which were available at different prices through different distribution channels.

In practice, most offices sell products at the same price through all distribution channels. It was necessary until mid 1990 to disclose in the product particulars for Company Representative business if the product was generally available more cheaply from IFAs (but not vice versa, as downward pricing pressure was not felt likely in the tied market).

This criterium is no longer with us but retrospectively would appear to have been rather unnecessary, at least for major product lines, as most providers appear to have concluded that Company Representatives would find it highly embarrassing to sell products which were available more cheaply elsewhere.

And there are also the systems implications of having to price business differentially.

SIB tentatively suggested that proposers from the channel which made the product available at the lowest price should receive the standard illustration. All others should also receive an illustration based on that premium rather than, as at present, the actual premium.

Whether from an altruistic desire to protect the principle of the illustration serving only as a broad guide to the expected payouts range, or from more mundane reasons of impracticality, it matters not, but the ABI and others were able to convince SIB to drop their proposals - or at least to refer them to a "Quality of Information" Working Party which has since become subsumed in the Retail Review.

Will there ever be much differential pricing? If so, should illustrations reflect this? Or, should this function be left to expense disclosure?
9. **PERSISTENCY**

9.1 **Definition**

The success with which the products sold meet the real requirements of the investor can be judged to some extent by the subsequent fate of that business.

So LAUTRO requires the persistency of the business written by every Company Representative to be monitored. However, it gives no guidance as to how persistency is to be measured, nor to what are minimal acceptable levels. Until recently, it even gave no clue as to exactly what it considered to be "persistency".

In Enforcement Bulletin Number 10 (September 1990) LAUTRO did, for the first time, give the following guidance. As a minimum, it is necessary to be able to quantify how much business sold in a certain month in one year is still in force in the same month of the following year. Further, this measurement should:

- be based on the number of cases and not the premiums.
- exclude any business which is "not taken up"
- exclude any business which is Cancelled.

Particularly if an office is only assessing persistency at the 12 month stage, I would suggest that periods should be measured in terms of premiums received rather than calendar months elapsed as it may well take 3 or 4 months between the cessation of premium payments and the policy status being changed to terminated on the computerised records system. It should also ensure that annual premium business on which the second premium fails to be paid is recorded.

One might wonder at the exclusion of Cancellations. Firstly, there are reasons besides cancellation why a policy, once put into force, may terminate with no premiums ever paid. The most common is likely to be the failure of a direct debit ever to operate. There may also be simple verbal or written requests by the policyholder for us not to proceed. Concentrating on the return of Cancellation Notices only does not make a lot of sense, whereas analysing all cancellations from outset as distinct from terminations with one or more premiums paid may provide some additional guidance as to the quality of selling practice.

Secondly, the Bulletin adds that Cancellations are required to be recorded separately under Rule 3.11(3). This is also somewhat of a red herring however, as Rule 3.11(3) does not require Cancellations to be recorded by the Company Representative - such records are therefore useless in this regard unless specifically enhanced for this purpose.

This, together with the suggestions in the Bulletin that NTUs should also be recorded by CR, gives the impression that LAUTRO are trying to slip in additional regulation by the back door.

Measuring NTUs by Company Representative is not in fact the small matter that LAUTRO may have considered it to be. Unless administration or management information systems have been designed to enable an analysis to be easily made of proposals and their eventual outcome by representative, this may prove an extremely expensive development to implement. Even for those with systems with the right data in the right place, the expense of producing and distributing regular reports still should not be taken lightly.
This is not to say that I do not agree that monitoring both Cancellations and NTUs by CR would further assist in the control of quality of new business. However, if LAUTRO are to require this to be done, the current guidance should be enshrined formally in their Rules. In its current format, some offices will feel obliged to follow and others will not. Would you not agree?

9.2 Measurement

There are several ways in which terminations rates could be measured.

a. The Crude Approach

\[
\frac{\text{Number of policies terminating in the period}}{\text{Number of policies written in the period}}
\]

This measure is easily calculated from, for example, new business returns but suffers from two major drawbacks if it is to be used to judge the quality of a Company Representative's business against that of this colleagues. Firstly, it is unstable when business volumes fluctuate, as terminations will be a function of the business written in earlier periods.

