Final Main Report

An assessment of the extent of an identified need for simplified, standard financial services products

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A report for the European Commission by:

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Executive Summary

S.1 There is a common concern that retail financial services markets do not work as well as other markets due to informational problems. This is one of the most common justifications for these markets being subject to specific regulation.

S.2 There is a broad range of regulatory tools that have been used to try to address these problems ranging from regulating the information that must be given out before, during or after the sale, to directly regulating the behaviour of those providing financial advice, to regulating the product terms themselves.

S.3 The European Commission asked Charles River Associates (CRA) to investigate whether a need for simplified, standard products had been identified in each of the Member States. The position in the UK was well known, the Sandler report[1] and the resulting proposals for stakeholder products represent the most recent instalment in the development of simplified products in the United Kingdom. So the study has focused on gathering information from the other fourteen Member States.[2]

S.4 The European Commission asked CRA to look across a wide range of product markets: basic deposit account with payment means; cash based savings products on which interest or other return is paid; credit or deferred debit card; private pension plans; motor insurance; home insurance; life insurance; mortgage credit; collective investment schemes; and financial advice.

S.5 The purpose of this project was to find out if a debate had taken place in other Member States regarding each of these product markets and whether this had resulted in simplified products being developed. Alternatively, if simplified products did not exist, might they have a role in the future or had other means been used to overcome informational problems.

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1 Medium and Long-Term Retail Savings in the UK: A Review, July 2002 by Ron Sandler for HM Treasury available from www.hm-treasury.gov.uk. This is commonly known as "The Sandler report".

2 Throughout this report, the term "Member States" refers to the 15 countries that were members of the European Union at the start of this project in January 2004.

S.6 To undertake this review, CRA assessed the academic literature on causes of market failure in retail financial services markets, undertook background research on recent regulatory changes in each of the Member States and conducted almost one hundred interviews with consumer associations, industry trade associations and financial regulators.

The case for simplicity

S.7 The major reason put forward in the literature for the regulation of financial products is the existence of asymmetric information i.e. when consumers know less about the market than the providers. There are several different aspects of the nature of financial products that lead to this information asymmetry, namely that financial products:

- Are complex, and consumers have limited understanding of them;
- Have a quality that can be hard to ascertain before acquisition (with some elements of quality not even being revealed after a long period of time); and
- Are infrequently purchased by retail customers.

S.8 In addition, problems have been identified with consumers being locked into particular products, either due to their own inertia or due to switching costs associated to the product. Further problems occur because consumers are often myopic.

S.9 Reviewing the product characteristics from a theoretical perspective suggests that the severity of the problems is likely to vary significantly between the product markets. From this assessment one would expect regulatory efforts to focus on:

- Limiting the problems due to switching costs and myopia for basic deposit accounts;
- Reducing the problems of search for cash based saving products, credit or debit cards, motor insurance, home insurance and mortgage credit; and
- Reducing complexity for pensions, life and collective investment products.

S.10 From a theoretical perspective, it is possible to determine where different types of regulatory intervention may be most appropriate. For example, for products with many complex terms but where consumers have the same basic needs, a simplified product may be the appropriate solution.

S.11 Alternatively, where individual products are not excessively complex, but the number of products and terms offered on the market make search expensive, simplified products may reduce choice unnecessarily, whilst information provision, such as comparative tables, may be a more appropriate regulatory tool.

S.12 Finally, where products have complex terms, whose value differs substantially from customer to customer, advice based regulation would appear to represent the most attractive way forward.

Are there simplified products?

S.13 To ensure consistency across Member States, it was important to define what we mean by a simplified product. In particular, we have differentiated between a simplified product and a simple product. While a simple product may evolve due to market forces, a simplified product is characterised by product specific constraints that have been imposed to solve the problems caused by complexity.[3]

S.14 We found that products that could be described as simplified had already been developed in twelve of the fifteen Member States. However, we found that these were predominantly focused on two product areas: bank accounts (of which there were six) and private pensions (of which there were nine).

[3] We therefore do not consider in detail economic issues such as network effects and moral hazard when considering the benefits from simplification or standardisation.

Table 1: Simplified products in Member States

Country	Does the country have simplified products?
Austria	Private pension
Belgium	Bank account
Denmark	None
Finland	None
France	Bank account, cash based saving, private pensions
Germany	Private pension, collective investment scheme
Greece	None
Ireland	Cash based saving, private pension, collective investment scheme, financial advice
Italy	Bank account, private pension
Luxembourg	Private pension
The Netherlands	Bank account
Portugal	Bank account, private pension
Spain	Mortgage
Sweden	Private pension[4]
United Kingdom	Bank account, cash based saving, private pension, life insurance, mortgage, collective investment scheme, financial advice

S.15 In very few cases did we find that product simplification was a primary objective in the development of the simplified product. Instead, regulation of the product design was taking place primarily for other purposes and it was decided that given a product was being promoted then efforts should be made to make it a "good product" for the consumer.

S.16 For banking products, interventions have focused on tackling financial exclusion, whilst in pensions, the focus has been on raising the level of savings for

[4] Part of a compulsory publicly administered pension.

retirement. Simplification has occurred as a by-product in achieving these objectives.

S.17 There is a consensus that products such as home insurance, motor insurance or credit cards do not generally represent a problem for consumers. Indeed, we found very limited support for a simplified motor product or simplified credit cards.

S.18 In other markets, such as cash based saving products or collective investment schemes, a small number of Member States have designed simplified products. However, looking more deeply at these examples suggests they arose due to concern regarding the complexity of new tax rules (the Savermark in Ireland and the development of CAT standards on both cash and equity ISAs in the UK) or because collective investment schemes were aimed at saving for retirement (AS Funds in Germany). Further, considerable standardisation was already in place for investment funds, not least because of the UCITS Directives. On the whole, these products were already seen as relatively simple for consumers to understand (although consumers might need help searching the market for the best product).

S.19 However, there is considerable concern expressed regarding the complexity of life insurance products in a wide number of Member States. In many countries, the products are seen as opaque and difficult to compare. Indeed, in many countries there is concern regarding the value of the product because of low yields and high costs, particularly if the costs of selling the product are charged upfront. However, we have not found any simplified life insurance products (other than in the UK) or strong direct support for such a product to be developed, except for those products that are covered by pension schemes.

S.20 The most difficult "product" to analyse throughout this study has been financial advice. The degree to which there is a well-developed advice regime varies significantly between Member States. The countries that impose only light regulation on financial advice have found it difficult to see what possible role simplified regime could play. Simplified financial advice was only identified in Ireland and the UK. In both cases it is associated to simplified products.

The success of simplified products

S.21 There are very few examples of successful simplified products.

S.22 Looking at pension products, the impact of the first wave of simplified pension products appears to have been disappointing in a number of Member States (including Austria, Germany and the UK). Indeed, we are already seeing the second wave of these products incorporating some important lessons learnt from the first wave.

S.23 It is also difficult to interpret the success of the basic bank accounts. In a number of countries the motivation for developing these products has been at least partly enabling electronic payment of benefits. It is difficult to know whether this itself would have been a sufficient incentive for those consumers without a bank account to get one.

S.24 Further, for many of these simplified products it is simply too early to come to strong conclusions about whether they have been successful. However, a number of common lessons have emerged:

- **Taxation:** There are three keys lessons regarding the interaction between simplification and taxation: (i) the necessity to restrict the cost of tax privileged products often results in complex eligibility and contributions restrictions which themselves make the product complex (for example, Riester products in Germany or ISAs in the UK); (ii) the (sometimes irrational) attraction of tax preferred products can mean that other features are ignored necessitating simplification to offset this (Savermark in Ireland); and (iii) simplification of the tax differences between products meeting the same consumer needs may be more important than other product feature (for example, see the findings of the SIVA review in Finland as well as the Sandler Report in the UK);

- **Formal objectives:** The absence of clear formal objectives of simplification has led to a lack of testing of the products that were to be introduced and a lack of targeted product design. This may be one important reason why many of the simplified products have been seen as a failure e.g. products may not have been popular in terms of take-up (even though they may have had significant impact on the market, such as the Stakeholder pensions in the UK). If objectives were clearer, analysis could identify whether costs of implementation outweighed benefits (for example, there has been significant analysis of the proportion of the population who are unbanked but little analysis of the proportion that would like a bank account but cannot get one) and the design of the products could be improved.

- **Distribution:** For products that are likely to remain "sold rather than bought" the level and structure of charges needs to be sufficient to reward the sale of these products. This means setting price caps is exceedingly difficult. In both the UK and Germany, limits on the level and structure of charges are believed to have been damaging to the development of the market.

- **Focal points of competition:** Apparently small product features can have a dramatic effect on the market. This was seen in mortgages where simplification in Spain appears to have changed the nature of competition between fixed and variable mortgages dramatically resulting in few fixed rate products being sold.

- **Consumer complacency:** Simplified products are often justified by those who design them on the grounds of weak consumer pressure implying that market forces will not lead to the development of good value products. However, simplification can actually result in deepening consumer apathy. For example, in Sweden, simplification of pensions was designed to facilitate active consumer participation in the investment decision. However, the evidence suggests many consumers invest in the default fund relying on this to provide reasonable returns and may not be making active decisions at all.

- **The environment:** There is a concern that simplifying a product in isolation will not help protect consumers or make the market work better. Indeed, the complexity of the overall system has been identified as a problem in both the UK and Germany contributing to low take-up of simplified pensions. That is, even if there is a simplified product, because it sits alongside a range of more complicated products, consumers nonetheless find the overall system to complicated to handle.

- **Simplified products can be designed by different market participants:** The genesis of the simplified products discussed in this report varies from country to country. We have found cases where a consumer association has taken it upon itself to design a simplified product, with the purpose of helping consumers purchase a complex Government sponsored product. In other Member States, consumer representatives and the trade association have negotiated terms without direct Government or regulatory involvement. However, in the majority of cases, it has been the Government who has been responsible for the creation of simplified products.

Alternatives to simplified products

S.25 The simplification of product terms is clearly not the only method to try to overcome the informational problem identified in retail financial services markets.

S.26 Rules determining the provision of information or the regulation of sales and advice process often have the same objectives. Equally, voluntary codes may introduce similar restrictions through self-regulation.

S.27 The weight placed on different regulatory instruments varies significantly:

- Information provision is seen as important for the majority of products but the provision of comparative tables have focused on banking products, motor and home insurance and collective investment schemes;

- Sales and advice regulation focusing on investment funds, life insurance and pension products; and

- Voluntary regulation being especially important for banking products, mortgages (although this is due to a European wide voluntary scheme) and collective investment schemes.

S.28 European Directives are having an increasingly important influence on the balance of regulation. UCITS, the Third Life Directive, IMD, and MiFID have all resulted in European wide changes to regulation in the market covered by this report. The impact of European regulation has been considerable, for example, the Third Life Directive reduced the degree of regulatory intervention in product design undertaken by many Member States. In contrast, UCITS has resulted in considerable increase and standardisation in the information provided on investment funds.

S.29 Finally, rules aimed at solving other problems, such as compulsory third party motor insurance targeting issues of adverse selection, have resulted in very high levels of participation in the market (unsurprisingly given the compulsory nature of the product) and considerable standardisation has occurred through the minimum product features which are deemed necessary to meet these other objectives. This has resulted in a marketplace, which successfully serves consumers with little further regulatory intervention being required.

S.30 Our assessment of the use of alternative forms of regulation across the Member States has resulted in a number of common themes developing:

- No single regulatory tool is seen as sufficient in any Member State across all products. Indeed information provision, sales and advice regulation and product regulation were often seen as complementary. Only in a minority of Member States did we see alternative forms of regulation explicitly considered as substitutes, for example, the reduction in the sales and advice requirements for simplified products in the UK and Ireland.

- There is a recognition that the provision of information is important but that there can be too much information and this needs to be structured and limited to be useful for consumers. However, there is very little analysis of whether consumers are being given too much information or the additional value of increasing the level of information provision. There is a clear danger that this results in too much information.

- Disclosure of information in itself is often insufficient as differences in the ways characteristics are presented, the terminology used and compliance with rules on disclosure makes using the information a challenge for consumers.

- Voluntary codes do provide a potential substitute for regulatory intervention and some interventions achieved by the regulator in one Member State have been achieved by collective action in another Member State. For example, in Italy the basic bank account has been produced by the banking association, whereas this was created by the Government in France and Portugal. In other Member States, there appears a complementary basis, with the regulator setting the framework and the trade associations setting out the detailed implementation (for example the banking code in Greece). We have also seen examples where self regulation preceded Government intervention, which could then rely on the experiences gained during self regulation (The Netherlands).

An identified need for simplified products

S.31 To determine whether there is a need for simplified, standard products we have relied on the interviews undertaken in each Member State and with European wide trade associations and our own assessment of the market place.

S.32 Based on the interview programme undertaken for this project, we have assessed whether respondents in each of the Member States have identified a need for simplification in each product category. There are relatively few examples of explicitly identified needs:

- In Ireland a basic bank account is currently being debated but this is not seen as a solution to a problem of product complexity but rather a part of their national payment strategy.

- In Finland some participants thought that the idea of a simplified home insurance or life insurance product could be beneficial, if this was undertaken alongside existing products. In particular, this might address the problem of different products competing on the level of exclusions.

S.33 In other cases, there is a clear need to take stock of the current simplified products and determine if these need further modification to ensure their success in the market place.

S.34 There are also a small number of cases, where our indicative analysis, undertaken for the purpose of this project, suggests the need for a simplified product. For example, we have identified particular countries where the development of a basic bank account or simplified home insurance might be beneficial. However, these are specific examples based on the problems they face in these particular product markets. Examples, include whether a basic banking product might be beneficial in Greece or a home insurance product in Italy.

S.35 In other cases, this analysis suggests that the UK is relatively unusual and supports the argument that a simplified product may be required under the UK's particular circumstances but that might not be the case in other countries. For example, the UK appears to be unusual in the degree to which investors in collective investment schemes invest in equity and the level of choice in the UK. If other markets develop in this direction, a greater case for a simplified collective investment fund could be made in the future.

S.36 This would suggest that the need for simplified products needs to be made on a case by case basis, and situations where they are likely to be valuable appear to be the exception rather than the rule.

S.37 One area where there was common agreement was the opacity of life insurance products. In particular, investment based life insurance products were commonly identified as the most complex product. In addition, in many countries there was considerable scepticism regarding whether more information could result in better consumer understanding. In this case, there appears a clear call for action. A number of proposals have been suggested:

- Unbundling the investment and life insurance component so each can be compared to separated products;

- Incorporating such a simplified product in the simplified prospectus so it could be compared to other medium term saving products on a like for like basis;

- Encouraging individual Member States to have a consistent tax system for products meeting the same consumer needs.

S.38 Each of these proposals would be likely to increase the degree to which products serving the same consumer needs compete with each other since this would allow them to be more easily compared to substitutes and also to prevent tax arrangements from distorting competition between products.[5]

S.39 Overall, we were surprised regarding the degree to which all participants in a Member States shared a similar perspective. It was often the case that consumer association shared the views of the financial regulator and the industry trade associations about the appropriate regulatory tools (even if they disagreed about current implementation).

Cross-border arguments for simplification versus standardisation

S.40 There are good theoretical arguments regarding how simplification or standardisation could increase cross-border activity.

S.41 However, there is a clear tension between simplified standard products, such as the UK's stakeholder products, designed to solve domestic market information asymmetries and standardised products that could assist cross-border trade. In particular these products often involve:

- Different objectives – with simplified products often being aimed at access considerations for low income, financially unsophisticated consumers (clearly this is the case for basic bank accounts but also risk controlled collective

5 In particular it was noted that some collective investment schemes compete directly with some unit-linked life insurance products and yet tax arrangements differ in a number of Member States. Similarly, money market funds may compete with deposit accounts. As noted above, the issue of different products competing to meet the same consumer need and yet facing differential tax

investment products) whereas cross-border trade has typically involved more highly sophisticated consumers valuing differentiation (for example UCITS has allowed individuals to diversify their portfolio by giving them greater investment freedom);

- Different preferences of target consumers – the target audience for simplified, standardised products are likely to be the more unsophisticated consumers for whom understanding products and which products are of best value is likely to be important and concerns regarding cross-border trade are likely to be limited. By contrast, sophisticated and relatively wealthy consumers are the ones most likely to be interested in the increased choice offered through cross-border trade. Indeed, since simplified products have often been aimed at marginal consumers of financial services products, it also seems unlikely that these consumers would be the ones which providers would seek to attract were they to enter a market through the freedom to provide services or freedom of establishment; preferring instead to attract high net worth consumers who are less likely to be focused on simplified products.

- Different product features – barriers to cross-border activity often relate to characteristics of the product that the consumer is unaware of e.g. the ability to get the product authorised swiftly. These are often supply-side factors of concern to providers but to which consumers are often relatively oblivious.

S.42 The view that simplified, standard products would not have a significant impact on cross-border trade needs to be contrasted with the overwhelmingly positive reaction in our interviews to standardisation resulting from the UCITS Directives which were seen to have increased choice of investment funds and increased the speed with which new products were brought to the market. In particular, this was seen to have been especially beneficial to some of the smaller Member States. We have therefore focused on how standardisation could impact cross-border activity.

arrangements was highlighted in both the SIVA review in Finland as well as the Sandler Report in the UK.

S.43 Based on our analysis we can compare each of the products both in terms of the potential for standardisation to reduce the barriers to cross-border activity and whether this would result in material benefits.

S.44 In summary, we find that there are a number of products where the extent of the barriers to cross-border trade in retail financial services mean that standardisation is very unlikely to yield significant benefits. These include:

- Bank accounts – while physical access to a distribution system remains an important component of consumer preferences, standardisation would be unlikely to increase cross-border activity. Hence until a significant proportion of consumers are willing to use bank accounts through only remote channels, this suggests that the cost of developing or accessing a distribution network for providers is likely to remain a more important barrier than the standardisation or otherwise of the underlying product. This makes consumer purchase, freedom of services and freedom of establishment problematic.

- Pensions – standardisation may be able to overcome issues regarding consumer protection and marketing differences. However, even if tax and annuitisation rules could be over come through product standardisation, the credence nature of products means standardisation is likely to be insufficient to encourage cross-border activity other than for very sophisticated consumers. Again this would appear to reduce the potential for trade via consumer purchase, freedom of establishment or freedom of service.

- Financial advice – it is very difficult to see how financial advice can be standardised when it is inherently dependent on local issues such as the whole range of products available in the local market, the tax environment including the different tax regimes on all products etc. Cross-border trade in financial advice is likely only to be possible if there was a range of standardised products (which was available in all Member States) and then it would need to be limited to that range. Financial advice is also likely to remain face to face for the foreseeable future meaning only freedom of establishment is likely to a meaningful way forward.

- Motor insurance – although products are perceived as simple, since they are fundamentally linked to the domestic legal system, a system such as the 26th regime would be necessary to facilitate cross-border activity. Standardisation alone cannot encourage further cross-border activity. Freedom of establishment remains the most likely route to cross-border activity.

S.45 There are other products where the barriers to trade appear relatively small and cross-border activity may be at an economically efficient level already:

- Collective investment schemes – the UCITS Directives have clearly already brought about cross-border activity through a degree of standardisation being imposed on the underlying features of the products. It is unclear that there are additional gains to be made that are linked to standardisation of the product.

- Credit cards –there is already a large extent of standardisation in credit cards across Member States and furthermore, there has been considerable cross-border activity into the larger credit card markets suggesting that cross-border trade is not being prevented but rather than the size of the market is determining the level of trade.

S.46 However, there are a number of products where standardisation might increase cross-border activity and a cost benefit analysis is required to investigate whether the benefits are likely to outweigh the costs:

- Deposit accounts – the importance of physical proximity is likely to recede more quickly for deposit accounts than with bank accounts implying that apparent differences in interest rates on deposit account may offer the opportunity for cross-border arbitrage.

- Life insurance – there is an opportunity to encourage trade in simpler life products, such as unit-linked life insurance and term assurance. However, domestic brands are likely to remain pre-eminent in traditional or guaranteed products. Indeed, given that unit-linked bonds are essentially comprised of simple term products and UCITS-like funds it would be surprising if it was not possible to design a product that could be traded. However, if there is a competitive market for insurance products and trade in UCITS and term assurance, the benefits may already have been exploited.

- Home insurance – although these is significant variation in the product features required in different countries and the resulting prices that will be offered to particular consumers, setting minimum terms and conditions may allow more certainty for consumers regarding product coverage and may help facilitate cross-border trade through freedom to provide services. However, local knowledge may still be required to understand the risks faced by insurers (although understanding risk could be outsourced). Further, there is considerable uncertainty that the benefits from negotiating such standards would justify the costs.

- Mortgages – For the time being consumers in many countries need physical distribution. This is likely to prevent standardisation realising substantial benefits from freedom of services or consumer purchases. In countries where mortgages are facilitated through brokers cross-border trade appears to be possible. There do appear to be a number of legal issues that would need to be overcome to make a standardised mortgage product feasible, in addition providers will need to understand local housing markets in order to be in a position to offer mortgages at economic rates. However, any economies of scale in mortgage financing may be facilitated through increasing mortgage securitisation reducing the potential gains from trade from future standardisation.

Section 1 Introduction

1.1 Charles River Associates was commissioned by the European Commission to assess the extent of an identified need for simplified, standard products in Member States of the European Union.[6]

1.2 In the absence of simplified products, we were asked to review whether similar problems exist in other member states that might benefit from the development of simplified products or whether these problems had been overcome by other means.

1.3 A third and final objective was to review the role simplified products could play in addressing barriers to the cross-border provision and/or purchase of financial services between member states.

A definition of a simplified, standard product

1.4 One of the first tasks was to agree what we meant by a "simplified product". We have categorised simplified products as going beyond purely standardisation of the product terms, such that this results in consumer finding it easier to understand and compare products.

1.5 Given the differences in terminology used in different Member States, it was important that this was based on the underlying characteristics of the product rather than how it was described. For a product to be termed a simplified product, for the purposes of our project, the simplification must:

- Impose constraints on product terms (so where the market has brought about products with focal points of competition this is not captured as a simplified product – this would already be a simple product);
- Be product specific (so conditions on the presentation of interest rates set out in the Consumer Credit directive that are applied to all credit products would not be captured and neither would conditions such as maximum interest rates applied for solvency purposes);

- Be aimed at addressing the problems in a particular product market (so provider innovation to reduce complexity that is not co-ordinated by a trade association would not be captured as this would reflect competition on product terms potentially making simplification unnecessary); and

- Have its aim as reducing market failure due to complexity (so compulsory motor insurance with specified terms e.g. must cover 3rd party insurance would not be captured since the aim is to overcome adverse selection problems rather than complexity). This may not be the primary aim of the product but should lie behind the development of the particular product terms.

1.6 There may be standardisation of products that has not resulted in simplification. This has often come about during the development of tax preferred products (which stipulate maximum contribution levels for example) or where Member States have tried to achieve other objectives, such as encouraging investment on the domestic stock exchange.

1.7 The implication of this definition is that in some cases, there may not be a need for **simplified** products because the market has created a **simple** product. These simple products would not be captured in our definition of simplified products, but rather would suggest that there was no need for simplified products since there was no market failure driven by complexity. Although, on the face of it, this definition appears pedantic, we have found it invaluable for enabling us to make assessments between countries.

The structure of the report

1.8 We first review the methodology used in this project and explain how we have classified the views of government, regulators, consumer bodies in addition to industry participants.

[6] Throughout this report, the use of the term “Member States” refers to the 15 countries that were members of the European Union at the start of this project in January 2004.

1.9 This report then looks at the theoretical arguments for simplification, the types of market where this might be favourable compared with alternative solutions such as providing more information or regulating the advice market.

1.10 The report is subsequently structured in terms of the product categories set out by the Commission. For each product, we review where simplification, rather than standardisation, has taken place, the similarities between these products and the types of simplification. We go on to consider whether other alternative forms of regulation have been used to over come the problems in the market or whether we can identify a need for simplified product.

1.11 The final chapter of this report sets out whether there are pan-European arguments for simplification or standardisation in terms of it being beneficial to cross-border trade and integration of retail financial services markets.

1.12 In a separate report, we set out the situation in each of the Member States. This looks at whether simplified products have been developed, their genesis, and the impact they have had on the market.

1.13 Since financial services markets are dynamic markets which can rapidly change and the regulatory debate in each member state is constantly under review, it must be noted that information contained within this report is accurate at the time of writing and may become out of date as the relevant markets develop. Due to the length of this project, the date of writing will vary from country to country between February 2004 and September 2004.

Section 2 Methodology

2.1 The data collection for the project was completed between January 2004 and July 2004. This involved two stages of desk based background research before undertaking an extensive interview programme in each of the 14 Member States. Additional interviews were undertaken in the UK to investigate issues that arose from the debates held in Member States.

2.2 It should be noted that the aim from these different components was to focus on whether there was an identified need for simplified products in the different Member States. If there were no such simplified products then it was important to consider the alternative forms of regulation that were in place in the Member State so that we could feed this into our assessment of whether there was value in considering the benefit of simplified products in the future. The aim was to understand the alternative regulatory tools used to make this assessment and not to provide a comprehensive description of the regulatory system in each country.

Stage 1 - Background research

2.3 The aim of Stage 1 was to develop our understanding of the problems with, and possible solutions to, consumer detriment and to develop the questionnaire that was used as the basis for structured interviews across the Member States. This stage had a number of components:

- Examining the academic literature;
- Developing a questionnaire for use in each of the Member States;
- Further reviewing the UK debate;
- Background information on European wide regulation in financial services aimed at reducing consumer detriment;[7] and

[7] Since financial services is typically a highly regulated sector, we did not examine all regulation, in particular we excluded those elements of regulation that are aimed at preventing contagion of financial crises.

- Developing a list of signs of market failures that are identified in various markets and we would gather from the interview participants.

2.4 The purpose of agreeing a questionnaire with the European Commission was to ensure that we covered all the key issues in the interviews and that the questionnaire took into account the perspective of government, regulators, industry participants (through their trade associations) and consumers (through Government departments responsible for consumers and consumer bodies).

2.5 This was used as a guide during the interview phase (Stage 3). As we expected this was a useful starting point, however, the structure of the interviews varied according to the aspects that were interesting in a particular Member State and areas of expertise of those being interviewed. A summarised version of the questionnaire was sent to interviewees prior to the interview.

Stage 2 - Member State background research

2.6 As a complement to the background research in the UK, we undertook desk based research into the financial services sector in each of the Member States. The main purpose of the first part of the background research was not only to tailor the questionnaire for the country, but also to inform the team in advance of interviews so that those interviews could be more productive and focused. This research focused on identifying:

- Government based reports into financial services (identified through the national press, the Government and regulatory websites);
- Evidence of any debate regarding simplification or where this has resulted in the development of simplified products;
- The alternative forms of regulation that were used in particular product markets and any assessment of their relative success; and
- Information in the media highlighting market failures in financial services and any attempts to solve these problems.

Stage 3 - Member State Interviews

2.7 The most important element of the data collection process was the interview programme undertaken in the Member States. This used structured interviews based on the questionnaire described above. As anticipated this involved spending around 2-3 days in each of the Member States to conduct detailed face to face interviews with:

- Government officials;
- Regulators;
- Trade associations; and
- Government departments responsible for consumers and consumer associations.

2.8 Additional interviews were also undertaken over the telephone. This captured groups that were suggested during the first round of in-country interviews or who were not able to meet us while we were in the country.

2.9 In addition to the trade associations in Member States, there are a number of European level trade associations. These European wide associations provided a useful pan-national perspective, particularly on questions about current barriers to trade across Member States.

2.10 In total nearly 100 interviews were conducted with market participants. This split varied according to countries – in particular those countries with a single financial regulators typically had fewer interviews than those where there are different regulators for different products or types of institution.

2.11 Furthermore, there was some variation across countries due to the willingness of some bodies to be interviewed for the purposes of this project.

Table 2: Interviews undertaken by type and Member State[8]

Country	Regulator / Government	Trade Association	Consumer representatives
Austria	3	3	1
Belgium	2	4	
Denmark	2	3	1
Finland	3	4	1
France	5	2	1
Germany	3	7	1
Greece	3	1	
Ireland	2	2	1
Italy	3	2	1
Luxembourg	4	3	
The Netherlands	2	2	1
Portugal	3	2	1
Spain	3	3	2
Sweden	3	3	2

Stage 4 – Confirmation from Member States

2.12 The final component of the data collection methodology was to return our country chapters to interview participants for review and to incorporate their comments. This was especially important where we have quoted directly from the interview.

8 Note that in a small number of cases written statements were provided rather than interviews being conducted.

However, this also ensured that we had properly identified the major issues of most importance in each Member State and that our research had been accurate.

Section 3 Consumer detriment and simplified products

3.1 Before considering the question of whether a need for simplified, standard products has been identified in different Member States, it is useful to consider why, from a theoretical perspective, a simplified product might be beneficial.

3.2 This helps us to establish:

- The types of market conditions where benefits may arise from the development of simplified products and where they are not likely to be useful;
- Where alternative forms of regulation might be substitutes for simplifying products and where different forms of regulation would be complementary; and
- The questions and data required to understand where these benefits might be greatest.

3.3 In this section, we focus on the problems caused by informational problems between consumer and providers and how this leads to consumer detriment. Consumer detriment can take a number of forms from buying the wrong product (because it is inconsistent with the consumer needs) to buying a product that is poor value (compared to other offerings on the market) or not buying a product altogether (when the consumer would benefit from the purchase).

3.4 This section is based on a review of the academic literature on the need for financial services regulation and the relevant theoretical literature regarding how markets operate where there are problems of information. In developing this chapter, we have looked at the literature across Europe. However, perhaps unsurprisingly, research has focused on the UK where there has been the greatest regulatory interest in product complexity.

3.5 For the purposes of our analysis we are not interested in how product design can be used to meet other problems in retail financial services such as solvency issues. Finally, we leave the discussion of the theoretical relationship between simplification and trade to Section 5 which specifically examines the issue of cross border trade in financial services within the European Union.

Information asymmetry

3.6 The major reason put forward in the literature for the regulation of financial products is the existence of asymmetric information i.e. when consumers know less about the market than the providers.[9] There are several different aspects of the nature of financial products that lead to this information asymmetry, namely that:

- They are complex, and consumers have limited understanding of them;
- Their quality can be hard to ascertain before acquisition (with some elements of quality not even being revealed after a long period of time); and
- They are infrequently purchased by retail customers.[10]

3.7 Each of these issues is considered in turn below.

<u>Complexity of characteristics</u>

3.8 Unlike many goods and services purchased by consumers, financial services products are often seen as complex products with multiple terms and conditions that take significant effort to understand. However, it is clear that this complexity and the perception of complexity varies according to both the product and the consumer.

3.9 For example, many financial services products have large numbers of characteristics that are of relevance to the consumer and would need to be taken into account before an informed purchase could be made. For life insurance including an investment element these could include charges, investment approach, surrender penalties, premiums, maturity values and pay out on death.

3.10 Indeed even a product that many would consider to be significantly simpler such as a credit card has faced considerable concern regarding complexity of pricing. Typically this varies according to the type of transaction (cash, foreign exchange, goods and services), and whether the consumer has revolving credit, with

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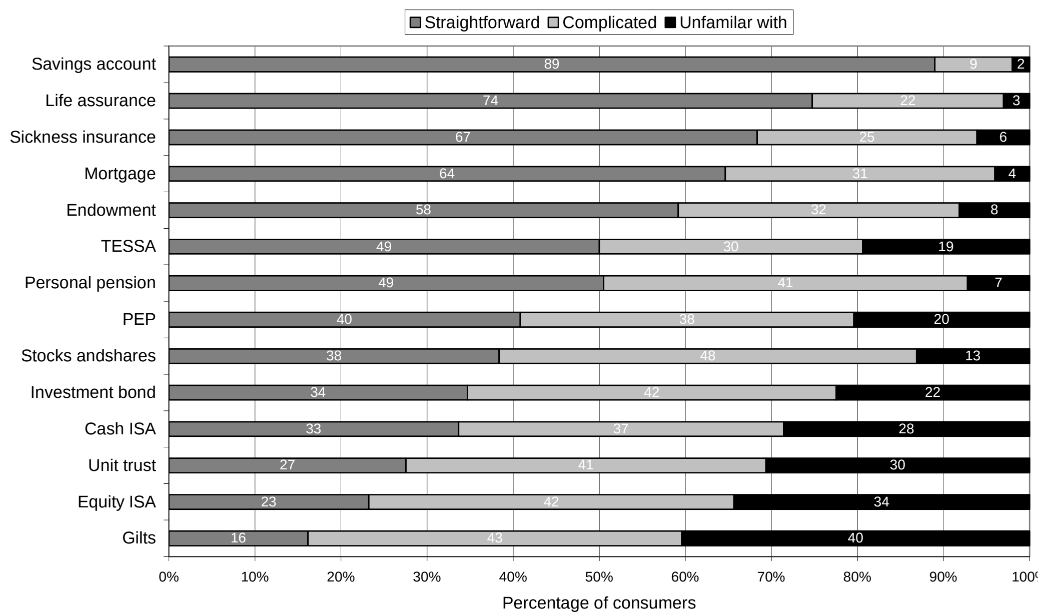
9 Strictly speaking, information asymmetry is when two parties have different information. However, the form of this of most interest to us here is when consumers have *less* information than providers.

10 Financial Regulation: Why, how and where now? Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, 1998.

different interest free periods available under different circumstances for one particular credit card. Although the use of a common measure, such as an annual percentage rates (APRs) is enforced in Member States, concerns remain that this is insufficient to understand prices. Indeed there have been claims that two cards with the same APR, can have a difference in charges of up to 70% for a same amount of money due to due to different methods of calculating the APR and when the interest is due.[11]

3.11 The perception of complexity varies between products and between consumers. Research undertaken for the Financial Services Authority in the UK demonstrates this variation by both consumers and products.[12]

Figure 1: Perception of complexity of deciding which product is right for them



Source: Better informed consumers, BMRB, April 2000, Consumer Research 1 for the Financial Services Authority

3.12 The perception of complexity is likely to differ considerably depending on factors such as:

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[11] Treasury Select Committee, oral evidence, 9th September 2003

[12] Better informed consumers, BMRB, April 2000, Consumer Research 1 for the Financial Services Authority. Both Figure 1 and some of the bullets following are taken from this research.

- Historical development of the market – for example, the use of collective investment schemes varies significantly between member states. This is likely to lead to greater familiarity in some countries and make it possible for consumers to draw on experience from previous consumers;

- Financial literacy – the FSA research found that those with lower perceived financial skills were more likely to find products complex;

- Socio-economic group and income – again the FSA research found those on lower incomes more likely to find products complex, which may be partly related to affordability of products and the likelihood of having purchased them in the past being lower than for other groups;

- Age – young people were, somewhat surprisingly, found to be more likely to find products complicated which again may reflect having had less experience of actually purchasing the products; and

- Product launches – for example at the time of the research above, ISAs (tax favoured collective investment schemes) had only existed for one year and hence consumers may have been unfamiliar with them for this reason.

Bounded rationality

3.13 The degree to which a product is perceived as complex depends upon the ability of individuals to process all the available information. The limited ability to process information when deciding which products to buy, introduces a concept known as *bounded rationality.*

> *"Bounded rationality refers to the limited human capacity to solve or anticipate complex problems"* [13]

3.14 Broadly speaking bounded rationality reflects the fact that information is costly to process and to communicate and hence individuals are unable to either gather or understand all available information regarding purchases. Although they act rationally within the limits of the information they do have, they may not either have all information or be able to process all information and hence may not appear to act rationally (compared to a situation where they were able to use full information).

3.15 If consumers are not able to use all the available information regarding a purchase, this can lead to the theoretical potential for product providers or intermediaries being able to take advantage of this situation:

> *"[Providers may be able to] …disclose information in a selective and distorted manner. Calculated efforts to mislead, disguise, obfuscate, and confuse are thus admitted."*[14]

3.16 In some markets competition will emerge around focal points, so competition focuses on a small number of dimensions that act as "rules of thumb" regarding whether a product is good value for example. Indeed this approach is not limited to the purchase of financial services but is found across a range of firms,

> *"An organization cannot afford to remember extensive and detailed information. Instead it attempts to codify information in the form of standardized rules that are meant to help the organization to adapt quickly and relatively efficiently to changes in the environment."*[15]

3.17 However, this is unlikely to be successful where products have many dimensions in determining whether the product is appropriate for a particular consumer.

3.18 This problem has been highlighted in terms of consumers making appropriate decisions regarding asset allocation. In particular, the recent Turner report[16] highlighted the evidence showing how consumer decisions were often highly dependent on the choices they are offered. For examples,

- Evidence that the asset allocation chosen by an individual depended on whether they were offered a number of equity funds and one bond fund or vice versa;

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[13] Modern Industrial Organisation, Carlton and Perloff, 1989, Harper Collins

[14] Transaction cost economics, Williamson in Handbook of industrial organization volume 1, Schmalensee, and Willig Eds, 2001 edition.

[15] The theory of the firm, Holmstrom and Tirole in Handbook of industrial organization volume 1, Schmalensee, and Willig Eds, 2001 edition.

[16] Pensions: Challenges and Choices: The first report of the Pensions Commission .

- Evidence that people invested in familiar investments, even if this imposed significant risk on them (for example, investing in the company you work for);

- Evidence that more complex choices (through greater fund choice for example) became overwhelming lead to a lower level of participation;

- Evidence that consumers put too much weight on recent past when making a decision but then become resistant to recognising a mistake.

3.19 Furthermore, when constrained by bounded rationality disclosure of more information to a consumer may make the problem more difficult rather than less resulting in consumers who are even less able to discriminate between appropriate and inappropriate products.

Conclusion on complexity

3.20 Within financial services, the variety of products available, the complicated concepts involved, quantity of jargon used and the difficulties of making optimum decisions in the presence of often unknown risks make many financial products too complex for some consumers. Indeed a common sentiment is that:

> *"Financial services is a market in which consumers cannot ever hope to be fully informed. There is simply too much information available, and it is of a complex nature."*[17]

3.21 Thus the asymmetric information problem with complex financial services products can be seen as a problem both of a lack of information provided to the consumer and of also the inability of consumers to process all the information that is there.

3.22 This suggests that in situations characterised by asymmetric information rather than bounded rationality, increased information provision may improve the market outcome. However, where consumers are unable to process the amount of information or the type of information, focusing the market on particular dimensions may be required.

[17] Consumer Detriment under Conditions of Imperfect Information, London Economics, OFT Research Paper 11, August 1997.

Difficulty in assessing quality

3.23 There are three main elements that are of interest regarding unobservable quality:

- Quality may be unobservable at the time of purchase;
- Quality may be unobservable until a considerable length of time has passed after purchase; and
- Quality may never be observed.

3.24 For most goods the quality of the product is relatively clear at the time of purchase, for example when buying a computer a consumer can judge quality through commonly understood specifications such as the speed of the processor or amount of memory. Based on this they can make an informed choice as to which is the best product for them to purchase at the time. Alternatively the quality of food may be unknown prior to purchase but as it is typically eaten quite close to the time of purchase the quality is quickly revealed. This information can then be used to determine from whom to purchase similar products on any subsequent occasion.

3.25 In contrast to these examples, many financial services products are long term products the quality of which cannot be observed at the time of purchase. Indeed it may not be for a considerable length of time before which quality can be assessed, if it is ever observed at all.

3.26 Within the academic literature, a distinction is made between "search goods" where quality is clear before purchase through searching, and "experience goods", where the costs of searching are so high that it is most efficient to purchase the good first and then learn the quality afterwards from experience. [18] It is reasonable to argue that many financial products fit this description, with a lack of consumer knowledge combined with product complexity leading to prohibitive search costs, and consumers purchasing with at least some degree of ignorance.

[18] Information and Consumer Behaviour, Nelson, Journal of Political Economy, 1970.

3.27 Furthermore, some financial products fit the description of credence goods, where quality is costly to learn even after purchase, and hence may never be known. [19] This seems reasonable, as it may not be possible for consumers to fully rate the quality of the financial product they purchased, even with the benefit of hindsight.

3.28 For example, many financial products contain some element of risk or uncertainty such as investment risk. Thus at the time of purchase, the final value of the product is unknown and hence it is very difficult to assess the quality of the product e.g. the investment strategy is hard to assess before the strategy has been fully put in place. Indeed it may be the case that even at the maturity of the product, it is not possible to fully assess the quality of the product. Although the final value of the product would be available, the consumer may not necessarily know whether this value exceeded reasonable expectations at the time of purchase, how it compares to the results from alternative offers available at the time, or whether the investment manager followed the expected strategy etc.

3.29 For instance, it may be that *ex post* the consumer did benefit greatly from the product they purchased. However this does not mean that *ex ante* it was the best product for them to purchase, taking into account the whole range of possible outcomes that could have occurred. The choice may have just been lucky and could have been disastrous in a range of alternative circumstances. The implication of this could be that consumers remain at an informational disadvantage, and are unable to learn from experience. Therefore even with repeat purchase, the consumer will not be able to fully assess the quality of the product.

<u>Infrequency of purchase</u>

3.30 Many financial services products such as pensions or life insurance are long-term products and hence may only be purchased a handful of times over a consumer's lifetime. There are a number of concerns that arise because of this.

[19] Free Competition and the Optimum Amount of Fraud; Darby and Karni; Journal of Law and Economics, 1973.

3.31 First, since purchases are so infrequent, the cost of finding out about all the products on offer at the time may seem substantial. If the acquired information is not used again for a number of years it may be out of date by the time of the next purchase. This reduces the incentive to search for information at the time of purchase.

3.32 A second problem caused by the infrequency of purchase is:

> *"The small-volume retail customer does not make frequent repeat orders of financial contracts, and therefore has a limited ability to learn from experience"* [20].

3.33 Through buying products the consumer can learn about their quality and thus become better informed (a similar idea to experience goods explained above), but for a consumer who only ever purchases one pension in his lifetime this process is not effective and thus consumers can suffer from a lack of information. A lack of repeat purchases means firms do not have as strong an incentive to provide high quality products, as they do not have to compete for future business and risk having consumers who are not happy with their purchases.

3.34 A third related problem stemming from infrequently purchased products, particularly those featuring long-term contracts is that firms may have an incentive to act in their short-term interest, at the expense of the long-term interests of their consumers.[21]

3.35 An example of this is when investing money, firms that behave so as to maximise the long-term returns to consumers can lose out in the short term to rival institutions that behave more recklessly e.g. by adopting high risk strategies. Given the infrequency of purchase, consumers may be unable to differentiate the "good" firms from their competitors and indeed may well mistake the reckless firms for good firms, confusing their potential to sometimes deliver higher short-term returns for better financial management.

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[20] Financial Regulation: Why, how and where now? Charles Goodhart, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, Steven Weisbrod, 1998.

[21] This problem is sometimes known as Grid Lock. The examples in the section are drawn from The Economic Rationale for Financial Regulation, David Llewellyn for the Financial Services Authority, Discussion Paper 1

3.36 Thus, when faced by rivals behaving for short-term gain, "good" firms can either begin to adopt short-term strategies, or they can continue to compete at a disadvantage to their less-scrupulous rivals. Either way - through adopting short-term strategies themselves, or losing market share to those who do - "good" firms will account for an ever-decreasing share of the market, and may disappear altogether.

3.37 Some argue this was the case in the personal pensions mis-selling scandal in the UK in the mid 1990s. Salesmen were paid on the basis of the number of sales they achieved, which encouraged them to sell products that were not in the best interests of their customers. This is also illustrative of the problems that can emerge with financial advice, which we return to later in the chapter.

Switching costs

3.38 Some financial products effectively "lock-in" consumers by imposing switching costs on those who decide to change to a rival product. It must be noted that not all of these costs are imposed by firms, and not all necessarily refer to a cost in the sense of a direct monetary cost. The various forms that these costs can take include:

- Learning costs;
- Transaction costs; and
- "Artificial" costs imposed by firms.[22]

3.39 Learning costs refer to the fact that experience and expertise with one brand cannot necessarily be transferred to another brand. In the case of financial products, different products may have an array of different rules and conditions associated with them, or may work in different ways (for example, when a claim can be made on insurance, or how much notice must be given to withdraw money from a savings account); when switching to a new product a consumer will incur a cost in familiarising themselves with these differences.

