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"ACHIEVING GREATER OPERATIONAL EXCELLENCE IN THE CURRENT INSURANCE ENVIRONMENT"

SPEECH TO DELEGATES

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"<u>DEVELOPMENTS IN U.K. REGULATORY STRATEGY AND IMPLICATIONS FOR NEW MARKET ENTRANTS</u>"

Good morning, ladies and gentlemen. It gives me particular pleasure to be here this morning, some thirteen years since I was last here as a member of the audience. A great deal has happened in the UK, and international, financial services scene since then.

As the concluding presentation in the program, I'd like to focus on some of the significant developments under way on the UK stage and attempt to advance our understanding of what these might mean for the future. Necessarily, anyone attempting to do this in the time we have this morning can only do so at the highest of levels. I should also emphasise that the views expressed are mine alone. Naturally, I'll be happy to conduct further, more in-depth conversations separately.

We will consider the current high level regulatory environment in the UK, examining what might be driving regulatory policy, current government perceptions and consumer agendas. We will also, briefly, look at the agendas coming out of Europe, consider the impact of two specific initiatives around the fair treatment of customers and pension "simplification" and attempt to draw some broad conclusions for those currently in, or considering entry to, the UK market.

First, the regulatory environment. Until the beginning of this year, regulation applied only to investment business, long term insurance and advice on these areas. It's scope, driven by the UK interpretation of the Insurance Mediation Directive, has now been extended to mortgages and short term personal insurances (general or property and casualty insurances). So, the coverage of regulation has become much more comprehensive, and there is likely to be more on the way. Proposals are being considered to regulate Self Invested Personal Pensions, for example.

The Financial Services Authority (FSA) has signalled its intention to move away from the current "prescriptive" style of regulation, where a rule book specifies what can, and can't, be done, towards "principle" based regulation. This refers to the eleven high-level principles enshrined within the FSA's remit by the legislation. We'll be returning to this theme shortly.

From Government, we see legislation that will radically simplify the rules for personal and private pension provision from 6th April 2006, reducing the current eight separate regimes to just one.

From Europe, we see a continuing drive towards a single market in financial services, of which the Markets in Financial Services Directive (MIFID) is part.

All this, on paper, sounds good news.

However, great strains have been placed upon the UK regulator as a result. The workload has increased exponentially, out of proportion to the limited additional budget made available, now that the general insurance sector and the mortgage market are regulated. It is perhaps no surprise, then, that the move to "principle" based regulation has been announced. This has the effect of returning responsibility for determining what is "compliant" in any given situation to the regulated community.

However, while all this has been going on, scandals have continued to emerge from the industry in the UK. One example is that of "precipice" investment bonds. These are extremely complex vehicles launched from the late 1990's onwards, which were marketed as having a performance "guarantee". Their underlying structure depended, in fact, upon continued positive stock market performance. As this did not materialise, clients were left holding serious losses. Some prominent distributors went out of business as a result and the matter has left yet another sour taste in the mouths of UK consumers, some of whom accused the FSA of being "asleep at the wheel".

The FSA has, in my view, often found itself between a rock, and a hard place, in attempting to reconcile the demands of government, consumers, industry and the restrictions of its own remit. An example can be found in the attempt to introduce "simplified" advice to support sales of the simple products proposed by the Sandler review of the UK long-term savings market a few years ago. The principled inability of FSA to remove the operation of this proposed regime from the Conduct of Business rules and the Ombudsman system made it's viability to providers largely unsafe.

We have been treated in recent times to the Prime Minister, no less, backed up by his Chancellor (whose creation the FSA is) criticising the regulator as a "restraint of trade". This contrasts strongly with the mood music coming out of, for example, the Treasury Select Committee, which spent much of the pre-election year lambasting the CEOs of product providers in public session. This seemed to project a government view of a bloated, complacent industry in need of root and branch reform.

Strangely, the industry seems also to be seen as a potential "milk cow" with proposals to tax the estates (known as "orphan estates") often currently used to back up With Profits funds or to provide operating liquidity. This is the latest in a series of potential, or actual, raids over recent years.

There remains an apparent agenda to force change, an agenda backed up by consumer perceptions.

These have been moulded by a wide range of adverse impacts. The most notorious has been the near collapse of Equitable Life, trapping thousands of policyholders, as they would see it, in an environment of reduced pension payouts and swingeing penalties for anyone trying to leave the fund. From previously iconic status, it is, in my view, hard to over estimate the negative effect this episode has had on the view of the UK consumer towards the current crop of long term savings providers. It is estimated that around two thirds of then Members of Parliament were customers at the time Equitable first ran into trouble. We have already considered Precipice Bonds, but there are other trouble spots such as Endowment Mortgages. The massive cost of the recently-completed review of personal pension sales has eroded capital within the industry badly, as have the falls in equity markets. There is accordingly, a consumer mistrust of existing brands and propositions which has resulted, at least in parts, in falling sales volumes.