Secondly, it takes no account of duration and a new CR would invariably have an apparently better persistency than one of long standing.

b. The Actuarial Approach

\[
\frac{\text{Number of policies terminating in period at duration } n}{\text{Total exposed to risk in period at duration } n}
\]

Adopting the correct exposed to risk approach removes both the problems possessed by the previous example. However, this is at the expense of the measure that is easy to explain in the enforcement context. The value of this should not be underestimated as the derivation from individual cases of any measure may have to be capable of being demonstrated to ARs or CRs so that both these and those responsible for ensuring their compliance have confidence in it.

c. The Compromise

\[
\frac{\text{Number of policies already terminated of those commenced } n \text{ to } n + t \text{ months ago}}{\text{Number of policies commenced } n \text{ to } n + t \text{ months ago}}
\]

A choice of \( t = 6 \) months for \( n = 0 \) and \( n = 6 \) and of \( t = 12 \) months for \( n = 12, 24 \) and 36 (far enough back to see us back to A-day at the time of writing) provides adequate protection from varying new business volumes whilst also giving adequate duration-related data.

From a practical point of view, it is possible to easily list the "exposed" policies and whether they remain active or not to provide a simple verification of the offending statistic.

This measure could be used also with premium or commission rather than policy numbers as numerator and denominator. I particularly like the form:

\[
\text{Commission recovered in respect of policies already terminated}
\]

\[
\text{Indemnity Commission Paid}
\]
Not only does this provide some general guidance as to financial impact for the terminations of a CR (and also, although somewhat more tenuously, to the office), when taken in conjunction with a numbers measure it can also give some indication as to whether larger or smaller policies than average are lapsing.

I would be most interested to hear what measures other offices are using.

9.3 Enforcement

My own office produces an analysis of persistency for each CR past or present on both the numbers and the commission basis outlined above. On this we highlight all those cases which fall below a minimum standard which varies by duration. The standard is relaxed for small volumes of business to allow for diminished statistical confidence.

No highlighting takes place for terminated CRs as, directly, nothing can now be done to improve the quality of selling in the future from that individual.

A summary report is produced which lists only those highlighted cases and this forms a very useful aid to policing.

CRs are sorted by Appointed Representative (if any), servicing branch and servicing division (direct sales or tied agency). Where there is an Appointed Representative, persistency figures for its overall business are also computed and regularly examined. Poor figures at this level can indicate a more serious problem that just that caused by one individual.

At either level, reasons for low persistency have to be established and actions taken to correct matters.

9.4 Some Findings

We also produce analyses by distribution channel - for comparison also including IFAs and off-the-page business - and by product.

We have noted, for example, that mortgage-related endowment business has poor persistency from both small tied agents and small IFAs but much better persistency when arriving from larger tied agents (e.g. building societies). This can probably be attributed to the tendency for the small agent active in this market to be somewhat of a source of last resort for mortgage finance, resulting in the greater likelihood that the borrower will get into financial difficulties after taking the mortgage or even simply stop the policy for which he merely signed up to get the loan.

Moreover, lenders are much more likely to be concerned with the preservation of the mortgage-related endowment where they themselves stand to suffer commission clawback should it terminate and it is they, rather than the small agent, who are likely still to be in touch with the borrower (for the collection of interest).

Since the recession started to grip, we have also noted a significant decline in regular premium Personal Pension Plan persistency across all distribution outlets. However, this is less likely to be the impact of desperate selling practices in the declining market and more the impact of redundancies or the declining earnings of the self-employed.

Do others have similar, or additional, findings to report?
10. **A REGULATORY MISCELLANY**

10.1. **Supervision**

Supervision of investment advisers rests either with their authorising body or, in the case of Appointed Representatives, the organisation which they represent. It manifests itself under various guises.

a) **Adequate Referencing on Appointment**

Recently stepped up by LAUTRO, a person wishing appointment as an Appointed or Company Representative of a life office now faces a fearsome barrage of referencing. Not only must the usual information regarding personal history be given but full credit checks should be made including verification of no outstanding County Court judgements against the individual or companies with whom he has been associated.