3.40 Transaction costs refer to costs incurred in actually switching products; the processes of examining alternatives, and then coordinating the changeover which may lead consumers to incur a range of costs in terms of time and effort.

3.41 These two costs represent the real social costs of switching products, though their size can be influenced by behaviour of firms (by, for example, making their products intentionally complex and different in their detail to those of rivals). Artificial costs, on the other hand, arise entirely at the discretion of firms, frequently in an effort to ensure customers make repeat purchases with their current providers.

3.42 An example of this for financial products is motor insurance or other insurance products, where consumers are not able to transfer their no-claims history, and can therefore lose out on their no-claims bonuses, which can significantly increase their premiums.[23]

3.43 In some cases there may be the perception by consumers of high switching costs, even when this is not the case. In these instances negative market outcomes of switching costs can result, even without there being any actually present. For example, even though banking accounts with payment means are used with considerable regularity, and hence the quality of the product should be observable, the rate of switching on these accounts is often extremely low. For example, in a recent survey 53% of consumers said they had banked with their existing bank for more than 10 years.[24]

3.44 One factor leading to this is that consumers perceive that the cost of switching is very high because the processing of direct debits or other regular payments may be interrupted when switching accounts. Regardless of whether this switching is administered well on average, the cost to an individual is believed to be

[22] Markets with Consumer Switching Costs, Klemperer, May 1987, The Quarterly Journal of Economics.

[23] Interestingly, we have been told that in a number of Member States providers of motor insurance have started to accept transfers of no claims histories in order to reduce the cost of switching for the consumer (and hence increase the potential market share for the provider willing to accept the transferred no claims history).

[24] Banking beyond borders: will European consumers buy it? KPMG, April 2004.

substantial if they happen to be the customer for whom the switching process does not go smoothly.

3.45 If this concern is merely one of perception rather than reality, then improving information regarding switching services could be the appropriate step. However, if artificial barriers are being placed on switching then product specific regulation could be required.

Myopic Behaviour

3.46 Myopic, or short sighted, behaviour is when consumers take an unreasonably short time horizon when making decisions or when they discount the future at a very high rate. This applies to a wide range of goods that consumers buy, for example we can frequently observe consumers buying products that are cheaper in the short run, but more expensive in the long term, than others available. Individuals may rush to buy the cheapest printer on the market, even if the cost of its cartridges are such that it will ultimately cost the consumer more than if they had bought a more expensive model.

3.47 However, consumer myopia is thought to be particularly problematic with financial investments, specifically with saving for retirement. Here many consumers assume that State provision will be sufficient for their expected post-retirement income and subsequently enter retirement on a lower income than they would have liked. In part this may be related to previous experience of earlier generations receiving generous State provision, or it could simply be evidence of consumers being unwilling to sacrifice their living standards now in order to secure a much higher one in the future.

3.48 Evidence of myopia in pension has been recently reported in the UK’s Turner Review:

- This illustrates, with US research, the difference between the very high proportion of participants at pension seminars who say they are going to join and the low proportion who eventually do; and

3.49 The high proportion of people who know they are not saving enough but do not then change their behaviour.[25] One survey found 76 percent of respondents believed that they should be saving more for retirement.[26] Indeed, of those that felt that they were at a point in their lives where they should be seriously saving already, only 6 percent reported being ahead in their savings, while 55 percent reported being behind.

3.50 It must be noted, though, that apparent myopia can sometimes be attributed to uncertainty surrounding the future, and can therefore actually be an informational problem. For example, individuals may not know when they will retire and hence how much to put into a pension, and crucially individuals do not know how long they will live and hence for how long they must live on the income generated from their pension. With investment products, investors do not know whether any money they invest will be lost in a stock market crash or just how generous (or otherwise) state pensions will be in the future. Thus we observe that many individuals in retirement regret not saving more for the future, yet younger individuals repeat the same mistake.

3.51 Furthermore this behaviour can be perpetuated by the structure of products. Individuals that put their money in long-term investments may face high surrender penalties for withdrawing their money early; given the uncertainty that surrounds the future, individuals cannot know if they may ever need their money at short notice. It may therefore be a perfectly reasonable (non-myopic) decision for individuals to invest in shorter-term products where they can access there money even though they have the intention of saving for the longer term. However, while this can partly explain a lack of investing in pensions, for example, it cannot explain a lack of saving overall.

[25] This draws on Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance, NBER Working Paper No.W8655 Choi ,2001 Choi, J., Laibson, D., Madrian, B. and Metrick, A. (November 2001).

[26] Self Control and Saving for Retirement; Laibson, Repetto, Tobacman, Brooking Papers on Economic Activity, 1:1998.

3.52 Interestingly, the opposite argument may apply to lower socio-economic groups. There is some evidence in the UK that low income individuals in particular value the locked in nature of some products because of the lack of self control:

> *"Here research has shown that what people who are on the margins of financial services most want is a product that encourages the discipline of saving small amounts regularly. They want to be able to gain access to that money when needed, but for withdrawals not to be too easy."*[27]

3.53 The same issue may explain why low income consumers may be reluctant to take-up bank account with credit facilities as these could potentially result in them borrowing and building up a stock of debt that they will not be able to service.

3.54 However, some consideration must be made before encouraging consumers to lock away money for a long period of time. Care must be taken since the need for precautionary or emergency savings before committing to long term savings is well accepted.

3.55 Therefore, the consequences of myopia are clear; if left unchecked individuals can end up making investment decisions that are ultimately not in their best interests; they could leave themselves with very low living standards in the future for desire of modest levels of saving in the present. Therefore, regulatory intervention may be justifiable on the grounds that it can help to reduce consumer detriment through overcoming the problem that individuals may save too little (even by their own standards) through encouraging the use of long term investments by making them easier to use and possibly also through regulating the presentation of information.

The need for simplified products from a theoretical perspective

3.56 The informational problems that are posed varies significantly between the product markets. Table 3 below we set out how each of these product measures up compared to the informational problems discussed above. From this assessment we would expect regulatory efforts to focus on:

[27] In or Out? Consumer Research 3, Financial Services Authority, July 2000.

- Limiting the problems due to switching costs and myopia for basic deposit accounts;

- Reducing the problems of search for cash based saving products, credit or debit cards, motor insurance, home insurance and mortgage credit;

- Over complexity for pensions, life and collective investment products (to the extent that risk is a particular concern).

Table 3: A theoretical assessment of the need for simplified products

	Basic deposit account with payment means	**Cash based savings products on which interest or other return is paid**	**Credit or deferred debit card**	**Pensions**	**Motor insurance**	**Home insurance**	**Life insurance**	**Mortgage credit**	**Unit trusts**	**Financial advice**
Complexity of characteristics	Relatively few key characteristics	Relatively few key characteristics	Complex pricing structure possible	Large number of potential characteristics, pricing structure complex	Relatively few characteristics of end product, simple price structure	Relatively few characteristics of end product, simple price structure	Large number of characteristics, often opaque pricing	Large number of different types, complex pricing	Reasonable number of characteristics, some complexity of pricing	Consumers often unclear over cost of advice
Difficulty in assessing quality	Transparent quality - cost or return relatively easily identifiable	Transparent quality	Few	Unknown performance of investment	Quality only directly observed at the time of claim, but frequency of claims high for the market as a whole	Quality only directly observed at the time of claim which is by its nature infrequent	Unknown performance of investment (if linked to investment); quality only slowly observed	Quality relatively easy to assess	Unknown performance of investment	Unknown quality of advice, and inability to judge to what degree past good advice was down to luck or skill
Infrequency of purchase	Continuously used, though new products "purchased" only moderately frequently	Continuously used.	Continuously used, though new products "purchased" only moderately frequently	Infrequent	Commonly annual renewal	Commonly annual renewal	Infrequent	Around 7-10 years	On average every 3-5 years	Variable, subject to other products
Switching costs	Low (although often perceived as high)	Low/ None	Low, in fact some benefits through interest free balance transfers	Depends on pricing structure	Potential loss of no claims bonus, considerable switching observed in some countries	Potential loss of no claims bonus, but considerable switching observed	Depends on pricing structure	Depends on pricing structure	Depends on pricing structure	Depends on cost
The potential for myopia	Concern regarding the use of credit facilities may lead to low take-up	Relatively certain; widely held.	Widely held, nature of card partly designed for uncertainty of future purchases	Unknown performance of investment and unknown need in future	Usually compulsory	Relatively certain; widely held, and those that do have this generally intend to keep it	Future needs for dependants unclear, performance of investment unknown	Interest rates uncertain, but repayment of loan predictable	Unknown performance of investment and some uncertainty of need for money in short time horizon	Uncertain, depends upon future investments and needs
A first principles assessment	Switching cost primary concern/myopia potentially causes low take-up for low income	Search only source of concern	Search only source of concern	Perceived by consumers as a complex product	Search	Search/complexity over exclusions	Perceived by consumers as a complex product	Search	Search/complexity over assessing risk	Assessment of quality

Different solutions to informational problems

3.57 However, even if there are informational problems in particular product markets that does not mean that simplified products are the most appropriate solution.

3.58 Given the different informational problems associated with financial services products there are a number of theoretical solutions: simplifying the consumer choice through simplifying the product; increasing the information provided to the consumer to help inform the decision; encouraging consumers to use financial advisers to assist them make these decisions.

Simplified products

3.59 From a theoretical perspective simplified products can help to address a number of issues mentioned above. For example, by standardising terms, they limit the number of choices that consumers need to make, facilitating product comparison and focusing the consumer on the factors that vary between their competing choices.

3.60 Simplified products can have reduced switching costs, enhancing competition and minimising the potential for detriment, as the consumer is always able to switch to another product should the first choice prove unsatisfactory.

Information

3.61 Where consumers are able to process the additional information, the provision of information will allow consumers to compare products and determine the product that is most appropriate for them.

3.62 Information provision may also assist consumers when comparing the merits of taking up a product with the available alternatives, offering the potential to reduce the problems of myopia.

Financial advice

3.63 One of the results of the complexity of financial services products is that consumers often rely on advisers to aid their understanding or to recommend particular products.

3.64 Since financial advisers will be advising a number of consumers on an on-going basis, they have the incentive to learn about the market in a way that the individual consumer, making only infrequent purchases, does not. Hence consumers can use financial advisers to take advantage of their greater knowledge. However, the relationships between advisers and providers remains an area of concern for regulators.

3.65 In the same fashion that consumers cannot ascertain whether they have chosen the best product for them, it is very difficult for them to assess the quality of the advice they are offered and to choose between advisers.

3.66 Therefore advice can help consumers to overcome the problem of asymmetry between the consumer and the provider but still result in asymmetry between the consumer and the adviser. This problem can be partially resolved by quality certification of advisers and regulation of the advice process.

3.67 The problem is often complicated by advisers being remunerated on a sales contingent fashion. This, it is argued, leads to an incentive compatibility problem where:

> *"Financial advisers carry out two functions: they provide advice about products and they retail the products, establishing a distribution channel between life offices and consumers. Some financial advisers may also derive their income from the life offices themselves, either through fees or commissions. This may pose incentive problems in the provision of advice to consumers."*[28]

3.68 Thus, recommendations by financial advisers may be influenced by commission payments that flow from the financial services provider to the adviser.[29]

[28] *Consumer Detriment under Conditions of Imperfect Information*, London Economics, OFT Research Paper 11, August 1997.

[29] In the UK, this incentive problem has been of considerable interest to the authorities over recent years. However, the only in depth analysis of commission bias was done by CRA and found that although there was evidence of product and provider bias in certain areas, it was not across the board. Polarisation: Research into the Effect of Commission Based Remuneration on Financial Advice, January 2002, by Charles River Associates for the Financial Services Authority. Available from www.crai.co.uk or published alongside CP 121 on the FSA's website www.fsa.gov.uk.

Implications of the literature for simplified products

3.69 The analysis above gives us a guide where simplified products may be valuable and where other methods for overcoming the informational problems such as the use of financial advisers or increased information may be the appropriate solution.

3.70 Simplified product are likely to be most valuable where:

- The products has many characteristics that need to be taken into account to determine whether the product is suitable; but
- There is little differentiation that is valued by consumers, i.e. a simplified product meets the needs of the significant group of consumers.

3.71 In contrast, increased information is likely to be beneficial if:

- The products are not in themselves complex but the number of products make search costs high; or
- Where it is valuable to focus consumers on a small subset of the dimensions of the product (or there is a particular aspect of the product that is causing concern).

3.72 Finally, we would expect regulation to focus on the advice process where:

- There are many dimensions to the products making choice difficult for consumers; and
- These result in a range of products that are suitable for different types of consumer. The advice process is needed to effectively match consumers to the type of product that best meets their needs.

The potential problems from simplified products

3.73 Before considering introducing simplified products into a market we need to consider both the potential benefits but also the potential costs. Introducing simplified products into a market has a number of theoretical risks associated to it. These fall into a number of categories.

3.74 To simplify a product requires you to remove particular dimensions or limit the choice along particular dimensions. This introduces a cost, in particular, a consumer who would prefer a product with different dimensions will suffer if he is forced to purchase the simplified product. This is likely to be the case where consumers have very different preferences requiring substantial product heterogeneity.

3.75 This requires the product designer to have as much information as the marketplace. Markets work by suppliers competing over offering different products to consumers. Consumer choices determine the products that are successful and those that fail. Simplification requires the product designer to understand what consumers want.

3.76 This problem is exaggerated when we think about the future. As consumers change and new ideas and technologies take-off, products should develop naturally to better meet consumer needs. This process of innovation can be stifled if the products are specifically designed to fit the market at a point in time.

3.77 Finally, simplified products can take the element of choice away from consumers. As the outcome does not depend on the search efforts of the consumer, the incentive to review different products is reduced. This it is argued can lead to less rather than more consumer pressure and reduce the level of financial awareness (from what is generally agreed to be a low base).

Section 4 Development and characteristics of simplified products

4.1 In this chapter we look at the overall findings in terms of whether we have found simplified products in the Member States. We then go on to look at which body has introduced these products into the market and when they were introduced.

The existence of simplified products

Table 4: Simplified products in Member States

Country	Does the country have simplified products?
Austria	Private pension
Belgium	Bank account
Denmark	None
Finland	None
France	Bank account, cash based saving, private pensions
Germany	Private pension, collective investment scheme
Greece	None
Ireland	Cash based saving, private pension, collective investment scheme, financial advice
Italy	Bank account, private pension
Luxembourg	Private pension
The Netherlands	Bank account
Portugal	Bank account, private pension
Spain	Mortgage
Sweden	Private pension[30]
United Kingdom	Bank account, cash based saving, private pension, life insurance, mortgage, collective investment scheme, financial advice

4.2 We found that in eleven of the other fourteen Member States there were products that could be described as simplified which have already been developed. Compared to the seven simplified products that have been launched in the UK, we

[30] Part of a compulsory publicly administered pension.

have only identified nineteen products that we have categorised as simplified products in the other fourteen Member States.

4.3 However, we found that these were predominantly focused in two product areas: bank accounts; and private pensions.

4.4 Although we have also found an isolated example of a mortgage product, there is an overwhelming consensus that complexity of these products does not represent a problem for consumers.

4.5 Similarly in home insurance, with the exception of concerns regarding the level of exclusions in the cover in Italy, this was seen as a product which consumers did not find to be unduly complex.

4.6 In a number of product markets, we did not find any evidence of simplified products or support for simplification, for example, there was little interest in a simplified motor insurance product or credit card product in any Member States from the perspective of regulators, the industry or consumers.

4.7 In other markets that have been a source of concern in the UK, such as collective investment products, there have been attempts to design simplified products in a number of Member States. However, looking more deeply at these examples would suggest these arose due to concern regarding the complexity of the tax rules (in particular that in Ireland consumers might be swayed by the tax benefits of the product and hence not place sufficient weight on searching between providers) or because the collective investment schemes were to be used primarily for saving for retirement (such as in Germany).

4.8 There is considerable concern regarding the complexity of life products in a wide number of Member States. In many countries, the products are seen as opaque and difficult to compare. Indeed, in many countries there is concern regarding the value of the product if products are held only for a short period of time and consumers are not able to switch between providers. However, we have not found any simplified life products (other than in the UK) or strong direct support for such a product to be developed. Although in Finland simplification indirectly in terms of removing unequal taxation of products, has been welcomed by some authorities. Further it should be noted that since many pension products have life insurance as the underlying investment vehicle and given that simplified pension products have been identified, there does not seem to be a strong reason why such a simplified life insurance product would not be possible to design.

The most difficult "product" to analyse throughout this study has been financial advice. The degree to which there is a well developed advice regime varies significantly between Member States. The states that impose only light regulation on financial advice have found it difficult to see what possible role simplified regime could play. Simplified financial advice was only identified in Ireland and the UK. In both cases it is associated to simplified products.

Genesis and objectives

4.9 We have found few examples where a concern regarding complexity has led directly to a simplified product being developed.

4.10 Instead, the reasons behind a simplified basic bank account and private pensions have focused primarily on take-up. For example, in many countries there is a desire to increase the size of private pensions and whilst developing products to meet these needs (often with tax encouragement), issues of consumer protection have also been built into the product at the same time.

4.11 Basic banks accounts have been developed in a number of countries because of a desire to move to electronic payment of benefits. Simplification can be seen as necessary in persuading banks to offer these accounts universally, at the same time however, the benefits of all members of society having access to financial services has also been incorporated into the product design.

4.12 In the UK, in the product markets we are concerned with, the UK Government departments have created all existing simplified products. The financial regulator (the FSA) does not have the power to create simplified products.

4.13 Looking at the majority of simplified products in the other Member States a similar pattern emerges. However, there are some notable exceptions:

- In Ireland, the simplified collective investment scheme was designed by the Consumer Association in response to a new tax preferred product designed by the Government. Although this provided generous benefits in terms of tax, there was a concern that without simplification consumers would get poor value products.

- In Italy, the simplification of pension charging structures has come about through industry agreement. The regulator, however, although not able to specify product restrictions of this nature, encouraged this through the authorisation procedure.

- In Italy, the simplified banking product has come about directly through the actions of the banking trade association.

4.14 This would suggest that although direct Government involvement is the most common way to develop a simplified product, this is not always the case.

4.15 The UK appears to be relatively unusual in the extent that it has had market based reviews (such as the Cruickshank review into banking and the Sandler review into investment product). Other Member States have focused on particular products that are seen to have particular problems.

4.16 However, it is important to note that during our interviews there was considerable concern about the practicality of bodies other than the Government developing products of this kind. For example, there was concern that the discussion of market wide simplification of products would be seen as anti-competitive (in particular, if the design was related to prices). Concern was also expressed about whether it was consistent with existing European directive such as the third life Directive.

4.17 In the following chapters we look at each of the product markets in turn considering the types of simplified product developed, why these have not been developed in other countries and whether there might be an outstanding need to develop these products in the future.

Section 5 Bank accounts with payment means

5.1 Following the analysis in the theoretical chapter, we would not expect bank accounts with payment means to be one of the areas for which there is the greatest concern regarding consumer detriment.[31] In particular, they are frequently used and quality can be quickly identified without consumers typically seeking advice regarding them.

5.2 However, in practice regulators and consumer organisations within Member States have a number of concerns regarding bank accounts. Firstly, they are concerned that not all consumers have access to a bank account.

5.3 Indeed, exclusion is of concern partly because of the view that other goods and services are more cheaply purchased when payments are made from a bank account. For example, utility bills are often cheaper when payments can be made direct from bank accounts. In addition, some countries may have restrictions on the use of cash from a money laundering or tax evasion perspective e.g. France does not allow cash purchases to be made above a certain value for this reason.

5.4 Secondly, there is concern that consumers do not switch bank accounts regularly, resulting in too little pressure being exerted by consumers on the providers of banking services.

5.5 In many Member States the low levels of switching between bank accounts that is observed was highlighted as a potential source of concern. Indeed in a recent survey 53% of consumers said they had banked with their existing bank for more than 10 years.[32]

5.6 Finally, a particular concern in some Member States was the confusion caused by banks using complicated fee structures where the definitions of these fees varied from one bank to another. For example, it was highlighted in Austria that there were a large number of different components of costs making comparability between providers difficult. Equally, in Greece, although banks have an

[31] Throughout this section, bank accounts with payment means will be abbreviated to “bank accounts”.

[32] Banking beyond borders: will European consumers buy it? KPMG, April 2004.

obligation to present their charges, the differences in terminology made comparison difficult.

5.7 Particular problems were identified in France regarding the lack of contracts between consumers and the provider of banking services. Although this has recently been addressed for new customers, it is unclear whether conditions for existing customers will be addressed. The particular aspect of concern is that consumers may not know what costs will be charged until after they have been imposed.

5.8 There are also a number of Member States where there have been concerns regarding the bundling of bank accounts with other products. In particular, lower charges can be obtained on bank accounts when other parts of the consumer's financial portfolio is placed with the same bank.

5.9 The interviews and our background research confirm that in most Member States bank accounts are seen as already relatively simple, however, some concerns remain.

5.10 However, where simplified products have been designed, these only aim at increasing access to bank accounts and the associated implications for financial exclusion. Discussions regarding the provision of basic bank accounts or a universal service obligation have been had in a large number of the Member States.

Simplified bank accounts

5.11 Simplified bank accounts with payment means have been developed in six countries - Belgium, France, Italy, the Netherlands, Portugal, and the UK. In all cases the primary driver for the development of simplified bank accounts has not been to overcome the problems of complexity *per se* but rather a concern regarding access and financial exclusion.

5.12 For example, in the UK 1 in 10 people were believed to be without a bank account, whilst in Italy there were around 23% of adults without a bank account before the development of the Servizio bancario di base (basic banking service).[33] Similarly the Belgian Bankers' Association's estimates for those excluded from basic banking services range from 40,000 to 100,000 people.[34]

5.13 Looking at the simplified banking product identified there are a number of characteristics that are common across the six countries with simplified products which will be considered in turn.

Common characteristics

Table 5: Characteristics of simplified bank accounts with payment means[35]

Restrictions / conditions	**Belgium**	**France**	**Italy**	**Netherlands**	**Portugal**	**UK**
Access	For all	When refused by credit institutions	From bank where do not already have an account	Basic banking service is reserved for those who do not have another bank account. Providers can not refuse access unless exceptional reasons	For those who do not have any account	No requirement for initial or regular deposits (some may have a £1 minimum opening requirement)
Level of charges	€12 per year	Free	No limit		Less than 1% of minimum wage	No charges to be applied for everyday transactions such as cash withdrawals or direct debits.
Credit facility	None		None		None	None
Services offered		Payment card must be provided	Bancomat card but no cheques	Bankcard for withdrawing cash must be available.		

33 Interview with the Italian Banking Association.

34 Finance et Société, Avril 2004, Fédération Financière Belges, available at www.febelfin.be.

35 Note that blank cells in the table indicate that there is no restriction in that particular characteristic in the country in question.

				No restrictions on the number or value of transactions.		

5.14 **Access to bank account**: The most important characteristic of each of these products appears to be the conditions under which consumers can access the product. For example, in Belgium all customers are guaranteed the right to a bank account and hence all banks must open a bank account for customers who ask for one. However, this is not the case in all other countries. The basic banking service in France is reserved for those individual who have been refused access to a bank account by several credit institutions. In this case, the person can contact the Bank of France, who designates a bank or the Post Office to open an account for the individual. Similarly in Portugal, customers who do not have an account elsewhere, have the right to get an account at one of the banks that participate in the Minimum Banking Service. In Italy, the basic banking service is not offered to individuals who are already customers of a bank i.e. customers can not switch from other types of current accounts to the basic banking service within a bank. However an existing customer can open a basic bank account at another bank.

5.15 **Level of charges**: In most but not all of the simplified products there are constraints on charges. In Belgium, banks are obliged by law to open a current account for consumers with basic payment and bank services for a maximum of €12 per year.[36] In France, the basic banking service is provided free of charge for citizens with minimum income. In Portugal, fees are regulated so that they must be less than 1% of the minimum wage.

5.16 **No credit facility**: In Belgium, Italy, Portugal and the UK, one of the key characteristics of the simplified bank account is that there is no credit facility allowed within the bank accounts. This is partly in order that banks will be more

[36] Avis sur le service bancaire de base, Conseil de la Consommation, law dated 1st September 2003, available at http://mineco.fgov.be/protection_consumer/consumption.

willing to offer the accounts to any customer, but also in order that customers will know that they will not get into debt by having the product.[37]

5.17 **Services offered:** Finally, the services offered are often specified. These include the ability to make cash withdrawals at the counter and regular statements of accounts. However, the exact detail of the payment options varies between the different simplified products. For example, in Belgium, 36 withdrawals or transfers per year are allowed, but a debit card does not necessarily have to be offered. In France an automatic payment card must be provided. In Italy a Bancomat card for cash withdrawals at one's own bank's ATMs or a prepaid Bancomat card for withdrawals at all ATMs and for POS payments must be provided, but, cheque books are not offered on the service.

Assessment of simplified products

5.18 Many of the simplified bank accounts have been developed in very recent times and hence it is impossible to find any hard evidence of their impact. Firstly, in many countries it was not possible to determine the number of people without banking services prior to the introduction of the basic bank accounts to determine whether these accounts had resulted in greater access to banking services for consumers. It has been argued that this lack of formal assessment reflects the fact that these products are introduced for political rather than economic reasons.

5.19 Secondly, even where there remains an unbanked population, it is accepted that some of the population would simply prefer not to have bank accounts. Indeed in Belgium, the banking industry believed that having unbanked consumers was the result of fear by consumers that assets may be seized (due to civil law restrictions) rather than the result of banks refusing clients.[38] Further, evidence from countries where welfare benefits can only be received through a bank account having less than 100% of the population with banking services supports the suggestion that some consumers prefer not to have a bank account (since those without bank

[37] In Portugal having an overdraft on a bank account would not be common and hence restricting the minimum banking service in this way was not seen as much of a restraint.

[38] Annual Report 2003, Belgian Bankers' Association, available at http://www.abb-bvb.be/gen/downloads/jr2003fr.pdf.

accounts are more likely to also be those eligible for receipt of benefits). Therefore providing access to bank accounts may be sufficient to solve any market failure rather than expecting all consumers to have a bank account.

5.20 Hence assessing whether simplified bank accounts have been beneficial is difficult both because of the lack of data, and also because it is not clear that aiming for a 100% participation rate actually takes account of consumer preferences.

Alternative interventions for countries without simplified products

Figure 2: Alternative interventions

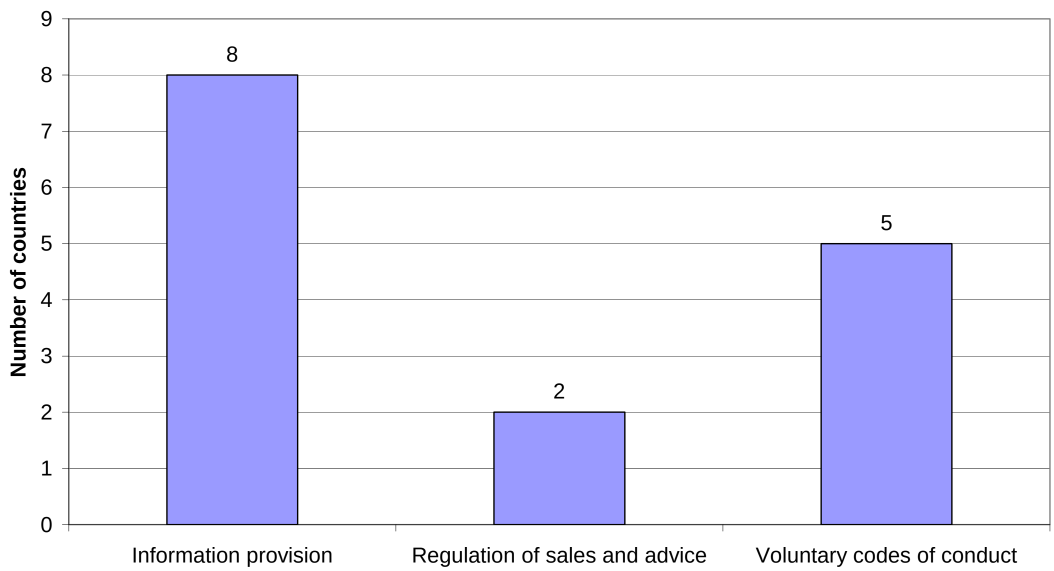


Figure 2 above shows the alternative interventions used in those countries where simplified products were not identified. There was no specific alternative intervention that was identified in Luxembourg.

5.21 The regulation of basic bank account has focused on information provision, and voluntary codes for banks.

<u>Information provision</u>

5.22 It is common for information provision requirements for current accounts to be set out in some detail covering for example: fees charged for the provision of services in connection with deposits and for other services in the area of private banking; the general business terms and conditions; information on the guarantee facility and the investor compensation scheme to which the credit institution is a member and on the amount and scope of cover.

5.23 Comparative tables are used in a number of different Member States. In Finland, Ireland, Spain, Sweden cost tables are produced on current accounts. Typically these will cover aspects such as the various possible charges including transactions charges (standing order, cheques etc) and service charges (setting up a direct debit, issuing a replacement PIN and unauthorised overdraft surcharge interest rate, etc). In Sweden these tables include the functionality to input typical transactions and identify costs from a range of different providers.

5.24 The tables are produced by different (often multiple) institutions in different locations including regulators (Ireland, Spain), banking associations (Finland) and consumer organisations (Finland, Sweden).[39]

5.25 In other countries (Belgium, Italy), similar approaches have been taken but with additional web-based functionality. Both Test Achats in Belgium and PattiChiari in Italy provide models in which consumers can enter their typical monthly profile and obtain information on the cost from different providers. Hence information on the cost for different services can be made specific to the individual consumer.

5.26 Furthermore, in some countries there are regulatory requirements on bank charges, either in the form of notifying charges before they can be applied (Spain) or requiring the permission of the regulator for the charges (Ireland).

Regulation of sales and advice

5.27 Financial advisers are not typically regulated for the sale of banking products. Primarily this is because there is no investment element in them.

Voluntary codes of conduct

5.28 Voluntary codes for banking exist in a number of Member States. This includes Finland, Ireland and Sweden. Typically these codes will cover aspects such as informing customers of charges being made in advance of them being deducted

[39] Note that in Finland both the trade association and the consumer association have comparative tables.

from accounts, explaining about complaints procedures and not having misleading information.

5.29 Codes that are intended to help consumers switch from one bank to another bank are found in the Netherlands. In addition a switching code is also being developed in Ireland.

Assessment of the need for simplified products

5.30 Based on the interviews within each of the Member States and our own assessment of the situation in the countries without simplified products, there may be particular countries that could benefit from a simplified basic banking product but the products would need to be designed with the particular circumstances in mind.

5.31 The main concern regarding bank accounts seems to be whether or not individuals have access to an account. However, simplified products are not the only solution to this problem.

5.32 In some countries, there are particular providers who are obliged to offer a bank account to any consumer already. For example, the Postbank in Germany had this obligation until recently (along with the payment of welfare benefits) and furthermore some of the savings banks in the different Member States are also obliged to accept any customer. Similarly the Postbank in Luxembourg retains this obligation. In France, the Bank of France will designate a bank or the French postal service to provide an account for a consumer if they have been refused at other banks.

Table 6: Compulsory offering of bank accounts

Country	**Do banks have to offer accounts to anyone?**
Austria	No
Belgium	Yes
Denmark	Yes

Finland	Yes
France	No, but Bank of France will designate a bank or the French postal service in the case of the consumer being refused elsewhere
Germany	No
Greece	No
Ireland	No
Italy	No
Luxembourg	Yes
The Netherlands	No
Portugal	No
Spain	No
Sweden	Yes
United Kingdom	No

Source: CRA country research and interviews

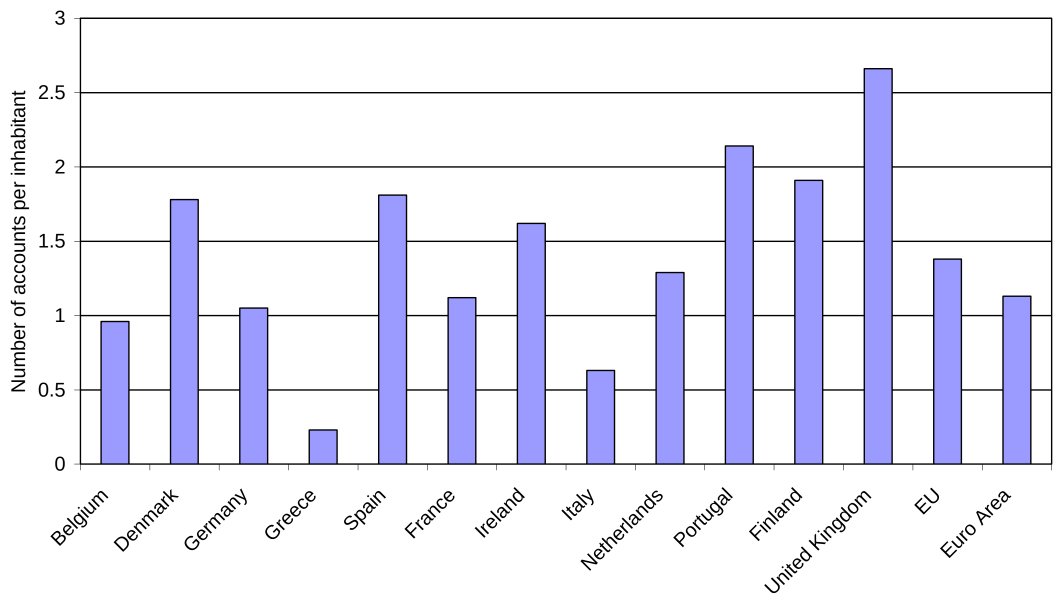
5.33 Alternatively, many countries have the requirement that all banks must offer bank accounts to any customer who wants an account (unless there are exceptional circumstances such as a criminal record etc) and this provides an alternative method of ensuring consumers have access to bank accounts without the need to design a simplified product.

5.34 We have not categorised the requirement to offer all customers a bank account as being equivalent to simplified products. Although this requirement may reduce exclusion, and hence may have a similar effect to simplified products, it does not, by itself, impose any restrictions on the product features of such an account.

5.35 In addition, even if providers are obliged to offer a bank account, and even if these bank accounts are simplified, consumers may just not wish to take out such an account because of their own preferences. This illustrates a more wide ranging issue for simplified products in that consumers may not want to take out these products regardless of how simplified they are made.

5.36 Based on our interview programme it is clear that not all Member States are aware of the proportion of the population who currently have access to bank accounts. Figure 3 below shows the number of accounts per inhabitant in the Member States. This is not a perfect proxy since, as is clear from the data, many individuals have multiple accounts and hence it is not possible to conclude what proportion of the population does not have an account simply from this data. Furthermore, it may be the case that in some Member States, finances are aggregated at a household level rather than at an individual level which would suggest that fewer than one account per household would be necessary. However, it is nonetheless indicative of the areas where there may be a concern.

Figure 3: Number of accounts on which payments can be made (per inhabitant)



Source: ECB Blue Book 2004, data refers to 2002. Note that data was unavailable for Luxembourg, Austria and Sweden from the same source

5.37 From Figure 3 above, only Greece has less than one account per inhabitant and does not currently have a simplified bank account (Italy also has less than one account per inhabitant, but developed the basic banking service in 2004 which is after the time that the data refers to). Indeed the data available suggests that Greece has only 0.23 accounts per inhabitant providing indicative evidence of a possible need for a simplified bank account. This was not identified as a current source of concern for the banking regulator in Greece who believed generally people did have access to the banking services they required. However, this seems worthy of further consideration.

5.38 From discussions in Member States, participants in Ireland indicated that there was a debate that was beginning to occur in Ireland regarding a possible need for a simplified bank account or universal bank account, although no decision has yet been taken regarding its necessity.

5.39 However, in some countries it seems to be the case that it is a Government desire to automate welfare payments that is driving the development of simplified bank accounts. That is, while the simplified bank account has been designed because of exclusion, issues of exclusion from banking services have only been raised because of the desire to automate welfare payments and a concern that automation of benefits would not be possible if large numbers of the population did not have bank accounts. This was believed to be the case in the UK and also in Ireland where it was stressed that the debate on the need for a universal bank account was being held in the context of the Government's national payments strategy regarding the electronic payment of welfare benefits. Hence it could be the case that it is Government requirements that are driving the development of simplified products rather than the needs of consumers.

Table 7: Automation of welfare payments

Country	**Are welfare payments automated?**
Austria	No
Belgium	Under discussion
Denmark	Yes
Finland	Yes
France	Yes
Germany	No

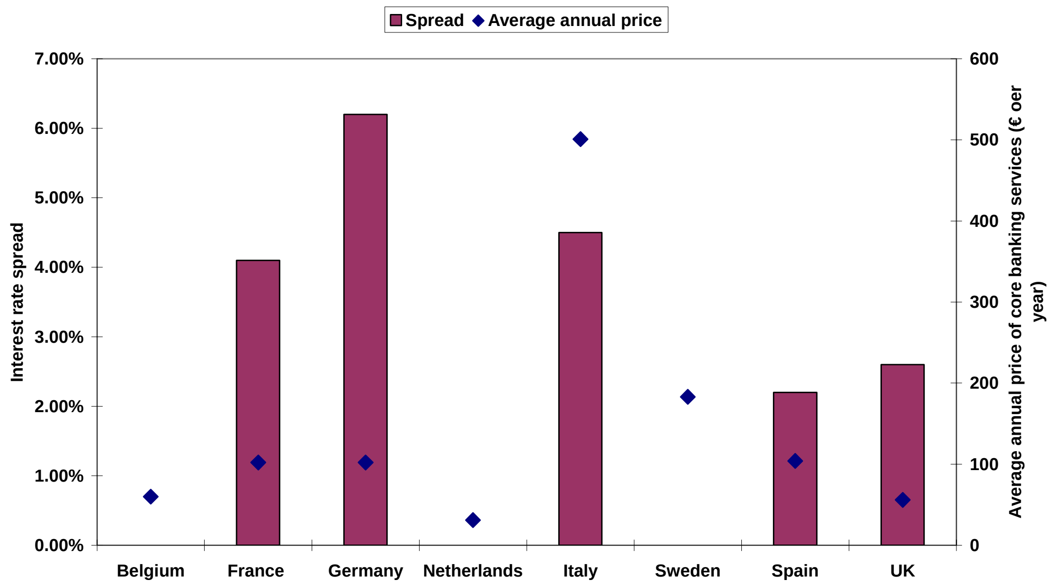
Greece	No
Ireland	Under discussion
Italy	No
Luxembourg	Yes
The Netherlands	Yes
Portugal	No
Spain	No
Sweden	Yes
United Kingdom	Automation about to occur

Source: CRA country research and interviews

5.40 With regard to the problems other than exclusion that were identified for bank accounts, it is not believed that a simplified banking product would alleviate these.

5.41 Some countries identified the complexity of pricing structures and the differences in terminology as preventing consumers from comparing different accounts. There are clear differences in the way different countries charge consumers for banking services. Some countries favour detailed product charges others pay a lower interest rate thus recouping the cost of providing the account. Indeed in France, there are restrictions in place such that providers are not allowed to offer interest on current accounts. However, in exchange for the absence of interest rates, banks offer free cheques. The range of different pricing approaches is shown for some of the Member States in Figure 4 below.

Figure 4: Fees versus interest rate spread



Source: EFMA World Banking Report (Comparable information from the same report is not available for the other EU Member States that are not specified in the Figure.) Data refers to 2003. The spread is a measure of the difference between the interest paid on savings and that received on loans.

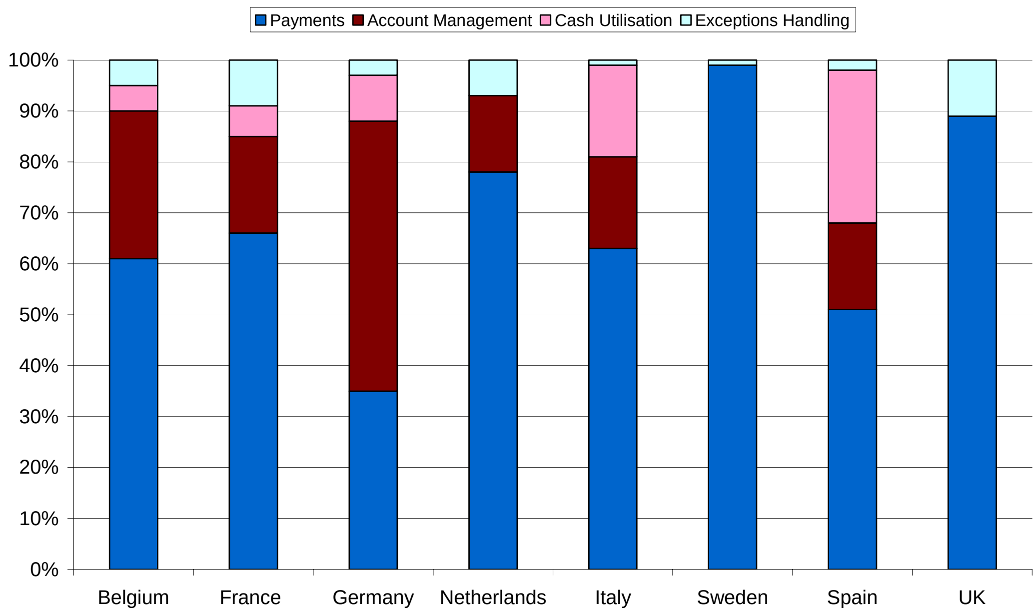
5.42 Price competition can occur in different ways for bank accounts e.g. it could be focused on account charges, transaction charges or on the interest rate. Having a variety of prices for different services means that consumers can choose an account that is value for money given their likely pattern of use. This encourages development of accounts that meet the needs of consumers. Hence there is no clear case, from a competition perspective, for a simplified product that changes the basis of competition.

5.43 However, it is also clear, that some consumers may not be able to compare a menu of prices easily and competition would work more effectively if the market focused on one type of price such as the interest rate.

5.44 Nonetheless, concerns regarding the lack of definition of costs may more easily be solved through the use of common terminology and definitions than through a simplified product which could bring the risk of changing the basis of competition if it focused consumer attention on one component of price rather than another.

5.45 Indeed, the problems associated with multiple price dimensions may also be overstated. It is clear from Figure 5 below that the category of exceptions (which typically has the largest number of different cost components) represents a small proportion of total fees on banking services in all countries. Therefore, a focus on the most important components of price, through the use of simplified information and improving access to comparable information, would appear to be a solution to this problem.

Figure 5: Sources of fees for core banking services



Source: EFMA World Banking Report (Comparable information from the same report is not available for the other EU Member States that are not specified in the Figure.) Data refers to 2003.

5.46 Equally switching has been identified as a potential source of concern. However, regulatory tools other than simplified products can be used to improve switching. For example, some argue improving switching is better done through designing switching agreements or codes such as that seen in the Netherlands and the UK and those proposed in Belgium and Ireland.

5.47 Indeed some argue that the market may solve this problem without regulatory intervention. For example, in Sweden it was argued that the development of internet banking (which varies across Member States) may improve switching as switching of internet banking is perceived as more straightforward (and may be less costly) compared to switching traditional accounts. Further, a significant proportion of those who have internet accounts will have switched accounts from a different source since these are relatively recent products across Europe.

5.48 It is beyond the scope of this project to identify whether there are any competition concerns regarding bundling. However, in both France and Greece, if products are to be available on a bundled basis then the individual components need to be either made available on a stand alone basis or comparison with standalone product facilitated. It seems likely that this approach would improve the bundling problem rather than needing to design a simplified product.

