

Submission to the Irish Financial Services Regulatory Authority

- Review of the Marketing & Sale of Trackers (Consultation Document CP3)

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Submission prepared by Duncan Robertson BSc FFA FSAI for and on behalf of Boal & Co (Ireland) Ltd.

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1. Introduction

1.1. Background

The Irish Financial Services Regulatory Authority (IFSRA) have received queries and complaints about the complexity and possibly misleading nature of Tracker Bonds. In light of this IFSRA are considering developing a Code of Conduct in relation to the advertising and marketing of these products.

To facilitate this IFSRA have issued a consultation paper (CP3) to review the Marketing and Sale of Trackers and have asked for submissions from interested parties. These submissions should address the 20 issues set out in the consultation paper.

1.2. Boal & Co

Boal & Co (Ireland) Ltd is the Irish member firm within Milliman Global, www.millimanglobal.com. Milliman Global is an international organisation of actuarial and consulting firms represented in major countries and principal cities worldwide, employing more than 2,600 people, with over 100 offices in

33 countries.

Boal & Co is a recognised product expert in the cross border insurance market and has been advised both insurers and intermediaries in this market. Boal & Co is currently Appointed Actuary to three Irish IFSC (i.e. cross-border) insurance companies and as part of this role is required to design, price and sign-off new product developments and product literature.

Duncan Robertson joined Boal & Co in November 2003. Prior to joining Boal & Co Duncan was Head of International Product Development for Abbey National's international insurance operations with responsibility for the product strategies of three insurance companies – Scottish Provident Ireland, Scottish Mutual International and Scottish Provident International. Duncan joined Scottish Provident in 1991 and moved to Ireland as Scottish Provident Ireland's Product Development Actuary in 1998.

Whilst Boal & Co employs qualified actuaries with significant product experience in both the domestic Irish and international markets, Boal & Co itself is not Appointed Actuary to any domestic Irish insurer, nor has it provided any consultancy advice to any insurers or industry bodies within the domestic Irish market. The comments and suggestions in this submission have no agenda to follow or positions to protect, and we would hope that IFSRA therefore find our perspective interesting and constructive. Boal & Co would be delighted to discuss further with IFSRA any issues raised within this submission.

2. Submission

A. Costs and Charges

2.1. Fees Paid

Please consider how the fees are paid or received and let us know what their effect is on the value of the investment both initially and ongoing.

The investor should be made aware of charges within the product. Charges should be regarded as anything that effectively takes income from the investors pot of money. These provide a drain on the returns that the investor would otherwise receive (if no charges existed). The investor should be in a position to know what the impact of these charges are on the return that they will receive.

The detail of how charges are taken and the impact of these charges at various stages of the life of an investment will be of interest to some investors. However for the majority of investors the provision of such information is likely to lead to information overload. Indeed those very investors who wish to know exactly how charges are taken are likely to be the more financially literate and, all else being equal, probably in less need of the disclosure protection.

It is my suggestion that the investors are provided with two numbers each of which represents the total charges within the product:-

- a) The charges over the life of the contract should be represented as the equivalent of a once-off initial charge. This measure would be described along the lines of effectively representing the part of the investors initial money which is not being invested.
- b) The charges over the life of the contract should be represented as the equivalent of an annual

percentage of fund charge. This measure would be described along the lines of effectively representing the annual drain on the returns provided by the investment.

These measures are of course a simplification of what might be complex charges, and therefore will be open to criticism for being over-simplistic. However I would view the down-sides of over-simplification more than made up for by the increased likelihood of awareness that individuals will have on the quantum of product charges.

The actual identification of charges, on which then to calculate the above measures, is not a trivial exercise. Charges which involve cashflows between parties, whether internal or external to a group of companies, will be easier to identify. However a difficult area will be the identification of charges contained within the ultimate financial instrument designed to provide the tracker bond returns. Charges can effectively be taken within this instrument simply through offering less attractive terms. In addition to posing a fundamental problem in itself, it does, if not tackled, provide the opportunity for a non level playing field between those providers who can manufacture the underlying investment vehicle within their group of companies and those that cannot. This area will require further discussion. At this stage of the consultation it is probably sufficient to be aware of the issue.

2.2. "Lock-in" provisions

We propose that "lock-in" provisions on Trackers are clearly disclosed in product documents. Please tell us what you think is the best way to implement such disclosures.

I agree that "lock-in" provisions should be clearly disclosed in product documents. I would however be wary of treating the reduced growth potential associated with these lock-ins in any different manner than any other part of the tracker bond design. There is a danger that if "lock-ins" are singled out that other equally significant (in terms of impact on growth potential) features will be introduced.

I therefore suggest that all product features are described appropriately, both upsides and downsides, and that any illustration of potential returns from a product adequately incorporate the effect of the product features.