Secondly, if the individual or firm has been a Company or Appointed Representative of one or more other LAUTRO members, enquiries should be made of that member including their views on whether:

- cancellation levels were acceptable
- persistency levels were acceptable
- the number of complaints and how many resulted in compensation being paid
- whether the representative failed to provide best advice or failed to adequately factfind consistently
- whether the Appointed Representative had ever been formally disciplined or, heaven forbid, charged with or convicted of fraud or violence
- how much was owed in terms of commission clawback or development loans and how these amounts are to be repaid
- why the Appointed Representative is ceasing to be tied to the member

This is, I believe, a laudable attempt to remove some of the "cowboys" from the industry. Too often since 1988 have individuals under investigation for devious practices been able to tie elsewhere with hardly a question asked of the former office regarding the true history of the agent concerned. Such lax referencing does neither the industry nor the "receiving" office any good as, more likely than not, the individual or firm continues with their dubious practice in the new setting.

b) **Periodic Inspection Visits (PIV)**

LAUTRO and FIMBRA make these of their members and LAUTRO members make them of their ARs. For good measure, LAUTRO also visits a random selection of ARs during a PIV of a LAUTRO member.

Early LAUTRO PIVs, particularly AR visits, certainly kept a few offices on their toes and threw up quite a few cases of lax supervision by LAUTRO members, particularly in the selling practices area. Several well known offices were, for a while, publicly prevented from recruiting further Appointed Representatives until they could demonstrate correct control procedures.

Another favourite "punishment" by LAUTRO has been for it to insist on the office writing to the recipient of "bad" advice, asking if he is happy with the service received and the product purchased. In the case of a negative reply, a more suitable product and, if necessary, compensation must be offered.
The quality of Appointed Representative regulation by LAUTRO members has, not surprisingly, improved considerably since the early days of FSA, although not every provider has yet been fully "PIVed" even once.

c) Ongoing Regulation

This includes such items as approval of AR stationery and advertisements, random sampling of factfnds and recommendations to check the quality of advice, mentions of compliance manuals, education of new Company Representatives, monitoring relationships with IFAs and 101 other activities.

The latest LAUTRO concept, Rules Bulletin 41, is for offices to ensure that Appointed Representatives maintain sufficient records, especially bank account details, of "the business which it carries out as an Appointed Representative". LAUTRO state that this is to enable members to monitor the financial solvency of their representative at any time, suggesting perhaps that an insolvent representative might be tempted to act other than in a proper manner.

Whilst not disagreeing that both from the compliance aspect and the business aspect, members are indeed interested in the financial solvency of their representatives, it is by no means an easy matter, as any accountant will say, to define whether or not a business is or is not insolvent at any given time. Further, it must be very difficult to assess whether a member is solvent with respect to his business as an Appointed Representative, independently of his position with regard to, for example, his estate agency business. After all, he is equally likely to be tempted off the straight and narrow if his estate agency business is in difficulties as he is if his business as an Appointed Representative is in difficulty. Conversely, an insurance selling business run profitably on the back of some other successful business venture in order to provide an all round service to a client portfolio, may not be of concern at all.

In my opinion, the question of solvency or otherwise is immaterial from a compliance aspect, as adequate monitoring of the AR's insurance activities should detect any misdemeanours whatever the financial circumstances. However, it is not irrelevant from a business point of view as the office is, after all, interested in the likelihood of repayment of any development loans granted or unearned commissions which may need recovery. The amount of information that the office requires from its representative should be a business decision, to be enforced directly rather than by reliance upon the force of regulations of rather dubious necessity.

Perhaps some will eventually conclude that there can never be adequate control of the non-corporate AR without ownership.

10.2. Indebtedness

It has also recently been forbidden, Rules Bulletin 41 again, to appoint an AR who is indebted, other than through a normal mortgage or trivially, to another LAUTRO member, an SRO or the ICS. This rule is of direct benefit to life offices already in the AR market, reducing the ability of ARs to bid up commissions in an effort to ease tough loan repayments. This may be seen by new entrants to the market as a cartel restricting their access. However, it does act in the interests of the consumer to the extent that it prevents some ARs getting deeper into debt and, possibly, either being tempted to oversell or going out of business and leaving their clients to fend for themselves.
Moreover, new entrants can enter at a price - by repaying the outstanding debt to the old office. So, in the balance, good - or not?

10.3  A Plethora of Regulators

An IFA could be regulated by FIMBRA, by another SRO (e.g. IMRO, if he is also a substantial fund manager), by any RPB (including the IBRC) or even by SIB itself. Tied agents are mainly regulated, indirectly, by LAUTRO. Is it any wonder that the public is still unfamiliar with the mechanisms of investor protection?