5.49 Finally concerns regarding a lack of information about the charges in advance of them being imposed can be improved through insisting on the provision of such information. Pre-sale this could be done in an easily accessible form including displaying this in bank branches (which is already required in some Member States), and having the information available on the internet as well as making use of the comparative tables and models that have already been mentioned and are available in a number of Member States.

5.50 An additional approach would be to oblige banks to provide summary information on the charges that were actually incurred by customers on an annual basis in order to highlight the cost of banking services.

5.51 We conclude that many Member States are improving the availability and usefulness of information to consumers. There are limited concerns with bank accounts across Member States and those problems that were identified, such as concerns over switching, are best solved through means other than simplified products. Simplified information that focuses consumers on the most important elements and allows comparison would appear to be more appropriate than simplifying products themselves.

Section 6 Cash based saving products

6.1 Following the analysis in the theoretical chapter, we would not expect cash based saving products to be one of the areas where there is the greatest concern regarding product complexity resulting in consumer detriment.[40] In particular, these are products that are frequently used, where there is little risk to the consumer's capital, and where quality can be quickly identified without consumers typically seeking advice.

6.2 The products are seen as being intrinsically simple with relatively few dimensions of competition, for example, the key dimensions of competition are the length of time for which the money is locked away and the return offered on the account. Price competition is often seen to be quite intense with interest rates widely published in banks and newspapers.

6.3 Indeed, because consumers are effectively "lending" money to providers and saving accounts do not offer payments services or credit facilities these are considered to be significantly simpler than bank accounts and are not seen as having the same issues with access.

6.4 Finally, it appears that physical presence is considerably less important for savings account than current accounts, making remote offerings (using telephone, post and internet channels) possible thereby reducing the costs of entry. In many countries we have seen recent entry of remote only providers of saving accounts, often competing directly on the provision of higher interest rates and lower lock-in periods. The success of these offerings appears to support the hypothesis that the market for cash based saving is working effectively.

6.5 The interviews and our background research confirm that in most countries the market is seen to offer saving accounts which are already simple and transparent and this market is not a cause of particular concern.

[40] This section will refer to cash based saving products as "saving accounts" throughout the chapter.

6.6 Although seen as simple, a number of countries have standardised elements of savings accounts through offering tax privileges on particular accounts. Examples of standardised saving accounts include:

- Belgium: There is a standardised tax privileged savings account.[41] The main area of standardisation is on the interest rate received, which, in order for it to be tax-exempt, must meet certain requirements including a maximum basic interest rate which is fixed according to a royal decree. In addition, a premium can be added to this if savings are held for some period of time.

- Ireland: The (now unavailable) SSIAs allowed individuals to save between €12.70 and €254 per month in a deposit account. The Government of Ireland would then add €1 for every €4 that individuals contributed. A condition of the account was that it must be held for at least 5 years to obtain the full benefit; else a tax would be applied that would take back the full amount of the Government contributions.

6.7 Interestingly, standardisation has been identified as a problem through introducing complexity to an otherwise simple marketplace. For example, a Belgium consumers' product testing association, Test-Achats, expressed concern about the lack of transparency in the calculation of the effective interest rate, which is seen as particularly complex. There have also been particular problems regarding how this interest rate has been marketed to consumers.

6.8 In Ireland, although the Government introduced the standardised saving product in the form of the SSIA, the Consumer Association nonetheless introduced the "Savermark" to help consumers with this new product.

6.9 Finally, in the UK one of the justifications for introducing the CAT marked cash ISA was because consumers placed too much weight on the tax preferences of the new tax privileged ISA account and would not focus enough on the other product terms.

[41] Instruments de placements, Aspects et Documents 215, Association Belge des Banques (Belgian Finance Federation)

Simplified cash based saving accounts

6.10 We have categorised three Member States as having simplified saving accounts: France (CODEVI, livret A, livret bleu and LEP), Ireland (Savermark), and the UK (CAT standard cash ISAs and the proposed Stakeholder cash product). Looking at simplified cash based saving products there are a number of characteristics that these product share which are shown in Table 8 below.

<u>Common characteristics</u>

Table 8: Characteristics of simplified cash based savings account

Restrictions / conditions	**France (CODEVI, livret, A livret bleu, LEP)**[42]	**Ireland (Savermark on SSIA)**	**UK (CAT marked cash ISA)**
Minimum contributions	Minimum payments are required LEP aims at low income persons	The account must accept minimum contributions of €12.70 per month	The account must accept contributions of £10
Interest rate regulation	The interest rate of the CODEVI and LEP are set by the Comité de taux reglementée (Consultative Committee for interest rate regulation)	For variable deposit accounts: interest rate must shadow the European Base rate by a margin of no more than 1% p.a. for the full 5 years For fixed rate deposits: a margin of no more than 1% p.a. below swap rates (the wholesale rates between banks)	Currently not more than 2% lower than UK base rate. This has been replaced by a 1% requirement for the Stakeholder cash product
Liquidity of assets (e.g. money can be withdrawn at all times)	Yes (CODEVI, LEP)	Money can be withdrawn within 7 days if desired (Although the account must be held for 5 years in order to qualify for tax benefits)	Within 7 working days or less
Charges	Level of charges is not regulated	There can be no account fees or hidden charges	No other charges for regular services except for replacements (e.g. duplicate statements, lost cards)

42 The abbreviation LEP stands for livret d'épargne populaire. The livret A can only be obtained at the Caisse d'épargne and the French postal service and the livret bleu can only be obtained at the Caisse de Crédit Mutuel. Their equivalent, the CODEVI, is offered by all commercial banks.

Tax- or other Government incentives	Interest is tax-exempt	Savermark applied to SSIA where Government adds €1 for every €4 contributed provided that the savings remain in the account for at least 5 years	Interest is tax-exempt

6.11 **Minimum contributions:** In each of the three simplified products there are conditions such that these products are accessible to consumers with low income and who are only able to afford relatively low levels of saving. In Ireland and the UK this is done by setting maximum limits on the minimum level of contributions that individual providers can set on their products such that providers must accept contribution levels of €12.70 per month in Ireland and £10 in the UK. In the case of France, we also have included a product that is specifically aimed at consumers on low income.

6.12 **Interest rate regulation**: One of the most important characteristics of each of these products is the regulation of the interest rate. In the case of France, the interest rate is guaranteed and set by an independent body. This makes comparisons between products easy and gives consumers security about their return. In the UK and Ireland, the interest rate is not set but in the simplified products (which sit alongside other similar tax-privileged products that do not meet the simplified standards) must be within a fixed margin of the base rate. In addition, there are constraints on the way that interest in calculated.

6.13 **Liquidity of assets:** All three saving accounts permit consumers to withdraw money at all times. In Ireland, it is possible to have access to the savings within 7 days, although this will result in a loss of tax benefits. In the UK, access is also allowed within 7 days, this is in contrast to the 5 year term applied to previous tax preferred cash based saving products in the UK (the TESSA). A similar mechanism is used in France where a bonus only results if the savings are kept in the account for a period of time (six consecutive months).

6.14 **Charges**: In addition to the regulation of the interest rates in UK and Ireland it is not possible to have additional charges. In France, although other charges are not regulated, products with no additional charges are available through Government owned distribution channels.

6.15 **Tax and other Government incentives**: Simplified products often resulted from products with tax incentives. Indeed, all of the simplified saving accounts feature tax-incentives. In France, the interest obtained on the CODEVI, livret A, livret bleu or LEP is entirely tax free. In the UK, CAT marked cash ISAs are tax free, but the tax privileges are not conditional on the simplified quality standard. In Ireland, the Government adds €1 for every €4 contributed provided that the savings remain in the account for at least 5 years – again this is a feature of the underlying SSIA rather than the Savermark simplification.

Assessment of simplified products

6.16 Looking at the three examples of simplified cash based savings accounts we find in the case of France that the simplified saving accounts are traditional and popular products, e.g. in France more than €111.8 billion are deposited in livret A's alone (a similar product to the CODEVI which is only available through particular providers). However, this is attributed to the tax privileges rather than the simplicity of the product.

6.17 The Savermark scheme in Ireland was not generally seen to have an impact on the market in terms of the amount of products purchased. However, the Savermark's effect were judged to be positive and somewhat larger as a reference point and in terms of helping to inform consumers about the new tax exempt products.

6.18 In the UK, the Treasury commissioned an examination of the ISA market after these products had been available for a year. They found that nearly all cash ISAs were CAT standard or offered better interest rates; whereas non-ISA savings accounts were typically at lower interest rates.[43]

Alternative interventions for countries without simplified products

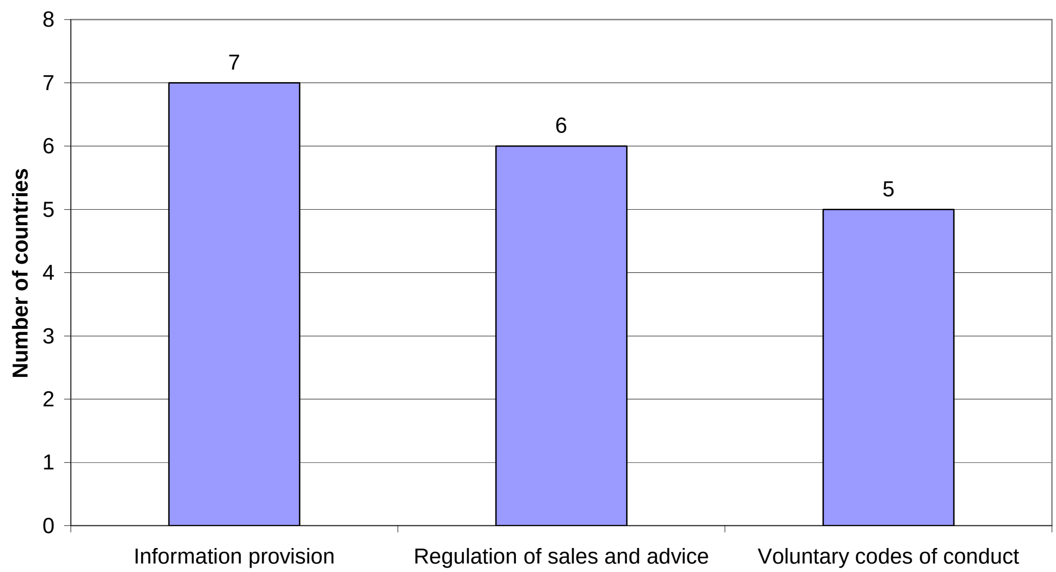
6.19 Looking at the majority of markets where we have not identified simplified products, we do not find many alternative interventions that have been aimed

[43] Standards for retail financial products, HM Treasury, January 2001.

specifically at problems particular to the savings market. Instead, we find industry wide initiatives applying in general to banking products.

6.20 As shown in Figure 6 below this largely focuses on information provision. Although cash based saving products are included in a number of banking codes, these codes do not have implications that are focused specifically on saving products.

Figure 6: Alternative interventions



6.21 There was no specific alternative intervention that was identified in Belgium and Spain.

Information provision

6.22 Generally, information provision on interest rates offered on different saving accounts is viewed to be widely available in the financial press as well as in banks. In a number of countries there was a rule requiring the presentation of interest rates within bank branches.

6.23 Although there are some concerns regarding how this information is presented and whether terminology means that consumers find it difficult to compare the information. Indeed, in a number of countries comparative tables are being considered to get round the problem of differences in terminology, and in other countries such as Denmark, these tables already exist for saving accounts.

6.24 In other countries, information for the products being offered by each bank is available through trade associations, however, this has not been set up to explicitly facilitate comparison (and hence comparison may not be easy for the average consumer).

Regulation of sales and advice

6.25 As saving accounts are seen as straightforward products which are thought to be easy to understand, we did not find extensive regulation of the sales and advice process. Instead, the regulation of sales and advice that existed was typically very general regulation rather than being focused on problems specific to saving accounts. Nor was there any concern regarding whether these products were being sold to the wrong individuals.

6.26 However, there are rules setting out when consumers need to be informed over changes in the terms and conditions and especially how interest rates changes need to be conveyed to consumers.

Voluntary codes of conduct

6.27 Moreover, although voluntary codes of conduct regarding cash based saving accounts are also relatively common these do not have specific implications for saving accounts. That is, in many countries (Denmark, Finland, Greece, Italy, Sweden) there were codes of conduct in the banking sector which therefore covered saving accounts, but the codes did not typically highlight features specific to saving accounts.

Assessment of the need for simplified products

6.28 Based on the interviews within Member States and our own assessment, there appears little need for a simplified saving account or for increased standardisation. Generally, saving accounts are seen to be simple, consumers appear to be able to choose between them and there are relatively few complaints received regarding these products. This results in effective competition meeting the needs of consumers.

6.29 In addition to standardisation of products and the simplified products described above, there are also alternative products provided by Government themselves. For example, in Portugal, Government saving certificates are available through the Post Office and these provide additional methods of cash based savings for consumers that can be easily accessed.

6.30 In most countries, regulators and consumer organisations questioned how these product could be made much simpler for consumers.

6.31 Traditional products such as savings books in Germany are seen as meeting consumer needs. In the case of the saving books, consumers especially like the transparency (current amount and all past transactions are recorded in one book), the fact that there are no hidden costs, that there is an agreed guaranteed interest rates and that savings books do not require a minimum savings amount.[44]

6.32 Furthermore, in a number of countries, employer-based saving schemes exist in which a part of the gross wage is transferred directly to a saving account. In this case, the employer is effectively certifying the scheme and the problems of information asymmetry are not seen to be a significant issue.

6.33 Despite the lack of concern regarding savings accounts it may be the case that, Governments see the need to encourage rainy day savings through the use of tax privileges. Rather than trying to increase switching to ensure that consumers choose the products that meet their needs at the best price, these products often are trying to encourage a savings culture and may encourage savings to be held for a period of time.

6.34 Experience suggests that introducing products of this kind can introduce complexity and consumers may be vulnerable to focusing on the tax characteristics at the expense of the other product features. When this is the case, there may be an argument for taking into account simplification when designing such a product.

[44] Interviews with the BdB on 10 May 2004 and with the DSGV on 21 May 2004 in Berlin.

6.35 Although there is no evidence suggesting a problem regarding competition on cash based products, one way of increasing transparency has been to focus price around a base rate, locking in price advantages after the product purchase has been made. Indeed, this has been suggested in a number of countries, for example, recently this has been suggested by consumer organisations in Austria and by the courts in Germany.

6.36 Overall, therefore we conclude that there is no need for a simplified savings product in any of the Member States.

Section 7 Credit or deferred debit cards

7.1 From a theoretical perspective, credit or deferred debit cards were not identified as a product where complexity was likely to be a problem. For most consumers they are products that are used continuously, even though purchasing a new credit or debit card may only occur infrequently. It is thought to be reasonably straightforward to assess the quality of the product and switching costs are also thought to be low, with introductory rates for balance transfers common in a number of Member States. It is also possible to hold more than one card at any time making comparison easier.

7.2 Complaints received on credit and deferred debit cards are usually not about the product features but rather about the problems encountered when cards are lost or stolen.

7.3 One area where complexity may be of concern is in the pricing structure. In particular, the price of a credit card can have a number of dimensions including: an annual fee; interest free period; interest rates and introductory offers.

7.4 The degree to which credit cards receive regulatory scrutiny depends partly on the popularity of credit cards in each of the Member States. In addition to the number of credit or deferred debit cards, the degree to which consumers use them for their revolving credit facilities or simply use the cards as deferred debit cards is seen as an important indicator as to whether regulators need to be concerned.[45]

7.5 Finally, although not specific to credit cards, a number of countries have identified over-indebtedness as a problem. In particular, there is a concern regarding the availability and expense of credit to low income consumers.

7.6 However, credit cards are already seen as being standardised. There was thought to be considerable standardisation of credit cards both within countries, and also across countries. A major reason cited for this, was that the international card

[45] Throughout this section we use credit cards to include deferred debit cards. Cards could be seen as deferred debit cards either because of consumer behaviour in which consumers never use the revolving credit facility or because some cards, that are commonly thought of as credit cards, do not offer a revolving credit facility.

networks such as Visa and MasterCard impose standardisation on card issuers in each of the Member States. For example, the various credit card networks have an "honour all cards" rule which ensures that if a retailer is part of the credit card network then it must accept all credit cards from that network. From the consumer perspective this clearly brings considerable benefits since consumers know that a card from one issuer will be accepted globally and that regardless of whichever issuer within a network they have chosen, they will receive the same terms and conditions at retailers as all other users of that network.[46]

7.7 In addition to standardisation being applied through the credit card networks, some standardisation is also applied through those aspects of credit cards that are covered through the European Consumer Credit Directives.[47] This includes the use of an annual percentage rate of interest (APR) or at least disclosing the total cost of credit in those Member States that did not have an established method of calculating an APR. However, while the APR should in theory include all the relevant credit costs, it is clear that is it applied in different ways in different Member States and even within some Member States. Indeed proposals for a revised Consumer Credit Directive note that,

> *"If the APR is to be fully reliable and usable throughout the European Union, ideally it should be calculated by the Member States in a uniform manner incorporating in the same way all the cost elements linked to the credit contract. Yet this is not always the case…"*[48]

7.8 The interviews with market participants confirmed that credit cards and deferred debit cards were almost universally seen as products that are already simple. It should not be surprising that we did not identify any credit cards in any of the Member States that were categorised as simplified, standardised products.

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46 There have also been debates in a number of Member States regarding whether retailers should be able to surcharge consumers for the use of credit cards more generally. However, since this relates to the action of the retailer, rather than the decision of the issuer, this is not considered any further.

47 Directives 98/7/EC and 90/88/EEC amending 87/102/EEC.

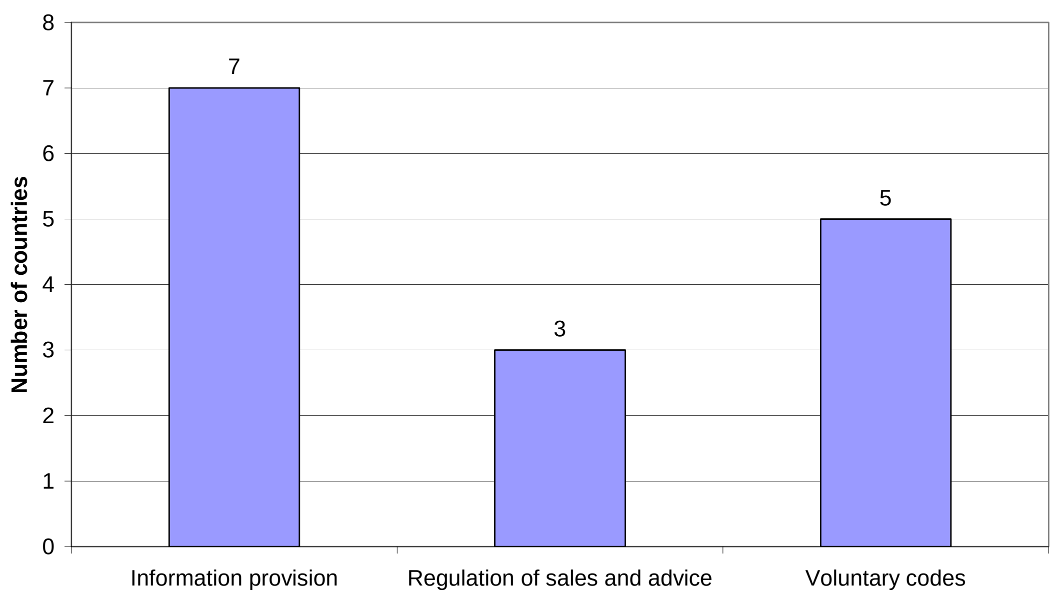
48 Discussion paper for the amendment of Directive 87/102/EEC concerning consumer credit.

Alternative interventions for countries without simplified products

7.9 As has been noted there were no simplified credit card products identified, and hence we examine the alternative regulations that have been used. We find that information provision is the main approach in most countries. Credit cards are not typically "advised" products and therefore it is no surprise that there are few Member States where regulation of the sales and advice process is applicable to credit cards.

7.10 Credit cards are included as part of voluntary codes for the banking sector, although some of these codes do have specific requirements on credit cards.

Figure 7: Use of alternative regulatory interventions[49]



7.11 In a number of the Member States, we did not identify any specific alternative forms of intervention for credit cards. This included Austria, Belgium, Germany and Spain.

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49 It should be noted that alternative interventions are not included for the UK since the motivation for the whole analysis study was the Sandler report in the UK.

Information provision

7.12 Rules on information provision were the main regulatory interventions highlighted during the research process. However, although there are typically requirements on the information that must be provided, in a number of Member States there were concerns that information, especially relating to pricing, was often complex and that improvements to information could still be made.

7.13 Credit cards often come under wider regulations regarding consumer credit in Member States and hence there are a variety of requirements to ensure that information is provided to consumers. For example, in Portugal information must be provided on aspects such as interest rates applied; explanations on when payment occurs; rules of responsibility when cards are lost and details of any reference rate that is used.

7.14 Cost tables have been produced in a number of countries, including Denmark and Ireland. In Ireland this was undertaken by the Irish Financial Services Regulatory Authority (IFSRA) and is regularly updated every six months. The tables have a simple layout, with a list of various important features relevant to credit cards, which include the APR charged, the levels of various fees (such as late payment, non-euro purchase fee) and the introductory offers given. However, IFSRA reported that the credit card tables were the most complex to undertake as the number of features on which prices differ, or where elements of service differ were much greater than in the other tables so far produced.[50]

Regulation of sales and advice

7.15 There was no formal regulation of the sales and advice process that are particularly aimed at credit cards in any of the Member States. However, credit cards do fall under sales regulation applicable to all products sold through banks in a number of Member States.

[50] Interview with IFSRA, 12th May 2004.

Voluntary codes of conduct

7.16 There were a number of countries in which banking codes were in use and, given that banks were typically the primary issuers of credit cards, these applied to credit cards as well as other banking products. For example, these included:

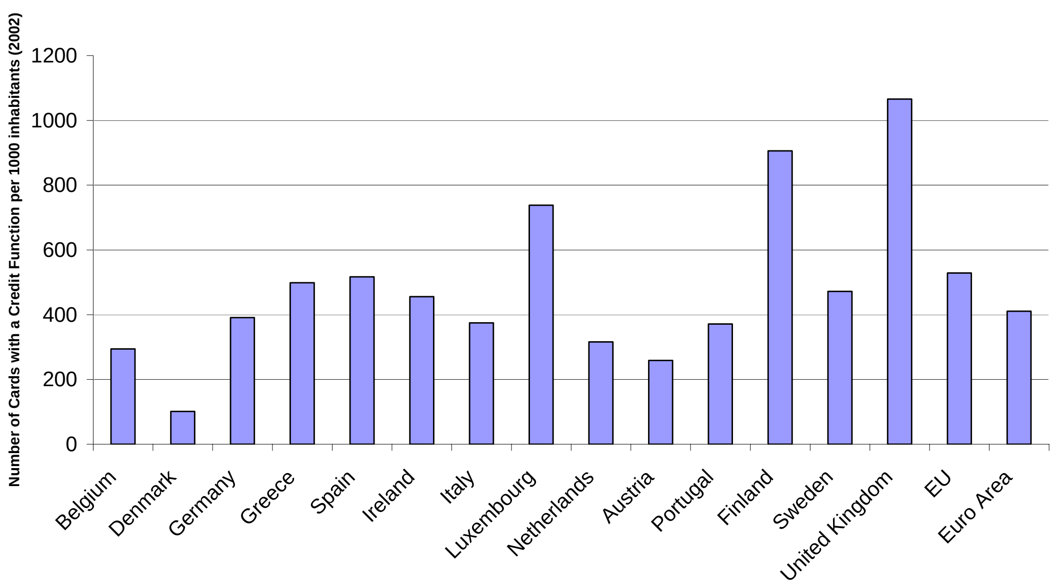
- France - where the Bank Charter is aimed at increasing transparency and ensuring that consumers have contracts with their banks, although this is primarily focused on current accounts rather than on credit cards; and

- Finland - where the Good Banking Practice code includes a requirement that banks take into account the consumer's ability to service debt when products with credit are offered.

Assessment of the need for simplified products

7.17 The use of credit or deferred debit cards varies significantly across the Member States.

Figure 8: Number of cards with a credit function per head of population



Source: ECB Blue Book 2004, data refers to 2002

7.18 Figure 8 shows that the UK has more credit cards per head than other Member States and indeed, this might explain why consideration was given to the development of a simplified credit card by the UK Treasury. However, despite proposals for a simplified product it was in fact decided not to have one.

7.19 If the concern with credit cards is that of a proliferation of issuers, which makes it difficult for consumers to compare products, then it would seem surprising to advocate a simplified credit card in other locations when this was not deemed necessary in the UK where there are more credit cards per head than elsewhere.[51] Furthermore, given the considerable standardisation that already exists in credit cards and also given that none of the Member States identified any strong concerns with credit cards, there is no identified need for simplified credit cards.

7.20 One exception is Denmark, where we have identified the Dankort, a payment card, as a form of standardisation, used to increase take-up in card based transaction and move the Danish market away from cheques. This card can be used in association with a credit or deferred debit card facility. However, we have not classified this as a simplified product.

7.21 Overall, competition was seen to be vigorous in many Member States. Indeed, in many countries there was evidence of new entry in issuing (often from other countries) and it was thought that switching between providers was reasonably straightforward suggesting that competition should ensure consumer protection.

7.22 However, there were concerns in three particular areas namely conditions for lost and stolen cards, over-indebtedness and pricing.

7.23 In Austria and Spain, there was a concern regarding the process for lost and stolen cards in where it was thought that greater clarity of the process was required.

7.24 Over-indebtedness was a source of concern expressed in a number of countries (including Belgium, France and Germany). However, it was the case that market participants were concerned that the availability of consumer credit, including

[51] Strictly speaking this would require information on the number of different issuers and different types of cards issued in each of the Member States. However, in the absence of this information, the number of cards per head has been used and information from the ECB Blue Book is supported by other sources which indicate that the UK has considerably more credit cards per head than other European countries and hence suggests that concerns regarding proliferation are likely to be strongest in the UK.

credit cards, allowed consumers to access debt too easily rather than complexity of credit cards per se having resulted in consumers mistakenly ending up in debt they could not afford.

7.25 In this regard, it would seem therefore that if a simplified credit card increased access to credit cards it could exacerbate this concern in those countries where this was seen as a problem rather than reduce it.

7.26 Finally, in some Member States, concerns were expressed regarding the complexity of pricing and some of these Member States have taken steps to attempt to address these concerns:

- In Sweden, there are current proposals for a new act on pricing information that would oblige providers to display comparative information. It may be the case that reducing the different pricing components could bring benefits to consumers through making comparisons easier. However, there was a concern in Sweden that this could lead to a streamlining of the prices that could be charged and a fear that this would lead to a reduction in the range of services offered by different credit cards.

- In the UK, instead of developing the proposed simplified product, the focus of attention turned to overcoming concerns regarding variation in the methodology used to calculate the APR. There are concerns that the APR does not contain sufficient information on the cost of borrowing and in particular that due to different rules in terms of timing of interest payments, and whether the interest rate applies to purchases and balance transfers, that the cost of borrowing can vary significantly even when the APR is the same. Hence, there have been suggestions that a table highlighting the key information should be provided on credit card marketing literature which would not only allow consumers to understand the most important features of the card but also enable comparisons to be made more easily, i.e. simplified information rather than simplified products.[52]

[52] This is linked to the Schumer box in the US which are meant to performs a similar function.

- In a number of countries, price caps are imposed on the interest rate that can be charged on credit which may act as a consumer protection measure by preventing excessive prices from being charged. This includes: Belgium; France; Italy; the Netherlands; and in part Portugal and Spain.[53] For example, prices for borrowing on credit cards are regulated in the Netherlands with the maximum interest rate constrained to be no greater than 17% above the base rate. The rationale behind the regulation is to protect consumers, as there are only four to five credit card providers in the Netherlands.

7.27 During the discussion of the Consumer Credit Directive, some participants considered whether a system of having maximum rates should be introduced at a European level to protect vulnerable consumers. However, this option has been ruled out.

7.28 Indeed, it should be noted that while a maximum rate could reduce potential consumer detriment for those consumers who have credit cards, it may also reduce access for consumers who are seeking credit and are deemed to be too risky given the maximum interest rate that is applied. Therefore, any maximum rate would need to be assessed with great care to determine whether it is beneficial.

7.29 Overall, while information provision is the focus of regulatory intervention for credit cards, it seems clear that more progress can be made. In particular, displaying the key information in an accessible form could be of benefit in a number of Member States. However, there was no evidence of a identified need for a simplified credit or deferred debit card.

53 Source: Discussion paper for the amendment of Directive 87/102/EEC concerning consumer credit.

Section 8 Private pension plans

8.1 Following the analysis in the theoretical chapter, we would expect to find that pensions are an area where we might be concerned about complexity. There are a large number of potential characteristics, and pricing structures are often complex and may lead to high switching costs. In addition to the difficulties of assessing likely investment performance, there is uncertainty over future need. Finally, they are typically purchased infrequently meaning there is little opportunity to learn from past experiences.

8.2 There was general agreement in the interviews that consumers perceived private pensions as complex. However, the most significant concerns were expressed about the personal pension market rather than the choices faced by consumers offered occupational pension schemes.

8.3 Hence in many ways, it should not come as a surprise that pensions are the area where we have identified more simplified products than any of the other types of product under consideration. In fact we have identified pension products that we have categorised as simplified in nine of the fifteen Member States.

8.4 However, unlike in the UK, where addressing complexity has been an explicit aim in the development of Stakeholder pensions, we find that in the other Member States, perceived problems of complexity were not the key motive for introducing simplified products.[54]

8.5 Rather, many Member States have designed products to encourage individuals to save for retirement. This is seen as necessary in the light of ageing populations and concerns that welfare benefits may no longer be able to sustain the level of pensions that have been paid historically. Given the desire to increase the prevalence of second and third pillar pensions, further requirements and restrictions were then considered in order to promote “good” products. In many

[54] The debate that led to the development of the original stakeholder pension focused heavily on the complexity of the product. More recently, the debate in the UK has been concerned with the “saving gap” and the degree to which simple products through low cost distribution may help to resolve this issue.

countries consumer associations and relevant ministries were involved in the legislative process and lobbied for elements of consumer protection.

8.6 In addition, to simplified private pension products, there are a number of examples where countries have standardised product terms. For example, in Denmark, there are standard terms under which retirement income can be received, however, this seems to have much more to do with tax requirements rather than any attempt to simplify the product for the consumer. Equally, in Belgium, there were restrictions on the geographical investment of the underlying funds, however, this again, appears to reflect a desire to support the national stock market, rather than simplify choice. Finally, in Spain, private pensions need to offer guaranteed interest rates, however, it is the market that has resulted in low switching costs and relatively transparent pricing structures. We have not categorised these products as a simplified pensions.

8.7 In a number of the Member States, the development of the personal private pension market is not seen as a high priority resulting in little interest in a simplified private pension product:

- In Finland, the level of public provision is seen as largely sufficient;
- In Greece, current policy is focusing on developing the second pillar pensions system; and
- In the Netherlands, there is a successful second pillar pension arrangements in place.

8.8 Given that pension products are often structured as life insurance products, requirements from various European Directives such as the Insurance Mediation Directive and the Third Life Directive are of relevance. However, these are discussed in greater detail in the chapters on life insurance and financial advice and the information is not replicated here.

Simplified private pension plans

8.9 Simplified pensions have been identified in: Austria; France; Germany; Ireland; Italy; Luxembourg; Portugal; Sweden; and the UK.

Common characteristics

8.10 Table 9 provides an overview of the main characteristics of the simplified pension products identified.

Table 9: Characteristics of simplified private pensions

Restrictions / conditions	Austria	France	Germany	Ireland	Italy	Luxembourg	Portugal	Sweden	UK
Investment restriction	At least 40% of assets invested in stocks listed in countries with market capitalisation not exceeding 30% of GDP.	Proportion of savings that may be invested in stocks depends on the number of years before retirement.	No explicit regulation, but providers must give guarantee on paid-in capital at retirement.	Apart from temporary cash holdings, only in pooled funds	Investment funds or shares.	Proportion of savings, which may be invested in stocks, depends on the number of years before retirement. Distributional funds are not allowed	Maximum level of equity is 55%.		Default fund must include a lifestyling element
Default fund								Yes	Yes
Switching of providers	Switching to other provider and/or other product possible after minimum of 10 years, no costs.	Must be possible	Right to switch to other products and/or providers with three months notice is mandatory.	Must be possible	Must be possible		Must be possible	Must be possible	Must be possible
Structure of charges		On contributions, AMC, exit charge (only within first 10 years) only	Distribution cost must be spread over 10 years (to be reduced to 5).	On contributions, AMC only	Must conform to one of three structures: AMC only; upfront fee and AMC; percentage of contributions plus AMC			On AMC only	On AMC only
Level of charges		1% AMC, 5% contributions, 5% exit charge		1% AMC, 5% contributions					1% AMC (changing to 1.5% for the first 10 years)
Tax incentives	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

AMC is the Annual Management Charge and in all cases represents a percentage of the value of funds under management. Hence where charges are described as "on AMC only", this means that charges must be applied as a percentage of the value of funds under management.

8.11 In addition to information requirements which are applied to all the simplified pensions, (albeit in different forms according to different Member States), restrictions on the following characteristics were found in two or more Member States: switching; investment restrictions; structure of charges; level of charges; and taxation

8.12 **Switching:** The majority of simplified pensions have in place the requirement that switching to other providers must be allowed. In some countries this was seen as a major change to pension requirements where consumers had previously been bound to a provider until retirement. In most cases switching to another provider must be possible within a short period of time, for example in Germany, consumers must give 3 months notice. In Austria, switching is only allowed after 10 years, although this was an improvement in terms compared to previous regulations.

8.13 **Default fund:** In both Sweden and the UK, default funds exist, although they operate in slightly different manners. In Sweden contributing to the simplified pension product is compulsory and hence it was deemed necessary to have a default fund for those individuals who did not make an active choice regarding the use of their funds. This default fund does not have any particular investment restrictions placed on it, but tries to replicate the typical investment chosen in the rest of the compulsory pension system. In the UK, by contrast, taking out a Stakeholder pension is not compulsory, but the default fund is nonetheless available for those consumers who do not wish to make an alternative choice of funds. In the UK, the default fund in the new Stakeholder pension must have "lifestyling" by which funds must be moved into less risky assets as retirement draws near although there is not a prescriptive approach to how this works.

8.14 **Investment restrictions:** The investment restrictions imposed are of a different nature in different Member States. For example, in Italy and Ireland the type of investment is regulated – in Italy, only investment funds or shares are allowed in the fund and in Ireland only pooled funds (collective investment schemes) can be used (apart from temporary cash holdings). In Austria, the requirement does not restrict the fund to particular types of investments, but rather to particular locations. In France, Germany and Luxembourg (and the default fund in the UK) there are requirements for lifestyling in which the proportion of the fund invested in equities must be reduced as retirement approaches. In Portugal there is a maximum proportion of equity investment throughout the life of the product.

8.15 **Structure of charges:** In six countries, restrictions have been put in place on the structure of charges that can be imposed on consumers. In some countries this has been driven by concerns about switching because of the impact of high upfront For example, acquisition and distribution costs for Riester products in Germany must be spread over at least ten years in equal sums, unless they are deducted as percentage from the client's contributions. In other countries, the structure of charges has been simplified to help consumers compare pension products and only some elements of charges were allowed. In Italy, for example, although there is no price cap, there are restrictions on the pricing structure, which must conform to one of three different structures.

8.16 **Level of charges:** In addition to constraints on the structure of charges, some countries have set a maximum level of charges. For example, in both France and Ireland, charges must be less than 1% annual management charge and 5% on contributions. In addition in Ireland there can be no charges made on transfers on the standard PRSA whereas in France a maximum of 5% can be charged on transfers although only if the consumer stays with the same insurance company for less than ten years. In the UK, charges must be less than 1% annual management charge although this limit is to be raised to 1.5% for the first ten years for the new Stakeholder pension.

8.17 **Tax incentives:** All the simplified pension products identified have tax incentives.

Assessment of simplified products

8.18 The assessment of simplified pension products is made more difficult by there rarely being explicit objectives. Although there are few explicit targets, the most common aim is to increase private provision to take pressure off the welfare system in the longer term. It is therefore useful to first consider how popular these products have been, and secondly, whether they have made the market work more effectively.

8.19 It must of course be noted that a high level of take-up of a new pension product does not make a product successful from a public policy perspective. Indeed, the introduction of personal pensions in the UK led to a mis-selling scandal.

8.20 There is only limited evidence on the popularity of simplified pensions in those countries where they have been introduced. In some cases the products have been introduced so recently it would be unfair to assess them at this stage.

8.21 The level of take-up is also a very blunt instrument for assessing the success of simplification. A low level of take-up can be due to a reluctance to invest in private pensions altogether. For example, in many countries, it is not been commonplace to save in products that lock the investment away until retirement or required to invest in an annuity at retirement. These factors are often common to pension products whether they are simplified or not. In the UK, we are fortunate to be able to assess the impact of simplification by comparison to the performance of existing private pensions regime. This is often not possible in many other Member States.

8.22 Equally, the level of take-up needs to be seen in the context, of the other products available in the market and maturity of the private pensions market overall. Therefore, we have put significant weight on to the assessment within the country as to whether it has been successful:

- In Austria, when these products were first introduced there was extremely low take up although second wave products have been more successful with 280,000 policies sold in 2003.[55]

- In France, it is too early to assess the uptake of the PERP pensions as the products have existed only since April 2004. However, the Association of

[55] Säule der Altersvorsorge, Federal Ministry of Finance, available at http://www.bmf.gv.at/Finanzmarkt/Altersvorsorge755/3SulederAltersvorsorge756/_start.htm.

Insurers provided a positive assessment of the first months because of significant take up.[56]

- In Germany, not even 20% of all people eligible for Riester tax benefits (about 30 million) have concluded a Riester contract and the number of private Riester products actually fell between 2003 and 2004, and only 10% of people interviewed by the German Institute for Old Age Provision said they would take out a product in the future. The scheme is currently being revised.[57]

- In Ireland, the PRSA has only been available since Spring 2003 and hence it is difficult to draw strong conclusions. Nonetheless, since their introduction, there has been a steady increase in their uptake, although the total numbers still remain small. By the end of June 2004, 32,920 PRSAs had been taken out, with a combined value of €83.6 million. Of these, 26,154 were standard PRSAs and 6,766 were non-standard.[58] In general, however, standard PRSAs in particular, were not thought to have had a significant impact.

- In Italy, by 2002 there were 95 open pension funds with around 340,000 members. However, open funds are thought to be more expensive than the closed funds which have the advantage of being distributed through workforces and trade unions.[59] In part the relatively low take up of schemes was thought to be due to poor tax incentives until 2000 (and subsequent declines in the equity markets are also thought to have had a detrimental impact).

- In Luxembourg, the first wave of simplified private pension products was strongly criticised because of their lack of flexibility since contributions were always paid out in the form of an annuity income (whereas the market was accustomed to fixed term life insurance savings products).

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56 Interview with the Association of Insurers, 26th July 2003.

57 DIA-Rentenbarometer – Riester-Rente stagniert, Deutsches Institut für Altersvorsorge, press release of 4 March 2004, available at http://www.dia-vorsorge.de/downloads/pm000027a.doc.

58 PRSAs exceed 30,000 at end June 2004 – Total Asset Value now over €83 million, press release, The Pensions Board, 6th August 2004.

- In Portugal, the PPR (Plano Poupança Reforma or Personal Retirement Plan (PPR) has been seen as a very successful product since its inception in 1989 because of strong growth in sales and the take-up across the entire socio-economic spectrum. Approximately 1.2 million people, around 12% of the total Portuguese population, have a PPR.

- In the UK, Stakeholder pensions were thought to have had a relatively limited impact on the market and according to the Pensions Commission, a substantially proportion of the funds in Stakeholder pensions were transfers rather than "new money". Further, it was noted that the take-up of pensions was significantly hindered by the overall complexity of the pension market, particularly in regard to the tax regime.[60] Finally, the level of existing price cap, 1%, was seen as too low given the current sales and advice regime, to provide to low income consumers, itself contributing to the "saving gap".

8.23 The emerging picture is that the success of the products depends on the strength of the tax incentives and the underlying preferences of consumers to participate in private pensions. There is no evidence to suggest Member States that imposed the most draconian simplification have seen the highest take-up.

8.24 Equally, only in Member States that have constrained the pricing and incentives to distribute the product, has simplification been seen as directly responsible for the low level of take-up.

8.25 Leaving the level of take-up to one side, it is interesting to consider the impact of simplification on the market. For example, whether it has resulted in consumers being better able to shop around, understand the product characteristics or take into account the charges on the product. As noted above, in many countries the products have been available for too short a time to make a detailed assessment regarding the impact of the simplified product on the market as a whole. Nonetheless there are a few examples of interest:

[59] COVIP data.

[60] Pensions: Challenges and Choices. The First Report of the Pensions Commission, 2004.

- In Ireland, the Irish Insurance Federation noted that existing pension providers moved towards the new standards and products became more flexible in anticipation of the PRSAs being launched. Further, the Irish Pensions Board believed that that the price cap on the standard PRSA had an effect on the pricing of non-standard PRSAs. As evidence of this they noted that none of the non-standard PRSAs have charges on contributions that are greater than the 5% price limit applied on the standard PRSAs.

- In Sweden, the level of take-up is clearly irrelevant (as it is compulsory) however, even though the pension has been simplified to encourage consumers to make an active choice in the investment decision, this has not resulted in much active participation. A significant proportion of consumers choose to remain in the default fund. Changes to encourage active participation are currently being reviewed. There is also a concern that the relationship between charges and the size of the fund has resulted in an inefficient number of funds.

- In the UK, it is recognised that the introduction of stakeholder pensions has resulted in large reduction in the price of private pensions in the UK. The industry often talk about the "1% world" meaning that charges on many products have been brought down to reflect the existing price cap on stakeholder pensions. There is no evidence to date to show that the ability to switch providers is increasing the intensity of competition.

8.26 It is interesting to note that a number of countries have revised their initial simplified pension product a few years after introducing the first. This is true for Austria, Germany, Luxembourg, and the UK.

8.27 There are therefore a number of lessons to learn from the simplification that has occurred to date, these involve: reduced incentives to sell the products, lack of flexibility, remaining complexity, lack of transparency. We discuss each of these in turn.

8.28 In a number of Member States simplified products were introduced with reduced incentives to pay for distribution and advice. In Germany a major problem associated with the simplified pension products was the lack of incentives for sales agents to sell the products. The Riester product has a requirement to spread the costs of selling the product over ten years, and hence incentives given to the sales force compared unfavourably to competing products. Similarly, in both Ireland and the UK, there is concern that the price cap on charges has been set at too low a level and hence will reduce the incentives for product providers to market these products aggressively and have impacted the incentives for sales agents to sell the simplified pensions. Indeed in the UK, it has been concluded that these were set too low since the price caps will be raised on the new Stakeholder pension and the cost of distribution reduced through a simplified advice regime. It remains to be seen whether this will be sufficient to make the distribution of stakeholder pensions economic.

8.29 In a number of countries, flexibility to switch between pension providers, is not seen as nearly as important as having some access to the funds invested prior to retirement. In Austria, France and Luxembourg the first wave of simplified pension products was criticised for not giving sufficient flexibility to consumers. In Austria policyholders were not allowed to access their money or switch provider prior to retirement, which made the investment decision a final one for life and was seen as the key reason why the first wave of products was not very popular. Under the new scheme a contract holder has several switching and/or withdrawal options after the minimum contract term of 10 years. In Luxembourg the first wave product was similar to the one in Austria, but under more recent regulations consumers have access to 50% of their savings as a lump sum payment at the beginning of retirement without having to repay tax benefits, with the rest used for a life-long pension. The PERP in France, only introduced this year, is already criticised because it only provides for an annuity income. This suggests that it would be difficult to design a pension product across Member States. However, this is a more fundamental issue for private pensions than simplification *per se*.