The basic consumer needs remain, however, and there is a broad consensus around the savings, pension and protection "gaps" in the UK as being substantial and, probably, growing.

The UK response to the EU Financial Services Action Plan could perhaps be fairly stated as slow to get off the ground and, in some cases such as IMD, to have been overweight once recognised. Why has this happened? My own theory, as one trained in Scottish law, a system based upon Roman law, is this. When I read a Directive, it speaks to me of broad situations and overall desired outcomes. It does not attempt, over hundreds of pages, to prescribe what should happen in specific circumstances. However, this is precisely the approach historically taken by UK legislation under English law, an approach replicated to date in the Conduct of Business rule books published by the FSA, which currently has 40 staff working hard on level 2 of the Markets in Financial Instruments Directive (MIFID). It is simply a head-on clash of two legal systems with different philosophies.

However, there are signs that this situation is improving, with far better, multi-level, engagement with proposed Directives across the UK industry, and a realisation that it is not necessary to "gold plate" every Directive.

My own reading of MIFID is that it is largely liberal in nature and that the reliance on "home state" regulation for cross-border sales could well be beneficial. There is a danger of regulatory arbitrage, but my view is that the provisions of the Directive will form a "floor". How high the UK regulatory system is currently above that "floor" in comparison with other member states is a matter for debate, and it will be interesting to see how far the existing Conduct of Business rule books are rationalised. Perhaps it is too much to hope that they might be abandoned altogether in a combination of the impact of this and "principle based" regulation?

The first prototype of "principle based" regulation can be found in the FSA's recent papers on "Treating Customers Fairly". This is presented as an amplification and articulation of behaviour already required by the sixth of the eleven principles for the conduct of business in the UK. Paradoxically, it has created some nervousness in the regulated community because, as indicated earlier, it places the onus for compliance back on them, rather than having a box-ticking approach. They must decide, given their own business circumstances, what is appropriate in the context of "fair treatment" what is right for them and their customers.

The FSA has clearly stated that it expects to see "cultural change" in UK financial services as a result of this initiative. This resonates with the government agenda referred to earlier and is informed by recent mis-selling scandals involving complex, opaque products.

It will affect ALL business areas within UK financial services and will particularly require a review of current management information and the way in which this is used, once obtained, by the Board in setting priorities for the business in relation to customers. Changes to the marketing of products are likely to be required. A strong current area of focus is around the traditional use of Independent Financial Adviser firms for the sale of complex products such as in-retirement income vehicles. How will the provider firm be sure that the sales, and after sales, processes of these firms deliver fair customer treatment? How will they avoid damage to their brand when things go wrong? There is more work to do here, but more than one commentator has suggested that a return to direct distribution could result over time.

Whatever the result it is the clear intention of the regulator that, as far as possible, never again should the inappropriate sale of complex products result in consumer detriment. In my view, there is a policy objective somewhere to ensure that a deep pocket is put behind every such sale – although that is, of course, pure speculation on my part!

And now, a very quick look at another area of government intervention in recent times – the UK pensions market, or at least the privately provided part of it, whether Group or Individual. I have already referred to the date for "simplification" of the existing regimes, known in the UK as "A" day. However, there are other significant interventions such as the recent creation of a Pension Protection Board broadly modelled on US lines following some high profile failures of under-funded Defined Benefit pension schemes following the insolvency of the sponsoring employer. This aims to provide an underpin to scheme arrangements that will at least leave current and deferred pensioners with something to live on other than state benefits. It will be funded by a levy on existing, open, schemes. My personal view is that it is likely to accelerate the already steep rate of decline in provision of Defined Benefit schemes in the private sector, as will be shown in the following charts.

However, the changes on “A” day are massive, fundamental, and will, as one national newspaper put it, open up “New Pension Freedom for Millions”. This is one headline that I would, for once, agree with! It will also lower the barrier to entry as a provider in the pensions market, previously largely the domain of insurance companies. Change, as ever, opens opportunities. In this case, these opportunities will need to be supported by technology-based solutions, given the track record of the existing industry players in some cases. The scale of change is presented in the charts, and I will make no further comment on them.

So, what are the implications of all this?

There can be no doubt that the existing UK financial services industry has sustained a lot of “hits” in recent years. These “hits” have weakened both consumer confidence and the capital structures of providers. However, in my view, the regulatory burden is likely to ease in coming years through pragmatic as well as policy considerations. This will make it relatively easy to enter the UK and, by implication, European, markets at a time of structural change. These changes will see further consolidation amongst providers and distributors, with many more of the former closing to new business. In 2000, there were £6bn of funds under management in closed life companies. That figure is now £200bn and is forecast to reach £400bn by 2010.

This shrinkage of capacity will tend to raise margins and provide opportunities to new entrants to the market, <u>provided</u> they read the policy and regulatory signals correctly.

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