There would be, in my opinion, several benefits that would derive from a slimmed-down structure of regulation. Let me first propose such a structure, then identify some of its benefits.

1.  **LAUTRO**

   LAUTRO would regulate Providers as it does at present. However, FIMBRA would become merely a committee of LAUTRO, consisting mainly of IFA representatives.

2.  **FIMBRA**

   It would have substantial representation on the main LAUTRO Board and would carry out those compliance functions for IFAs that Life Offices carry out for their tied agents. It would advise LAUTRO on any specific regulations required for the independent sector. All IFAs, possibly excluding very small RPB members, would be required to join.

3.  **IMRO**

   As present, but with the addition that any FIMBRA member who wished to handle clients' money would also have to belong.

4.  **SIB**

   SIB would cease to directly authorise any Provider or IFA.

5.  **RPBs**

   RPBs would only be allowed to authorise those of their members who were not in FIMBRA to act as IFAs if their income from financial advice was very small. For example, less than 5% of their total income or £5,000 per annum, whichever is the smaller.

The benefits of this structure are:

a)  **LAUTRO** is the ultimate regulator for almost all life assurance and unit trust activities.

b)  It may be possible to convey to the public that client monies would only be directly handled by IMRO members.

c)  **FIMBRA** would be better funded.

d)  **ICS** could operate much as under the present temporary regime. **FIMBRA** would be responsible for the first level of payments, **LAUTRO** the next and the other SROs for any remaining uncovered liabilities.
The format that I have suggested would almost certainly tread on too many toes to be capable of practical implementation and would require changes to primary legislation (e.g. to stop direct authorisation). What practical position could we reach? And is Sir Kenneth Clucas likely to end up there too or not?

When debating any structure to last in the long term, there is also the possibility that the EC might sooner or later require all financial advisers, whether tied or independent, to be regulated centrally. If this came about, and with the MCA already gone, would ease of administration alone be sufficient motivation for remaining tied?

10.4 Polarisation

The concept was simple. Advisers were to be either the representative of a life office or independent and required to select the "best" product from the whole market.

No longer were IFAs to be allowed to skimp on their research by limiting their consideration to a few favourite offices - nor were company salesmen to be able to plug a gap in their range by offering products of another insurer.

Polarisation has generally worked well, with most of those who remained IFAs operating with considerable professionalism with regard to best advice and spread of their business.

Some small offices previously operating in the broker market have lost market share because many smaller IFAs, when faced with the possibility of having to justify their recommendation in the future, have not unnaturally played safe by sticking to the more well known names. However, those smaller players with something special to offer in terms of product or service are still able to prosper.

Company salesmen and tied agents, too, are also generally much less coy about their status. I am sure that the "Buyers' Guide", backed up by regulations requiring business cards and letterheads to disclose status, has assisted in ensuring that the appropriate disclosure is made.

Yet survey after survey has shown that the public at large doesn’t seem to care about independent advice, trusting rather to the name of the adviser, whether tied or not. Is it all really worthwhile?

10.5 Channelling, Badging and other Weakening of Polarisation

Perhaps the most confusing aspect of Polarisation, and the one still giving rise to most controversy, is that regarding the ability of one organisation to have both Appointed Representative and IFA subsidiaries. Major banks and building societies have made use of this dispensation to operate tied branch networks retailing mainly bulk mortgage-related business and IFA arms providing full professional advice.

The rules of engagement require the IFA arm to operate from different premises, but introductions from the branches are allowed either where the customer requests independent advice or where the tied agency cannot offer a suitable product.

More questionably, information and advice can be 'channelled' between client and IFA through the manager of a branch of the bank or building society. This makes it even more unlikely that the customer will be able to distinguish when he is receiving independent advice and when not.
In a discussion paper on Polarisation issued in September 1991 as part of its Retail Review, SIB indicated that it did not intend to make changes in this area, however.

In the paper, SIB are also seeking views on "badging", which is where a provider can complete its product range with another office's product thinly disguised as its own. They are also examining excluding unit trusts and PEPs altogether from the grip of polarisation and lifting the "better than best" requirements from organisations with both tied and IFA arms.