8.30 Even though the products were designed with the intention of simplification this has often left considerable complexity through the tax rules. In Germany in particular, the process of applying for the tax benefits associated with the Riester products is so complicated that only a small share of all holders of a Riester pension actually claim the benefits.[61] Further, the tax benefits on Riester products depend on a variety of factors including income, marital status, number of children etc. Moreover, due to budgetary constraints the Government decided to phase in the benefits, making an assessment of the benefits even more complicated and adding to the negative perception of these products in Germany. Further, since the associated tax benefits are capped, Riester contracts typically have a low value, which makes them relatively unattractive for both providers and intermediaries – in particular, there is concern that the tax issues complicates the sales process for intermediaries. In the UK, it is thought that the general complexity of the tax and legal system is also preventing the take up of stakeholder products even though the product itself is simplified i.e. that the complexity of the market still prevents a simplified product from being sold. Without simplification of the tax rules, simplification of product terms is likely to less effective (or not effective at all).

8.31 They are even seen in some countries where attempts to simplify the products are seen as making it increasing complexity. In Germany the many product standards have led to very complex and inflated contracts. According to surveys done by the Federal Association of Consumer Organisations (VZBV), consumers do not reject Riester products in principle, but still see them as "highly complicated".[62] Consumer associations have therefore demanded that Riester products are made more transparent.

Alternative interventions for countries without simplified products

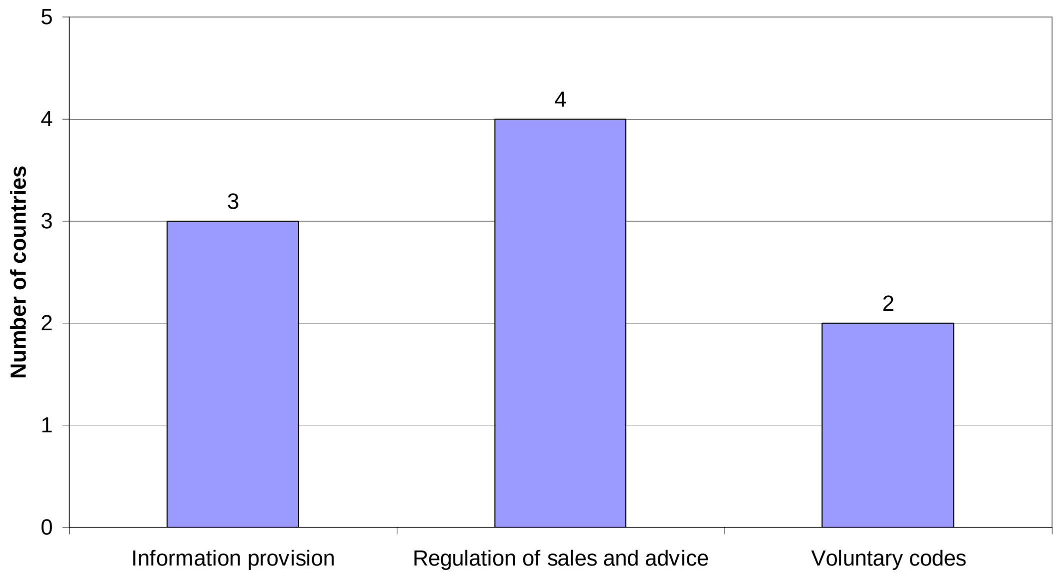
8.32 Looking at the countries where we have not identified a simplified pension product (Belgium, Denmark, Finland, Greece, Netherlands, and Spain). We now

[61] Consumers must apply for tax benefits each year and according to statements from Allianz, the largest insurer in Germany, only 50% of all customers with a Riester contract applied for the tax benefits in 2003 and 50% of those did not manage to correctly fill out the corresponding forms when they tried for the first time (see Allianz Leben: Riester-Rente bleibt ein Ladenhüter, Financial Times Deutschland, 28 January 2004, available at http://www.ftd.de/ub/fi/1074926714994.html.

[62] Erfahrungen mit der Riester-Rente in der Beratungspraxis, Barbara Sternberger-Frey, in: Thesenpapiere zur Konferenz am 4. November 2003 in Berlin – Riester-Rente: Top oder Flop? –

turn to whether we can identify alternative forms of regulation that might be achieve the same objectives. Alternative interventions for pensions have focused on the regulation of sales and advice.

Figure 9: Alternative interventions



Information provision

8.33 Pension products are subject to a variety of information requirements. However, the savings instruments underlying pension products (like mutual funds or capital life insurances) are often subject to differing information requirements and similarly may differ by distribution channels. Particular interventions regarding information include:

- In Finland, the Consumer Insurance Ombudsman Bureau (CIOB) is frequently used by consumers and is responsible for comparing products. For pensions they provide a comparison of costs and contract terms (e.g. whether the investment can be transferred, without cost or at all, from traditional insurance to unit-linked insurance and vice versa). They also list companies in terms of average returns over the past 3 years. The different product features are compared in separate tables.

Anforderungen an eine zukunftsfähige Altersvorsorge, p. 5, available at http://www.vzbv.de/mediapics/thesenpapiere_tagung_riester_11_03.pdf.

- In Greece, if pensions are distributed through banks, information must include a full description of both expected returns and potential risks to be incurred. For example, they must give the consumer a clear and accurate description of the factors determining the rates of return on the specific products, including alternative assumptions as to the main determinants of the rates of return (scenarios on the evolution of stock market indices, exchange rates etc.), and mentioning at least two representative examples (such as a favourable and unfavourable scenario).

- In the Netherlands, the Financial Information Leaflet must be provided. It is not limited to pensions, but is required for a wide range of products that the Netherlands authorities describe as complex. It covers a range of different factors including the financial risks of the product, the obligations if the product is purchased, an example of the return and costs, and information about exit conditions.

Regulation of sales and advice

8.34 As noted above, pensions are affected by European Directives which impose requirements to act in the best interest of the consumer, know the customer before undertaking the advice process, and disclosure of relationship between the adviser and the product provider and any payments made resulting from the advice by the provider to the adviser.

8.35 Other regulatory developments include:

- In Denmark, although advice on pensions remains relatively unimportant due to the strength of the employer based pension arrangements, imminent market regulation will allow employees the right to opt into pension schemes of other industries for the first time. Constraints on the advice process are going to be relied on so that switching between schemes is appropriate. Indeed, it was considered whether only independent advisers should be allowed to provide advice on this process.

- In the Netherlands, there have been proposals to set up a dual system in which advice may either be given through an independent intermediary with a license or an adviser who is active under the responsibility of a regulated financial institution. This is in addition to the implementation of the Financial Services Act which aims in part to create a unified legal framework rather than the current rules which differ by product and distribution channel.[63]

Voluntary codes of conduct

8.36 In both Finland and the Netherlands, there are voluntary codes of conduct for life insurance products which also apply to the sale of pensions. The details of the code relate mainly to the provision of information including that relating to the provision of intermediary services.

Assessment of the need for simplified products

8.37 Based on the interviews within each of the Member States and our own assessment and the poor performance to date of simplified pension products, there appears a very weak case for the introduction of simplified products in the way the "first wave" of simplified pension products were introduced.

8.38 Indeed, the current prospects for private pensions in some of these markets may make a simplified pension completely unnecessary. For example, a number of countries are focusing on employer based private pension schemes, where the issues of information asymmetry are typically less, other Member States appear to be relying on the effectiveness of the sales and advice regime.

8.39 The current level of pension provision needs to be borne in mind when assessing whether there is a need for a simplified pension in the remaining Member States. For example in Finland, statutory provision reduces the need for intervention in the private pension market. In the Netherlands, participation in occupational schemes is as high as 90%. Similarly, in Greece, there is significant change underway, but this is focusing on the introduction of the first occupational schemes to sit alongside the first pillar pensions. The market for individual pensions is extremely small and the problems appear to reflect a lack of

[63] Wfd: veel nieuws onder de Zon?, Speech, Minister of Finance, G.Zalm, 19th February 2004, available at www.skhb.nl

recognition by consumers that public provision will not be sufficient rather than anything that could be addressed through simplification.

8.40 In addition to the current level of public and occupational provision, the impact of alternative regulatory interventions should be taken into account when considering the need for a simplified pension. At present we have no evidence that a lack of regulation is causing market failures to be exacerbated. However, as the need for personal provision of pensions grows, as seems likely due to demography and changes in welfare states, there may need for consideration as to whether these regulations remain sufficient.

8.41 As well as existing market conditions in countries without simplified products, it is also important to consider the impact of the simplified products that have been identified. It is important to note that there has been wide-ranging criticism of the "first wave" of private pension products. Some go even as far as to state that the simplified pensions reduced confidence in the private pension system in general. The experience of simplified products across Member States provides us with a number of valuable lessons regarding simplified pension products.

8.42 Although simplification can reduce the perceived complexity of products, intrinsically complex products will continue to be sold rather than bought. Introducing a simplified product will therefore only work if there is sufficient incentive to sell it (it will not serve as a benchmark otherwise, since people will not know about it). Hence it is important to ensure that there are sufficient incentives available for providers and distributors to sell pensions to consumers. The examples of Germany, Ireland and the UK suggest that price restrictions have not been a successful component of a simplified pension to date.

8.43 The structure of the simplified product is often determined by political necessity rather than as assessment of the cost and benefits of regulation. Indeed, we did not find schemes to monitor the cost of introducing simplified products. The only examples of systematic schemes to consider the cost of regulation are in the Netherlands, where no simplified pension product exists. In the UK, the Financial Services Authority has to undertake cost benefit analyses when changing regulation, however the Stakeholder pension was designed by the HM Treasury.

8.44 As virtually all simplified private pensions of the “first wave” have suffered from significant design problems the lessons for future development of simplified products need to be drawn with care. The products that seems to be seen as the most successful so far is the PPR in Portugal, where it is notable that there are no restrictions on either the structure or level of prices, and where the primary restriction is on the proportion of the fund that can be invested in equity.

8.45 As the majority of the simplified pension products have faced significant problems and this has resulted in significant changes to the design, the current assessment of the impact of simplification has been disappointing. However, it is too early to say that simplification has been a failure. It remains to be seen whether the revised private pension products and the more recent introductions, such as France, and other countries will prove more successful than the “first wave”. However, before these results are available, it is difficult to make a strong case that simplified pensions can make the private pension market work more effectively.

The proposals from the European Financial Services Round Table (EFR)

8.46 Recently the EFR set out proposals for the development of a standardised pension, the Pan-European Pension (EPP).[64] It is interesting to review the structure of this proposal against the lessons learned above. The EPP is an individual or group contract with the following characteristics:

- **Degree of standardisation:** Highly standardised with identical basic characteristics. However, it explicitly allows for additional risk as an option;
- **Price regulation:** No uniform fee level, with providers free to set levels to cover costs. It is unclear whether they propose any standardisation in the structure of charges;
- **Tax:** Tax incentives according to the EET model (i.e. contributions and investment gains are tax exempt and any pay out taxed) but consistent with

[64] Creating a common structure for pan-European pensions, Recommendations of the European Financial Services Round Table, September 2004.

existing tax incentives in Member States. No discrimination between contribution made to EPPs in home country or another Member State;

- **Product structure:** Single or regular flexible contributions to the product, but tax incentives only received if held to retirement. Proceeds available only under extreme restricted circumstances. Vested rights portable at any time.

- **Risk:** Maximum limits per investment category may apply and zero risk option must be available returning contributions;

- **Annuitisation:** Could be lump sum or annuity but could be constrained by Member State.

- **Information requirement:** Minimum level of information applies in all Member States. EU wide standard summary of key features and terms of EPPs.

8.47 The proposals set out by the EFR are sometimes referred to as using the "26th structure". The idea is that "an agreement by Member States on a single set of autonomous rules for pension solutions that would apply uniformly throughout the EU. There would be no discretion for Member States to add additional national requirements i.e. to gold plate the rules."

8.48 The proposals set out by the EFR appear to learn from the attempts at simplification in Europe. In particular, they rule out price constraints that have caused the most significant problems to date with simplified pensions, while allowing risk control measures commonly observed in simplified pension products (and which do not appear to have significant unintended consequences). By allowing some access to funds, this will avoid the problems seen in a number of Member States. The focus of consumer protection is on simplified information rather than draconian simplified product standards.

8.49 Most importantly, by allowing Member States to impose national restrictions over the use of funds and attempting to separate product structure from the tax system this may offer a workable template for the development of a European simplified pension.

Section 9 Motor insurance

9.1 Following the analysis in the theoretical chapter, motor insurance is not one of the areas for which a large concern regarding complexity and resulting consumer detriment is expected. Products are purchased or renewed annually, there is a very simple pricing structure focused on the annual premium for cover and, with the exception of the possible loss of no claims bonuses, there are fairly low switching costs.

9.2 In a market in which competition is focused on price and where aspects such as the level of cover or exclusions are harder to identify and compare, there may be a danger that competition reduces the level of coverage in order to gain market share through lower prices. That is, firms may be able to gain share by offering products with a lower level of cover since these are likely to be lower cost and hence likely to have lower prices.

9.3 There are several reasons for the absence of a problem of complexity:

- In the case of motor insurance, the presence of compulsory insurance, and the minimum requirements imposed through that, go some way to preventing any significant detrimental reduction in cover from occurring. All countries have compulsory third party insurance, which is already a standardised product with minimum coverage;[65]
- Information regarding prices is believed to be easily accessible and due to the standardised features of the compulsory motor insurance, consumers can easily compare different offers on the basis of premiums;
- In a number of Member States, brokers act on behalf of consumers to help them search across the market; and
- There are thought to be low switching costs between providers, and consumers often exercise this option to get cover from rival providers.

[65] Compulsory motor insurance with specified terms covering third party insurance is not covered under our definition of simplified product because the aim is to overcome adverse selection problems and the cost imposed on other drivers in the event of an accident rather than complexity.

9.4 Further, in Austria and the Netherlands, standardisation has also been brought in through the use of model contract terms:

- In Austria, the insurance association (VVO) provides model contract terms for its members. These contracts have a block exemption from the European Commission. It is believed that these contracts generally still follow the traditional product design that existed prior to liberalisation for both third-party and comprehensive motor insurance, and hence consumers can compare prices relatively easily.

- In the Netherlands, the availability of standard policy models developed by the Dutch Association of Insurers contributes to increasing standardisation of motor insurance.[66]

9.5 Although all countries impose a minimum standards for motor insurance it is however clear, from Table 10 below, that the level of cover varies significantly between Member States.

Table 10: Comparison of compulsory motor insurance coverage (€)

	Personal Damage (€)		Material Damage (€)	
	Minimum	Maximum	Minimum	Maximum
Austria	1,090,092	2,180,185	2,180,185	2,180,185
Belgium	unlimited	unlimited	unlimited	unlimited
Denmark	11,692,605	11,692,605	2,284,761	2,284,761
Finland	unlimited	unlimited	3,300,000	3,300,000
France	unlimited	unlimited	460,000	460,000 (PA, PV)
Germany	2,500,000	7,500,000 (PA,PP)	50,000	500,000 (PA)
Greece	500,000	500,000 (PA)	100,000	100,000 (PA)
Ireland	unlimited	unlimited	114,276.43	114,276.43 (PA)
Italy	774,685.35	2,582,284.49 (PA)	774,685.35	2,592,284.49 (PA)

66 Financial Sector Monitor 2003, Dutch Competition Authority, October 2003, available at www.nmanet.nl.

Luxembourg	unlimited	unlimited	unlimited	unlimited (PA)
Netherlands	136,134	6,806,703 (PA)	13,600	6,806,703 (PA)
Portugal	600,000	600,000 (PA)	600,000	600,000 (PA)
Spain	350,000	350,000 (PA)	100,000	100,000 (PA)
Sweden	32,637,075	32,637,075	32,637,075	32,637,075
United Kingdom	unlimited	unlimited	367,863	367,863 (PA)

Source: Conseil des Bureaux, Paris, 13 Avril 2004, Calcul des cours des nouveaux Etats members au 17 mai. Key: PA=per accident, PP=per person, PV=per vehicle

9.6 Standardisation is achieved not only through the regulations of individual Member States regarding compulsory insurance, but also through European Directives.[67] There have been four motor insurance directives and there are currently proposals for a fifth. Although the existing directives have mainly focused on the implications for cross-border driving, they have nonetheless had implications for the compulsory insurance required.

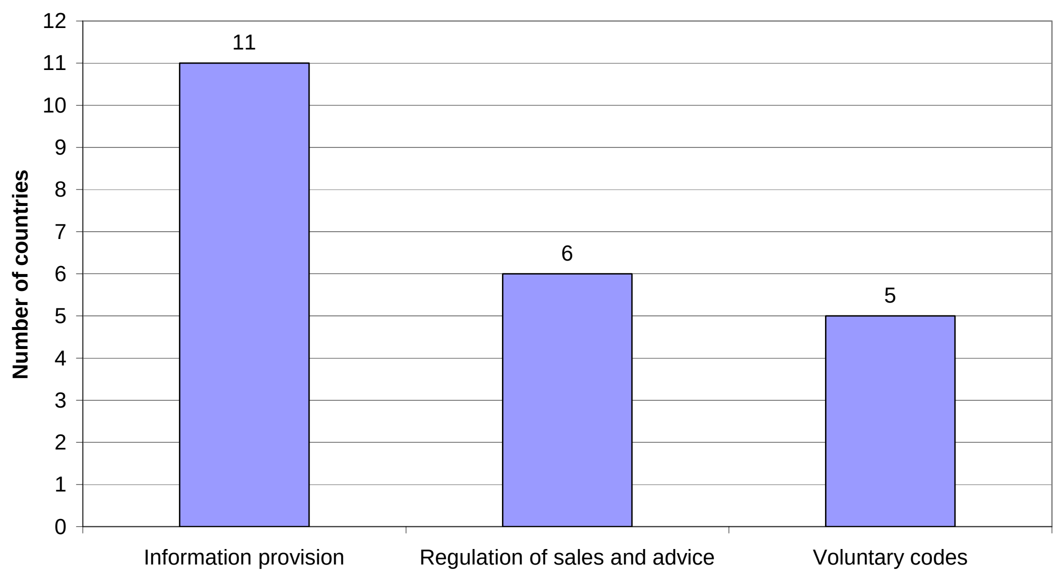
9.7 As well as ensuring that compulsory cover is in place in all Member States, the existing directives have required minimum levels of cover and ensured that all passengers in the vehicle fall within the definition of victims covered by the compulsory insurance. The most recent proposals suggest that the minimum level of cover should be increased to €1 million per victim for personal injuries and €0.5 million per claim for damage to property. However, it was noted that in a number of Member States, national legislation requires unlimited cover for personal injuries and many Member States also apply minimum amounts of cover much greater than that required in existing directives. Additional standardisation is likely to be brought in through proposals to require cover for pedestrians and cyclists irrespective of whether the driver was at fault.

9.8 The interviews and our background research confirm that in most Member States the market is seen to offer motor insurance policies which are already simple and transparent, and although some concerns remain regarding the unwillingness of consumer to shop around, this market is not a cause of particular concern. It is not surprising therefore that we did not find any Member States who had produced a simplified, standardised motor insurance product.

Alternative interventions for countries without simplified products

9.9 As has been noted above, there are no motor insurance products that have been identified as simplified in any of the Member States. Since motor insurance is relatively standardised because of obligatory third person liability, alternative regulatory interventions are not as numerous as in other products and focus, almost universally, on information provision. Detailed regulation of sales and advice is not typical with motor insurance. (Although intermediaries or brokers may be used to search across the whole market, there are no "best advice" or detailed know-your-customer requirements as there are in, for example, life insurance.) Voluntary codes of conduct for insurers apply in a number of Member States, although they are typically fairly general rather than having a specific focus on motor insurance.

Figure 10: Alternative regulatory interventions for motor insurance



[67] Proposal for a directive of the European Parliament and of the Council amending Council Directives 72/166/EEC, 84/5/EEC, 88/357/EEC, 90/232/EEC and Directive 2000/26/EC on insurance against civil liability in respect of the use of motor vehicles.

9.10 There was no Member State in which no alternative interventions to a simplified motor insurance product were identified.

Regulation of information provision

9.11 Information regarding insurance contracts in general is regulated in nearly all Member States covered. Besides mandatory information provision in insurance contracts such as the duration of the contract, most market participants noted that comparative tables and websites are commonly available for motor insurance. For example:

- In Denmark, the insurance association's website has tables covering motor and home insurance – known as the insurance "magnifying glass". They estimate that the tables have around 10,000 visits per week suggesting considerable usage of them.

- In Finland, the Consumer Insurance Ombudsman Bureau (CIOB) has an extensive web site including frequent price comparisons across the industry as well as producing insurance comparisons on their website. This includes a comprehensive listing by provider of which components are included (e.g. moose/damage/fire insurance), annual costs, excess amounts, who is eligible, discounts and bonus calculations.

9.12 In Ireland, where IFSRA produces cost tables for a number of different products, a slightly different approach has been used for motor insurance compared to other products for which IFSRA has developed cost tables. Information is conveyed through describing what different companies can offer different example consumers using 8 profiles e.g. a 39-year-old engineer living in Clare, driving a VW Passat worth €14,000. As well as giving the cost of each policy (separately for men and women), the survey gives details of the main policy benefits, such as whether they include a recovery service, or a replacement or hire car.

9.13 As a very interesting development, the profiles that are used change in every edition of the cost survey in order to stop "gaming" by providers, where they lower prices just for the specific profiles in the survey in order to appear cheaper than they actually are in general. Hence the changing profiles prevent false focal points of competition from developing in a way that would not be in the interest of consumers.

Regulation of sales and advice

9.14 Although detailed regulations on sales and advice are not in place in most countries, brokers may be used to search the market and requirements may be placed on them. For example, in Austria, brokers are generally required to act in the interest of clients and hence would have this obligation when searching for motor insurance policies as well as for other products.

Voluntary codes of conduct

9.15 Voluntary codes are less prevalent in motor insurance than in some other product area. Typically they are in the form of codes of conduct by the insurance association which relate to the providers' general conduct. Although in Belgium, the Association of Insurers' code of conduct requires that the insurance company providing motor insurance provide its services within a reasonable delay in case of an accident.

Assessment of the need for simplified products

9.16 In the majority of Member States, the last decade has seen deregulation of the motor insurance market leading to the development of a range of policies, variation in coverage and less standardisation than had previously been observed. It is thought that this deregulation has had an impact on pricing – typically leading to a reduction in prices.

9.17 For example, the Austrian Insurance Association believes that the average premium has fallen since liberalisation. Similarly, in Germany, both BaFin (Federal Financial Supervisory Authority) and the German Insurance Association believe that consumers have enjoyed lower rates and various discounts as a result of liberalisation. Further, in Luxembourg, it is thought that liberalisation has led to lower premiums for safer drivers in particular.

9.18 Nonetheless, in other countries there are concerns both about the variation in prices and in some cases increasing prices.

9.19 Deregulation has meant that in some countries there are concerns about comparing the different levels of prices and cover that consumers face and further that systems of no-claims bonuses have become more complex.

9.20 A number of measures have also been taken to improve the functioning of the motor insurance market in addition to the alternative regulatory interventions described above. Some countries have a system of an "insurer of last resort" and some have in place claims settlement agreements which often ensure a minimum standard of service. Furthermore, in the great majority of Member States switching between providers was thought to be straightforward with consumers regularly engaging in this.

Deregulation

9.21 In many of the Member States, deregulation is a relatively recent process that has occurred and this has led to a wider range of products being available. For example:

- In Austria, all terms and conditions of third-party motor insurance contracts had to be approved by the insurance supervisory authority until 1994, but since liberalisation, a variety of discounts and rebates have emerged; and

- In Spain, products used to need approval from the Finance Ministry, but now the market has been liberalised and so they are moving away from having standard products.

9.22 Although deregulation was typically seen as positive from the perspective of competition and developing a wider range of products to meet consumer needs, there was concern that it had led to information being more difficult to compare due to the different services offered. For example:

- In Finland, the Consumer Ombudsman Bureau compared different motor insurance policies (in 2002 and again in 2004), and found (in both instances) significant variation in the product characteristics. They also found making price comparisons to be difficult sometimes, although they did not call for any action from the industry and did not suggest the need for a simplified product.[68]

- In Sweden, the regulator reviewed the impact of the 1995 deregulation of the motor insurance market and found that insurance companies use different standards when calculating premiums which makes it complicated and difficult for consumers to understand. In addition, while insurance is largely the same across all providers there were large differences in excess amounts.[69]

Pricing

9.23 There are a number of countries where it is thought that deregulation has led to both an increase in the variation in prices, but also some countries where there are concerns that it has simply led to an increase in price.

9.24 In particular, there have been concerns in Ireland over increasing prices for motor insurance. However, this was put down to increasing legal costs and the rising value of compensation claims as well as an increase in the number and severity of accidents. By contrast there was no suggestion that it was due to the complexity of the product and hence could be solved by simplified products.

9.25 Similarly, in Italy, the AGCM (Italian Competition Authority) studied the impact of liberalisation since 1994.[70] They found that premiums soared immediately after liberalisation and that price increases continued over the intervening years. They also found that although costs have been rising, there is no evidence of innovation and the products are considered not to have improved in quality. This led to concerns over the competitiveness of the industry although it has also been noted that consistent losses have been made by virtually all insurers in the post-

[68] Consumer Ombudsman Bureau News Release: 25th May 2002 and again 10th June 2004. It should be noted that regulations in Finland state that premiums shall be within a reasonable distance from the costs (as they are believed to be by the Finish Insurance Supervisory Authority).

[69] Motor Insurance After Deregulation, FI Report, 7th March 2000.

[70] Indagine conoscitiva sul settore assicurazione autoveicoli, Autorità Garante della Concorrenza e del Mercato (2003).

liberalisation era which is believed to mainly be due to a significant increase in compensation claims many of which are thought to be fraudulent.[71]

9.26 The Danish Consumer Agency argues that motor insurance features a relatively high degree of price variation (although we have not been able to find empirical evidence to support this), implying that this may be due to complexities, which prevent consumers from comparing effectively between products. Indeed, the Danish Consumer Council identified motor insurance as a market where they would like to see a simplified product developed.

9.27 However, even in market that is seen as highly standardised there are concerns regarding the level of price dispersion. Motor insurance is believed to be well understood and already quite standardised in the Netherlands,

> *"According to the consumer association, Consumentenbond, the policy conditions of non-life insurance are largely standardised. The trend towards increasing standardisation in non-life insurance is partly the result of statutory provisions (for instance third-party liability and motor vehicle insurance), criteria of re-insurers, cost efficiency, but also the availability of standard policy models developed by the Dutch Association of Insurers."*[72]

9.28 Despite this standardisation, there is a fair amount of price dispersion observed. The Netherlands Consumers' Association tested premiums paid for motor insurance and found a difference of:[73]

- 45% between the highest and lowest price for third party liability insurance;
- 37% between the highest and lowest price for third party liability insurance and limited damage coverage; and
- 22% between the highest and lowest price for third party liability insurance and full damage coverage.

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[71] L´assicurazione R.C.Auto in Italia: l´interpretazione della crisi, i possibili rimedi, le linee di ricerca futura, Working Paper n. 20, Centro di ricerche assicurative e previdenziali (CERAP), March 2001.

[72] Financial Sector Monitor 2003, Dutch Competition Authorities, October 2003, available at www.nmanet.nl.

[73] Specifically, they tested characteristics for a man or woman, younger than 24 years, 0 accident-free years and 10,000 km per year with a Opel Corsa, 8 years old. Source: "De goudkoopste autoverzekeringen", Geldgids November 2003, de Consumentenbond, Netherlands Consumers' Association. The spread is calculated as a percentage of the final price.

9.29 These differences are thought to persist because consumers will often assume that the insurer, after years without any claims, will be more inclined to accept claims than when the insurance commences shortly prior to the claim. However, many companies allow the carrying over of accident-free years, although each typically has its own system of calculating the percentage reductions for this.[74] (Alternatively the price differences may reflect companies focussing on different niches of the market.)

9.30 The implications of this is that price differences may be reduced by improved information, for example, consumers need to be made aware of the degree to which no-claims bonuses can be transferred between providers.

Regulation of no-claims bonus

9.31 Deregulation has also contributed to a change in the system of no claims bonuses which were previously calculated according to legal requirements in a number of Member States.

9.32 In Austria, although it is no longer compulsory, it is thought that most providers of third-party motor insurance still tend to follow the former bonus-malus (no claims bonus) contribution system according to which the value of premiums is determined by past damages claims.[75]

9.33 In Belgium, the bonus-malus system, in which percentage reductions in premiums after one year of accident-free driving was fixed by law, was found to contravene the third non-life directive and hence Belgium abandoned it. It is thought that the abolition of this system has led to an increasing complexity of tariffs. Indeed the Belgian Association of Insurance and Finance Intermediaries believed that prohibiting the bonus-malus system works against in the opposite direction of creating a simplified product.[76]

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[74] Taken from www.independer.nl.

[75] KFZ-Haftpflicht, Austrian Federal Ministry of Justice, office for consumer issues (Bundesministerium für Justiz, Büro für Konsumentenfragen), brochure February 2003.

[76] Interview with the Association of Insurance and Finance Intermediaries, 6th July 2004.

9.34 In France and Luxembourg the bonus-malus system only fixes the coefficient of the premium but not the initial premium itself, which may be set freely by insurance companies. In a decision on 7th September 2004, the European Court of Justice judged that the bonus-malus system in France and Luxembourg may continue to be applied.[77]

9.35 In Spain, it was thought that complexity may have arisen due to the way no claims bonuses were earned and when these are lost. Currently this was thought to vary between insurance companies and meant that consumers did not always understand why they were treated differently by different companies, although this was not seen as a major area of concern.

Insurer of the last resort

9.36 Where there are concerns about access to motor insurance, an alternative regulatory intervention is to set up an "insurer of last resort". This ensures that consumers are not denied access to motor insurance. For example in Spain, if three insurance companies refuse cover then the consumer can go to the Consortium that must offer cover and a similar approach is used in France.

9.37 Similarly, since 1st February 2003, Belgian consumers who have been denied motor insurance from three different companies or were proposed a tariff five times higher than the tariff for the "best conditions" (les meilleurs conditions) have been able to turn to the "Bureau Central de Tarification" (Central Office of Price Setting). This office fixes the premium and condition for motor insurance for those who were refused a motor insurance in the market place and selects an insurance company to cover the risk.[78]

Claims settlement

9.38 In both Spain and France there is a national agreement on claims settlement (to which approximately 90% of the motor insurance in Spain has signed and nearly

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[77] See the judgements from the European Commission C-346/02 and C-347/02 available from http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en.

[78] Assureur Info.Numéro 8, 26th February 2004, available at http://www.assuralia.be/fr/sector/annual_report/ assurinfo03.pdf.

the entire French market). This ensures that compensation is completed quickly as regards material damages and allows insurance companies to recognise quickly who is responsible for what. In Spain, it facilitates daily settlement of claims as well as ensuring that each insurance company can deal with their own clients.[79] Hence this system facilitates minimum service levels across the industry with respect to claims.

Switching

9.39 In most Member States it was argued that the motor insurance market was not complex and that this, along with a general sense of being fairly competitive could be demonstrated by the level of switching that was observed and that was thought to be high in comparison to other financial services products (including those being considered in this research).

9.40 For example, in Portugal, although motor insurance policies are typically automatically renewed unless cancelled by the policyholder, the market is characterised by a high level of switching, estimated at around 30% of the market.[80] Furthermore, it used to be the case that consumers would have to pay a penalty of 50% of the remaining premiums for the year if they cancelled a policy, but this has now been removed.

9.41 In fact, in Portugal there was thought to be a problem of excess switching. Current rules indicate that cover must be given from the day that the consumer arranges the insurance, but consumers have until the end of the month to pay the premium. In the absence of an accident, this allows the consumer to conveniently forgo the payment of the premium at the end of the month and start a new policy with a different provider. Hence, policyholders are able to have continuous cover without paying any premiums. If an accident occurs, then the consumer makes sure that the premium is paid for that month.

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79 Interview with Unespa, 19th May 2004.

80 Interview with Associação Portuguesa de Seguradores, 8th June 2004.

Conclusions

9.42 Overall, there were not thought to be major concerns in motor insurance markets in Europe that could be solved by the introduction of simplified products. Motor insurance is already seen as very standardised, and potential consumer protection from the erosion of cover is prevented by the compulsory requirements.

9.43 Denmark was the only country where there was any support for a simplified motor insurance product. However, it seems that there is little to be gained from such a product in view of the fact that compulsory insurance is already required in all Member States and imposes minimum standards across Europe.

9.44 Although there was some concern that the system of no-claims bonuses could reduce switching, there was limited evidence provided that this was preventing consumers from switching generally. Furthermore, the proposals for a fifth EC directive on motor insurance require the insurer to provider an accident statement to the policyholder within 15 days of the end of the policy in order that the consumer would be able to demonstrate their record of accidents under their previous policy. It seems likely that this requirement on information provision would act to make switching between insurance companies easier for consumers – particularly for those who have built up a long no-claims history.

9.45 Hence we conclude that there is no need for a simplified, standardised product - mainly because there is already considerable standardisation. The market for motor insurance is believed to work well, with transparent information widely available, intense price competition and consumers switching between providers.

Section 10 Home insurance

10.1 Based on the theoretical analysis, we would not expect home insurance to be a product where there are significant problems arising due to complexity. The price of the product is often extremely simple, being based on an annual premium, which is renewable annually.

10.2 However, given the value of the insurance is only tested when a claim is made and this is likely to be relatively infrequent, there is the potential for firms to compete on the level of exclusions. If consumers are not able differentiate between providers offering a high level of cover compared to those offering a low level of cover, we would expect to see products offering too low a level of cover winning market share (since with a less costly product they should be able to offer lower prices) and for this to result in consumer detriment. If this were the case, regulation that set a minimum level of provision or differentiated between products offering different level of cover may be beneficial.

10.3 In addition to the problem over what is, and what is not covered by the policy, there is a problem caused by consumers facing very different risks. As the risk of home insurance varies due to geography, there will be some households that have significantly higher risks, due to the potential for flooding or earthquakes for example. If these risks are paid through more expensive cover for those at most risk, this may result in very expensive cover and even a lack of cover altogether. Left to the market, we may end up with some consumers not being covered.

10.4 It is, however, important at this point to differentiate between building insurance cover and contents. In many countries, building insurance, although not compulsory from a Government perspective, is mandated by mortgage providers as a condition of the loan. As the mortgage provider has every incentive to have the building covered and given that they can compare across many properties, it is unlikely that they would accept a product that reduced the level of cover below a satisfactory level. In this case, it is unlikely that the product terms vary significantly and therefore price competition is unlikely to lead to the problems above. This would suggest problems are only likely to occur in terms of contents cover or building insurance where the property is already fully owned.

10.5 Although we have not found any simplified home insurance products we have found significant standardisation that has tried to solve the issues identified above. Firstly, there are a number of examples where standardised products have attempted to define a minimum level of exclusions:

- In Austria, there are model contract terms for home insurance provided by the Austrian Insurance Association which include damages due to storms, but exclude flooding damages (although the provider can add those to individual contracts). Indeed, home contents and building insurance must include fire insurance as well as damages due to explosion or lightning.

- In Belgium, home insurance is not compulsory by law and there are no standardised contracts. Nevertheless, the 1998 Royal Decree stipulates that companies need to provide simplified formulas for calculating the appraisal value;

- In Denmark, there is a standardised home insurance product, designed by the consumer association and the insurance trade association, that sets a minimum level of cover;

- In Finland, there are structured home insurances products. For example Finnish home insurance consists of three layers: a.) buildings and contents insurance; b.) legal expenses insurance; and c.) liability insurance. These layers are always the same, providing a form of structural standardisation.

10.6 The creation of a standardised home insurance product, which includes coverage for flooding, shares the risk across all consumers and may prevent the disappearance of the market for home insurance with flood coverage. In fact, the creation of standardised home insurance with compulsory flood insurance for everyone may be the only way to ensure that flood insurance exists for everyone. However, such a product would also lead to a cross subsidy from those who are not at risk from flooding to those who are and hence may be seen as “unfair” to those who are not at risk from flooding. In addition, it may not give the appropriate incentives to prevent consumers locating in areas at risk of flooding. There have also been a variety of attempts to do this:

- In Belgium, the consumer watchdog, Test-Achats, specified product characteristics that should be met in a product. They were of the view that the majority of home insurance contracts ("l'assurance globale habitation") do not cover all risks sufficiently and hence they drew up a list of responsibilities, which should be fulfilled to protect consumers sufficiently which included coverage of natural catastrophes;

- In Denmark, holders of a fire insurance policy are obliged to pay a tax of 20 DKK. (€3) to a fund, which pays compensation for damages caused by floods and pays costs to re-establish private forests damaged by storms.

- In France, home insurance is compulsory and there is already a degree of standardisation as it must cover the risk of flooding, storm and terrorism. In fact, the French Government supplements the available private insurance capacity in case of terrorist attacks. According to the Association of Insurers, it is important that the state creates a basis covering natural disasters and terrorist attacks on which insurance companies can build.

- In Luxembourg there have been attempts to introduce compulsory natural catastrophe insurance. However, politicians and consumer association did not want the remaining 95% of the population to pay higher premiums in order to cross subsidise the 4-5% of the population who are in danger of flooding. Hence the insurance, which would have been an extra charge of €100, was not accepted. The consequence is that home insurance for houses exposed to the risk of flooding is believed to be prohibitively high.

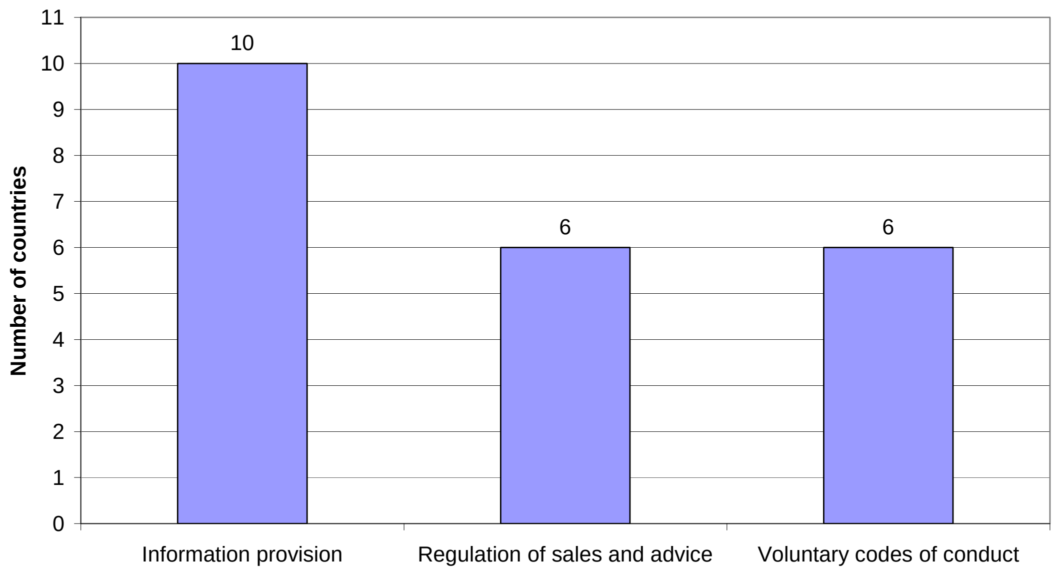
10.7 In none of these examples did the product design try to inform consumers over the level of cover and help them choose a product appropriate for their needs, therefore we did not categorise any of these products as simplified.

10.8 Before examining the case for simplified home insurance products we examine the alternative forms of regulation used.

Alternative interventions for countries without simplified products

10.9 Looking at our alternative forms of regulation, we find the majority of Member States have regulation on information provision that is applicable to home insurance products. Although there is little specific regulation of the sales advice regime for home insurance, this does apply in 6 of the 14 Member States without simplified products.

Figure 11: Alternative interventions[81]



10.10 There was no Member States in which no alternative interventions to a simplified home insurance product were identified.

Information provision

10.11 Information has been seen as the most effective means of making the home insurance market work. This has taken a number of forms:

- The role of Test-Achats (the Belgian Consumer Association) in attempting to create quality mark could also be presented as information provision.

[81] It should be noted that alternative interventions are not included for the UK since the motivation for the whole analysis study was the Sandler report in the UK.

- Comparative tables are used in a number of countries to allow comparison across Member States. For example in Finland and Denmark, the Consumer Ombudsman and Insurance Association respectively provide an on-line comparison of the products offered by different companies.

- In Portugal, under the Conditions of Coverage Act, consumers are provided with a sheet where everything is defined and stipulated.

<u>Regulation of sales and advice and voluntary codes</u>

10.12 Financial advisers are not typically regulated for the sale of home insurance. Primarily this is because there is no investment element in them.

10.13 In the case of the regulation of sales process and that of voluntary codes of conduct, home insurance is covered in the general rules but there are few specific constraints that apply to this product.

10.14 There has been a debate about whether the sales process can be changed to facilitate switching:

- At present in France consumers cannot cancel their insurance in the last two months before the contract expires because it is automatically renewed. A law is being discussed in 2004 to oblige insurance companies to inform consumers in advance about the switching possibilities.

- In the Netherlands a particular problem that has been identified was the long contractual terms and periods of notice which were thought to be inhibiting switching. In response to this, regulation is under discussion to prohibit unreasonably long periods of notice. Furthermore, the Dutch Association of Insurers has advised its members to allow policyholders to opt for one-year contracts as a result of continuing requests from the Netherlands Consumers' Association.

Assessment of the need for simplified products

10.15 Leaving aside elements of standardisation in the majority of Member States, the market for home insurance was not seen as suffering from excessive complexity. However, there are some concerns regarding the market for home insurance although the nature of these concerns varies between Member States. For example:

- In France and the Netherlands there is a concern regarding the ability of consumers to switch between policy providers;
- In Germany, there is a concern that since liberalisation of the insurance sector, some risks, such as flooding, are not being covered;
- In Greece there is a concern regarding the very low level of provision;
- In Ireland there is a concern regarding the way building and contents insurance are bundled together; and
- Finally, in Portugal a problem was identified that products did not build in sufficient increase in cover over time such that home owners who had the correct level of cover when they purchased the product had insufficient cover at the time of making a claim.

10.16 Only in a small number of countries were minimum standards identified as a solution to the problem of information asymmetry. In Italy, it is believed that concern regarding the level of exclusions is resulting in too few consumers purchasing home insurance. In Finland, there is a concern that foreign entrants are coming into the market offering a lower level of provision and that this will result in the level of cover declining as domestic companies compete with them.

10.17 However, even in countries where complexity was identified as a potential problem, there was scepticism over the value of simplified products. In Spain for example, where policies were seen as complex and consumers did not focus enough on the product terms (as they were bundled with mortgages), simplification was not seen as likely to be effective.

10.18 This is because it was noted that consumers have different needs and require different levels of cover e.g. some consumers may want to insure the whole risk, but others only 50% of any damage. The freedom of consumers to choose a level of provision appropriate to their circumstances was seen as more important than problems arising due to complexity.

10.19 Despite problems of transparency in information, we could not therefore identify a large-scale problem of complexity. Even if coverage specified in home insurance contracts was deemed not to be transparent, simplification as a solution was viewed with scepticism. In fact, in Ireland it was mentioned that consumers would like to have a greater choice of products and that therefore there was little justification for simplification or standardisation that would not encourage the development of a greater variety of products.

10.20 However, we identified a need for transparency in information, especially with regard to what is covered in case of an accident. For example, in Austria consumers complained that risks covered are not stated in the contract or that the information is only to be found in the small print. Similar concerns were also raised in Spain where both the regulator (DGSFP) and the consumer association (AUSBANC) believed that understanding the level of cover and exclusions was often very difficult.