B. Disclosure

2.3. Dividends and interest income

How should the treatment of dividends and interest income be disclosed in Tracker documents to ensure that investors are informed about how they will affect the returns they may earn on the Tracker?

Documentation should make it clear whether the index, or share price, on which returns are based does or does not include dividends (or interest payments). Any illustration of potential returns from a product should, if appropriate, adequately incorporate the effect of non-receipt of dividends.

IFSRA may wish to consider whether investors should be provided with more explicit information on the impact that loss of dividends can have on returns from equities. I would suspect that many investors are unaware of the importance of dividends on overall returns. For example perhaps providers should state a current consensus view on the typical returns that might be expected from equities where dividends are excluded. This is probably useful information. However I would caveat it by saying that it should be considered within the context of all other disclosures to avoid information overload.

2.4. Disclosure of death benefit provisions

What are your views in relation to the disclosure of death-benefit provisions in Tracker documents? How should the costs associated with the provision of this benefit be disclosed to investors to ensure clarity?

The impact on the investment of the death of the investor (or insured life for life assurance policies) should be clearly stated within product literature. The costs of any death benefit provisions should be identified separately as an additional "insurance premium" charge within whatever method of disclosing charges in general is adopted by IFSRA.

2.5. Reference to guarantees

Should the requirements about references to guarantees in advertising that currently apply to investment firms, be applied to all providers of Trackers? If the guarantee is partial, should any additional or more prominent disclosures be made? How should the impact of early encashment (if permitted) on the guarantee be disclosed?

It is an interesting observation that Investment Firms can only call something a guarantee when a third party provides the guarantee and that traditionally insurance companies have only called something a guarantee if the guarantee is provided by the insurance company themselves! What this does demonstrate is that there should be one approach for all providers, whether they be banks, insurers, building societies etc.

The important thing for an investor is to know who is providing the guarantee. The investor then needs to be given some idea as to the credit worthiness of the company providing the guarantee. It is likely that AA+ and Aa2 will have little meaning to most investors so instead (or perhaps as an additional item) I suggest that IFSRA provides suitable terminology depending on the credit rating provided by independent agencies. For example simple words like "Very Strong", "Good", "Weak" etc. rather than quote the letters.

The level of the guarantee should be made very prominently. As a solution for addressing partial guarantees IFSRA may wish to consider whether the "least" that an investor might get back, or the most that can be lost should be clearly stated. If appropriate it is essential that investors clearly understand that guarantees do not apply on early encashment. Indeed, if appropriate investors should be clearly warned of the risks on early encashment of getting back significantly less than the money invested.

2.6. Third Parties

How should disclosures about third parties be made in product documents?

The parties providing the growth potential and the guarantees within a Tracker product should be disclosed. If these are third parties then they should be clearly identified in product literature.

2.7. Front page of Tracker document

What do you think about our proposal to include this statement on the front page of any documents issued to promote Trackers: "This investment cannot be encashed prior to the expiry of the period of the investment instrument" where this is the case?

When early or partial encashment is allowed we propose that details of any penalties that apply to such encashments should be provided. These should set out the actual penalties or the method for calculating these penalties.

I agree with the sentiment of the statement regarding inability to encash early, however I believe that it would be preferable to use more simple language than "encashed" and "investment instrument".

Where early encashment is allowed I agree that the method for calculating the value that will be paid out should be clearly explained. (I would concentrate more on the amount paid than the penalty applied.) Within the methodology there should be no room for discretion.

2.8. Suitability of Investment

We also propose that Tracker documents should clearly state that the investment is not suitable for the provision of regular income.

I agree with this in general but would point out that there may be occasions in the future where a Tracker is designed for the purpose of being suitable for regular income. I therefore suggest that the above proposal is adopted in the majority of cases but that the statement can be omitted if the provider is satisfied that it can be clearly shown that the product is suitable for the provision of regular income.

2.9. Currency Risk

How should currency exchange risk be disclosed to consumers?

Where currency risk exists in a product then the product literature should clearly state that the risk exists and provide some quantification on the extent of the risk. Some sample wording from IFSRA may be useful in this regard.

2.10. "Averaging"

What do you think about our proposal that where "averaging" is provided for, it should be fully disclosed how rising and falling markets will affect the investment? Details of any costs involved should also be revealed in product documents.

My comments on "averaging" are similar to those on "lock-ins" above.

I agree that "averaging" should be clearly disclosed in product documents. I suggest that all product features are described appropriately, upsides and downsides, and that any illustration of potential returns from a product adequately incorporate the effect of the product features.

C. Documents issued to clients

2.11. Standard Note

Should a standard contract note or confirmation be specified for Trackers which must be provided to any consumer investing in such a product?