In my view, any of these measures would severely undermine further the distinction between tied and independent advice and should be resisted unless we want to lose the benefits of polarisation so painfully gained.

10.6 Multi-ties

In its September paper, SIB also reaffirmed its commitment to polarisation. In doing so, one of the hares which it had itself raised earlier in the year, multi-ties, was run to ground. A multi-tie is where an agent can recommend the products of various offices. It covers both the case where he must select the best product in a class for his client and where he need not.

Nevertheless, some would still say that there would be a benefit to the public of a type of multi-tied agent who offered the products of the 'best' provider in each of a number of product ranges. Relative to an IFA, he would generally be more able to advise on the specific features of these products through increased familiarity and would also hopefully have developed a closer operating relationship with the administrative staff of the limited number of offices concerned. Relative to the tied agent, he would not be placed in the possibly invidious position of having to offer the poor products of a single company's range along with the good. Of course, clear disclosure of the terms on which the agent operated would have to be made.

Regulation of these entities would be difficult and it would, I think, be necessary for them to be regulated by FIMBRA (if it is still around) as I cannot envisage any adequate method of sharing either the compliance function or the responsibility when things go wrong between a number of different life offices.

Perhaps semi-independent would be a better phrase than multi-tie!

Indeed, the wide industry opposition to multi-ties may have been as much a rebuff of SIB's far from subtle attempt at regulatory buck-passing as an expression of concern for the future of polarisation. What do you think?

Multi-ties are not forbidden in many European countries and both SIB and the industry may yet have to revisit the whole polarisation issue once again in the post-1992 environment.

10.7 "The Halo Effect"

A recurring problem has been that the phrase "Appointed Representative of ..." has been taken by many customers to mean that the whole business of the representative, rather than just his relevant investment business, is in some way supervised by the named insurance company.

This "halo" effect has already cost some companies a considerable amount in ex-gratia payments to protect their good name when their representatives have been found to have been engaging in additional unauthorised investment activities, usually fraudulent.
Revised LAUTRO regulations due to come in force next year, will make it a requirement for representatives to disclose that they are only representatives of the nominated company for those classes of business for which they are authorised to advise and require the representative not to utilise business cards or stationery with this disclosure on at all in connection with his other activities.

The revised LAUTRO regulations, following SIB principles, also now make the life insurer potentially liable to pay compensation if one of its representatives engages in unauthorised financial activity causing losses to investors. However, if the life office can demonstrate that it did all it could to detect whether or not such activities were being carried out - after all, even compliance officers respect the privacy of the home - then they are absolved from any form of statutory responsibility.

Perhaps the dimming of the halo effect and the increased policing of extra-curricular activities on behalf of representatives will reduce the number of scandals - or at least the cost of ex-gratia payments.
We start with an office which has analysed the expenses attributable to its with profits life business using the basis suggested in Chapter 6.

Table 1 - Expenses (£m)

<table>
<thead>
<tr>
<th>Per Policy</th>
<th>Commission Related</th>
<th>Fund Related</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>Servicing</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Investment</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Our objective is to arrive at an arithmetical formula that relates the expenses to number of policies, premium income and fund size (these being the three parameters which our office has elected to use).

Totals should be determined for new business and business in force in terms of number, annual premium and fund size. The distribution of new annual premium by class, term and premium magnitude is also determined and a 'model office' approach used to emulate the whole class by a small number of policy types.

In this case, let us assume that the three policy types in Table 2 are sufficient for modelling purposes. The commission rates applicable to each type are also recorded.

Table 2 - Model

<table>
<thead>
<tr>
<th>Policy</th>
<th>Term (yrs)</th>
<th>New Business</th>
<th>Existing Business (mid year)</th>
<th>Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>End'ment</td>
<td>10</td>
<td>15</td>
<td></td>
<td>31%</td>
</tr>
<tr>
<td>End'ment</td>
<td>25</td>
<td>25</td>
<td></td>
<td>66%</td>
</tr>
<tr>
<td>Whole Life</td>
<td>-</td>
<td>5</td>
<td></td>
<td>80%</td>
</tr>
<tr>
<td>Total</td>
<td>-</td>
<td>100,000</td>
<td>1,600,000</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