10.21 Therefore, simplified information was seen as a potentially beneficial approach in a number of Member States.

10.22 This was supported by evidence from the markets that were seen to be working well. In Portugal, the level of competition is very high, with each provider offering different covers and a range of packages. Nearly all of the policies cover the major risks: fire; explosion; flood; personal accident; and theft. Other risks are bundled-in by providers as a way to differentiate their products. The number of these additional features can vary greatly with some policies having five while others have twenty. Typically a provider will offer a range of packages including: popular package; medium cover; and luxury cover / all risks. The existence of multiple packages ensures that product features are not driven out by competition.

10.23 The provision of information was described as adequate and it was not seen as a problem in Portugal. Under the Conditions of Coverage Act, consumers are provided with a sheet where everything is defined and stipulated. This ensures that

"companies make it clear which covers are there" [82]

10.24 It seems therefore that a similar approach whereby consumers are informed as to the level of cover and the cost in a summarised and standardised manner, would appear a more appropriate solution that the use of simplified products.

[82] Interview with the APS, 8th June 2004.

Section 11 Life insurance

11.1 Life insurance products could be pure term insurance contracts in which regular premiums are paid and a lump sum is paid out in the event of death. Such contracts are straightforward, have relatively few characteristics, are well understood by consumers and since comparison of the premium for cover is the main characteristic that consumers focus on, would suggest a market focused on price competition.

11.2 Investment based life insurance products, on the other hand, are much more complex. There are a much larger number of characteristics and charges are often much more opaque. Switching costs are often dependent on the particular charging structures used and the length of time the product is held. As with any investment linked product, it is difficult to assess the quality of the product as investment returns are only revealed slowly over time and the products are purchased relatively infrequently.

11.3 Hence from a theoretical perspective, we might expect to see a need for simplification of investment based life insurance products, but would not expect such a need for pure term insurance products.

11.4 As with a number of the products under consideration, European legislation has brought in some standardisation of products, in this case through the Third Life Directive. Amongst other aspects, this includes requirements such as:

- The need to ensure the product has sufficient technical provisions. This has implications for certain aspects of the product features including in way reserves are calculated and the need to set a maximum interest rate when the product contains an interest rate guarantee. This does not affect unit-linked contracts, or with-profit contracts with no surrender value (and does not need to apply to single premium contracts for a period of 8 years);

- Limits on the degree to which the assets covering the technical provisions can be invested in certain categories;

- The enforcement of a cancellation period between 14 and 30 days from the time at which the consumer was informed of the conclusion of the contract;
- Information requirements including: definition of the benefits and the term of the contract, means of termination calculation and distribution of bonuses, premiums associated to particular benefits, surrender and paid-up values and guarantees, nature of underlying assets, cooling off period, tax, complaints and applicable law.

11.5 However, the Third Life Directive leaves Member States significant discretion to impose additional rules. In particular, the rules are set out as a minimum standard and Member States may lay down stricter rules authorised by their own competent authority. There is also relatively little specification on some aspects of the marketing the products for example, rules on the advertising of products to consumers.

11.6 Further, while the Third Life Directive does impose informational requirements, it does not go as far as the UCITS Directive. The UCITS Directive requires a simplified prospectus to be produced which must contain certain prescribed information and which must be acceptable in different Member States whereas the Third Life Directive is less prescriptive meaning that information is harder to compare and this results in greater variation across Member States.

11.7 In addition, the Insurance Mediation Directive imposes a number of constraints on the sales and advice process for insurance products. Details of these can be found in the chapter on financial advice and some of them are covered in the section on alternative regulatory interventions below.

11.8 Perhaps surprisingly, given the importance of life insurance in many Member States as the primary vehicle for long-term saving for retirement, there is little evidence of regulatory interest in simplified products for life insurance products (despite there being a number of simplified pension products identified). The UK Medium Term Investment Product and the earlier CAT standard insurance ISA therefore appear to be extremely unusual.

11.9 In this chapter, we focus on unit-linked life insurance contracts, we did not identify any evidence regarding a simplified smoothed investment fund (with the exception of the UK). However, some countries do impose restrictions on the returns that should be made to consumers. For example in Germany, funds must distribute at least 90% of the surplus profits made in the fund. This imposes standardisation across such funds in Germany, although we do not classify this as simplification because it does not actually make the product less complex for the consumer even though it may increase consumer protection.

11.10 The problems of complexity in life insurance have been identified in many markets but instead of focusing on simplifying products, the focus has been on the provision of information and regulating the sales and advice regime.

Simplified life insurance

11.11 Simplified life insurance products were only identified in the UK where the CAT standard insurance ISA is to be withdrawn once the Stakeholder Medium Term Investment Product begins in April 2005.

11.12 The CAT standard insurance ISA was not seen as a particularly popular product in the UK. However, this is thought to partly reflect the fact that the limits on the size of investments that could be made in the insurance ISA were different to those that could be made in ISAs where the underlying investment was a collective investment scheme. The current proposals are that both a unit linked insurance product and a collective investment scheme could form the underlying investment to the new Stakeholder Medium Term Investment Product, and hence the UK Government is proposing an equalisation of the tax treatment for both of these types of products.

11.13 There are a number of characteristics that were of importance in designing (and categorising) these products as simplified products.

11.14 **Minimum transaction size**: Both the CAT standard insurance ISA and the proposed Stakeholder Medium Term Investment Product have to accept minimum levels of contributions to the products.

11.15 **Investment restrictions**: The proposed Stakeholder Medium Term Investment Product will have restrictions in place on investments with a maximum of 60% of the fund invested in equities and property with the remaining 40% in less risky assets.

11.16 **Linked to underlying funds:** Both the CAT standard insurance ISA and the proposed Stakeholder Medium Term Investment Product have a requirement to reflect the value of the underlying assets. However, in the case of the CAT standard insurance ISA there was also a requirement to guarantee to return at least the value of premiums paid in after three years. For the Stakeholder Medium Term Investment Product, the product must be unitised with the price of units published daily. A guaranteed product was considered but it was decided against including this in the Stakeholder range.

11.17 **Price cap:** Both the CAT standard insurance ISA and the proposed Stakeholder Medium Term Investment Product have a price cap. In both cases this is set as an annual management charge as a percentage of the value of funds under management, with no other charges allowed. For the CAT standard insurance ISA, the price cap was set at 3% of funds under management, whereas for the proposed Stakeholder Medium Term Investment Product it will be set at 1.5% for the first ten years falling to 1% after that.

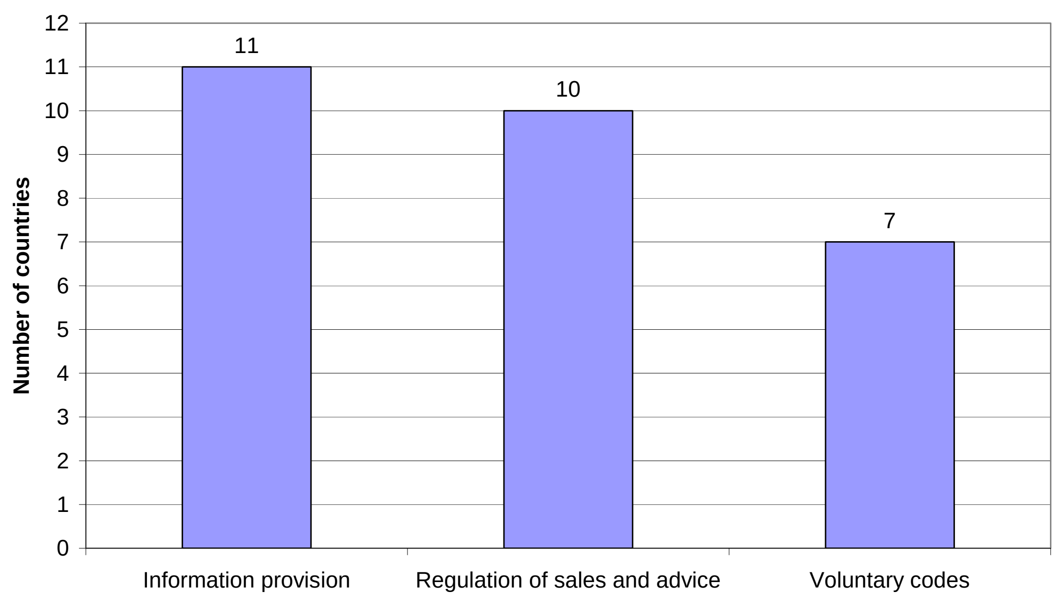
11.18 In addition to the Stakeholder Medium Term Investment Product, there are also proposals for a Stakeholder smoothed investment fund in the UK. There are various restrictions that are proposed for this product including the same investment allocation restrictions as the Stakeholder Medium Term Investment Product of no more than 60% of the value of the fund being invested in equity and property. In addition, there must be a “100/0” ownership structure in which policyholders own 100% of the fund and shareholders own 0% of the fund. Finally, there is to be a separate “smoothing account” with explicit charges so that consumers can identify the cost of the smoothing feature of the product.

Alternative interventions for countries without simplified products

11.19 In a number of Member States we have identified restrictions on the guaranteed returns of life insurance contracts i.e. where there are limits on the interest rates that providers can offer to guarantee in their policy. However, we have excluded this from our assessment of simplification because it is aimed primarily at solvency and motivated by the concern that – due to competitive pressure – insurance providers might promise policyholders so high an interest rate that it jeopardises their ability to fulfil their obligations vis-à-vis policyholders. In practice, where such maximums exist, for example in Germany, this has become a product standard with most providers adopting this maximum as their guaranteed interest rate.

11.20 As is common with most of the products, information provision is the most popular regulatory intervention although compared to many products, the regulation of the sales and advice process is high.

Figure 12: Alternative regulatory interventions for life insurance



11.21 There was no Member State in which no alternative interventions to a simplified life insurance product were identified.

Information provision

11.22 As noted above the Third Life Directive imposes various requirements to disclose information regarding life insurance products. The Insurance Mediation Directive also imposes information requirements regarding the advice process, and these are discussed in the section on the regulation of sales and advice below.

11.23 In many countries, life insurance products are subject to information requirements above that necessary for other products. This reflects the higher perceived complexity of the product: for example in Greece, minimum pre-contractual information requirements are set out by Law 400/1970 requiring more intensive information requirements for life insurance products and investment-linked insurance products (Article 13), than for general insurance products (Article 4) reflecting the perceived complexity of the products.

11.24 Other attempts to increase information provision for investment based life insurance products have included:

- The Financial Information Leaflet (FIL) in the Netherlands which was designed to overcome difficulties with previous information disclosure and in particular to enable the consumer to compare different products easily without overloading them with information. It is not limited to investment based life insurance funds but is required for a wide range of products that the Netherlands authorities describe as complex. It covers a range of different factors including the financial risks of the product, the obligations if the product is purchased, an example of the return and costs, and information about exit conditions.

- The requirement for an "information note" for life insurance contracts in Italy providing clear and accurate information with effort to avoid highly technical terminology. This covers aspects such as definitions of benefits, means and duration of payments, indicative future values based on an agreed 10% gross growth rate, details on exiting the policy and entitlement to a personalised plan indicating the potential benefits of the policy.

- A monitoring and tracking internet tool developed by UNESPA in Spain, in the life insurance market to increase the transparency of unit-linked products. Product information is updated on a daily basis with the current returns, allowing customers to monitor their product with graphs and various classification tools.

- In Sweden, SIF has issued guidelines on presentation of information when marketing insurance products in the Internet. This includes: providing contact details; information on general conditions; ensuring electronic marketing only goes to individuals who have agreed to it; allowing access to personal information; ensuring information is presented in a clear, accurate understandable manner and is available to be saved or printed, and ensuring a clear procedure for completing an agreement (e.g. a "double-click" system whereby the consumer has another chance after initial agreement to review the details of the contract).

11.25 In other countries, information provision regarding life contracts is currently under review. For example, in Austria the Financial Market Authority (FMA) recently announced that it is going to define minimum transparency standards for life insurance contracts. The exact contents of the minimum standards is still uncertain, but according to press releases the FMA plans to release guidelines on the regular provision of information of policyholders, e.g. about the investment strategy and the realised yield of their savings product.

11.26 A particular area of concern in many Member States, has been the value of the product in the early years of the investment and this has resulted in additional disclosure requirements regarding surrender terms. For example, in Austria surrender terms must be provided prior to signing the contract. In Belgium, the customer needs to be updated on a yearly basis as to the value at which the product could be purchased back. In Greece, this takes the form of a table setting out the value of surrendered products and the extent that these values are guaranteed at the point of sale.

11.27 Indeed when considering information on surrender values, it was not possible to find standardised information on this across countries and hence not possible to identify the impact of charges and undertake price comparisons.

11.28 However, as with pensions, there is considerable concern that consumer are already over loaded by information. The following problems have been identified:

- Added booklets and prospectuses are often not read – for example, in the Netherlands consumers can compare different products but they need to gather information by consulting a number of different documents;
- Standardised evaluation forms that display the effect of different instruments in a standardised form using key parameters of the individual tend to be much too long or incomplete and imprecise. It is seen as difficult to resolve this trade-off;
- Simple measures often require assumptions regarding the term of the product that only partially represent the characteristics of the product; and
- The requirements are potentially costly to the industry and to consumers.

11.29 Although there is concern regarding the ability of consumers to compare the price of life insurance products, there is little enthusiasm for information setting out comparable prices in life insurance products. Mostly this is seen as too difficult. According to the Ministry for Consumer Protection (BMSG) in Austria, there are no plans to introduce a total expense ratio (TER) requirement for life insurers similar to that for investment funds.

11.30 There are some notable exceptions, such as in Denmark, where there is considerable pressure being exerted to include life products in the comparative tables. Similarly, in Italy, ISVAP is currently undertaking research into the possibility of improving the information sheet by shortening it and including some numerical indices e.g. developing summarised information sheets which would highlight the key features of the policy including cost, risk etc

11.31 Although, there is considerable pressure in some countries to introduce comparative tables for life insurance, in the same manner as it is applied to non-life products such as home insurance, this is currently being resisted. The life insurance industry see the products as too difficult to compare and would rather focus on transparency at the point of sale. This illustrates the difficulty in creating comparable information that consumers can use.[83]

Regulation of sales and advice

11.32 The Insurance Mediation Directive (IMD) imposes considerable standardisation of the sales and advice process across Europe and indeed the implementation of the IMD is leading to increased regulatory attention being placed on this at present.

11.33 The IMD brings some standardisation of information provision of the advice process to the life insurance market. This includes:

- Before the conclusion of any contract the intermediary must inform the customer whether he has a voting right of 10% of the insurance undertaking or whether the insurance undertaking has a voting right of 10% of the intermediary business;
- The intermediary must inform the customer whether he is under obligation to conduct business exclusively with one insurance undertaking; and
- The intermediary must inform the customer whether he gives his advice on a fair basis in which case it must be on the basis of an analysis of a sufficiently large number of insurance contracts available on the market.

11.34 One of the requirements of the IMD is the “know-your-customer” regulation and the need to do a fact find to understand the consumer background and financial position. The intermediary must disclose any relationship between the adviser and the product provider and any payments made resulting from the advice by the provider to the adviser. The intermediary must specify the demands and needs of the customer and the underlying reasons for any advice given to the customer.

[83] It should be noted that in addition to a simplified life insurance product, there are comparative tables for investment bonds in the UK.

11.35 In Sweden, a new act on financial advice came into force on 1st July 2004 which implemented many of the requirements of European Directives. As well as requirements for suitable advice and training and competence, all the advice given in the advice process is to be documented and the documents given to consumers (whether the consumer wants it or not).

Voluntary codes of conduct

11.36 There are a number of countries that have voluntary codes in the insurance sector that apply to life insurance (Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands). Most of these are fairly general codes requiring insurance providers to provide quality services and to act in the best interests of their clients in a fair and transparent way.

11.37 For example, in the Netherlands, the various insurance advisers have signed the GIDI code of conduct for the provision of information for intermediaries in 2001.[84] Many of the provisions of the code are now taken up through the IMD or Third Life Directive, although the code was in place before either of these Directives were imposed.

Assessment of the need for simplified products

11.38 Based on the interviews within each of the Member States and our own assessment of the situation in the countries without simplified products there is a consensus that investment based life insurance products tend to be complex.

11.39 Equally, there is also a consensus that pure term assurance is very simple with price competition a focus. There were no concerns expressed about term assurance whereas there were considerable concerns regarding investment based life insurance.

11.40 Even where the fundamental structure of the investment based life insurance products is perceived to be simple (Austria, Greece) the legal and tax framework

[84] The code of conduct for the provision of information can be found under http://www.verzekeraars.nl/smartsite.dws?id=43&mainpage=6.

mean the resulting product is complex and it is impossible to make product comparisons.

11.41 We have found considerable concern regarding the level of complexity of life insurance products. This has focused on complexity arising from: the method of distribution, the tax treatment, the bundling of products and how the returns to the ultimate consumer is determined.

11.42 Indeed, the method of distribution varies between Member States. Some countries appear to have succeeded in getting some life products bought through direct channels. However, the great majority rely on selling through intermediaries. Banks clearly dominate in Austria, Belgium, France, Italy, Portugal and Spain. The small proportion bought direct suggests that consumers see the products as relatively complex and hence seek advice on them. However, there is also concern that the distribution itself is complex with consumers not understanding exactly what service they are being offered. This should be improved following the implementation of the IMD that requires contractual ties to particular providers to be disclosed.

Table 11: Distribution of life products[85]

	Austria	Belgium	France	Ireland	Italy	Netherlands	Portugal	Spain	Sweden	UK
Insurance company employees	22%	2%	16%	20%	9%	26%	5%	-	28%	29%
Agents (tied and multiple)	4%	4%	8%	24%	20%	57%	13%	13%	-	-
Brokers	17%	24%	9%	55%	1%	-	2%	9%	19%	64%
Other networks (bank, post office)	55%	53%	61%	-	71%	17%	80%	67%	45%	-
Others	2%	18%	6%	3%	-	-	1%	11%	8%	6%

Source: European insurance in Figures, Complete Data 2002, CEA

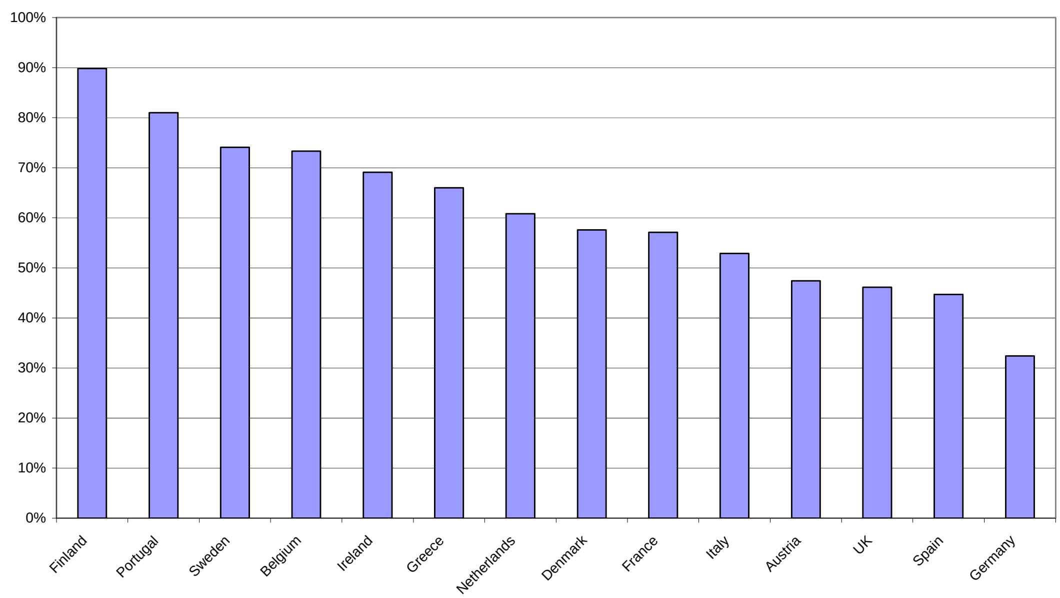
11.43 Often the tax treatment of life contracts has evolved over a considerable period of time and in many cases it is seen as complex with consumers unable to understand

85 Note that columns may not sum to exactly 100% due to rounding.

exactly what tax advantages are being conveyed by the products. Furthermore, tax treatment has often resulted in a divergence between investment based life insurance products and collective investment schemes despite the view that in many cases these products are serving the same consumer needs. Indeed, such a view was not only put forward in the Sandler Review, but has also been under discussion in Finland where there were proposals to equalise the tax treatment across different both life insurance based products and collective investment schemes (although these proposals were not, in the end, taken forward).

11.44 It has been argued that regulatory driven simplification is less necessary in concentrated markets. Firstly, in highly concentrated markets consumers face less choice and hence comparison between the various providers of a product is necessarily easier. Secondly, a small number of players are better able to co-ordinate a movement to simplified product terms if they wish to move the market and hence there may be less need for this to be driven through regulation (clearly there could in theory also be competition issues resulting from high levels of concentration). The figure below supports this argument, that at least in 2001, the UK was a relatively fragmented market in comparison to other Member States.

Figure 13: Market shares (%) of the 5 largest life insurance and pension companies in each Member State, 2002



Source: European insurance in Figures, Complete Data 2002, CEA

11.45 It was noted in a number of countries that investment based life insurance products involve bundling together an insurance contract with an investment fund. However, the value of the whole-of-life component of the contract and the value of the investment part of the contract are not separated. Hence it is impossible for the consumer to compare this bundled product to the cost of separately purchasing a whole-of-life policy and an investment fund.

11.46 In some countries, there have therefore been calls for these two components to be separated in order that consumers can assess the value of the bundled product in comparison to the cost of separate products. It has also led some regulators to suggest that consumers should insure their lives in a traditional life contract and invest in a pure savings instrument separately. In addition, such unbundling could lead to the benefits to cross-border and other trade from the UCITS Directives also accruing in the life insurance sector. For example, if the underlying investment components are unbundled from the insurance aspect of the product, then it may be possible to increase competition in these two separate elements. Since the UCITS Directive already applies for the underlying investment, additional simplification and standardisation beyond this may not be required. The degree to which disclosure of simplified information allows the value of each component to be understood, should be investigated by the European Commission.

11.47 Finally, the complexity regarding the relationship between the return on product and the underlying investment is seen as an important argument for standardisation or simplification. It has often been almost impossible for the consumer to understand the relationship between the returns on the underlying assets and the resulting returns to them. This is particularly the case for non-unit-linked life insurance, but even with unit-linked life insurance there are concerns that charges have been very opaque in the past implying that consumers struggle to understand the returns that they should expect.

11.48 Despite the considerable complexity associated with life insurance products, there remains little current enthusiasm for the development of simplified products in this area. Indeed, we did not find any country in the EU that was currently considering the development of simplified products in life insurance or who accepted the merits of one (other than the UK).

11.49 This seems surprising when the underlying issues around life contracts appear to be very similar to those of pensions. It is possible, that the lack of enthusiasm for life products reflects the history of deregulation. In particular, there is concern that liberalisation of insurance products was largely driven by European legislation:

- Many countries claimed that prior to the Third Life Directive product design of life insurance was much more closely regulated than it is today; and

- This involved product design and charging structures being presented to the regulator before the product is authorised (indeed a number of regulators argued that intervention in product standards became impossible due to the Third Life Directive).

11.50 Many countries therefore see it as ironic that further regulation might be required to limit the level of variation when they are still benefiting from the liberalisation introduced into the life insurance market during the early 1990s.

11.51 Furthermore, it has also been noted that the Third Life Directive and the Insurance Mediation Directive do bring in considerable standardisation particularly with respect to information provision including relating to the sales and advice regime. Since these Directives will ensure that consumers receive information that they previously did not in a number of Member States, there was also a view that these Directives should be allowed to have an effect before additional regulation is put in place.

11.52 Nonetheless, from a public policy perspective it seems likely that if simplification can be made to work for private pensions, such simplification may also be applicable to life contracts. Indeed there is recognition that life products are complex and there are doubts as to whether information provision will be able to resolve these issues.

11.53 This would tend to suggest that the impact of pension simplification should be assessed when there has been sufficient time for the recently developed simplified pension products to have taken root in their respective markets to establish whether there are beneficial steps that could also be applied in the life insurance market.

11.54 Further, this would allow the recent European Directives to have an impact establishing whether there remains a need for a simplified life insurance product since many of the areas of greatest concern seem to be areas that may still be remedied through the informational requirements of these Directives.

Section 12 Mortgages

12.1 Following the analysis in the theoretical chapter, mortgages are one of the areas where there is the greatest concern regarding consumer detriment arising due to product complexity. In particular, given the amount of money being borrowed and given that the choices consumers make directly impact on the variability in the level of repayments, and hence its affordability, there is the potential for considerable consumer detriment.

12.2 In addition, mortgages are seen as having relatively complex structures with a number of key dimensions including: the rate structure (which can be fixed or variable, discounted or capped), the term of the product and the repayment structure. This often results in a wide number of product offerings and correspondingly high search costs for consumers.

12.3 Finally, it is common for products to have lock-in periods and redemptions penalties especially on, but not limited to, fixed rate mortgages, making switching between providers expensive and making the initial choice of provider and product even more important.

12.4 During the interviews with regulators and consumer groups this impression was confirmed. It was generally argued that mortgages are products which consumers find difficult to compare.

12.5 However, there were a number of exceptions, e.g. Denmark, where the market had focused on simple mortgage contracts, although even in these countries new products offering consumers greater flexibility (but with associated complexity) were starting to emerge.

12.6 Given the concerns regarding complexity and search it is unsurprising that we have found a number of investigations into whether the mortgage markets in different Member States are working effectively. They support the conclusion that the market for mortgages may not work as well as hoped.

12.7 However, we did not find support for a simplified or standardised product during the interviews or in these investigations. Several reasons explain why a simplified products were not seen as viable solution:

- The existence of alternative regulatory measures were seen as addressing the problem and need to be given the time to succeed;
- The way different markets work needs to be taken into account meaning the lessons from one country were not directly applicable to another; and
- The impact simplified products have had on the mortgage market where they have been introduced.

12.8 Alternative regulatory measures relate primarily to the provision of information. A potentially significant measure has been the creation and setting up of the European code of conduct on home loans, which was finally adopted in March 2001. This code of conduct is particularly interesting as it is the result of long discussions between industry and consumer associations and explicitly attempts to standardise the information that is provided.

12.9 The impact of the code of conduct on home loans is not yet clear. On one measure, that of the proportion of mortgage providers who have signed up to the code of conduct, the code of conduct would be seen as very effective since in many Member States, 90% of mortgage providers have signed the code. However, it is clear that of those who have signed the code, not all have fully followed through on the implementation particularly with regards to the introduction of the European Standardised Information Sheet (ESIS). In addition, there are a number of areas under debate regarding the improvements that could be made to its implementation and the time at which the ESIS needs to be handed to the client.

12.10 Furthermore, in some Member States, including France and the UK, there are concerns that the national requirements and the requirements of the code of conduct are either in contradiction to each other, or at the very least lead to the replication of information being provided to consumers. In particular, in France it is thought unlikely that implementation will increase unless the ESIS be considered as equivalent to the "offre préalable" (preliminary offer), which is required in France since the former does not encompass all of the requirements of the latter.[86]

12.11 It is important to understand how different markets work before imposing restrictions that might be appropriate in one market but would not be appropriate in another. This point is illustrated by looking at how the German mortgage market works.

12.12 In Germany, consumers normally enter into long-term credit contracts without a right of early repayment. This has led to the market developing short-term contracts for customers with a higher likelihood of early repayment. Other consumers who are unlikely to want to repay early choose the long-term contracts which are correspondingly cheaper. This self-selection makes short-term contracts more expensive compared to countries which have flexible mortgage allowing all consumers to repay early without penalty.

12.13 If a simplified or standardised product leads to a fall in redemption penalties this could in fact increase the cost of long-term contracts for people who knew they were unlikely to repay early.[87] Hence such an approach would benefit some consumers but only by worsening the deal offered to another group of consumers.

12.14 Finally, a particular concern expressed regarding mortgages is that any simplification or standardisation would drive differentiated products from the market. In this case the evidence shows the good and bad impacts that can result from simplification:

[86] First Annual Progress Report on Implementation of the European Code of Conduct in the European Union by 30th September 2002, European Banking Association, European Association of Cooperative Banks, European Savings Banks Group, European Mortgage Federation, European Federation of Building Societies and Eurofinas.

[87] For example in the US borrowers typically take out a 30-year fixed interest rate mortgage but redemption penalties are practically non-existent. The secondary market (which operates under a risk of not receiving the expected return from the borrower if he pre-pays) offers a mechanism for pricing that risk. This means that the prepayment risk is shared among the borrowers and borrowers who do not prepay effectively pay for other borrowers' mobility. "Mortgage markets: why US and EU

- In Spain, the simplification has resulted in the whole market moving over to variable interest products. This has caused some concern and is seen to have reduced consumer choice; whereas

- In the UK, the introduction of CAT standard products is associated with the reduction in the use of excessive redemption penalties which was seen to have been beneficial to the working of the market.

Simplified mortgages

12.15 Simplified mortgage products exist in Spain and the United Kingdom. We have also identified standardised (rather than simplified) mortgage related products in France in the PEL (plan d'épargne logement) and the CEL (compte d'épargne logement).

12.16 The Spanish and UK products are significantly different from one another. The UK CAT standard is a voluntary product standard offering different features for variable and fixed rate mortgages. The Spanish rules apply across the market but had a considerable impact on the two types of product offering.

12.17 Below we consider the characteristics that are common across both countries with simplified products.

markets are so different", Cole, A. and Hardt, J. available at http://www.housingfinance.org/IndustryInformation/Europe_coles_hardt.pdf.

Common characteristics

Table 12: Characteristics of simplified mortgage product[88]

Restrictions / conditions	Spain	UK (CAT standard mortgage)
Minimum transaction size		No more than £10,000
Information provision	Standardised leaflet. Location and content of clauses is strictly specified.	Straightforward, clear and fair
Binding offer	The offer is binding for 10 days. This allows the customer to consider the clauses and to compare among providers.	
Structure of prices	Interest rates must be advertised as a percentage point difference to the index of reference.	No more than 2% above the base rate for variable rate mortgages Downward changes to base rate to be reflected within one calendar month.
Limit on the types of charges.	Only the interest rate, an upfront fee and a possible early redemption fee can be charged.	Maximum booking fee no more than £150 for fixed rate mortgages and not allowed for variable rate mortgages No separate charge for mortgage indemnity guarantee
Early redemption	Early redemption penalties must not be more than 1.0% of the outstanding balance.[89]	Maximum of 1% of amount owed for each remaining year of fixed period reducing monthly. Not allowed if stay with same lender or for variable mortgages

12.18 **Minimum transactions size**: only the UK product places restrictions on the size of the mortgage through having a limit on the minimum mortgage size that can be imposed by providers. The intention being to provide access to simplified products for a wide range of consumers.

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88 Note that blank cells in the table indicate that there is no restriction in that particular characteristic in the country in question.

89 Rules Concerning Transparency and Consumer Protection in the Spanish Mortgage Market, Asociación Hipotecaria Española.

12.19 **Information provision**: In Spain, information provided to consumers with details of the terms of the mortgage has also been standardised as well as standardising the brochure that consumers receive with the offer. In the UK, the only restriction is that information that is provided is straightforward, clear and fair.

12.20 **Binding offer**: In Spain, offers must be binding for 10 days so that consumers can consider the offer. A public notary checks the clauses (within 3 days) of the offer and makes sure these are in correspondence with the needs of the consumer.

12.21 **Structure of prices**: The greatest similarity between the products in Spain and the UK is the restriction on the structure of charges. In Spain, as part of the standardisation, a strict formula was imposed in the way that the interest rate are to be calculated. Thus, mortgages must be stated as a margin (in terms of percentage points) over the Index of Reference. This index is published by the Bank of Spain (BDE) and later distributed by the Spanish Mortgage Association (AHE) and disseminated by most of the media. (Indeed it was thought that consumers had a very high awareness of the Index of Reference and when it was changed.) In the UK, the price for variable rate mortgages must be related to the base rate set by the Bank of England and the price must be no more than 2% points above this base rate.

12.22 **Limit on charges**: In both Spain and the UK efforts have been made to limit the number of charges imposed on the product. In Spain, regulation limits the prices to having only one fee at the beginning of the mortgage, an interest rate and in certain conditions an exit penalty or early redemption fee. This is thought to make comparison of products very easy for consumers. In the UK, there is a maximum booking fee of no more than £150 for fixed rate mortgages (with an equivalent charge allowed for variable rate mortgages), and no separate charge for mortgage indemnity guarantee (which was common prior to the introduction of the CAT standard mortgage).

12.23 **Early redemption:** Finally, both simplified products try to reduce the charges that could be imposed on consumers if they wanted to switch providers. In Spain, if consumers want to cancel or switch the mortgage then up to 1% of the outstanding mortgage can be charged. Likewise in the UK, there is a maximum of

1% of amount owed for each remaining year of the fixed period reducing monthly and no such charges can be applied on variable rate mortgages.

Assessment of simplified products

12.24 Looking first at Spain, a positive impact of standardisation has been the decline in prices. Spain ranks among the cheapest countries in the EU for mortgages when considering both the cost of obtaining the mortgage and the interest rate.[90]

12.25 However, although this has resulted in low overall prices, the standardisation is believed to have had the effect of focusing consumers on this rate with the result that they choose mortgages with the lowest rate at a point in time. According to the Spanish Mortgage Association, this focuses competition on short term, variable interest rate mortgages to the detriment of creating a market where the goal is to acquire the best product in a long-term context and where other factors such as the variability of the interest rate and the cost of repayment are also important.[91]

12.26 In fact, standardisation is believed to have led to the decimation of the fixed interest rate mortgage market, implying that more risk is moved to the consumer.[92] Another reason for the disappearance of the fixed interest rate market is the introduction of the right to early repayment.[93] Related to the disappearance of the fixed interest rate mortgage market is the concern that product variation and innovation in general has been reduced. Indeed, according to the study by Mercer Oliver Wyman, Spain ranks very poorly on product coverage – of eight of the countries examined in the study, only Portugal ranks behind Spain regarding the issue of product coverage i.e. the extent to which there are gaps in the product range available. In particular compared to other countries, there seem to be gaps

90 Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman, October 2003.

91 Interview with AHE, 19th May 2004.

92 The percentage of fixed interest rate mortgages decreased from around 90% in 1986 to around 3% in 2002. “Evolucion del saldo de la cartera hipotecaria a tipo fijo”. Available from the AHE website. The ultimate sources are the FHE (1986 & 1994) and the BDE (1997& 2002).

93 Interview with the European Mortgage Federation, 1st July 2004.

regarding the availability of different options for the structure of repayment such as interest only mortgages.[94]

12.27 The example of Spain shows that although the introduction of a standardised product can make the market more competitive in terms of lower average prices, it has also led to less product variety on offer and to more risk being transferred to consumers as more variable interest rate contracts are taken out. The disappearance of the fixed interest rate market is seen as a consequence of this product regulation.

12.28 Nevertheless, it should be kept in mind that the legislation applied to all mortgages available in Spain, whereas a simplified product that is offered as an optional product alongside other existing mortgages would not necessarily lead to the same consequences.

12.29 Simplified mortgage products (CAT standard mortgages) were also introduced in the United Kingdom. The products have not been seen as very successful in terms of market share.[95] Indeed, a number of providers who moved to offering CAT standard mortgages following their introduction, actually suffered from a significant loss of new business.

12.30 In the assessment of CAT standard products in the UK undertaken by HM Treasury, they were seen as successful through,

> *"encouraging progress in increasing the proportion of mortgages with no minimum indemnity guarantee on fixed or variable rate mortgages, and with no redemption charge after fixed rate periods."*[96]

12.31 However, in today's market, CAT standard mortgages are not seen as being an important influence on how consumer choose between products. Indeed, a reflection on this is that in the recent investigation into how the mortgage market

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[94] The other countries compared on this basis were: Denmark, France, Germany, Italy, Netherlands, and the UK along with Portugal and Spain. Source: Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman, October 2003.

[95] Interview with the Association of Private Building Societies, 6th July 2004.

[96] Standards for retail financial products, HM Treasury, January 2001.

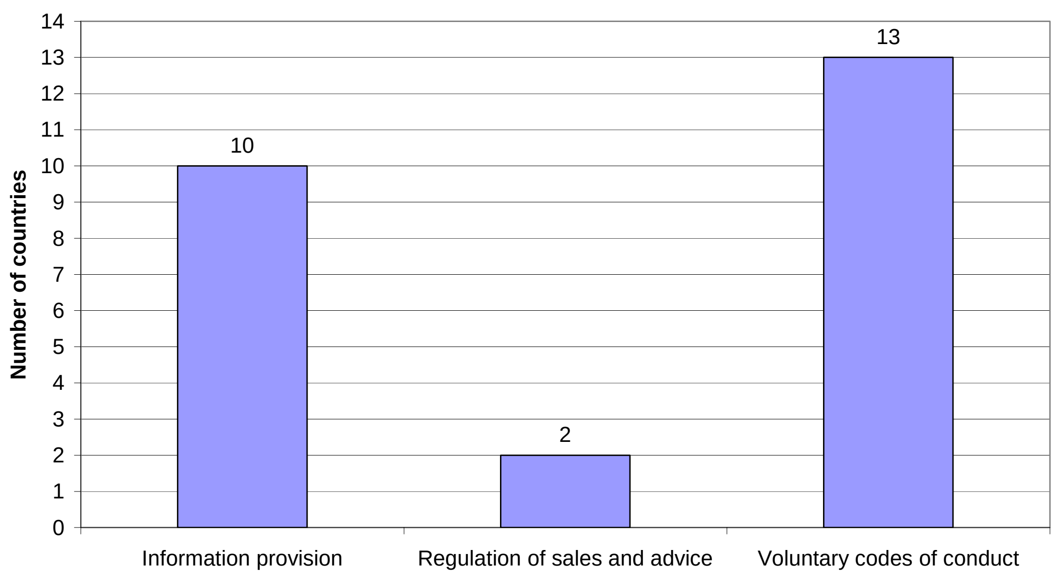
is working in the UK (the Miles Review), CAT standard mortgages were not even considered.

Alternative interventions for countries without simplified products

12.32 The most common alternative intervention that was identified was the voluntary code of conduct on home loans, although it is important to note that this has mainly focused on improving the provision of information through standardising the information given to consumers. In addition, many other interventions have been made that focus on information provision.

12.33 Other regulatory interventions include legislation with regard to the right to repayment and caps on redemption fees.

Figure 14: Alternative interventions



12.34 There was no Member State in which no alternative interventions to a simplified mortgage product were identified.

<u>Information provision</u>

12.35 One of the potentially most significant information measures relates to the European code of conduct on home loans which has brought in standardised information across Europe. Since this has been done through the use of a voluntary code, it is considered below in that section.

Provision of information regarding costs

12.36 One area of concern expressed in some countries was that consumers do not understand the impact of interest rate movements and hence some Member States have tried to address this by providing additional information to consumers:

- In Finland providers ask consumers whether they would be able to repay the loans if interest rates increased by 3 or 4% points.[97]
- In Portugal, providers must show the effect of a 1-2% price increase in the contract.

12.37 In addition, the comparison of costs was seen as an area for improvement and including a common cost measure seen as facilitating comparisons. However according the European Mortgage Federation (EMF), including the APRC (Annual Percentage Rate of Charge) in mortgage contracts is a concern because a number of Member States (Denmark, Germany, Spain, Ireland, the Netherlands, Austria, Sweden and the United Kingdom) apply the consumer APRC to mortgage credit. The EMF argues that using an APRC that contains all cost information does not facilitate comparisons because mortgage loans comprise more costs elements than consumer loans and these cost elements vary widely from one country to another. Consequently, they argue that a so-called "wide APRC" would not be comparable at European level and would have a negative impact on pricing transparency in the banking sector in the EU.[98]

Regulation of sales and advice

12.38 In some countries the regulation of the sales and advice process is covered by the regulation of consumer credit. With the exception of Germany, Spain, Greece, Austria and Portugal, information requirements, which relate to mortgage credit lenders also apply to intermediaries.[99]

97 Interview with Finnish Bankers' Association and Finnish Consumers' Association, 29th and 30th June 2004.

98 Annual Report 2003, European Mortgage Federation, see http://212.3.246.147/1/IPGCACFDFHEO BAJ DOAHDBHPKPDB69DBYEWTE4Q/EMF/Docs/DLS/2003-00268.pdf

99 The Protection of the Mortgage Borrower in the European Union, European Mortgage Federation, November 2003. We received the document from the European Mortgage Federation.

12.39 Lenders may also be able to consult central databases regarding borrowing and repayment behaviour. For example negative databases (which register repayment defaults) are available in Denmark, France, and the Netherlands. Lenders in other Member States (Austria, Belgium, Germany, Greece, Ireland, Italy, Portugal, Spain, Sweden, UK) have access to both negative and positive (register that loans have been taken out) databases.[100] However, consultation of databases is only compulsory in Belgium and the Netherlands.[101]

Voluntary codes of conduct

European code of conduct on home loans

12.40 The European code of conduct on home loans evolved from discussions between the industry and consumers associations initiated by the European Commission in 1997. The Code of Conduct was adopted in March 2001 and came into force September 2002.[102]

12.41 The aim of the code is to provide consumers with the most suitable information in a standardised form, enabling them to compare the offers of different product providers not only in their own countries but also across borders. The code includes two sets of information to be given to consumers:

- A generalised set of information; and
- A single sheet with pre-contractual information presented in a standardised and therefore comparable form – the European Standardised Information Sheet (ESIS).

12.42 Table 13 shows the coverage of the European code of conduct in the Member States.

[100] Negative databases register repayment defaults whereas positive database register the loans taken out by consumers.

[101] The Protection of the Mortgage Borrower in the European Union, European Mortgage Federation, November 2003. We received the document from the European Mortgage Federation

[102] Interview with the Association of Private Building Societies, 6th July 2004

Table 13: Percentage of industry covered by the European code of conduct (2002)

Country	Signed the code of conduct/ % of national mortgage market covered
Austria	607 credit institutions, 90% of the market
Belgium	36 credit institutions, 90% of the market
Denmark	6 credit institutions, 94% of the market
Finland	350 credit institutions, 90% of the market
France	9 credit institutions, 30% of the national market.[103] During our interview with the French Bankers Federation, we learned that around 50% of all credit institutions have signed the code of conduct.
Germany	1454 credit institutions, no indication of national market coverage
Greece	21 credit institutions, 88%
Ireland	11 credit institutions, 95%
Italy	492 credit institutions, 95%
Luxembourg	16 credit institutions, 90%
The Netherlands	116 credit institutions, 99%
Portugal	21 credit institutions, 99%
Spain	Due to problems of incompatibility between national legislation and Code of Conduct implementation has been delayed
Sweden	90 credit institutions, 95% of the national market
United Kingdom	144 credit institutions, 98%

Source: European Agreement on a Voluntary Code of Conduct on Pre-contractual information for Home Loans, First Annual Progress Report on Implementation in the European Union by 30th September 2002, by the European Banking Federation, European Savings Bank Group (ESBG), European Association of Cooperative Banks, and European Mortgage Federation. French detail is based on more recent interview evidence.

[103] According to the same report, a coverage of 50-55% of the national mortgage market will not be exceeded if the French government does not respond to the official request made by the French Bankers' Federation that the ESIS (European Standardised Information Leaflet) be regarded as equivalent to the "offre préalable".

12.43 Despite the large number of credit institutions that have signed up to the code of conduct (as seen from the table above), the degree to which they have actually implemented the requirements under the code is much less overwhelming.

12.44 Indeed, the European Commission has investigated the degree to which implementation actually occurs and the report undertaken found that in only 50% of cases were individuals given the ESIS, although this varies with some Member States being considerably worse than this.[104] Furthermore, in only 5% of the cases was the personalised information that is required under the code of conduct both complete and correct.

12.45 However, it is noted that there is no clear prescribed moment at which such information should be provided to consumers and hence the report indicated that in practice the 50% figure may be more reflective of the proportion of cases in which personalised information is given, but that consumers may not be given this information at the time of the first offer when they are still shopping around. If one of the aims of the ESIS is to facilitate shopping around, then consumers not receiving it at this stage of their decision making process severely limits its ability to do this.

12.46 Further, it was noted in this report that despite credit institutions in the UK having signed the code of conduct, implementation was not actually occurring because mortgage institutions in the UK had collectively agrees not to implement the code.

12.47 In addition, the early evaluation of the code by others has been somewhat negative:

- According to the Verband der Privaten Bausparkassen (Association of Private Building Societies), the main problem in the implementation of the single information sheet is the question when it should be handed to the consumer.

- The Belgian Federation of Insurance and Finance Intermediaries deemed that the information in the ESIS is still too complex – the tables on the ESIS are so

[104] Monitoring the uptake and effectiveness of the Voluntary Code of Conduct on Pre-contractual Information for Home Loans, Institute for financial services e.V. , for the European Commission.

complicated that even they themselves as intermediaries cannot understand them.

- According to the Association of Building Societies, critics of the current situation (including the European Commission) do not understand that the provider can only fill out the single information sheet after he has collected a lot of information from the consumer (regarding his financial standing or the object he wants to buy).[105]

12.48 Problems regarding the "offre préalable" (preliminary offer) were also mentioned. The Association of Private Building Societies noted that this complicates re-financing for providers because by the time the consumer decides to conclude the contract the general interest rate situation could have changed and providers would have to accept a loss on this contract.[106] (However, whether providers make a loss or a gain depends on the direction of the movement of the interest rate.)

12.49 Further, having a preliminary offer, which is binding for the lender for the same fixed period allows potential mortgage purchasers sufficient time for comparisons among providers which is likely to be to the consumer's benefit.

Other codes of conduct

12.50 In addition to the EU wide code of conduct, some countries researched have additional codes relating to the providers of mortgages. In the Netherlands, several codes of conduct exist, e.g. the Gedragscode Hypothecaire Financieringen (Code of Conduct for Mortgages), and the Stichting Erkenningsregeling Hypotheekadviseurs (Institute for the recognition of rules for mortgage advisers). Moreover, mortgage providers (offices or advisers) can acquire a Keurmerk Hypotheek Bemiddeling (quality mark for mortgage advice). Distributors with the certificate are deemed to be independent and consumers are guaranteed a high

[105] Interview with the Association of Private Building Societies, 6th July 2004.

[106] The "offre préalable" is a feature of the French mortgage system according to which product providers bind themselves for a certain period of time to the offer made to the consumer.

degree of professionalism, independent advice and consideration of the requirements.

12.51 The voluntary Mortgage Code, introduced in 1998 in the United Kingdom was thought to represent an interesting example of self regulation where all intermediaries accepted registration, training and monitoring by an independent body as well as a mediation service.[107] However, it should be noted that mortgages will soon come under the UK Financial Services Authority's regulation suggesting that the voluntary code has not been seen as sufficiently successful to maintain reliance purely on self-regulation.

Consumer protection measures across Member States

12.52 Additional measures which may simplify the product in the eyes of the consumer cover the following factors:

- Whether product providers are prevented from obliging customers to take out other services (e.g. home insurance). That is, that preventing bundling of products may make a product more simple;
- The right of reflection;
- The right to early repayment;
- Whether product providers have to offer a contract and the time during which the offer is valid; and
- Whether redemption penalties are regulated.

12.53 Table 14 compares the extent to which Member States have implemented regulation regarding these consumer protection measures.

[107] Report from the Expert Group on mortgages.

Table 14: Other consumer protection measures

Country	Does national legislation forbid the linking of other services to the granting of a mortgage?	Does national legislation grant borrower a right of reflection?	Do product providers have to offer a binding contract and for how long is the offer valid?	Does national legislation grant borrower the right to early repayment?	Are redemption penalties regulated?
Austria	Linking of services to mortgages is not regulated. There are no legal requirements which oblige the borrower to take out specific insurance with regard to the mortgage credit.	No, once the contract is signed the borrower is not entitled to a right of reflection.	There are no restrictions unless one has been negotiated in the contract.	Yes, but only in the case of variable interest rate contracts.	Cancellation fees may only be charged when the customer cancels the contract during a fixed-interest period.
Belgium	Yes	No	Yes, written offer must specify the validity period (normally two to three months).	Yes	Lender may stipulate compensation, but compensation is limited to three months of interest. In addition to legally established indemnities, lender cannot claim for further contractual penalties.
Denmark	No, any services can be linked to the loan	The loan offer is binding for 6 months	Yes offer is binding for the lender and optional for the borrower for 6 months	Yes (unless loan is in irredeemable bonds)	Lender can charge the borrower for the costs arising from the early repayment but cannot claim for further contractual penalties
Finland	No	No	No	Yes	Only allowed for mortgages greater than €16,800 and where the interest rate is fixed for three or more years
France	No, insurances are required as condition to obtain a loan.[108]	The borrower has a “cooling off” period of 10 days as from the receipt of the “offre préalable” and he may not waive this period.	The “offre préalable” is a contract stating the total cost of the credit, the TEG (taux effectif globale, an interest rate encompassing all the costs of the credit excluding insurance), rights and obligations of the lender and the borrower.	Yes. The borrower may always repay the loan in advance although the agreement may prohibit prepayments less than 10% of the original amount of the loan.	The legal rules determine the maximum the contract may provide for.

[108] Lenders take out group insurance policies as a general rule and it is suggested to borrowers that they accept the insurance. The borrower is free to opt for personal accident insurances. In this case the lender may refuse to insure him. To avoid adverse selection (cover of “good” risks with personal accident insurance and more substantial risks by group insurance) lenders are generally obliged by insurance companies to suggest to borrowers to take out group work-life insurance.

Germany	No legal requirements to take out an insurance, however the costs of a residual debt insurances has to be indicated in the contract.	According to Art 242 of the BGB the bank has to allow the borrower an adequate period of reflection	If the bank makes the offer there are no legal provisions for deadlines.	No right exists for fixed interest rate contracts, unless the fixed interest rate period ends before the end of the loan contract or after a period of 10 years. In case of a variable interest rate contract the borrower is allowed to cancel the contract without paying an indemnity.	In the case of fixed interest rate loans, the borrower has to compensate the bank for losses that have arisen from the pre-payment. Additionally the bank can demand a service charge of €250.
Greece	The linking of services to the mortgage is not regulated.	Right of reflection depends on the terms in the contract.	There is no obligation for the offer to comply with certain standards such as deadlines.	Yes. The procedures are fixed by the contract.	Lender is allowed to charge the costs involved in early repayment under the condition that he explains pre-contractually the conditions and calculation of charges.
Ireland	Loans made to individuals acquiring such services from the lender, its agents, etc may not be on a more favourable basis. However the mortgage lender is obliged to arrange for mortgage protection insurance.[109]	No	No	Yes	Lender may not apply a redemption fee in the case of a variable rate loan. For fixed interest rate loans the method of calculating the charges must be included in the contract. The method is not standardised in any law.
Italy	No	The law does not entitle the borrower to a right of reflection.	There is no provision for a mortgage offer.	Debtors my repay all or part of their debt early by paying the bank a contractually determined all-inclusive fee.	Amount of the fee is established in the loan contract.
Luxembourg[110]	Home insurance are not compulsory but they are often a condition of mortgages. The law does not forbid a linking of services.	No	No	Unless the contract states the contrary, national legislation does not grant borrower the right to early repayment.	Not thought to be prevalent.
The Netherlands	No regulation on the linking of services to mortgage credits exists. Lender can oblige the borrower to take out certain insurances.	The borrower has no legal or contractual right of reflection.	Offer is binding for the lender but the time during which the offer is binding is not regulated.	There is no legal right of repayment but according to the code of conduct on mortgage lending allows early repayment.	In principle lenders can claim further penalties but in practice the only penalty is the restitution of the loss of interests.

[109] Unless the borrower has an equivalent policy in place, the property will not be the principle residence of the borrower or his dependents, the borrower falls into a high-risk/high cost insurance category or the borrower is over 50 years of age.

[110] The information is based on the interview with the Luxembourg Bankers' Association.

Portugal	There are no legal obligations that oblige the borrower to take out insurance.	There is no right of reflection for mortgage loans.	The offer is binding for the time agreed upon by the parties, if a deadline has not been fixed the contract continues to exist for 5 days	If borrower repays early, he has to pay all of the interest. However the credit contract can stipulate the early repayment and its conditions.	No legal restriction exist fees or penalties. However the lender cannot claim for further penalties.
Spain	Yes, property damage insurance	Yes, offer has a validity of 10 days.	Creditor is bound by the offer for 10 days.	Yes, borrower must apply for an early repayment in writing according to the notice required in the contract.	For variable interest loans the cost may not be more than 1% of the capital paid off even though a larger commission could be agreed.
Sweden	The linking of services to the mortgage credit is not regulated but mortgage credit for villas is not approved unless fire insurance has been taken out by the borrower.	The borrower is not entitled to a right of reflection, except for the case of distant sales.	Creditor is bound by the offer but there is no specific time during which he is bound.	The borrower may in any case withdraw from the contract. In case of fixed interest rate contracts the borrower may in reality at any time withdraw from the contract.	There is a concern that repayment fees are in-transparent
United Kingdom	There are no requirements for consumers to take out an extra insurance.	Yes because a natural period of reflection exists as the conveyance (transferring of property) process is being concluded and the borrower is able to withdraw from the contract before completion.	There are no legal deadlines. Loan contract is not concluded until the borrower signs the proposed credit agreement.	There is no legal entitlement to repay early but this is always possible.	The lender may make a charge. There are no legal requirements controlling the calculation of the charge.

Source: "The Protection of the Mortgage Borrower in the European Union", European Mortgage Federation, November 2003. We received the document from the European Mortgage Federation. Where information was unavailable from this source, additional information was based on country interviews and research

12.54 The table shows that significant regulatory differences exist in the Member States and that some of the problems identified e.g. regarding the range of products in particular countries, such as in Germany, can be linked to the absence of a right to repayment. Furthermore, for countries with substantial consumer protection measures already in place, as for example in Ireland, France and Belgium, there may not be a need for a simplified product.

Assessment of the need for simplified products

12.55 There is considerable concern regarding how effectively competition works in the mortgage market and whether consumers can choose products effectively given the inherent complexity.

12.56 The European mortgage market has been subject to a number of market studies on behalf of the European Mortgage Federation, the Centraal Planbureau (CPB; Netherlands Bureau for Economic Policy Analysis) and the IFF (Institut für Finanzdienstleistungen; Institute for Financial Services). These studies provide useful evidence regarding the extent of market failure in the mortgage market and hence whether there is a problem that simplification or standardisation might address. However, the study by Mercer Oliver Wyman (MOW) noted that institutional differences, such as in home ownership rates throughout the EU make the separation of "market failure" from "cultural, institutional and legal diversity" difficult.[111]

Market completeness and price competition

12.57 The MOW study provides indicators on the mortgage markets in various Member States and below we note the indicators on market completeness and price.

[111] Study on the Financial Integration of European Mortgage Markets", Mercer Oliver Wyman and European Mortgage Federation, October 2003. Available from http://www.hypo.org/Content/Default.asp?PageID=106.

Table 15: Completeness index and price competition[112]

Country	Completeness Index	Adjusted Price
Denmark	75%	0.84%
France	72%	0.89%
Germany	58%	0.70%
Italy	57%	1.34%
The Netherlands	79%	0.97%
Portugal	47%	0.95%
Spain	66%	1.03%
United Kingdom	88%	1.15%

12.58 The market completeness index combines information on:

- The loan to value level offered to borrowers
- The extent to which borrowers can access the mortgage products;
- The range of products available to the borrower;
- The information quality; and
- The ease of accessing mortgage products.

12.59 The relatively low completeness index for Germany, Italy, Portugal and Spain is consistent with the findings from our background research and country interviews. There are gaps in the product range relating to fixed interest rate products in the Spanish mortgage market because of the introduction of caps on repayment

[112] Note that information is only available on these countries.

charges and the requirement that variable interest rates must be referenced to the index of reference published by the Bank of Spain.[113]

12.60 In France, it is not possible to obtain credit on the basis of a property for which the initial credit has been paid back (reverse mortgages). However, the French Treasury is currently conducting a study on equity-release and reverse mortgages to find out how these products work and it is expected that by the end of the year banks will be allowed to offer these products.[114] Further, products with tax benefits such as the plan d'épargne logement (PEL) and the compte d'épargne logement (CEL) are widely available and they allow a wider range of consumers to access the mortgage market. However, it may be the case that the presence of these products has been to the detriment of alternative product development.

12.61 According to MOW, the requirements under the current Consumer Credit Directive to state the amortisation schedule clearly in the contract restricts the range of products offered. For example, they argue that this makes it impossible to offer flexible variable rate mortgage contracts. This is important in the context of simplified products because it shows that,

> *"Sometimes consumer protection measures that are formulated without consideration to consumer preferences can restrict product choice due to the constraints that are placed on products."*[115]

12.62 Although MOW's example is in fact incorrect (since the Consumer Credit Directive excludes credit intended primarily for the purpose of acquiring or retaining property rights in land or in an existing or projected building i.e. it excludes mortgage credit), the observation that regulations to improve one aspect of consumer protection could inhibit innovation in another area is nonetheless important.

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[113] The overall completeness index for Spain is better than the index related purely to product completeness since Spain scores well on aspects such as distribution and information and advice.

[114] Interview with the Ministry of Economics, Paris, 21st June 2003

[115] Study on the Financial Integration of European Mortgage Markets", Mercer Oliver Wyman and European Mortgage Federation, October 2003.

12.63 Examining the level of prices across European mortgage markets may also be a potential indicator for problems of complexity in the market although high prices may be an indication that consumers are willing to pay for additional benefits.[116]

12.64 The information in Table 15 above indicates that average adjusted prices are all within a relatively narrow price range. Further, MOW concludes that product differences are the major determinants of differences in nominal prices and account for 60% of price variation.

12.65 Some information is also available on price dispersion within national markets. For example in the Netherlands, Van Leuvensteijn and Hassink find that lending rates were dispersed across lenders for mortgages with default insurance from the Dutch National Mortgage Guarantee. After controlling for the characteristics of the individual borrower the authors find that the range between the highest and lowest lending rates between lenders fluctuated over time between 0.86 and 1.24 percentage points and remains about 1 percentage point on average. The authors attribute the price differences to the presence of imperfect information, caused by the search costs of borrowers or by agency costs of lenders.[117]

12.66 Overall, the MOW study concludes that price dispersion between Member States is not substantial, although the evidence on the Dutch mortgage market hints at potential problems due to large group of uninformed consumers.

12.67 Indeed concerns regarding the availability of information on interest rates were expressed in other countries for example in Belgium Test-Achats, noted,

> *"The Belgian market for mortgage loans resembles more an oriental market where the whole world is obliged to bargain to find a good deal. The consumer is proposed arbitrary and opaque tariffs.[118]"*

12.68 In general, the results of the market studies and the comments point to problems caused by complexity and the view that information provision on the cost of

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[116] For full details the pricing methodology of the MOW study should be consulted.

[117] Hassink, W. and van Leuvensteijn, Price-setting and Price Dispersion in the Dutch Mortgage Market, November 2003, CPB discussion paper, available at www.cpb.nl.

[118] Tarifs hypothecaires: quelle jungle!, Budgets et Droits No. 161, Mars-Avril 2002

mortgages was not very transparent was also typically from interviewees. Indeed, MOW find that,

> *"Information on mortgages is widely available in the United Kingdom, Germany and the Netherlands via the internet, specialist and generalist press and through an established mortgage advisor network. Price information is not easily obtainable in France, Italy and Portugal. Additionally, in countries where the prices are sometimes negotiated at an individual level, the published rate is clearly only an indicator of the rate that may be charged."*[119]

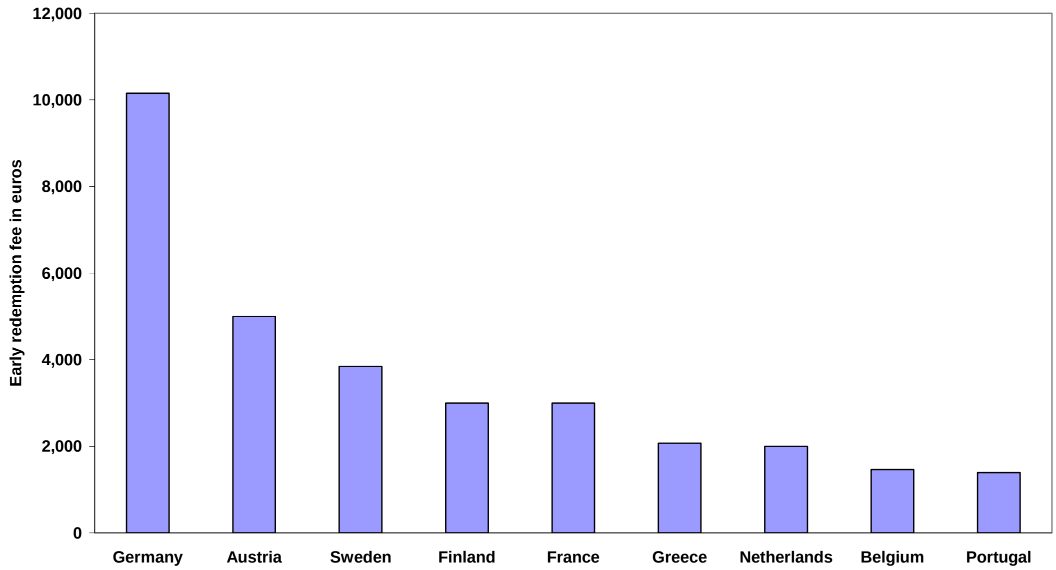
12.69 Hence rather than imposing simplified or standardised mortgage products, providing better information may represent a more practical solution, particularly since there is an identified lack of transparency of information. As noted above, according to the IFF report for the European Commission on the implementation of the code of conduct for home loans, this code has not yet led to an improvement of the situation, although this could reflect the relatively recent implementation.

Redemption penalties

12.70 A further area of concern that was expressed in some, Member States was that of the use of redemption penalties and also the transparency of repayment charges. High redemption penalties may reduce competition because consumers are not willing to switch to less expensive foreign providers because of the cost of exiting their existing contracts. In the extreme they are thought to lead to consumers being unwilling to relocate for another job.

[119] Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman and European Mortgage Federation, October 2003. We received the document from the European Mortgage Federation.

Figure 15: Early repayment fees[120]



Source: Vorfälligkeitsentschädigung in Europa, Institute für Finanzdienstleistungen im Auftrag des Verbraucherzentrale Bundesverband e.V. (vzbv), 23rd January 2004, available at http://www.iff-hamburg.de/iff-aktuell.html

12.71 Although the calculations in Figure 15 above need to be treated with caution due to the underlying assumptions on which they were based, the figure does show the large discrepancies between early repayment fees charged in Germany and those charged in other Member States. Indeed, commenting on the report it was concluded that,

> *"The absurd height of the early repayment fees in Germany show that the market here does not function."*[121]

12.72 However, as discussed earlier, it may be the case that high redemption penalties are to the benefit of those who do not switch their mortgage early as they then do not have to cross subsidise those consumers who do exit the contract early.

[120] The calculations in the Figure refer to a case study where "A consumer borrowed €100,000 on 1st February 1998 for 10 years with a fixed interest rate of 6.0% per annum. The lender had to pay monthly rates of about €500 (every 1st of the month). Exactly five years later the consumer wants to pay the money - still €100,000 - back. The contract still had five years to run, until Feb 1st, 2008. This was defined as the "residual term". We want to know how much the consumer has to pay on Feb 1st, 2003 for the premature termination of the loan." Since this represents a very specific model, the degree to which it is a typical mortgage contract will vary in different Member States. Hence for further details the original source report should be consulted to understand the calculations that underlie the results.

[121] Edda Müller, Vorstandschefin des Verbraucherzentrale Bundesverband e.V. (vzbv), available at http://www.iff-hamburg.de/6/aktuell-040622-01.html.

Table 16: Prevalence of redemption penalties on mortgages

Country	How prevalent are redemption penalties / fees on mortgages?
Austria	Cancellation fees may only be charged for pre-mature cancellation during a fixed-interest period. The indemnity is either fixed as a percentage of the mortgage or calculated according to the actual loss of the lender (any percentage indemnity may not exceed the actual loss).
Belgium	A maximum penalty of three-month interest rate payments exists. Mortgage penalties are not very prevalent. Lender is not entitled to claim for further contractual penalties.
France	Not very prevalent because legal rules determine the maximum penalty and no compensation for lost interest occurs when the repayment is beyond the control of the borrower such as change of place of work, death or forced cessation of occupation. Banks are likely to ask for the legal maximum penalty. Further contractual penalties are forbidden.
Germany	Cancellation of fixed-interest loans is restricted and an indemnity must be paid. For variable-interest loans, no indemnity must be paid (cancellation period of 3 months must be respected).
Ireland	Redemption fees are prohibited on variable rate mortgages under the 1995 Consumer Credit Act. A breakage fee can be applied when a fixed rate mortgage is ender prior to maturity of the fixed rate term. The methodology for calculating this must be set out in the loan offer.
Luxembourg	Not thought to be prevalent
The Netherlands	All mortgage supplies in the Netherlands make use of a system in which consumers with a fixed interest rate contract who want to switch their mortgage need to pay an interest fine. The height of the fine is usually equal to the loss of income that a switch causes the supplier. Lender can claim for further contractual penalties, but in practice only the loss of income is charged according to the Ministry of Finance. According to the Netherlands Consumers' Association, not only interest penalties are prevalent. The majority of mortgages are paid back with the amount saved in life insurance contracts. Interim stopping of this life insurance contract costs a lot of money to the consumer.

Source: Interviews with Member States

12.73 Table 16 above indicates that redemption penalties are already regulated in a number of countries although the level of the penalty that can be imposed may not be directly regulated. Hence there may well be countries where redemption penalties could be excessive reducing competition. It may therefore be the case that the success of an optional standard as set out in the UK could be effective in dealing with this.

12.74 However, we have also seen the potential for simplification to have dramatic effects on the market. The example of the introduction of standardised mortgage product in Spain has shown that, while there may be benefits (at least in the short term) from lower prices, there is also the risk that standardisation can lead to lower product innovation and, in Spain, the potential for consumers to bear more risk over the lifetime of the product. Therefore simplification or standardisation should only be undertaken when other methods have been seen to be ineffective.

12.75 Indeed, given the relatively recent implementation of the EU code of conduct in mortgages, it would seem that this experiment with simplified information should be monitored carefully to see if this results in benefits and to establish whether identified concerns remain. Focussing on ensuring that those who have signed up to the code of conduct on home loans actually implement the various obligations, as well as resolving the difficulties where national requirements and European standards are not compatible, would therefore seem the better course of action compared to designing simplified, standardised mortgages across the EU.

Section 13 Collective investment schemes

13.1 From a theoretical perspective, there are a number of reasons why collective investment schemes might benefit from simplification more than many of the other products under consideration.[122] In particular:

- There are a reasonable number of product characteristics that need to be assessed including factors that consumers find difficult to comprehend, such as the risk associated with the fund, and relatively complex charging structures; and
- Given the medium term nature of the product, purchases are made less frequently than for example the general insurance products, and do not have the continuous use of the banking products.

13.2 In the majority of Member States there is a consensus that investment funds are already standardised. Much of the standardisation that has occurred is due to the UCITS Directives,[123]

> *"The 1985 Directive enabled "harmonised" products to be marketed in other Member States as a result of mutual recognition among supervisory authorities"*[124]

13.3 It is further thought that the various UCITS Directives have aided the development of a single market for investment funds and on the face of it this has resulted in considerable cross-border trade and greater choice in a range of countries (see the cross-border chapter for a more extensive discussion).

13.4 Indeed, some argue that the UCITS Directives are unique in leading to the only financial product defined by European legislation and this has resulted in a *de facto* simple product,

> *"The term has become synonymous with a saving product that combines simplicity, transparency, and security (through appropriate investor protection safeguards)."*[125]

[122] Throughout this chapter we use the term investment funds to refer to collective investment schemes.

[123] UCITS means "undertaking for collective investment in transferable securities" as defined in the Directive 85/611/EEC. The purpose was to establish the internal market for investment funds.

[124] Cross-border marketing of "harmonised" UCITS in Europe: Current situation, constraints and ways forward Price Waterhouse Coopers, November 2001.

13.5 However, in practice the UCITS Directives place relatively few constraints on products, indeed the most recent version, UCITS III, has relaxed many of the previous requirements and has therefore included funds that were historically excluded from UCITS: money market funds, “funds of funds” or certain index funds. [126]

13.6 Nevertheless there remain significant limitations on product features, for example, by ensuring a minimum level of diversification. By setting minimum standards for how much can be invested in shares issued by the same body, these restrictions do impose some degree of consumer protection as they limit the risk from being exposed to one particular asset rather than a class of assets such as equities. However, these conditions appear to result in the great majority of funds already on the market in a country being compatible with the UCITS III Directive.

13.7 UCITS III also introduces the possibility of a single authorisation for investment fund management companies, which would be valid throughout the EU. Hence, management companies authorised in their home Member States should be permitted to carry on the services for which they have received authorisation throughout the EU.

13.8 In addition to the restrictions on product features and the single authorisation, the UCITS Directives have also imposed standards on the minimum level of information provision required to market an investment fund. UCITS III has taken this further through the development of a simplified prospectus.

13.9 It was recognised that prospectuses for investment funds had become cumbersome and complex. Therefore, a simplified prospectus has been developed which is aimed at being a “succinct” document that represents a valuable source of information for the average investor. It should be available free of charge

[125] Asset management in Europe: The way forward, Investment Management Association, 20th May 2003.

[126] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertaking for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses.

before the conclusion of the contract and it should inform investors of the availability of more detailed information in the full prospectus.

13.10 Unlike many European Directives, the simplified prospectus does not represent a minimum standard to which Member States can add additional requirements, but rather it can be used as a marketing tool in all Member States without alteration except translation. Member States may not, therefore, require additional documentation to be added.

13.11 Amongst other aspects, the simplified prospectus covers:

- Investment information
  - A short definition of objectives;
  - Investment policy and risk profile;
  - Historical performance and a warning that this is not an indicator of future performance (can be attached to the prospectus); and
  - Profile of the typical investor it is designed for.
- Economic information:
  - Tax regime;
  - Entry and exit charges; and
  - Other possible expenses and fees distinguishing those paid by the unit holder and those to be paid from the common fund or the investment company's assets.
- Commercial information:
  - How to buy and sell units;
  - The flexibility to change investments and the charges applicable;
  - When and how dividends are distributed; and

- Frequency of price updates and where and how prices are published or made available.

13.12 Therefore, UCITS III appears to represent simplified information rather than a simplified, standardised product.

13.13 Indeed, some argue that UCITS, in terms of achieving European wide harmonisation of marketing requirements represents a "pilot" project for other parts of the financial services sector. That is, the model of simplified information, rather than simplified products, could be used in other product categories.

13.14 Despite the considerable standardisation, concern was also voiced regarding the differential implementation of UCITS, and how the rules had been interpreted differently in different countries.

13.15 The interviews and our background research confirm that in most Member States there is concern regarding the potential complexity of investment funds. Organisations in most Member States saw the current level of standardisation as sufficient. However, in a minority of markets further restrictions simplifying the product have been deemed necessary.

Simplified collective investment schemes

13.16 There are three countries in which simplified collective investment schemes have been identified: Germany (AS Funds), Ireland (Savermark) and the UK (CAT standard equity ISAs and the proposed Stakeholder Medium Term Investment Product). However, the genesis and characteristics of these products differ significantly.

13.17 In Ireland, the product terms were created by the Consumer Association in response to a new tax preferred product created by the Government to encourage saving. In Germany, AS Funds were created by the Government, encouraged by the fund management sector, so that they would be able to compete in the market for long-term saving for retirement. In the UK, CAT standards were launched by the Government at the same as the equity ISA itself was launched.

Common characteristics

Table 17: Characteristics of simplified collective investment schemes[127]

	Germany (AS Funds)	**Ireland (Savermark)**	**UK (CAT standard equity ISA, medium term investment product)**
Structure of charges	Not regulated outside of Riester product	No charges based on contributions	Only annual management change based on fund value
Level of charges		The charge can be no more than 1.5% p.a.	Currently no more than 1% per annum, but new Stakeholder range will increase this to 1.5% for the first 10 years.
Conditions on switching	Transfer of fund shares to other funds free of charge after three quarters of contract term.	There can be no account fees or hidden charges	No exit penalties
Access to invested funds	Withdrawals are always possible. With savings plan, cancellation possible quarterly or monthly in case of unemployment/invalidity.	Access within 7 days if desired	
Level of acceptable risk	Restrictions on proportions invested in real estate and equities	No constraints	Currently, at least 50% to be invested in shares / securities listed on EU stock exchanges. New Stakeholder range to have equity and property investments combined not exceeding 60% of the fund.

13.18 **Structure of charges:** There are constraints on the structure of charges for simplified collective investment schemes. In Ireland, the Savermark requires there to be no initial charges. In the UK, only an annual management charge based on the value of the fund is applied with no initial charges being allowed. In Germany, there are no particular constraints placed on AS Funds but there is a requirement on the timing of charges for all collective investment schemes. In particular, if the purchase of fund shares has been agreed for several years, a maximum of one third of the payment agreed for the first year may be used to cover costs. All other costs must be distributed equally over the remaining payments.[128]

13.19 **Level of charges:** In Ireland, the maximum level of charges in the Savermark is no more than 1.5% annual management charge based on the value of the fund. In the UK, the existing CAT standard equity ISA has a limit of a 1% annual management charge based on the value of the fund. However, this will increase to 1.5% for the first 10 years of the product under the new Stakeholder Medium Term Investment Product.[129]

13.20 **Conditions on switching:** There was considered to be no need to prevent exit or redemption charges in the Savermark in Ireland as they were not prevalent in the market but the German AS product requires that there is free switching after three quarters of the contract term. In the UK, it is not possible to impose exit charges on simplified investment fund products.

13.21 **Access to the invested funds:** Although the Savermark had limits on access to funds (in order to be eligible for tax privileges) this was related to the underlying product rather than the simplified version. For a fund to qualify as an AS Fund it needs to have the option of a retirement saving plan attached to it.

13.22 **Level of acceptable risk:** The German AS Funds limit the share of the underlying investment that can go into stock and shares, bonds and real estate. There are a number of investment restrictions imposed on AS Funds including that only 30% of the fund assets may be invested in real estate funds and the share of equities is limited to a maximum of 75%. In the UK, one of the primary differences between the new stakeholder equity product and the CAT standard ISA is that there will be a limit of only 60% invested in equity (currently the CAT standard equity ISA requires only that 50% of the fund is invested in shares or securities listed on EU

[127] Note that blank cells in the table indicate that there is no restriction in that particular characteristic in the country in question.

[128] Investment Act, article 125, available at http://www.bafin.de/cgi-bin/bafin.pl?sprache=0&verz=04_Rechtliche_Grundlagen_amp_Verlautbarungen*02_Gesetze&nofr=1&site=0&filter=&ntick=0.

[129] It is worth noting that in three other Member States, there appear to be restriction on pricing of collective investment schemes, although we have not defined these as simplified products.

stock exchanges which does not impose any restriction on the investment allocation).

Assessment of simplified products

13.23 Unfortunately, there is limited evidence supporting the benefits of simplified collective investment schemes.

- In Ireland, it is important to note that the Savermark was introduced at the launch of a new tax preferred products, SSIAs, and hence it is hard to observe the "before" and "after" situations, and thus observe how it affected the market. It is possible that by introducing the product standard so early, it stopped a negative market outcome developing in the first place – i.e. some interviewees believed that it could have played a preventative role.

- The Irish Consumer Association (CAI), responsible for the Savermark, argue that it has reduced charges, and this conclusion has been agreed with by independent commentators,

"[the Savermark] promoted competition among financial institutions. The result is reduced charges on certain Special Savings Incentive Accounts (SSIAs) and improved terms and conditions"[130]

- Industry experts argue that AS Funds have has a very limited impact on the German collective investment scheme market since their introduction in 1998.[131] On 31 May 2004, there were 34 registered AS Funds available.[132]

- As already mentioned, AS Funds can be used within a Riester pension provided that the fund holder fulfils the Riester criteria and has received Riester certification from the BaFin. If AS Funds are not certified as Riester products, there are no tax benefits associated with them. The fund industry sees this as the main reason for the fact that demand for AS Funds has never been very strong and that the funds have only played a minor role since their

[130] SSIA Savermark standard is established by consumer group, Aileen Power, Sunday Business Post Online, 3rd March 2002.

[131] Interview with the BVI, 10th June 2004.

[132] Übersicht der Altersvorsorge-Sondervermögen (AS-Fonds), Bundesverband Investment und Asset Management, 31 May 2004, available at http://www.bvi.de/downloads/lias0504.pdf.

introduction in 1998.[133] In fact, over recent years both the number of AS Funds and the value of assets in them have fallen.[134]

- In the UK, the Treasury commissioned an examination of the ISA market after these products had been available for a year. They found that charges on CAT-standard equity ISAs were around half of those on comparable non-CAT standard equity ISAs. They also found that just under two-thirds of CAT standard equity ISAs were tracker or index funds. (It is interesting to note that these index funds would not be acceptable under the new Stakeholder Medium Term Investment Product since they typically had a 100% equity allocation.)[135] However, CAT standard equity products have not been seen as having had a large impact on the market. Only products that already fulfilled the quality standard have used the CAT standard and this is not seen to have had a significant impact on consumer behaviour. In particular, consumer awareness of the CAT standard remains very low, as does consumer understanding of what it represents.

Alternative interventions for countries without simplified products

13.24 Looking at the majority of countries where we have not identified a simplified collective investment scheme (Austria, Belgium, Denmark, Finland, France, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden) we now turn to whether we can identify alternative forms of regulation that might achieve the same objectives.

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[133] Investment 2004 – Daten, Fakten, Entwicklungen, Bundesverband Investment und Asset Management, 2004, available at http://www.bvi.de/downloads/jb_2004_v2.pdf. The view was also confirmed during our interview with BVI, 10th June 2004.

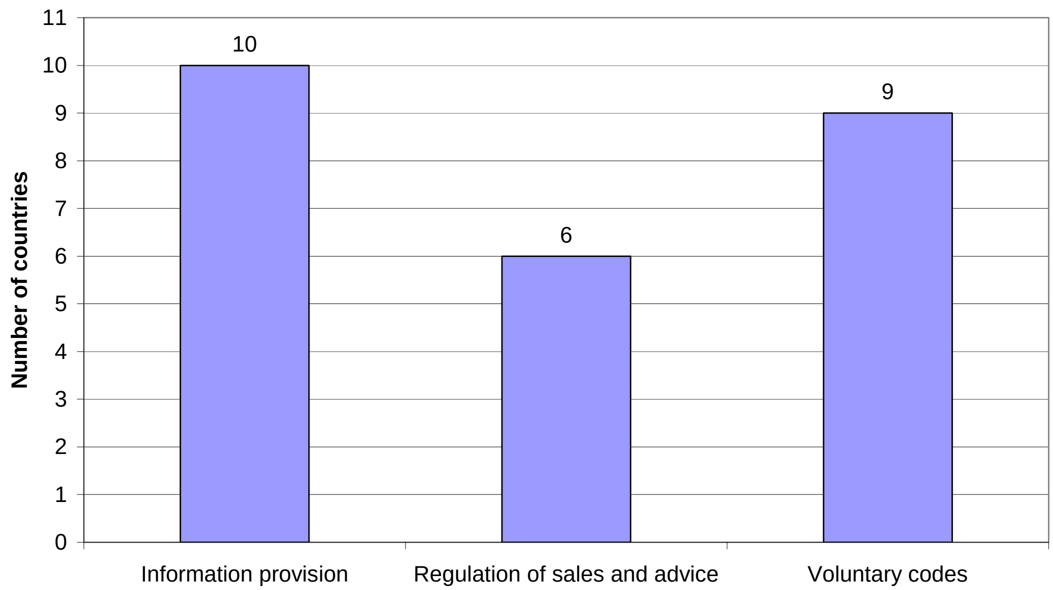
[134] On 31 May 2004, there were 34 registered AS Funds available compared to 47 at the end of 2001. Total fund assets held by AS Funds stood at €1,759.3 million at the end of 2003 (2001: €2,805 million), representing 0.4% of total assets held by all retail funds in Germany. Sources: "Übersicht der Altersvorsorge-Sondervermögen (AS-Fonds)", Bundesverband Investment und Asset Management, 31 May 2004, available at http://www.bvi.de/downloads/lias0504.pdf; information provided by vzbv; and "Investment 2004 – Daten, Fakten, Entwicklungen", Bundesverband Investment und Asset Management, 2004, available at http://www.bvi.de/downloads/jb_2004_v2.pdf; and "Investment 2001 – Daten, Fakten, Entwicklungen", Bundesverband Investment und Asset Management, 2002, available at http://www.bvi.de/downloads/CORE-4WXJRQjb_2001.pdf.

[135] Standards for Retail Financial Products, HM Treasury.

13.25 As is common with many products, information provision is the most popular alternative intervention, although voluntary codes and the regulation of sales and advice are both more common for investment funds than they are for most other products.

13.26 Every Member State has some form of intervention for collective investment schemes.

Figure 16: Alternative interventions for collective investment schemes



<u>Information provision</u>

13.27 Given the UCITS III Directive there is a significant degree of commonality in the information provision across Member States. Indeed, many of the requirements made in the UCITS Directives regarding information were already in place in many of the Member States.

13.28 Regulators have spent considerable effort considering how risk can best be communicated to consumers and whether additional constraints are necessary for the presentation of information on past performance.

13.29 In many countries, funds are classified into investment classes. According to the investment fund industry, these are often seen as sufficient to signal to consumers the type of risk being undertaken. However, in a number of countries alternative measures of risk have been developed.

13.30 For example in Belgium, the Banking, Finance and Insurance Commission has established global risk groups for the investment funds. The risk class is determined by the monthly volatility of the stocks, annualised over a period of six years.

13.31 In Italy, there is a voluntary self-classification system of investment funds and pension funds that began in 1984 with Assogestioni (the mutual fund association) and its predecessor driving the process. This has now developed to such a degree that there are now approximately 50 categories (30 for equities and 20 for bonds) including information on the currency, market, type of issuer, whether it is an equity or bond fund, information on credit risk etc. The main advantage is that it provides information at different levels of financial sophistication. Although mainly aimed at financial advisers, the private investor can read the initial summary indicators and will have some useful information – including aspects like equity / bond / balanced / high or low risk flexible investments.

13.32 There has also been considerable concern about how to standardise performance data, for example in Austria this can only be reported on a per annum basis and must be in accordance with international standards with regard to the calculation method, the choice of suitable benchmarks and an appropriate contemporary time period (1, 3 and 5 years or a multiple thereof as well as year-to-date and since foundation of the fund).[136]

13.33 Comparative tables are relatively common for investment funds, these are often facilitated by the investment fund trade association, such as the tables drawn up by drawn by the Union of Institutional Investors in Greece. In Italy, some provision of comparative information already exists with one of the PattiChiari initiatives to provide information on low risk bonds.

[136] Qualitätsstandards der österreichischen Investmenfondsbranche – Juli 2003, VÖIG, 2003, Article 35.

13.34 Relatively few countries have designed information standards for investment funds that facilitate comparison to other products. In the Netherlands, however, the Financial Information Leaflet (FIL) was designed to overcome difficulties with previous information disclosure and in particular to enable the consumer to compare different products easily without overloading them with information,

> *"The financial information leaflet can, therefore, be regarded as a simplification of the other documentation such as contracts, enclosures, general terms and conditions and prospectuses."*[137]

13.35 The FIL is not limited to investment funds but is required for a wide range of products that the Netherlands authorities describe as complex. It covers a range of different factors including the financial risks of the product, the obligations if the product is purchased, an example of the return and costs, and information about exit conditions.

<u>Regulation of sales and advice</u>

13.36 The way investment funds are distributed varies significantly around Europe, with the independent channel being important in countries such as Italy and the UK and banks being important in France, Germany, Belgium, Denmark, Ireland, Spain, Portugal and Sweden.[138] There is increasing importance given to multi-manager or open architecture distribution models.

13.37 However, in many countries, whichever channel is being used, there are rules stating that the advice given must be in the interests of the consumer. For example, in Austria, providers of investment funds are required by law to act in the best interest of consumers. Intermediaries have to understand the investment experience of a prospective customer and must provide all information necessary for the consumer to take an informed decision.

13.38 In Finland, despite the lack of direct supervision by either the Finnish Financial Supervision Authority or Finnish Insurance Supervisory Authority of financial

[137] Taken from www.afm.nl

[138] Cross-border marketing of "harmonised" UCTIS in Europe: Current situation, constraints and ways forward, Price Waterhouse Coopers November 2001.

advice, there have been guidelines regarding investment services.[139] These state that an investment services undertaking must provide its customer with information concerning investment services, the fees and other charges to be collected, as well as such information regarding the securities concerned that may have a significant effect on the customers' decision-making, unless this is clearly unnecessary due to the nature of the investment service or other circumstances.

13.39 There is some concern regarding the information provided during the advice process in some countries. For example in Austria, the Association for Consumer Information (VKI) would like to improve the information given during the sales process for investment funds. According to the Securities Supervision Act (Wertpapieraufsichtsgesetz), the sales process must be documented, but only in a very superficial way (it must be recorded which topics were discussed, but not which "promises" the seller made). The VKI has suggested that a more detailed documentation of the sales process should be mandatory, including a better standardisation of customer risk classes (those are perceived as rather "blurry" at the moment). This is seen as essential to make liability of advisers effective.[140]

13.40 Generally there is an acceptance that greater focus on the sales and advice process is appropriate for investment funds. To some extent this reflects existing requirements of European directives, where, for example, the "know-your-customer" regulation and the need to do a fact find to understand the consumer background and financial position is a requirement of MiFID.

Voluntary codes of conduct

13.41 It is common to find voluntary codes of conduct for investment fund providers. The great majority of these focus on information provision and the relationship between the fund manager and the consumer. For example:

- The Association of Austrian Investment Companies has quality standards focused on information provision and making products more transparent for

[139] Guidelines on practices to be applied in the provision of investment services. Financial supervision Guideline No 201.7; AUTHORITY Dnro 11/268/98; Issued 25.11.1998; Supersedes guideline 203.1; Dnro 1/544/94, 14.1.1994; Valid from 1.1.1999.

consumers. It covers many of the UCITS requirements, as well as the requirement to only report performance data on an annual basis.

- The French Association for Financial Management (l'Association Française de la Gestion Financière) has ethical rules in place.[141] The code covers issues regarding information provision and confidentiality of consumer information. In addition, it covers competence, care and diligence in identifying the interest of the investor, aims to prevent all conflicts of interest and providers agree to manage the investments in an autonomous, independent and transparent way.

- The ALFI Code of Ethics in Luxembourg prescribes that managers must promise to furnish transparent and objective information to the investors on the investment policy, management results and projections of future trends.

- The Portuguese Association of Investment, Pension and Property Funds (APFIPP) has a high level code of conduct including ethical principles as well as covering information requirements. Further, the code stresses the importance of providers knowing the client and their objectives.

- The Spanish Securities Commission (CMVM) has recently developed a procedural guide on the provision of investor information. Although this is voluntary, all of the major important providers have agreed to follow it. Amongst other things this includes ensuring that there is matching of product risk level and the risk profile of the target clientele.

Assessment of the need for simplified products

13.42 Based on the interviews with Member States and our own assessment of situation in the countries without simplified products, there is considerable scepticism about whether simplification of collective investment schemes would be beneficial. Indeed, looking at the examples above, where simplified products have been identified, they are unusual. The Savermark was introduced to help consumers purchase a new tax preferred saving product being introduced by the

[140] Interview with the VKI in Vienna on 2nd June 2004.