The following parameters are now calculated:

\[ K_I = \frac{\text{Initial Per Policy Expenses}}{\text{Total New Numbers}} = \frac{10,000,000}{100,000} = 100 \]

\[ Q_I = \frac{\text{Initial Commission Related Expense}}{\text{Total New Indemnity Commission}} = \frac{12,000,000}{\left(15,000,000 \times .31\right) + \left(25,000,000 \times .66\right) + \left(5,000,000 \times .80\right)} \]

\[ = 0.477 \]

\[ K_s = \frac{\text{Servicing Expenses}}{\text{Total In-force Numbers}} = \frac{20,000,000}{1,600,000} = 12.5 \]

\[ f = \frac{\text{Investment Expenses}}{\text{Total Fund}} = \frac{8,000,000}{3,750,000,000} = 0.00213 \]

The RIY for a policy could then be calculated as 100\(r\)%, where

\[ P \{s \over a\}^{07-r} = P \{s \over a\} - (1-t_I) ((1+Q_I) C_I P + K_I) (1+i) a \]

\[ - P (1-t_I) C_s \{s \over a\}^{07-(t_I)} - (1-t_I) K_s \{s \over a\}^{07-(t_I)} \]
where, \( P \) = Annual Premium

\[
i = 0.07 - f(l-t_s)
\]

\( C_i \) = rate of indemnity commission

\( C_s \) = rate of renewal commission

\( m \) = period after which renewal commission commences

\( t_i \) = rate of tax relief deemed applicable to initial expenses

\( t_s \) = rate of tax relief deemed applicable to renewal and servicing expenses

Should you care to apply the above formula to 10 and 25 year endowments with \( P = 600 \), \( t_i = 0.2 \), \( t_s = 0.25 \) and LAUTRO commission (but taking \( m = 1 \) for simplicity) the following RIYs result.

<table>
<thead>
<tr>
<th>Term</th>
<th>RIY</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>1.9%</td>
</tr>
<tr>
<td>25</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

For whole life business, the calculation must be done over a term to age 75. The commission rate would be that for the term to age 85 however, assuming that the LAUTRO basis was still being followed. This leads to some interesting results for entrants aged 65, for example, when the commission rate for a 20 year policy is effectively deemed to apply to one of term 10.
Table 1 shows the outcome of applying the formula derived in Appendix 1 to a selection of endowment policies with differing terms and premiums.

<table>
<thead>
<tr>
<th>Term</th>
<th>Premium (p.a.)</th>
<th>£300</th>
<th>£600</th>
<th>£1200</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>2.5</td>
<td>2.0</td>
<td>1.6</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>1.1</td>
<td>0.9</td>
<td>0.8</td>
<td></td>
</tr>
</tbody>
</table>

However, the variation of the effect of expenses by premium is in reality determined by the policy fee (or enhancement for size) structure applicable to that class.

If the office applied no policy fee at all, it would in fact be wrong to imply that the RIY would vary by premium level. The Appendix 1 calculations should be reworked with $K_i$ and $K_s$ both zero, $Q_1$ redefined ($Q_1^i$) with a numerator equal to all the initial expenses and a new parameter, $Q_s^i$, expressing servicing costs as a percentage of in-force premiums (say £500m in this case).

We can therefore calculate:

\[
Q_1^i = 0.875 \\
Q_s^i = 0.04
\]

and term independent RIY values of 2.1% for 10 year endowment and 1.0% for 25 year policies.

If, as is more likely, there is a policy fee of, say, £10 p.a. I would suggest proceeding as follows:

\[
K_1^1 = 10 \\
Q_1^i = Q_1 + \frac{(K_1 - 10) \times \text{Total new numbers}}{\text{denominator for } Q_1} \\
K_s^1 = 10 \\
Q_s^1 = \frac{(K_s - 10) \times \text{Total in force numbers}}{\text{Total in force premium}}
\]

In our example, we now get $Q_1^1 = 0.835$ and $Q_s^1 = 0.008$, giving the results in Table 2.

<table>
<thead>
<tr>
<th>Term</th>
<th>Premium (p.a.)</th>
<th>£300</th>
<th>£600</th>
<th>£1200</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>2.2</td>
<td>1.9</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>1.0</td>
<td>0.9</td>
<td>0.9</td>
<td></td>
</tr>
</tbody>
</table>

Table 2 varies less by premium than does Table 1, providing a fairer reflection of the actual impact of expenses upon the different policies.