[141] Professional Ethics Code, adopted 11th June 2001, available at www.afg.fr.

Government and AS Funds grew out of the fund management industry wanting to compete for pension savings.

13.43 The lack of interest in product simplification within Member States is probably at least partly due to the standardisation resulting from the UCITS Directives.

13.44 There are also a number of other reasons regarding the lack of need for simplified products which are explained below. These include some products already having price constraints, there being no evidence of simplified investment funds having lower overall charges, weak evidence of proliferation of funds being a concern and the need for risk control of these funds being limited in most Member States.

Price constraints

13.45 Firstly, although there are relatively few simplified products we can observe three more countries (in addition to Germany, Ireland and the UK) that have imposed price constraints on investment funds. In Finland, for example, there are constraints on the structure of prices, such that this consists of only a subscription fee, annual management charges and redemption fee. However, some of the constraints in different countries are somewhat contradictory with German excluding redemption fees seemingly to lower switching costs while Denmark requires that initial and exit charges are passed on directly in the form of charges rather than acting as a cross-subsidy across consumers. In contrast, Spain is similar to Ireland and the UK as it has a maximum level of charges for investment funds.

Table 18: Constraints on the charges of investment fund products142

Country	**Constraints on product charges**
Denmark	No load products are not allowed - Front end load must cover initial costs
Finland	Only three components to the pricing structure (subscription, annual management charge and redemption fee)
Germany	Redemption fee not allowed.

[142] Only those countries where there are constraints in pricing are included in the table.

Ireland	The charge can be no more than 1.5% p.a.
Spain	Spain has maximum caps on fees
United Kingdom	Price cap on CAT mark equity ISA. Performance fees are not permitted.

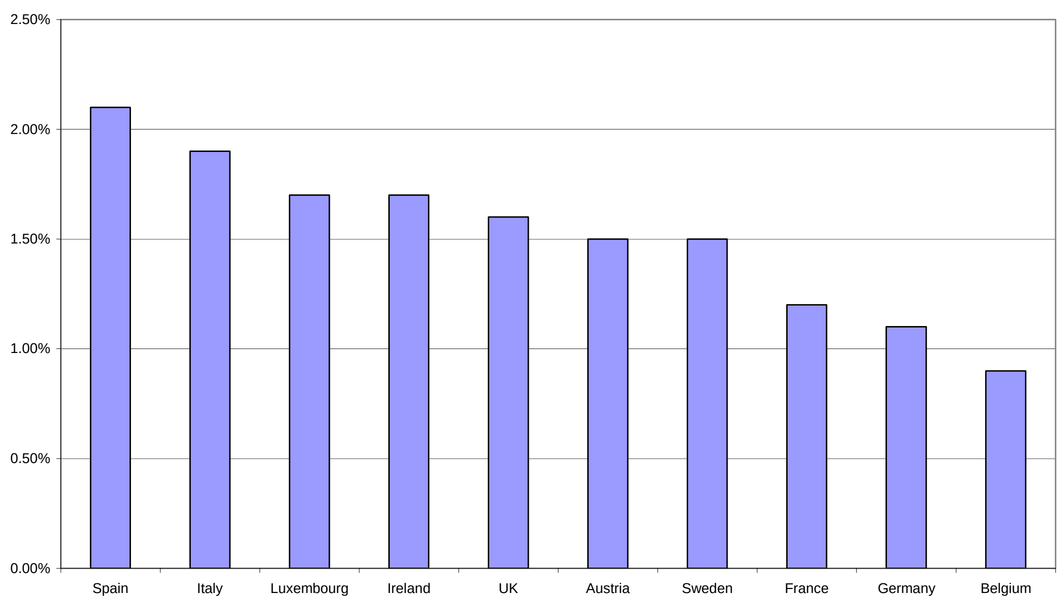
Source: http://www.fefsi.org

13.46 The motivation for regulating the level of prices is to protect investors from high prices (this is thought to be especially in Spain as investors rarely observe the level of charges). The price ceilings are thought to play an important role in protecting investors as otherwise managers are thought likely to increase those fees when the market's performance rises.

The impact of simplified products

13.47 Secondly, there is relatively little evidence that the simplified products developed to date have resulted in a better performing collective investment fund markets. For example, there is no clear relationship between countries with simplified products and those with low charges. Germany has lower than average charges, whilst the UK and Ireland appear to have an average level of charges.

Figure 17: Asset management fees (TERs)



Source: Fitzrovia (2002), Comparison of Annual Charges for Collective Funds across Europe: weighted average TER by domicile of actively managed equity funds investing across Europe. Information on other Member States is not available from the same source.

Product proliferation

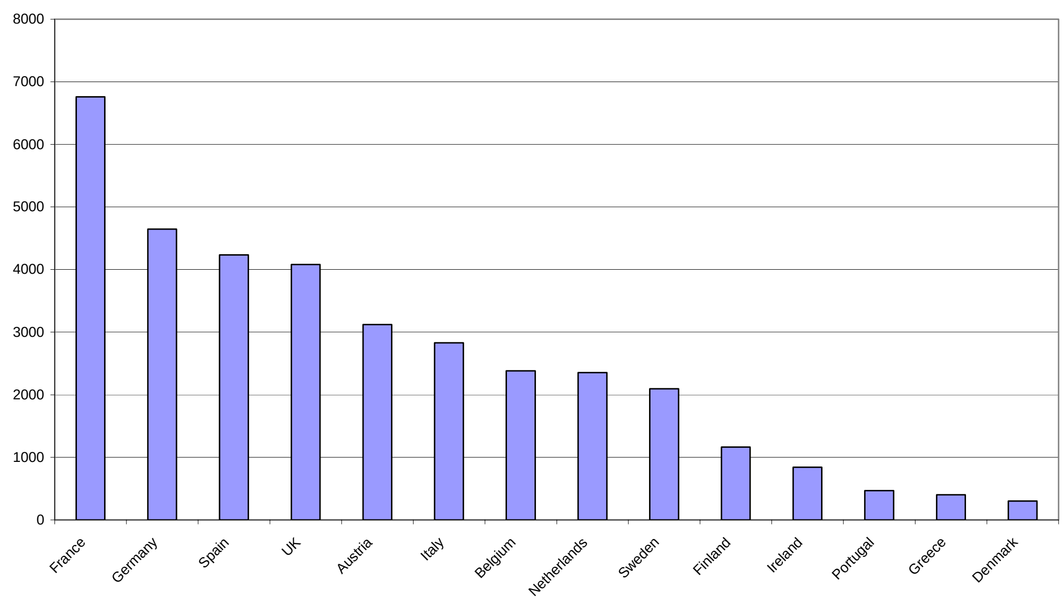
13.48 Thirdly, there appear to be a good argument that although there might be a case for a simplified product in a market like the UK, the markets in other Member States are sufficiently different to make simplified products irrelevant.

13.49 The Sandler report in the UK criticised the industry for excessive differentiation. However it is difficult to determine how many funds are enough indeed the argument has been posed the other way round – that there are too few funds in a number of countries and increased differentiation is to the benefit of consumers,

> *"While investors in big markets can choose among thousands of products, availability is restricted to a few hundred in countries like Denmark, Greece, Portugal and Norway"*[143]

13.50 As seen in the Figure 18 below the number of funds available in each national market varies significantly. However, the UK does not have the largest number of funds, France, Germany and Spain having a larger number of funds. Therefore, this would suggest the case in other Member States could be similar to the UK.

Figure 18: Number of funds available in national markets (31 March 2001)

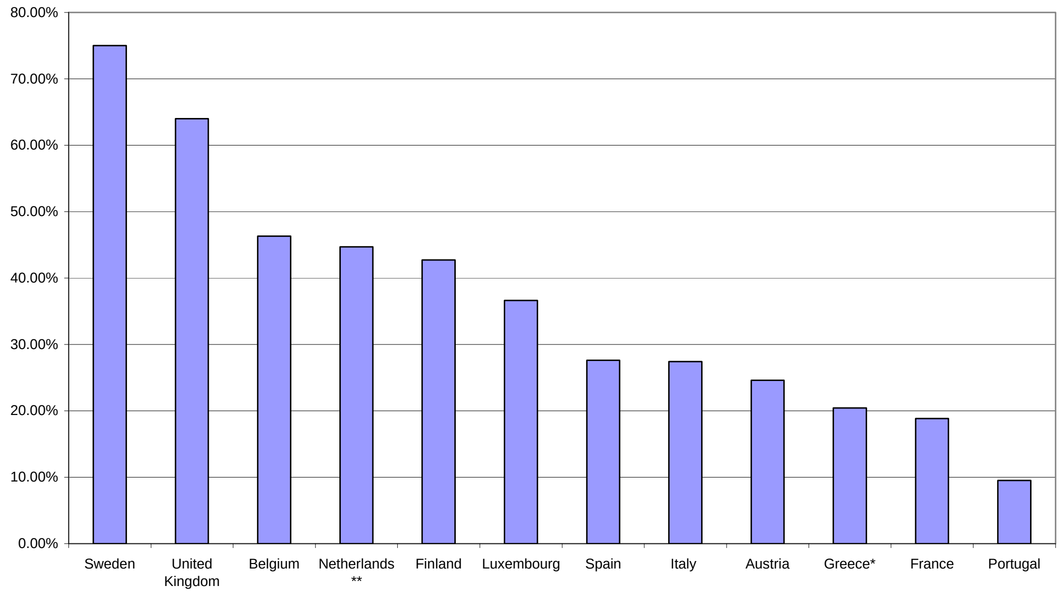


Source: The benefits of creating an integrated EU market for investment funds Friedrich Heinemann ZEW (April 2002)

Risk

13.51 Fourthly, it is also important to consider the impact of risk. Much of the regulatory attention in the UK has focused on risk controlled products, that is limiting the amount of equity investment. Indeed, the new equity medium term products impose a limit of 60% being in equity. However, with the exception of Sweden, other member states are still more focused on fixed income securities (in particular, domestic debt).

Figure 19: Percentage of Equity funds



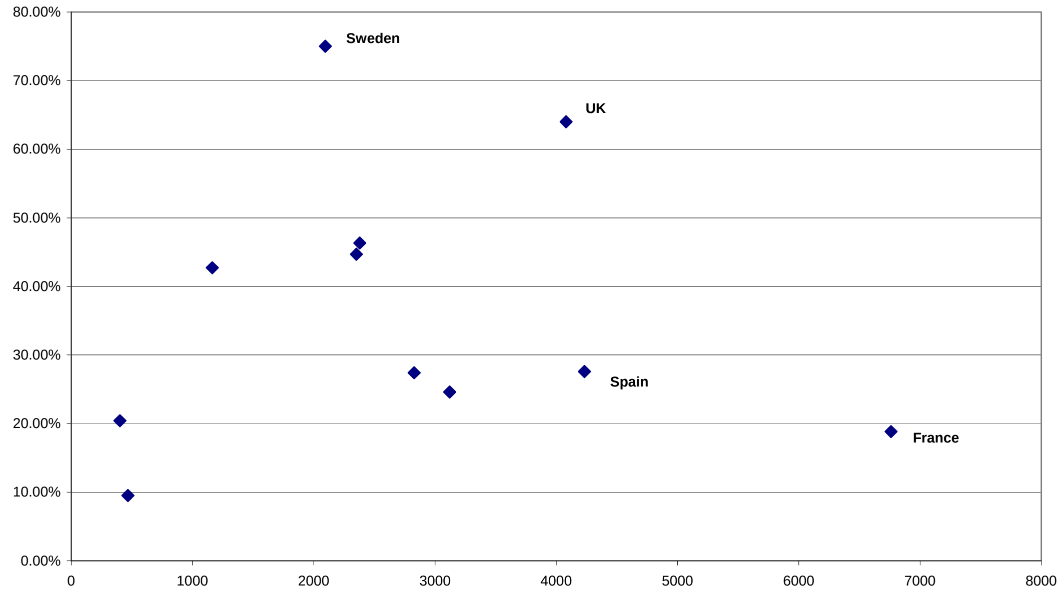
Source: http://www.fefsi.org (Data for Germany and Ireland unavailable)

13.52 As seen in Figure 19, every market other than Sweden has a significantly lower share of equity products than the UK. Therefore the level of concern regarding the marketing of equity funds is correspondingly likely to be lower.

13.53 If we examine the relationship between equity based funds and the number of funds, we find that the UK is very unusual, having a relatively high number of funds and a higher percentage in equity. Countries like France have many more funds, but they are largely bond based.

[143] The benefits of creating an integrated EU market for investment funds, Friedrich Heinemann ZEW (April 2002).

Figure 20: Trade-off between equity and number of funds



Source: http://www.fefsi.org. Only those countries which are outliers are named in the Figure.

13.54 Interestingly, we find the countries closest to the UK, Spain and Sweden are relatively unusual. Spain has maximum prices already and Sweden's investment in funds is thought to be due to a very successful tax privileged product, Allemansfonder, and related to the investment freedoms in the compulsory pension scheme. This is discussed in the Sweden country write-up and the pensions chapter. However, it is interesting to note that one of the issues in Swedish pensions is that there is too much choice of funds and that this choice needs to be simplified if consumers are to make active decisions.

13.55 However, despite these concerns, there were strong views against simplification in the form of restricting the investment allocation as in the UK,

> *"I don't understand the concept of investment allocation restriction if the product is for people of all ages. Bringing the UK style of standardised investment fund products in to Sweden would not be good idea. CAT standards are not beneficial to any one. There is no need for that kind of fund. Balanced funds already exist and are effectively a form of simplification. Equally, Swedish investment fund market has already developed further than elsewhere, UK style simplified products can be useful in the early stages of development when people are still unfamiliar with or excluded from the market. This is not the case in Sweden and therefore there is no need for these kind of products."*[144]

[144] Interview with SIFA, 2nd July 2004 and 1st September 2004.

Conclusions

13.56 It is interesting that we again find that the case for simplification has been suggested due to the introduction of a new tax privileged product suggesting that simplification may be a necessary complement to any new proposals to enhance saving through offering tax benefits. In Ireland, for example, the simplified kitemark the "Savermark" was felt to be necessary for the tax preferred product but not seen as necessary for collective investments as a whole. This is a least indicative that the underlying product does not require simplification although the taxation environment needs to be designed with care.

13.57 Finally, there are signs in other countries that proliferation is not an inevitable outcome of competition. In Belgium for example, banks feel there are too many different kinds of UCITS (i.e. telecom stocks in southern Italy) and too many providers, all of which have their own UCITS products. There are attempts to reduce the number but this is driven by cost concerns by banks.[145]

13.58 Therefore, it seems that there were specific circumstances in the UK that justified a simplified product. These are not common in all the other Member States, and therefore the current requirements for the provision of simplified information, through the simplified prospectus, are likely to be sufficient.

[145] Interview with Febelfin, 2nd July 2004.

Section 14 Financial advice

14.1 Following the analysis in the theoretical chapter, financial advice is an area where we might be concerned about complexity. Consumers in many Member States are said to be unclear as to the cost of advice, particularly since this is often paid by the provider of the product on behalf of the consumer and hence can appear to be free to the consumer. Further, consumers are often in a very poor position to observe the quality of advice at the time of purchase. Even some time afterwards, it is difficult to assess whether good or bad outcomes are due simply to luck or the skill of the adviser.

14.2 This would therefore appear to support efforts to simplify or standardise the process by which consumers purchase advice.

14.3 We have also found it useful to differentiate between simplified advice and simplification of the status of the advisers or how they are paid. In a number of Member States there is regulation trying to simplify for the consumer the choice of adviser and how the advice is paid for:

- For example, in Belgium, Portugal, Spain and the UK (although this is about to change) there are restrictions on advisers, such that they either provide advice on the products of one product provider or provide advice across all providers on the market. This was intended to simplify the choice for consumers as to the type of adviser. In the UK, there is evidence that this succeeded in informing consumers about the type of adviser they were using;

- In other countries there have been limits imposed on how payment for advice can be made. For example, in Sweden the consumer must pay the adviser directly for non-life products. This is intended to simplify the relationship between consumers and their advisers; and

- Finally, disclosure of the level of charges or commission paid to the adviser has also been adopted to inform the consumers regarding payments being made on their behalf (for example, Finland). This disclosure has also been stipulated in the Market in Financial Instruments Directive (see discussion below).[146]

14.4 In terms of simplifying the choice of adviser, there are clear alternatives to simplifying statuses. These include:

- Standardising the training and competence regime needed to be an adviser and signalling the quality of the adviser through certification. This has been seen in many Member States; and

- Publishing comparative information on the terms under which different advisers will provide advice. The development of the "menu" or Fees and Commission statement in the UK, could be seen as a method of facilitating comparison across advisers.

14.5 In this chapter, however, we focus on where the service called "advice" has been simplified.[147] That is, to treat advice in a similar way to the other financial products under consideration, we are interested in constraints on the product, not the provider.

14.6 Nor do we discuss restrictions placed on the payment for advice that are directly related to product simplification. For example, to reduce switching costs on some simplified products, the cost of distribution needs to be spread over time as is seen with the Riester pensions in Germany. The discussion of this can be found in the relevant product chapters. We have categorised this as a characteristic of a simplified product rather than simplified advice.

14.7 However, it is clear that financial advice is very different to the other areas that we are assessing in this report which all represent financial products. Indeed, we have indicated that an alternative regulatory intervention to having simplified financial products is to have regulation of the sales and advice process. However,

[146] In a number of countries, regulation of financial advisers is currently under review. For example, in the Netherlands, the regulator is considering whether commission disclosure is required or whether only fee based advisers should be able to call themselves independent.

[147] As we see below, where advice has been simplified, this service can be provided by different types of advisers, i.e. the advice service can be simplified without simplifying the status of advisers.

for financial advice, the *removal* of the sales and advice regulation may be the mechanism by which simplification is undertaken.

14.8 Indeed, in some cases the objective of simplification of the advice process has been to make it affordable while retaining the appropriate level of consumer protection. That is, simplification of advice has resulted because other regulatory initiatives have meant the regulatory restrictions on advice could be relaxed.

14.9 Particular difficulties were faced when dealing with the concept of simplified financial advice in Member States which did not have a long history of regulating financial advice itself since, in the absence of regulated financial advice, it is difficult to imagine what simplified financial advice would be, or indeed what benefits it could bring.

14.10 Furthermore, it is important to note that simplified financial advice has only been proposed in two countries in which it has been firmly linked to the sale of simplified financial products. Therefore, given that we have identified relatively few simplified, standardised products, it is perhaps unsurprising that few countries have considered whether the regulation of financial advice can be simplified for this reason.

14.11 However, although few Member States have extensive experience with the regulation of sales and advice regime, this is changing across Europe as Member States transpose the Insurance Mediation Directive (IMD).[148] While many Member States will have had in place for many years a number of the requirements in the Directive, other Member States will be bringing these in for the first time.

14.12 The IMD imposes a number of conditions on the sales and advice process. Amongst others, these include:

[148] Directive 2002/92/EC of the European Parliament and of the Council of 9th December 2002 on insurance mediation.

Registration:

- Insurance intermediaries must be registered in their home Member State (or the names of people within the management who are responsible for the mediation business); and
- The register will specify the Member States in which the intermediary conducts business.

Professional requirements:

- Intermediaries must possess appropriate knowledge and ability;
- Intermediaries must be of good repute having a clean police record in relation to serious criminal offences and should not have been declared bankrupt (unless they have been rehabilitated in accordance with national law);
- Intermediaries must hold professional indemnity insurance covering the whole of the European Community for at least €1 million per claim and €1.5 million per year for all claims

Information:

- Before the conclusion of any contract the intermediary must inform the customer whether he has a voting right of 10% of the insurance undertaking or whether the insurance undertaking has a voting right of 10% of the intermediary business;
- The intermediary must inform the customer whether he is under obligation to conduct business exclusively with one of more insurance undertaking;
- The intermediary must inform the customer whether he gives his advice on a fair basis in which case it must be on the basis of an analysis of a sufficiently large number of insurance contracts available on the market; and
- The intermediary must specify the demands and needs of the customer and the underlying reasons for any advice given to the customer.

14.13 In addition to the IMD, the Market in Financial Instruments Directive (MiFID) also imposes requirements on financial advisers. Indeed, the provision of investment advice has been specifically included within the investment services requiring authorisation under MiFID.[149]

14.14 MiFID imposes a number of requirements on intermediary businesses including amongst other requirements:

- The need to maintain records of all services and transactions undertaken sufficient to enable the relevant authority to monitor compliance with the MiFID requirements and to ascertain whether they have complied with all the obligations with respect to clients; and
- A range of requirements regarding conduct of business obligations:
    - Providing information on costs and associated charges;
    - Obtaining the necessary information regarding the clients knowledge and experience in investments, their financial situation and their investment objectives (know-your-customer requirements) so as to recommend suitable investments; and
    - Adequate reports on the service provided to clients including the costs associated with the transactions and the services undertaken on behalf of the client.

14.15 Hence it is clear that both the IMD and MiFID impose conditions on the advice process in particular with regard to know-your-customer requirements and the need to explain the reason for the advice given as well as disclosing the number of companies from whom the adviser can recommend products.

14.16 The IMD was in the process of being transposed into national legislation in a number of countries during the research process whereas MiFID was only adopted

[149] Directive 2004/39/EC of the European Parliament and of the Council of 21st April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

in April 2004 and hence the transposition process had not started for this Directive. Nonetheless, the IMD requirements lead to standardisation of insurance intermediation as similar minimum requirements are in place across the European Union.

14.17 Therefore, even though there may not have been extensive regulation of the sales and advice regime in the past, European regulation will require this in the future. It is a legitimate question as to whether simplified products could imply that this regulation is unnecessary.

14.18 To examine this we look at the two countries in which simplified financial advice has been identified (Ireland and the UK). In both of these it is notable that there has been a very clear recognition of a trade off between product regulation and the regulation of sales and advice. Historically, both of these countries have had relatively less product regulation as compared to other countries and instead there has been a focus on imposing greater sales and advice regulation.

14.19 By contrast of course, in other countries, where there has been considerably more product regulation, there has, arguably, been less need for detailed sales and advice regulation. Hence in both the UK and Ireland, where detailed product regulation has been increased in the form of the design of simplified products by Government, there was a decision to reduce the sales and advice regulation on these products.

14.20 Indeed it was a specific proposal in the Sandler Review in the UK that if product regulation was to be used then sales and advice regulation should be reduced. In fact the Sandler Review proposed that the majority of the conduct of business regime should not be applied to the Stakeholder range of products, specifically that there should be,

> *"no requirement for those selling the products to be FPC3 [Financial Planning Certificate 3] (or equivalent) qualified, as financial advisers are; no COBs [Conduct of Business] requirement to provide "suitable advice"; and no requirement to "know the customer"."*

14.21 In fact the current proposals in the UK have not gone this far and the basic advice regime retains the suitability requirements and the need to know certain pieces of information about the customer (more details are provided on this below).

14.22 It should also be noted that in both the UK and Ireland, the products that have the simplified financial advice process attached to them are products which have price caps. There was concern in both the UK and Ireland that imposing price caps without reducing the sales and advice process would lead to products being uneconomic.

Simplified financial advice

14.23 There are two countries where simplified financial advice processes have been identified: Ireland and the UK. The characteristics of the simplified advice processes are similar in a number of ways.

14.24 In both Ireland and the UK, the simplified financial advice process is applied only to the sale of simplified products. In fact in Ireland it is applied to a subset of this as it is only applied to the standard PRSA (pension) when this is distributed via employers. In the UK, the proposed basic advice regime will (probably) be applicable to the new Stakeholder range of products (Stakeholder pensions, the Medium Term Investment Products which could be a collective investment scheme or a unit linked life insurance product, Smoothed Investment Funds, and Child Trust Funds).[150]

14.25 In both Ireland and the UK, the simplified financial advice process involves a reduction in the fact find or know-your-customer requirements compared to those processes in place for other similar, but non simplified, products. In Ireland, when providing advice on the standard PRSA distributed via employers, advisers can simply establish whether employees have a pension and, if not, can offer the

[150] The most recent announcement by the FSA has cleared the use of the basic advice regime for Government Stakeholder products with the exception of the smoothed saving products, where further research is being undertaken. See press release: http://www.fsa.gov.uk/pubs/press/2004/092.html.

PRSA without having to undertake a full fact find process.[151] In the UK it is proposed that the fact find,

> *"is limited to establishing the consumer's position on broad issues such as risk, savings objectives, significant financial priorities and obvious counter-indications."*[152]

14.26 In the UK it is proposed that individuals giving basic advice will not be required to hold financial planning qualifications, although firms will have to ensure that they are competent to administer basic advice.

14.27 In the UK it has also been proposed that sales interviews are pre-scripted by the firm and there are clear limits as to the issues on which advice can be given. The customer will be given a record of the interview and of the responses they gave.

Alternative regulatory interventions without simplified products

14.28 As discussed above, the development of "simplified advice" has been a response to increased product regulation and has taken the form of reducing the sales requirements. Hence, alternatives to this would therefore be other forms of regulation being taken away.

14.29 There is some evidence that some regulators take into account the level of regulatory burden and its effectiveness e.g. many Member States recognise there can be too much information provided to consumers (although there has been little analysis to identify what is the right amount of information). However, there is much less recognition of the trade-off between different forms of regulation.

14.30 This trade-off is most articulated in the Netherlands, where the identified complexity of the product impacts on the level of information provision that is required. This would imply that a "simpler" product would require less information to be provided. Indeed, in the Netherlands, only those products which are considered to be complex are required to provide the Financial Information Leaflet.

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[151] Interview with Irish Pensions Board, 12th May 2004.

[152] A basic advice regime for the sale of stakeholder products, June 2004, Consultation Paper 04/11, Financial Services Authority.

14.31 However, based on the evidence from our research there are no other examples where alternative regulations have been reduced in the light of the development of simplified products.

Assessment of the need for simplified products

14.32 The success or otherwise of simplified financial advice is impossible to judge at present. In part this is because it is inevitably linked to the success of simplified financial products in the UK and Ireland, which themselves have not yet been launched or have only been recently introduced to the market.

14.33 In any event, it will be almost impossible to establish the degree to which take-up of the standard-PRSA in Ireland or the new stakeholder range is driven by the product or by the simplified advice process.

14.34 However, it will clearly be important to assess whether simplified financial advice provides the same level of consumer protection as existing sales and advice regime. This will require careful analysis over the coming years.

14.35 Nonetheless there are some lessons that can be learned.

14.36 First, it seems to be the case that left to itself, the market in some Member States is unable to design simplified financial advice. This is because intermediaries, once regulation of the sales and advice process is established, appear concerned that they will face ex post regulation if they do not follow the highest level of advice process, such as using an extensive fact find etc.

14.37 In this situation, intermediaries will always tend to increase the level of information gathered to minimise regulatory risk. Hence, it may be necessary to have regulatory intervention regarding what would be seen as an acceptable level of simplified financial advice such that intermediaries can choose to follow this process.[153]

14.38 Second, simplified financial advice has been linked to simplified products wherever it has been observed. However, not all products are typically advised,

[153] Indeed, this point was recognised in the Sandler Review.

and hence for many of the products that we have identified as simplified (notably banking products), a simplified advice process is unnecessary because a regulated advice process is seen as unnecessary. Moreover, since few countries have had any systematic debate about product complexity, and since few countries have historically had a detailed advice process, it should not be surprising that the issue of the need for simplified financial advice has not been raised.

14.39 Third, in the countries with "simplified advice" there has been a recognition of a trade off between product regulation and the regulation of advice. It is this trade-off that explains why it is that simplified financial advice has been closely linked to simplified products. For example, IFSRA highlighted that the standard PRSA has lower sales regulation than other products because it is a simplified product and indicates that this trade-off between product and advice regulation means that if there was further simplification of products, they would be seeking to reduce the advice regulation. Perhaps, only once countries have gone above the "efficient" level of regulation does this trade off become a meaningful concern.

14.40 Indeed, if simplified products provide a higher level of consumer protection than non-simplified products, it would seem entirely plausible that a reduction in the regulation of advice could be undertaken without damaging consumer protection since this would be maintained through the product regulation.

14.41 Arguably this trade-off has been implicit at a country level with some countries favouring detailed product regulation with limited advice regulation and others favouring advice regulation with limited product regulation. However, the development of simplified financial advice in Ireland and the UK suggests that this trade-off is beginning to be observed within countries rather than just between countries.

14.42 Fourth, it is also important to note that the simplified products that have had associated simplified financial advice in both Ireland and the UK have also had price caps. Not only has this potentially afforded some degree of consumer protection, but it has also led to considerable pressure from provider and intermediary firms to reduce costs of advice in order for the products to be economic to sell.

14.43 Finally, the recognition of a trade-off between the regulation of advice and the regulation of products, suggests that it is important to not set the minimum standard for both of these aspects of regulation at a level above an efficient trade-off. That is, if one of the benefits of simplified products is that the cost of the sales and advice regime can be reduced, then it must be the case that the minimum sales and advice regulation imposed at a European level must not be above that level deemed necessary for these simplified products.

14.44 As the minimum level of different forms of regulation rise (information provision, sales and advice process) due to European legislation, the debate of the appropriate trade-off and the implications for discretionary regulation within the country are bound to intensify.

Section 15 Cross-border trade

15.1 In this chapter we are interested in whether simplification and standardisation of products can improve cross-border activity. We consider a wide definition of cross-border trade including both consumers seeking to purchase from providers located in other countries (which could include intermediaries undertaking this activity on behalf of the consumer) as well as providers seeking to serve a foreign market through either the freedom to provide services or freedom of establishment. Mergers and acquisitions would therefore be seen as an alternative approach to serving the market compared to undertaking cross-border trade.

15.2 To date, integration through mergers and acquisitions of existing domestic providers has significantly outweighed cross-border activity in retail financial services.

15.3 In principle, both the standardisation of product design and the simplification of products to consumers offer the potential to significantly increase cross-border activity. Theory suggests a number of possible mechanisms that could bring this about:

- Standardisation could reduce the costs of entering a market as it reduces the need to understand country specific regulatory requirements for products thus increasing trade through the provision of services or establishment.

- Standardisation may mean the same product can be marketed in different Member States. Designing a single product for many European markets may lead to economies of scale in design and manufacturing thereby reducing the price of products throughout Europe. This could lead to design and manufacturing taking place in the country with a comparative advantage.

- Standardisation may mean the lessons and experience learnt in one country can be better exploited as a new market develops in another country. (This may be seen as unattractive from an individual Member State's perspective as it may benefit external providers.)

- A standardised product may reduce regulatory costs e.g. once the product is authorised in one country it may be possible to get the product authorised more quickly in other Member States. This may increase the speed with which innovative product design is introduced among Member States.

- Standardisation may reduce consumer uncertainty regarding the purchase of a product from another Member State e.g. if all products have the same requirements in terms of consumer protection.

- Simplification and standardisation may increase the willingness of consumers to buy products directly meaning that barriers due to distribution are overcome allowing the benefits from trade to be released.

- Standardisation and simplification may help consumers to compare products meaning any differences in services or price can be exploited by them.

15.4 However, there are also a number of compelling arguments why standardisation or simplification may have little impact on cross-border activity:

- Some of the most important features when buying or selling a product cannot be standardised through product design e.g. tax differences and differences in the underlying legal structures. The importance of tax differences can be overstated however. There are some products where differences in tax treatment across borders may prevent trade, as only by buying the product from a domestic manufacturer may any tax benefits be realised. However, there are other products where it is these very tax differences that are currently driving cross-border trade.[154]

- Differences in the underlying preferences of consumers in different Member States means that they favour different types of products making standardisation and simplification difficult and potentially harmful. These may result from history e.g. this is analogous to left and right hand drive cars which limited trade for many years. Alternatively, it may be due to

[154] In principle, both could be true for the same product affecting different types of consumer.

differences in consumer appetite for risk, e.g. some countries may favour fixed rate products and others favour variable rate products on either loans or savings. Sharp differences in preferences may mean that it is inevitable that products remain differentiated between Member States if they are to meet the needs of the domestic market.

- Powerful relationships between distributors and manufacturers may mean that intermediaries encourage consumers to purchase products from domestic providers, or that establishing as a manufacturer in a country may still not provide access to consumers. Standardisation is unlikely in itself to change these relationships, although simplification may increase consumers' buyer power.

- Given the information asymmetry between consumers and providers, consumers may use signals such as an established reputation or significant physical assets as a signal that the provider will be around in the longer term. Standardised product features may not be able to substitute for these characteristics, meaning acquisitions or mergers with existing providers may be the efficient means for foreign players to enter a market. Further, at none of the interviews was standardisation or simplification of individual products suggested as a reason that would encourage mergers to occur.[155] Nonetheless, standardisation of products could allow for common manufacturing of products to be sold in multiple locations allowing economies of scale to be exploited as mentioned above.

- Although standardisation could yield theoretical benefits, it is argued that the gains from foreign entry are largely already being exploited through European wide consolidation in the life insurance and banking industry. However, if further consolidation is prevented through concerns regarding national ownership or competition law this argument may have run its course.

[155] Indeed such a justification would have been surprising since it would imply that the cost savings associated to standardisation in products would be material in determining whether mergers between entire companies should be pursued.

- Financial products are regulated in a number of ways. This includes product regulation but also covers conduct of business regulation. Even if standardisation is achieved through product regulation, companies will still need to understand the conduct of business rules (pre-contractual information, advertising rules) to start selling into a country. Therefore, product standardisation alone (in terms of product characteristics) is unlikely to impact cross-border activity where other regulation remains different. UCITS implicitly recognises this through product standards and rules regarding information provision.

- Linked to this, different countries have chosen to adopt different regimes to meet the same objectives. For example, historically, some countries have chosen to regulate product standards and have limited regulation of the sales and advice regime, whereas others have chosen to regulate the sales and advice regime and have limited product regulation. Hence, if standardisation of products is imposed this may result in over-lapping regulation in those countries that have previously chosen to regulate through the sales and advice process. This would impose an additional regulatory cost. Indeed, a country with a heavily regulated advice regime may value product differentiation more than a country that has always relied on regulation of product terms

- The gains to providers from standardisation encouraging cross-border activity are likely to be small where there is limited intellectual property protection on new product design. This means that although new products cannot necessarily be introduced from other Member States, ideas will be replicated and exploited by domestic players. Hence individual providers may not have sufficient expected returns from standardised products to justify the cost of trading across borders.

- It is argued that the gains (for either consumers or providers) from trade are likely to be small as although there is little trade in retail financial services products, there is considerable trade in the inputs. That is, where there is cross-border trade in the underlying inputs of the product, there may be little to be gained from cross-border trade in the final product. Indeed, a similar view would be taken in many service industries. For example, most hairdressing is undertaken by domestic providers, however, the cost elements in terms of equipment and labour are commonly traded. This argument may hold for investment products, where domestic products can invest in other Member States. Similarly, it may also apply for protection products, where the underlying risk can be re-insured in a different Member State. Hence cross-border trade in wholesale financial services, that has been encouraged in recent years due to European legislation, may have already led to a substantial proportion of the gains from trade having been exhausted already.

- Finally, a key factor in cross-border trade is that of product differentiation. Consumers searching across borders are looking for product features that are not available in their domestic market, similarly providers entering new markets are typically seeking to offer products that are not already available in those markets. Further, differentiation may be of benefit to providers in insurance markets in order to reduce risk through diversification. Standardisation may reduce the benefits from cross-border activity if it prevents product differentiation.

15.5 During our interview programme we tested these arguments with interview participants, asking for evidence to support their arguments. Given the range of theoretical arguments for standardised and simplified products improving cross-border activity, we were surprised with the level of consensus. No interview participant believed that simplified, standard products would have a significant impact on any type of cross-border trade for the product under consideration.

15.6 Further, it seems clear that there is a tension between simplified standard products, such as the UK's stakeholder products, designed to solve domestic market information asymmetries and standardised products that could assist cross-border trade. In particular these products often involve:

- Different objectives – with simplified products often being aimed at access considerations for low income, financially unsophisticated consumers (clearly this is the case for basic bank accounts but also risk controlled collective investment products) whereas cross-border trade has typically involved more highly sophisticated consumers valuing differentiation (for example UCITS has allowed individuals to diversify their portfolio by giving them greater investment freedom);

- Different preferences of target consumers – the target audience for simplified, standardised products are likely to be the more unsophisticated consumers for whom understanding products and which products are of best value is likely to be important and concerns regarding cross-border trade are likely to be limited. By contrast, sophisticated and relatively wealthy consumers are the ones most likely to be interested in the increased choice offered through cross-border trade. Indeed, since simplified products have often been aimed at marginal consumers of financial services products, it also seems unlikely that these consumers would be the ones which providers would seek to attract were they to enter a market through the freedom to provide services or freedom of establishment; preferring instead to attract high net worth consumers who are less likely to be focused on simplified products.

- Different product features – barriers to cross-border activity often relate to characteristics of the product that the consumer is unaware of e.g. the ability to get the product authorised swiftly. These are often supply-side factors of concern to providers but to which consumers are often relatively oblivious.

15.7 The view that simplified, standard products would not have a significant impact on cross-border trade needs to be contrasted with the overwhelmingly positive reaction in our interviews to standardisation resulting from the UCITS Directives which were seen to have increased choice of investment funds and increased the speed with which new products were brought to the market. In particular, this was seen to have been especially beneficial to some of the smaller Member States.

15.8 This chapter therefore focuses primarily on how standardisation was identified as potentially able to reduce some of the barriers to trade. In the next section we go through each of the barriers identified during the in-country interviews, determine the degree to which this is likely to be alleviated by standardisation and illustrate this with product examples.

15.9 We then turn to whether the benefits realised from standardisation lowering the barriers to trade are likely to be significant. This covers some of the problems identified in the interviews regarding standardisation taking place at the European level.

15.10 Finally, we provide a product-by-product review of the case for standardisation as a tool for increasing cross-border activity in retail financial services products.

Would standardised products reduce the barriers to cross-border activity?

15.11 There are a wide range of barriers that were identified during the research and interviews that were likely to hinder the development of cross-border trade. This section examines the various barriers and considers the degree to which standardisation would impact cross-border trade (in addition we note where simplification was also thought to be relevant).

15.12 This section is grouped around the following different categories:

- Consumers;
- Providers and distribution;
- Transactions costs; and
- Domestic government policies.

Consumers

15.13 There are a range of barriers to cross-border trade relating to the characteristics and preferences of consumers and we examine these to see whether simplification or standardisation would impact these factors and thereby alter cross-border trade.

Consumers needs differ

15.14 One issue that was raised in a number of different countries was that both within countries and across countries the needs of consumers differ. This may reflect a number of factors including culture, wealth and the relationship with the welfare state (welfare provision is covered under domestic government policies below).

15.15 There were therefore concerns expressed that if simplified or standardised products were developed, they may be marketed as being suitable for all consumers when in fact they are not. For example, developing a range of simplified products across the EU could lead to the sale of products into the accession countries which could be unsuitable for the majority of consumers in those countries.

15.16 Similarly, it was noted by Greek interviewees that consumer needs differ across products, and that the level of sophistication of consumers differs both within and between Member States. In particular, it was highlighted that in the investment product sector there is greater interest in cross-border trade as investors are on average better qualified to understand investment markets abroad than the average bank customer is to understand foreign banking sectors,

> *"People who understand the regulation of the financial system and the harmonisation of standards and procedures and possess the necessary level of education are more likely to be unsuspicious and thus invest abroad."*[156]

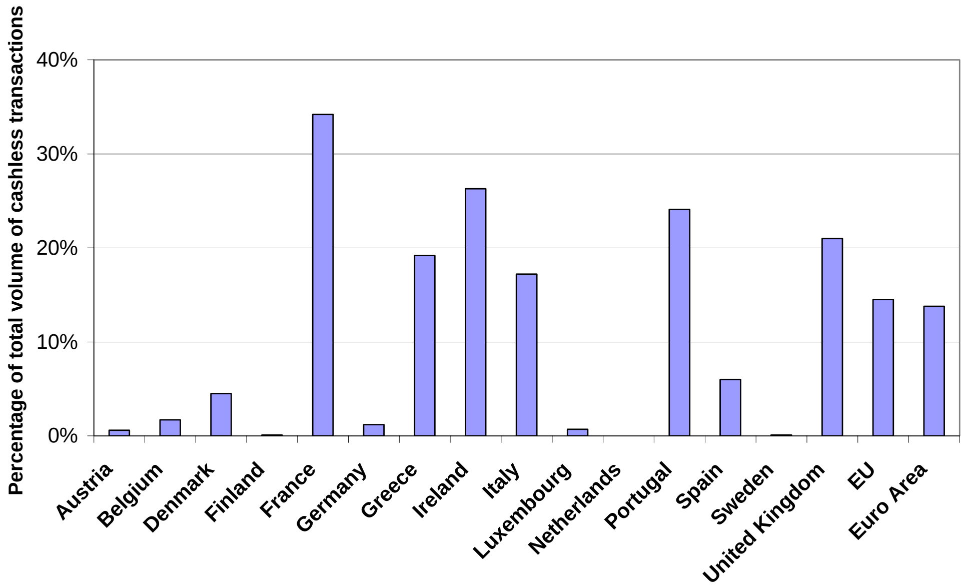
15.17 Therefore designing a simplified product that was appropriate for the level of sophistication in each country would be a very difficult task.

15.18 A further issue that was raised in a number of countries was that the way consumers use particular products varies substantially across Member States. For example, there is considerable variation in payment means across the Member States.

15.19 Figure 21 below provides an indication of this and it is clear that in France, Greece, Ireland, Italy, Portugal and the UK, the use of cheques is very common with over 17% of cashless transactions in this form. By contrast, in all other Member States, cheques represent no more than 6% of cashless transactions and in Finland, the Netherlands and Sweden they are virtually non-existent.

[156] Interview with the Hellenic Capital Markets Commission, 14th May 2004.

Figure 21: Cheques as a percentage of total volume of cashless transactions



Source: ECB Blue Book 2004, data refers to 2002.

15.20 Designing a standardised product across Europe would therefore be fraught with difficulties as local usage would impact the product characteristics that consumers would expect to see as part of the product. However, in this particular example, there were also concerns that designing a product to meet the present needs of a range of consumers from different countries could have detrimental implications for other countries. For example, in both Finland and Sweden, there was a concern that standardising banking products would include the use of inefficient paper based payment means.

15.21 There is, therefore, considerable concern regarding having too much flexibility e.g. Nordic countries would not like to reintroduce cheques into banking products, but other interviewees argued that differences in consumer needs necessitated a flexible product.

15.22 In the mortgage market it was noted that consumers in some countries had a preference for fixed rate mortgages whereas those in other countries preferred variable rates. Further, even within countries where the majority prefer one type, there may remain other consumers who have different preferences. Hence if standardised products were designed there might be a need for more than one standard to be set in particular product categories.

15.23 Very similar to this is the level of coverage that insurance based products offer. Currently this is seen as a barrier to cross-border trade. For example, it was noted that in motor insurance a replacement car is expected in Portugal but only typical in Spain if the policyholder depends on the car e.g. by being a taxi driver. Similarly, when considering the risks that would need to be insured, these would also differ. In Portugal, earthquake insurance would not be needed, but some people in some places might need flood insurance, although not everyone. There was a concern expressed by the Portuguese Insurance Association that minimum standards across Europe would not protect everyone, but comprehensive cover would be too expensive and unnecessary.[157]

15.24 However, there were differences in opinion as to the level of commonality in requirements across products. For example, the Danish Consumer Council noted that home insurance requirements are fairly standard – consumers want protection from fire, burglary etc.

15.25 Overall therefore in considering the design of standardised or simplified products, it was noted that designs at a European level would be hard to achieve where consumer preferences and expectations differed across the Member States. This places a significant barrier in terms of European wide simplified products and means European wide standardised products will need to incorporate significant flexibility.

15.26 In particular, this suggests that the design of simplified or standardised products for the benefit of domestic markets may differ across countries. Hence if simplification or standardisation was done at a domestic level it is likely that this would lead to a range of simplified or standardised products being developed for the domestic market. Whilst this may be good for improving domestic market failures, it may not assist cross-border trade. However, if products were designed at the European level, then it may be difficult to design products that meet the needs of consumers from many countries and hence some products may not be

[157] Interview with APS, 8th June 2004.

produced or purchased at all in some countries which would therefore clearly fail to have an impact on cross-border trade.

15.27 In many ways this reinforces the model used for UCITS – where standardisation placed minimum requirements on the product to facilitate international trade, allowing countries to simplify the product further to meet particular domestic concerns.

Switching

15.28 Switching costs (perceived or real) were thought to be a problem for cross-border trade. In banking services in particular, it was noted that switching bank accounts with payment means was often perceived to be a problem even when the bank takes the responsibility for costs and all the paperwork. It was noted in many countries that consumers are reluctant to switch banks to other domestic providers and therefore thought unlikely that consumers would change their behaviour because of the presence of simplified or standardised products,

> *"Customers do not even change banks in Sweden so why would they do it with foreign providers"*[158]

15.29 Hence, where barriers to cross-border trade occur due to switching costs, standardised products would not increase trade unless they explicitly addressed the cause of the switching cost (which may be particularly difficult to do since it is likely to be linked to characteristics of existing products). Overall there was not thought to be a difference between the extent to which standardised and non-standardised products would be affected by the level of switching costs.

Search costs

15.30 Search costs in financial services are perceived to be relatively high. As many products are complex to understand, consumers are often unwilling to search across providers but rather put their faith in a well known brand or an adviser.

15.31 Simplification, and to a lesser extent standardisation, offers the potential to reduce the perceived complexity of the product and therefore make comparisons easier.

[158] Interview with CBFB, 1st July 2004.

However, this was not identified as one of the primary barriers preventing cross-border activity with the exception of variation regarding exclusions on some insurance products (such as home insurance) representing a problem for comparison.

Security through brand awareness

15.32 Interviewees disagreed about whether standardisation could help overcome the preference for consumer to favour domestic providers (commonly known as home bias). Home bias represents the fact that the majority of consumers seem to prefer domestic suppliers and have a suspicion of foreign providers. Indeed, in Italy, ADUSBEF noted that it received dozens of phone calls, with potential customers worrying about the lack of physical presence on the territory from a particular foreign provider including asking comments such as,

"'will it not walk away with my money?' and 'can it be trusted?'" [159]

15.33 This is clearly a bigger issue for products where the money is locked away for many years where consumers are concerned whether the company will still exist in the future. Therefore this is likely to be a more significant problem for long-term saving products than insurance or credit products.

15.34 Further evidence is provided by a recently published survey of consumer preferences conducted by the Finnish Federation of Insurance Companies. The survey found that nine out of ten respondents to the survey believed that compulsory insurance was always best purchased from domestic providers.[160]

15.35 In other countries, it was noted that the action of some providers impacts the likely success of other providers. In Sweden, one concern expressed regarding cross-border trade is that some foreign companies have penetrated the Swedish market but left very soon afterwards which leads consumers to prefer domestic suppliers who they believe will remain in the market for a longer period of time,

[159] Interview with ADUSBEF, 14th April 2004.

[160] Insurance Survey 2004: FFIC, available at http://www.vakes.fi/svk/suomi/vakuutusala/tutkimukset/vakuutustutkimus2004.pdf

> *"Foreign providers who have entered the market have left relatively quickly which has not been good in building consumer confidence in foreign providers. It would take a long time for the Swedes to trust foreign providers. We would never put money on a company we knew nothing about."*[161]

15.36 This seemed even more the case in Finland, where the Finnish Ministry of Finance argued that foreign ownership led to a loss of customers,

> *"Even Nordea [a big Nordic conglomerate operating across the whole of Scandinavia] lost some of its Finnish customers after it merged with a Swedish bank, due to consumers not being willing to put their money in "foreign" hands."*[162]

15.37 However, despite the suspicion of foreign providers, it was noted that there were potential trends reducing this,

> *"… as the movement of workers becomes more common then consumers may begin to trust the brands of other providers as well."*[163]

15.38 Further, the Danish Consumer Council believe that simplified or standardised products could play a key role in building consumer confidence and in reducing home bias. If EU-wide simplified products were developed, they argue that consumers would recognise the product they were buying and would know that they were benefiting from a strong degree of protection, and would therefore worry less about the country of origin of the product they were buying.

15.39 Hence it seems that one potential advantage from simplified or standardised products could be to reduce home bias through giving consumers confidence in the product terms in such a way that they become less concerned about the characteristics of the provider, or indeed about the asymmetry in the information that they know about the provider (potentially a greater problem for foreign providers than for domestic providers).

Providers and distribution

Physical presence to signal commitment

15.40 Despite the advent of the internet, it is clear that physical presence in a country still makes a big difference to trade. Indeed, the German Ministry of Finance

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[161] Interview with CBFB, 1st July 2004.

[162] Interview with FMoF, 29th June 2004.

[163] Interview with SBA, 2nd July 2004.

argued that consumers would like to have the agent "on site" i.e. to have the ability to see them face-to-face indicating a preference for physical presence as opposed to trade occurring through the freedom to provide services.

15.41 In part physical presence is useful because of the reason described above, namely that some consumers prefer to undertake face to face transactions. However, it is also important as a signal of intent to remain in a market place. This is because the sunk costs of investing in a country through establishing there are greater than those when trading via the freedom to provide services. Hence having a physical presence may allow providers to signal to consumers that they intend to remain in the marketplace and therefore helps to overcome concerns regarding security.

15.42 It is, however, conceivable that standardisation and simplification could reduce the need for physical presence as consumers become less concerned about the need to observe a company being located in their country. However, standardisation does not alter the underlying preference for physical presence per se. Further, there is no reason to believe that having standardised products would increase the likelihood of investing in physical presence.

Physical presence to service the client

15.43 Physical presence may be important as a signal of commitment, it may also be an integral part of the product itself. For example, many transactions still occur in bank branches and consumers appear unwilling to undertake these remotely.

15.44 For a product such as financial advice, many models have been attempted to provide advice over the telephone or on-line, however, there are very few examples of successful remote advice models. Although it is possible this may change in the future, there is no strong evidence that this process is underway. For these products, there are currently substantial barriers to cross-border activity through consumer purchase or freedom of services.

15.45 As above, there is no reason to believe that having standardised products would increase the likelihood of investing in physical presence and hence where physical presence is required to service the client, no indication that standardised products would reduce this barrier to cross-border trade.

Access to distribution

15.46 In a number of countries, it was clear that major banks distribute not only bank accounts, but also mutual funds and insurance products of many kinds. Hence in these countries, interview participants often argued that banks controlled the distribution network to consumers. It was therefore argued that access to distribution rather than product design was what prevented cross-border trade since foreign providers could not actually access the domestic customers.

Table 19: Distribution of life products[164]

	Austria	Belgium	France	Ireland	Italy	Netherlands	Portugal	Spain	Sweden	UK
Insurance company employees	22%	2%	16%	20%	9%	26%	5%	-	28%	29%
Agents (tied and multiple)	4%	4%	8%	24%	20%	57%	13%	13%	-	-
Brokers	17%	24%	9%	55%	1%	-	2%	9%	19%	64%
Other networks (bank, post office)	55%	53%	61%		71%	17%	80%	67%	45%	-
Others	2%	18%	6%	3%	-	-	1%	11%	8%	6%

Source: European insurance in Figures, Complete Data 2002, CEA

> *"This is the main problem, marketing and distributing the product rather than the product itself."*[165]

15.47 Indeed, the Portuguese Association of Investment, Pension and Property Funds reiterates this point,

> *"90% of transactions are made at banks. This could be because the client knows he can talk to someone if problems arise. This accessibility is seen as a plus. The foreign providers that have had a physical presence have done better e.g. BNP Paribas, Barclays, Schroeders. This is due to being able to buy face to face and seeing the establishment of branches as a strong commitment to the Portuguese market which transmits confidence and peace of mind."*[166]

[164] Note that columns may not sum to exactly 100% due to rounding.

[165] Interview with the CMVM, 8th June 2004.

[166] Interview with the APFIPP, 9th June 2004.

15.48 In addition, UK fund providers also argued that distribution was a more significant issue than product terms regarding their entry into other markets.

15.49 Far from improving the ability to gain access to customers, it was thought that standardisation would have no impact on cross-border trade while access to distribution remains a problem. This was particularly thought to be the case because banks were thought unlikely to be prepared to distribute products which were in direct competition to their own products and which did not offer consumers additional choice (from which the banks could presumably gain some of the profits) i.e. if banks offered a standardised product, they would not be prepared to distribute the standardised product of a competitor which would be in direct competition to their own product.

15.50 There were conflicting views on the role of intermediaries in terms of assisting or hindering cross-border trade. Some countries saw them as lowering barriers to distribution, e.g. in Portugal, the Consumer Institute questioned whether the lack of financial advisers in Portugal was one of the reasons why there was little cross-border trade occurring.

15.51 However, in the Netherlands intermediaries were thought to represent an additional barrier to foreign providers since providers would need to be able to provide back office systems for the benefit of service to intermediaries.[167] Similarly, in Belgium, there was thought to be considerable dependence on intermediaries, and hence seen as important for foreign companies to access this network and that if they fail to do this insurance products from foreign providers will not be sold.[168]

15.52 It is not thought to be the case that simplified or standardised products will themselves impact the access to intermediaries for foreign providers. Instead it is thought more likely to be the case that foreign providers who have something different to offer are more likely to manage to obtain access to intermediaries

[167] Interview with the Dutch Association of Insurers, 14th May 2004.

[168] Interview with Association of Insurers, 7th June 2004.

compared to those who offer the same product features as domestic providers – this idea is developed further below.

15.53 However, in the longer term, simplified products could reduce the reliance of consumers on intermediaries circumventing any problems of foreclosure due to strong relationships between product providers and distributors.

Lack of local market knowledge

15.54 The Austrian Insurance Association (VVO) believes that one of the reasons for the lack of cross-border trade in, for example, motor insurance is that detailed knowledge about the local market is crucial, but difficult for companies from abroad to attain,

> *"The internal market for insurance products fails because of a lack of demand and because of foreign providers' lack of knowledge about local markets."*[169]

15.55 Standardised products in themselves, would not therefore overcome this barrier and it is thought that providers seeking to enter a market would need to acquire local market knowledge regardless of whether they were entering with a standardised or non-standardised product. Indeed, this also raises an additional point regarding the need for local market knowledge and the degree to which there are fixed costs associated with learning about a range of financial services products. For example, it may be the case that providers would be unlikely to establish in a different country on the basis of the development of one simplified or standardised product due to fixed costs of understanding local market conditions. However, if there were to be a range of simplified or standardised products, these fixed costs are shared across more products and hence entry may become more likely.

Service elements

15.56 The participants in a number of countries noted that the degree to which there was a service element involved in the product would impact the degree to which cross-border trade could be expected. For example with non-life insurance products, the issue of service was of importance and hence the threshold to overcome in order to buy, for example, home insurance from abroad was thought to be significantly higher than for life insurance. This is partly due to the uncertainties in the settlement process if a dispute between the provider and the policy-holder were to arise. For motor insurance, it may also be linked to the need to have a replacement car or access a network of garages at an early opportunity and a concern that foreign providers may not be able to provide such services. Hence standardising product terms alone, in the absence of standardising service elements may make consumers unwilling to purchase such products across borders. Similarly, the level of on-going service required in offering a product would impact the likelihood of entering a market for a provider regardless of whether the product itself was standardised or not.

15.57 Equally, claims with non-life products can arise with relatively high frequency, which means that the process needs to be easy to complete. By contrast, the majority of life-insurance contracts have investment underlying them and could therefore be based elsewhere as long as there is certainty that it can be redeemed at the end of the contract period.[170]

Transaction costs

Currency differences

15.58 It was noted in a number of countries that the introduction of the euro has removed a significant barrier to cross-border trade for those countries who are inside the euro-zone. However, there remained a concern that the introduction of simplification or standardisation would still face barriers due to exchange rate differences with those countries outside the euro zone. Indeed, standardised products would face this barrier in exactly the same way that non-standardised products would.

[169] Interview with the VVO, 2nd June 2004.

[170] Drawn from the interview with ISA. Although it should be noted that dealing with a difficult process based in another country may not be entirely desirable for the beneficiaries of life insurance policies and hence concerns about this may represent a similar barrier to trade.

Language

15.59 An additional barrier to cross-border trade that was discussed during interviews is that of language, although it is clearly a barrier that varies across the Member States and varies according to the respective languages of consumer and provider. For example, it was noted that French consumers go to Luxembourg because they understand the language and hence are able to understand the product (but implicitly that they may not be prepared to deal with providers operating in other languages).

15.60 Languages cause a barrier both for consumers seeking to purchase across countries, but also for providers who have to offer information and services in local languages.

15.61 Similarly, in Greece, language was also seen as a barrier to trade,

> *"Cross-border trade is free even now but there are significant language and cultural barriers".*[171]

15.62 It was thought that the introduction of a standardised product would not lower the barrier to trade that is due to different languages in Europe.[172] Standardisation in itself does not reduce the need to have documentation and customer servicing in the host language. Although it would be cheaper for providers if identical documents in French could be used in Belgium, France and Luxembourg (or documents in German used in Austria and Germany, or documents in English used in Ireland and the UK), such documents rely on more than just the products being standardised but also require standardisation in the information requirements or the sales process as well.

Lack of European clearing system

15.63 A particular barrier to cross-border trade that was highlighted during interviews in Ireland was that of the lack of a single clearing house across the euro zone. That is, it was noted that a cheque written in euros in one Member State would not

[171] Interview with the Bank of Greece, 13th May 2004.

[172] Interview with the French Banking Federation, 21st June 2004.

currently be accepted in another Member State also in the euro zone and it was believed that this had significantly dampened the benefits of a single currency.

15.64 However, it should also be noted that while other countries supported moves towards an automated clearing house across the euro zone, they would not want to see cheques as a payment instrument within this structure due to the paper based and "low-technology" type of payment it represents.

15.65 It was thought that not only did the lack of a European clearing system impact cross-border trade in bank accounts, but that it also has knock on consequences for other products. It was thought that this would be necessary before it would be possible for financial products to be highly traded across borders. It was not thought that simplified or standardised products would overcome this barrier or would speed the development of a European payments system.

Domestic government policies

Welfare provision

15.66 It was noted in the majority of countries that the provisions of domestic welfare states varied considerably across the EU. An implication of this is that the degree to which consumers would require particular products, especially third pillar pensions, varies between Member States as there is less need for individual provision if the state will provide sufficient income in retirement. Linked to this, the extent of the provision required will vary between Member States and the importance of private provision (and hence potentially the degree to which risk tolerance will vary) also differs across Member States.

15.67 Standards put in place would therefore have to take into account the local welfare provision which the consumer faced since recommendations to invest in a product are likely to be impacted by state provision. Hence, depending on their design, standardised products may be suitable for consumers in one Member State, but not in another suggesting that standardised products may not lead to additional trade compared with non-standardised products.

Tax

15.68 A similar issue that was raised in all countries was the implications of tax differences between countries. According to the Belgium Association of Insurers, tax advantages prevent cross-border trade because the tax advantages of life insurance are only realised if the products are bought from insurance companies in Belgium.[173] The Association of Insurance and Finance Intermediaries also maintains that there should be a harmonisation of tax advantages for life insurance that on a European level to increase cross-border trade.[174]

15.69 Indeed, most countries thought that tax, along with legal and other regulatory issues represented the most significant barriers to entry and something that would prevent standardisation or simplification from having an impact on cross-border trade,

> *"Heterogeneity between countries on legal, tax and regulatory issues means than attempting to use simplification to boost cross-border trade is not easy. Countries would need to deregulate in order to enable a boost in cross-border trade… Standardisation is one way to iron out anomalies across Europe, but the regulatory, tax and legal problems are much bigger"*[175]

15.70 However, tax differences were not always seen as an issue preventing cross-border trade. Indeed in Luxembourg, a different view was taken in which tax arrangements were typically seen as a factor that led to cross-border trade rather than as a barrier to cross-border trade i.e. Luxembourg participants believed that differences in tax arrangements was a differentiating factor enabling cross-border trade. In particular, it was noted that the general fiscal environment in Luxembourg is favourable for companies for subsidiaries to set up funds and hence considerable numbers of foreign providers have entered the Luxembourg market. Indeed, it is noted that a very high proportion of cross-border trade in mutual funds are Luxembourg domiciled funds. Thus standardisation of products that brought standardisation of tax treatment could actually have the effect of reducing the cross-border trade that currently occurs.

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[173] Interview with the Association of Insurers, 7th June 2004.

[174] Interview with Association of Insurance and Finance Intermediaries, 6th July 2004.

[175] IIF Interview, 11th May 2004.

Legal structures

15.71 In each of the Member States, legal structures were identified as a significant barrier to cross-border trade in financial services. This was the case across all of the product markets under examination. For example, according to the Spanish mortgage association, simplified products would not have any impact in the mortgage market across borders because of different legal systems relating to property ownership,

> *"[mortgages]…cannot grow across borders as the basic concept of property in each country would have to be changed."*[176]

15.72 However, despite this, standardisation was thought to have the potential for improving cross-border trade. The French Association of Insurers believed that instead of using simplified products to increase cross-border trade, a "26th regime" should be created. The "26th regime" would consist of a European self-standing legal scheme defining a general type of product regulation, and hence products could be traded cross-border using European regulations and standards whilst maintaining domestic standards. Therefore, this would have the advantage of reducing the barrier to trade that is caused by legal structures differing across the EU.

15.73 Similarly, the German Association of Private Building Societies argued that the introduction of an optional "European" harmonised legal framework (i.e. a 26th regime) for these "European" products could solve the problem of differences in legal structures. However, they were concerned that a European certification system (i.e. products that are simplified or standardised at a European level) should not reduce product variety. Furthermore, they also noted that it would be important to take care not to distort competition between different product types by providing a European certification scheme for one group, but not for others.[177]

15.74 Although this was seen as a benefit by some, others believed that having a European regime alongside domestic regimes would in fact add to complexity and

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[176] Interview with AHE, 19th May 2004.

[177] Interview with the German Association of Private Building Societies, 6th July 2004.

confusion among consumers who may not understand the relative merits of the two different approaches.

> *"Contract law would need to be harmonised before any product simplification could be attempted. If there would be EU-level contract law alongside the national laws it might be difficult for consumers to understand which law was better for them. It would be highly unlikely that contract laws could ever be harmonised across the EU as the countries with more extensive protection would not be willing to accept a reduced cover…How would consumers know whether European contract law was better than national law – this would make things more complicated and would not enhance consumer trust."*[178]

15.75 In addition, the French Association of Insurers believed that if standardisation was to be undertaken, then this should be done through using EU regulation rather than using Directives,

> *"We would end up with 25 different simplified products and not a unified European product. It needs to be done through a regulation."*[179]

15.76 Hence, although the potential exists for product standardisation covering legal structures to increase cross-border trade, there are dangers associated with this regarding the resulting clarity for consumers of how the standardised legal regime compares to what they are used to or expect.

Regulatory structures and standards

15.77 Generally, financial products that are sold cross-border must still comply with the laws of the resident buyer. This implies that companies need to create products that are specific to the countries in which they are sold. Simplified or standardised products alone would not change this.

15.78 Instead, the Luxembourg Ministry of Finance argued that an alternative to simplifying products could be to apply the producer country law to financial products. Thus they believed that consumers would benefit from a larger choice of products consisting not only of products complying with the local laws (i.e. with the laws of the country of residence of the consumers), but also of products complying with the producer country law.

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[178] Interview with FFIC, 30th June 2004.

[179] Interview with the Association of Insurers, 26th July 2004.

Consumer protection

15.79 An additional issue that was particularly raised in Finland and Sweden was the different levels of consumer protection that were to be found across Member States. Representatives in both of these countries maintained that the consumer protection standards were much higher in their own countries than in the majority of countries across the EU,

> *"The Finnish insurance contract law is very comprehensive and provides better cover than the equivalent European Acts. Since the contract law varies across the borders, it would seem that harmonisation of the law would be required or alternatively the EU would need to impose a Directive that would over rule national legislation. There is a worry in Finland that this might lead to weakening of the protection provided to Finnish customers"*[180]

15.80 It was also noted that the deposit guarantee system is different in each country hence there was a fear that either standardisation would lead to a reduction in the deposit guarantee compared to Finnish and Swedish products, or that it would lead to a confusion by consumers regarding what level of protection they were afforded. Hence although such standardisation may increase the potential for cross-border trade, the trade that actually occurs may not, in fact, be to the benefit of consumers.

15.81 The Netherlands Consumers' Association does not believe that simplification of products will increase cross-border trade because they advise their members to only buy products where it is clear that there is a strict regulation and supervision and it is impossible to know where and if supervision is a good as in the Netherlands. If cross-border trade is to increase, they argue that a European regulator should be created. [181]

Marketing differences

15.82 Marketing rules are seen as imposing a barrier to cross-border trade. In particular in Denmark it is seen as too expensive and cumbersome to produce specific marketing for each individual country so that it complies with specific national rules. It is believed that having common marketing regulations in the EU would

[180] Interview with FMoF, 29th June 2004.

[181] Interview with the Netherlands Consumers' Association, 5th July 2004.

also offer consumers a high degree of protection irrespective of the country of domicile of the company from which they receive advertising. Hence if standardised products brought with them standardisation of marketing rules and regulations then this could reduce barriers to cross-border trade for these standardised products in comparison to non-standardised products.

Money laundering requirements

15.83 Money laundering requirements were universally seen as a barrier to switching that have even stronger implications for cross-border trade,

> *"money laundering requirements are inefficient because 99% of people are honest and because the remaining 1% would find alternative, illegal, solutions in order to avoid those requirements."*[182]

15.84 This was thought to generally be a problem both for consumers seeking to purchase across borders, but also for companies seeking to provide products across borders. In general it was viewed as a fixed cost that prevented people from switching from one provider to another.

15.85 For banking products, problems with consumer identification when purchasing financial services products from abroad were raised (the acceptance of digital signature would help). The majority of interviewees did not believe that product simplification would be an important tool to facilitate cross-border trade where money laundering requirements were currently preventing trade since standardisation would do nothing to alleviate this barrier to trade.[183]

The benefits from standardisation

15.86 Above we have identified if standardisation would reduce the barriers to cross-border activity, however, even if standardisation is successful in reducing barriers we need to determine whether the benefits would outweigh the costs. This is not intended to represent a full cost benefit analysis but rather provide indications of the benefits to focus further discussion. The legislative or regulatory costs of imposing any such standardisation are not considered.

[182] Interview with ADUSBEF, 12th February 2004,

[183] Interviews with the BdB and the GDV, 10th May 2004.

15.87 In the interviews a number of arguments were made regarding where the benefits were likely to be highest. These depend upon a number of categories:

- The current level of cross-border activity;
- The difficult of implementing European legislation;
- Differences in benefits from retail financial services cross-border activity by Member States; and
- Differences in benefits from retail financial services cross-border activity by product.

The current level of cross-border activity

15.88 In a number of markets under consideration in this project, we may already be observing an appropriate level of cross-border activity. Credit cards were thought to be a good example of this. In many countries the market is relatively small, with a focus on other products, such as debit cards.

15.89 It is also worth noting that there is considerable standardisation in place in the credit card arena in which global credit card providers such as Visa and MasterCard enforce strict standards across the world.

15.90 In the largest credit card markets, we have already seen considerable foreign entry, with American credit card companies taking significant market share. Arguably, similar levels of entry are already seen in other Member States or will occur when the market is large enough to warrant it.

15.91 Standardisation of these markets would therefore be unlikely to bring significant benefits.

Different implementation of European legislation

15.92 One of the concerns expressed about using simplification or standardisation to increase cross-border trade was the scepticism that this would have any impact due to the observation that countries have differential implementation of European legislation which significantly weakens any benefits for cross-border trade.

> *"Standardisation would bring the confidence of knowing that minimum standards are the same…but implementation of previous directives differed and hence the implementation of standards could also differ"*[184]

> *"if standardised products were to be used, then standardised implementation would be needed as well"*[185].

15.93 Although the Portuguese Securities Market Commission (CMVM) did indicate that UCITS has brought some benefits for cross-border trade, it was argued that this was muted in its success by the differential implementation by the various different countries. In particular, the CMVM noted that the differential implementation of the UCITS Directives implied that aspects such as differences in asset valuation meant that trade was not yet straightforward.[186] Further, CMVM argued that the lack of tax harmonisation was likely to hinder the growth of investment funds despite the UCITS Directives.

15.94 Hence it was thought that standardised products alone would not bring benefits unless there was standardised implementation of the standardised products.

Previous European legislation on standardisation

15.95 There was further scepticism identified regarding the success of previous standardisation. For example, it was argued by the Bank of Portugal that some standardisation of consumer credit had been in place since 1990 (although this mainly related to information) and that this has had a very limited impact on cross-border trade. They therefore questioned whether simplification elsewhere was likely to have any impact.

15.96 In addition, the Portuguese Insurance and Pensions Funds Supervisory Authority observed that motor insurance was already very similar across Europe and yet consumers were not seeking to purchase that across borders. Further they noted that 150 life insurers had entered Portugal under the Freedom to Provide Services regulation, but few consumers are purchasing from them, thus it was unclear why a standardised life insurance contract would make a difference and why additional

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[184] Interview with Ausbanc, 19th May 2004.

[185] Interview with CICR, April 2004.

[186] Interview with CMVM, 8th June 2004.

insurers would enter the market beyond those already in the market from whom consumers were not currently purchasing products.

15.97 Similarly, in the life insurance sector, the Spanish union of insurance and reinsurance companies believed that the internal market did not work despite ten years of insurance directives partly because they had been implemented in different ways. However, they also argued that time was required to observe whether the most recent insurance related directives would have an impact as it may be the case that enough has already been done.[187]

15.98 However, considering the example of investment funds would seem to suggest that there were possibilities for cross-border trade. It was argued that this was likely to be due to the advantages of international diversification in investments.[188] Hence the benefits of standardisation of investment funds through the UCITS Directives may not be easily applicable to other financial services products if the success of that standardisation was due to the specific nature of those products in which international diversification was seen as an important characteristic.

Product design by legislation leads to a lack of innovation

15.99 In a large number of countries, there was a concern that the market should be left to design products rather than regulators designing them and that in particular, regulatory design of products would lead to a lack of innovation. This was a problem that was viewed as being acerbated when undertaken at a European level compared to at a national level (where it was already a substantial concern). Indeed, in a number of interviews the length of time taken to update the UCITS Directives was seen as evidence of this phenomena.

15.100 One concern is that legislative design could lead to the design of products that do not meet the needs of consumers generally because it is not done through a market driven process.

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[187] Interview with Unespa, 19th May 2004.

[188] Interview with BDP, 8th June 2004.

15.101 A second concern is that if there is a set of products that are designed and badged as simplified or standardised then this group could be set in stone and hard to change i.e. potentially unnecessary product boundaries could be crystallised. This could have the implication that consumers believe that each separate product with a standard is indeed a separate product that should not be seen as competing with other products. This could have particular implications given the similarities between unit linked bonds and investment funds in terms of meeting the same medium to long term savings need for consumers. Indeed this was recognised by the Sandler report in the UK which suggested that both should be included in the "medium term savings product". Similarly, this was noted as a concern in Finland in the SIVA report.

15.102 Therefore if standardisation is designed on a European basis, this could suggest that such a standard needs to be voluntary. Furthermore, it stresses the importance of ensuring that considerable effort is put into the product design to prevent issues of contagion into other product markets. That is, designing a standardised product for one particular product type could have an impact on a different product type (potentially because they both meet the same needs).

15.103 Finally, the apparent lack of success of previous European legislation, in particular the differential implementation, also led interviewees to doubt the true impact of simplified or standardised products on cross-border activity. In particular, there was concern that trade in UCITS funds reflected tax competition from Ireland and Luxembourg rather than a truly sustainable source of competitive advantage.

15.104 In a number of cases there was considerable concern that both standardisation and simplification could have a potentially negative impact on cross-border trade by stifling innovation and reducing differentiation between Member States (which may be the economic reason for trade occurring in the first place).

Increased competition in small countries

15.105 An additional argument that was made was that the benefits due to simplification or standardisation were likely to accrue to the smaller, rather than the larger, countries in the EU. For example, COVIP, the Italian pensions regulator did not believe that simplification at a European level would have a cross-border impact on large countries. The reason for this is that if standardisation is imposed, then large countries would gain any competitive benefits from national standardisation and the cross-border element would bring limited additional benefits. They argued that there would be more difference for small countries.

Illusion of cross-border trade

15.106 In a number of countries, the UCITS directives were held up as useful examples of standardisation that had helped to allow cross-border trade. Hence the Italian fund association, Assogestioni, noted that about 5-10% of the UCITS purchases are cross-border, which was considerably greater than the corresponding share in life insurance, which was estimated by them as being close to 0%,

> *"UCITS have had a positive impact, both in Italy and in Europe more generally…it signals that the product is the same stuff, regulators in other countries can't stop it"*[189]

15.107 Similarly there are around 1,000 foreign funds in Finland although it is thought that these are mainly invested in by institutions.[190] However, despite the positive impact, it was not clear that it was UCITS per se that had encouraged cross-border trade,

> *"It is hard to believe that UCITS was the driver of the market – hard to say that regulation drove the market."*[191]

15.108 Instead it was believed that the large players across Europe who were already operating cross-border were typically desiring more integration and wanting to operate across the EU and hence were attempting to drive the regulation.

15.109 It was also noted that the UCITS Directives allowed providers to have considerable flexibility in product terms despite the underlying standardisation and hence providers were not unduly constrained in the product offerings that could be made to consumers. This may suggest that the impact of standardisation of underlying, supply-side features may be very different to the impact of

[189] Interview with Assogestioni, 15th April 2004.

[190] Based on evidence from the interview with FMFA who indicated that data on the retail / institutional split was unavailable.

[191] Interview with FMFA, 28th June 2004.

standardisation or simplification of demand-side features which constrain the choice for consumers.

15.110 The UCITS example also raises a question as to whether additional standardisation is actually required for other investment based products. For example, both pensions and unit-linked life insurance can be based on UCITS funds and hence if standardisation has already occurred for the underlying investment it is not clear that from the provider side it is needed for the whole product as well. Although this may require competition in the domestic market to be working effectively for these gains to be passed onto consumers.

Product variation

15.111 Product variation was seen as potentially causing both a barrier to, and an opportunity for, cross-border trade. It was thought that in cases where it represented a barrier to trade then standardisation could bring benefits, but in those cases where product variation was actually driving the cross-border trade, then standardisation could actually reduce cross-border trade.

15.112 In particular, in Luxembourg it was noted that consumers from other countries seek Luxembourg based products because of the additional product features that are available from Luxembourg suggesting that trade is driven by product differentiation. Similarly, the Luxembourg Ministry of Finance argued that introducing a simplified product would not lead to more cross-border trade because consumers would not be attracted by a products that is offered in their domestic market. If this is in fact correct then this would suggest that standardised products would be likely to reduce cross-border trade, or at best have no impact.

15.113 Instead, they argued that consumers are attracted by differentiated products that can not be purchased in domestic markets. Furthermore, it is thought that companies would not have an incentive to market a simplified or standardised product cross-border given that higher profit levels would typically be expected for differentiated products.

15.114 It seems clear therefore that the degree of standardisation that would be imposed could have significant implications for the impact on cross-border trade. For example, if there was simplification across a range of product features such as proposed in the Sandler report in the UK, this would lead little scope for providers to differentiate their products. By contrast standardisation of underlying structures could still allow providers to offer differentiated tailored products to those who require them.

Small benefits to trade in small value products

15.115 A further point with regard to transactions costs is that there may be limited gains to be had either for consumers searching for foreign providers or for providers deciding whether to enter other markets if there are only very small potential benefits from trade to be accrued. For example, from the consumer perspective, Spanish interviewees thought it unlikely that cross-border trade would occur for low value purchases such as deposit accounts. It was argued that a very large difference in interest rates would be required for people to bother searching and switching across border. Similarly, in Greece it was noted that it is only material differences such as those between interest rates that can stimulate cross-border trade in financial products.

"Interest rate differences are what will stimulate cross-border trade."[192]

15.116 Furthermore, only a very sophisticated consumer would go through the trouble of comparing the rates to such an extent. Similarly, from the provider side, there would need to be the opportunity to make reasonable margins from offering a product in a foreign market. Alternatively, different product types could be used in competition with each other e.g. UCITS funds based on money market accounts could be used to exploit any differences in interest rates between countries.

[192] Interview with the Bank of Greece, 13th May 2004.

A summary of the merits of standardisation to encourage cross-border activity by product

15.117 Using the various categories of barriers to cross-border trade described above, we have examined the different products under consideration to identify whether there are likely to be benefits from cross-border trade. This involved considering whether each of the barriers imposed an important constraint on the particular product, and whether standardised products would reduce the barriers that were seen as currently preventing cross border trade from consumers purchasing this product across borders or providers entering new markets through freedom to provide services or freedom of establishment. Based on this approach we can therefore compare each of the products both in terms of the potential for standardisation to reduce the barriers to cross-border activity and whether this would result in material benefits.

15.118 In summary, we find that there are a number of products where the extent of the barriers to cross-border trade in retail financial services mean that standardisation is very unlikely to yield significant benefits. These include:

- Bank accounts – while physical access to a distribution system remains an important component of consumer preferences, standardisation would be unlikely to increase cross-border activity. Hence until a significant proportion of consumers are willing to use bank accounts through only remote channels, this suggests that the cost of developing or accessing a distribution network for providers is likely to remain a more important barrier than the standardisation or otherwise of the underlying product. This makes consumer purchase, freedom of services and freedom of establishment problematic.

- Pensions – standardisation may be able to overcome issues regarding consumer protection and marketing differences. However, even if tax and annuitisation rules could be over come through product standardisation, the credence nature of products means standardisation is likely to be insufficient to encourage cross-border activity other than for very sophisticated consumers. Again this would appear to reduce the potential for trade via consumer purchase, freedom of establishment or freedom of service.

- Financial advice – it is very difficult to see how financial advice can be standardised when it is inherently dependent on local issues such as the whole range of products available in the local market, the tax environment including the different tax regimes on all products etc. Cross-border trade in financial advice is likely only to be possible if there was a range of standardised products (which was available in all Member States) and then it would need to be limited to that range. Financial advice is also likely to remain face to face for the foreseeable future meaning only freedom of establishment is likely to a meaningful way forward.

- Motor insurance – although products are perceived as simple, since they are fundamentally linked to the domestic legal system, a system such as the 26th regime would be necessary to facilitate cross-border activity. Standardisation alone cannot encourage further cross-border activity. Freedom of establishment remains the most likely route to cross-border activity.

15.119 There are other products where the barriers to trade appear relatively small and cross-border activity may be at an economically efficient level already:

- Collective investment schemes – the UCITS Directives have clearly already brought about cross-border activity through a degree of standardisation being imposed on the underlying features of the products. It is unclear that there are additional gains to be made that are linked to standardisation of the product.

- Credit cards –there is already a large extent of standardisation in credit cards across Member States and furthermore, there has been considerable cross-border activity into the larger credit card markets suggesting that cross-border trade is not being prevented but rather than the size of the market is determining the level of trade.

15.120 However, there are a number of products where standardisation might increase cross-border activity and a cost benefit analysis is required to investigate whether the benefits are likely to outweigh the costs

- Deposit accounts – the importance of physical proximity is likely to recede more quickly for deposit accounts than with bank accounts implying that apparent differences in interest rates on deposit account may offer the opportunity for cross-border arbitrage.

- Life insurance – there is an opportunity to encourage trade in simpler life products, such as unit-linked life insurance and term assurance. However, domestic brands are likely to remain pre-eminent in traditional or guaranteed products. Indeed, given that unit-linked bonds are essentially comprised of simple term products and UCITS-like funds it would be surprising if it was not possible to design a product that could be traded. However, if there is a competitive market for insurance products and trade in UCITS and term assurance, the benefits may already have been exploited.

- Home insurance – although these is significant variation in the product features required in different countries and the resulting prices that will be offered to particular consumers, setting minimum terms and conditions may allow more certainty for consumers regarding product coverage and may help facilitate cross-border trade through freedom to provide services. However, local knowledge may still be required to understand the risks faced by insurers (although understanding risk could be outsourced). Further, there is considerable uncertainty that the benefits from negotiating such standards would justify the costs.

- Mortgages – For the time being consumers in many countries need physical distribution. This is likely to prevent standardisation realising substantial benefits from freedom of services or consumer purchases. In countries where mortgages are facilitated through brokers cross-border trade appears to be possible. There do appear to be a number of legal issues that would need to be overcome to make a standardised mortgage product feasible, in addition providers will need to understand local housing markets in order to be in a position to offer mortgages at economic rates. However, any economies of scale in mortgage financing may be facilitated through increasing mortgage securitisation reducing the potential gains from trade from future standardisation.

Annex 1 Interviewees

A.1 This section lists all of the interviewees who participated in the project. Interviewees are listed by institutional name in the local language, English translation (where applicable), abbreviation used in report, and country.

Asociación de Usuarios de Bancos, Cajas y Seguros, Association of users of banks, savings banks, and insurance, ADICAE, Spain

Asociación de usuarios de servicios bancarios, Association of users of banking services , AUSBANC, Spain

Asociación Española de Banca, Spanish Bankers Association, AEB, Spain

Asociación Hipotecaria Española, Spanish Mortgage Association, AHE, Spain

Associaacao Portuguesa de Seguradores, Portuguese Insurance Association, APS, Portugal

Associaçao Portuguesa de Fundos de Investimento, Pensoes e Patrimónios, Portuguese Association of Investment, Pension and Property Funds, APFIPP, Portugal

Association Belge des Banques (Febelfin is the umbrella organisation), Belgian Bankers' Association, ABBL/Febelfin, Belgium

Association des Compagnies d'Assurance du Grand-Duche de Luxembourg, Association of Luxembourg Insurances, ACA, Luxembourg

Association des Banques et Banquiers, Luxembourg Association of Banks and Banquiers, ABBL, Luxembourg

Association Luxembourgeiose des Fonds d'Investissement, Association of the Luxembourg Fund Industry, ALFI, Luxembourg

Associazione Bancaria Italiana, Banks' Association, ABI Italy, Italy

Associazione Difesa Utenti Servizi Bancari Finanziari Postali e Assicurativi , Consumer Association, ADUSBEF, Italy

ASSOGESTIONI, Mutual fund association, Italy

Autorité des Marchés Financiers, Financial Markets Authority, AFM, France

Autoriteit Financiele Markten, The Netherlands Authority for Financial Markets, AFM, The Netherlands

Banco de España, Bank of Spain, BDE, Spain

Banco de Portugal, Bank of Portugal, BDP, Portugal

Banque de France, Bank of France, Banque-France, France

Bundesanstalt für Finanzdienstleistungsaufsicht, Federal Financial Supervisory Authority, BaFin, Germany

Bundesministerium der Finanzen , Federal Ministry of Finance, BMF, Germany

Bundesministerium für soziale Sicherheit, Generationen und Konsumentenschutz, Federal Ministry of Social Security, Generations and Consumer Protection, BMSG, Austria

Bundesministerium für Verbraucherschutz, Ernährung und Landwirtschaft, Federal Ministry of Consumer Protection, Food and Agriculture, BMVEL, Germany

Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, Federal Association of German Co-operative and Raiffeisen Banks, BVR, Germany

Bundesverband deutscher Banken , Association of German Banks, BdB, Germany

Bundesverband Investment und Asset Management, Federal Association of Investment and Asset Management, BVI, Germany

Comisión Nacional del Mercado de Valores, Spanish Securities Commission, CNMV, Spain

Comissao do Mercado de Valores Mobiliarios, Portuguese Securities Market Commission, CMVM, Portugal

The secretariat of the Comitato inter-ministeriale per il Credito e il Risparmio, Cross-ministry committee on credit, CICR, Italy

Commissariat aux Assurances, Commissariat for Insurance, Luxembourg

Commission Bancaire Finacière et des Assurances, Belgian Banking, Finance and Insurance Commission, CBFA, Belgium

Commission de Contrôle des Assurances des mutuelles et des institutions de prévoyance, Commission for the Control of Insurances, CCA, France

Commissione di Vigilanza sui Fondi Pensione, Pension Funds Regulator, COVIP, Italy

Confédération Logement et Cadre de Vie, Association for the Defence of the Consumer, CLCV, France

Consumentenbond, Netherlands' Consumers' Association, The Netherlands

Consumers Association of Ireland, CAI, Ireland

Deutscher Sparkassen- und Giroverband, German Savings Bank Association, DSGV, Germany

Dirección General de Seguros y Fondos de Pensiones, General Directorate of Insurance and Pension Funds, DGSFP, Spain

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Annex 3 Glossary of abbreviations

A.3 A range of abbreviations has been used in the course of this report and they are listed below.

AFUB, Association Française pour les usagers de banques, French Association for bank usage

AK, Arbeiterkammer, Workers' Chamber

AltZertG, Altersvorsorgeverträge-Zertifizierungsgesetz, Act on the Certification of Old-Age Provision Savings Contracts

AMF, Autorité des marchés financiers, Authority for the Financial Markets

APR, Annual Percentage Rate

AS (Funds), Altersvorsorge-Sondervermögen Fonds, Old Age Provision Special Assets Funds

ATM, Automated Teller Machine

AVMG, Altersvermögensgesetz, Act on Old Age Capital

BAV, Bundesaufsicht für Versicherungen, Insurance Supervisory Authority

CCMIP, Commission de Contrôle des Mutuelles et des Institutions de Prévoyance, Commission for the Control of Insurances

CDGF, Conseil de Discipline de la Gestion Financière, Council for the Discipline of Financial Management

CEL, Compte d'épargne populaire, Popular saving account

CIB, Centre d'Information Bancaire, Banking Information Centre

CIF, Conseiller en investissement financières, Financial investment adviser

CLCV, Confédération Logement Cadre de Vie, Consumer Association

CMF, Conseil des Marchés Financiers, Council for the Financial Market

COB, Commission des Opérations de Bourse, Commission for the operation of the stock market

CODEVI, Compte de développement Industriel, Saving account for industrial development

DIA, Deutsches Institut für Altersvorsorge, German Institute for Old Age Provision

ESIS, European Single Information Sheet

FCP, Fonds Communs de Placement, Investment funds

GERP, Groupement d'épargne retraite populaire, Association for the People's Pension

INC, Institut National de la Consommation, Assocation of French Consumers

KonSchG, Konsumentenschutzgesetz, Consumer Protection Act

LEP, Livret d'épargne populaire, People's saving booklet

PEA, Plan d'épargne en action, Savings plan in stocks

PEE, Plan d'érpargne entreprise, Company saving plan

PEL, Plan d'épargne logement, Property saving plan

PERP, Plan d'épargne retraite populaire, People's retirement plan

PIF, Pensionsinvestmentfonds, Pension Investment Fund

PPESV, Plan partenarial d'érpargne salariale volontaire, Voluntary partner salarial saving plan

PZV, Pensionszusatzversicherung, Complementary Pension Insurance

RechKredV, Verordnung über die Rechnungslegung der Kreditinstitute und Finanzdienstleistungsinstitute, Regulation on Accounting of Credit Institutes and Financial Services Institutes

SCHUFA, Schutzgemeinschaft für allgemeine Kreditsicherung, Association for General Credit Protection

SICAV, Société d'Investissement à Capital Variable, Open-ended investment funds

TEG, Taux effective global, Global interest rate

TER, Total Expense Ratio

UCITS, Undertakings for Collective Investment in Transferable Securities

UFC, Union Fédérale des Consommateurs, Federal Association of Consumers

WpHG, Wertpapierhandelsgesetz, Securities Trading Act

ZKA, Zentraler Kreditausschuss, Central Credit Committee

ZV, Neue Zukunftsvorsorge, New Future Provision (new government premium scheme for private pensions since 2003)