I think that there would be great value in IFSRA specifying the information that **must** be included in a contract note, and providing guidance on the wording and format of that information. For some information it should be sufficient for the guidance to be general principles whereas there may be other information where it will be more appropriate for the guidance to be prescriptive.

I would be wary of a complete standard contract note being specified by IFSRA. There is a danger that this would err on being too "rules based" in nature with all the problems that rules based regulations are exposed to e.g. stifling innovation, creating an environment where providers play the rules.

2.12. Full set of terms

Should a requirement be introduced specifying that a full set of all terms and conditions be issued to consumers when they invest in a Tracker.

Yes. I would regard this requirement as a given.

D. Projections and past performance

2.13. Information about growth and return

How might information about projected growth or return on Trackers be presented to give a useful indication as to the probability of a particular return being achieved?

It is clearly important that any information on projected growth or return helps to aid, and not mislead, the investors understanding on the investment potential of the Tracker.

The fullest information will be achieved by presenting the probability distribution of the returns from the Tracker. However there is a real danger that this information will be difficult to interpret and may confuse rather than aid the investor. I therefore suggest that the solution is to find simple methods, which an investor may understand, for presenting the complex probability distribution.

It is a non-trivial task to identify these simple methods and there is no absolute correct approach. At the foot of this section I have set out some ideas which IFSRA may wish to consider, however these are only starting points. This area is worth further discussion.

It should be noted that whilst the probability distribution is subjective - there is no one correct answer – different experts will probably arrive at similar answers i.e. I would expect two experts to arrive at roughly the same conclusions on the likely probability distribution even if the exact numbers were slightly different. To encourage like for like comparison it may be useful for IFSRA to provide guidance on the parameters etc. that they would regard as reasonable within the derivation of probability distributions.

It is clearly imperative that a provider has a very good understanding of the likely distribution of returns. If a provider doesn't understand the likely returns on the product then what hope is there on them helping the investor to understand the product. This is an area which IFRSA may wish to consider further.

It should not be permitted to quote example returns in product literature which are unlikely to be achieved in practice. This could be set at some percentile, e.g. the provider is not allowed to quote returns greater than the, say, 66th percentile of returns. (The exact percentile is a matter for further discussion.) However care is needed here as there is a danger that providers will start developing products which focus on maximising this, say, 66th percentile number.

Finally I would regard it as a given that any projected returns should make full allowance for charges within the product.

Some measures to help understand the probability distribution

1. The investor should be informed of the worst case scenario.
2. The investor should be informed of a range of likely returns that a product may return. Care

should be taken not to use "average" or "mean" return where this measure does not accurately describe the probability distribution. This problem occurs in distributions where the upper and/or lower extremes of returns are very significant. For example imagine a Tracker which returns 0% or 200% and nothing else. Quoting an average return of 100% is not particular helpful. Therefore in quoting a typical return a "median" may be more useful or perhaps quoting a range using the 45th and 55th percentile. The presentation of these number should use simple language such as say "typical range of expected returns" rather than using probability jargon.

3. The investor should gain an understanding on the spread of likely returns. This could be achieved through incorporating the standard deviation of returns into a measure. For example the co-efficient of variation which equals the standard deviation divided by the mean. This measure could be translated into some terminology which an investor might understand. For example co-efficient of variation in excess of a certain amount could be described as "risky - product provides a wide range of both low and high returns", whereas a co-efficient of variation less than a certain amount could be described as "not risky – product provides a range of returns close to the quoted likely returns". IFSRA could set guidance on the terminology to be used for different levels of the "measure of spread".

Note that the above measures are neither perfect nor exhaustive of the different possibilities however I hope that they provide a sense for the extent to which complex probability measures can be expressed in simple to use language which would be of help to an investor in understanding the projected investment return profile of a Tracker product.

2.14. Should "back-testing" be prohibited

Would it be appropriate to prohibit the use of "back-testing" in Tracker promotions?

Yes. If used correctly back-testing can be very informative, however there are two many dangers of designing products that "play" on past returns.

2.15. "Health warnings"

How should "health warnings" about past and projected performance be made?

The appropriateness of "health warnings" will depend on what approaches are actually adopted for back testing and future projections following this consultation.

I would suggest that back-testing is not allowed, and hence no requirement for any health warnings. For future projections I have recommended an approach which simplifies probability distributions by presenting some probability measures in easy to understand language. I would suggest that there is a prescribed health warning to accompany these measures which covers the eventuality that the future may differ from the measures presented and that the measures themselves are to some extent approximate.

E. Taxation treatment

2.16. Highlighting taxation

How should product documents make consumers aware that there are different taxation implications when investing in different types of Trackers?

I think that it would prove difficult for product documents to cover all the different tax implications

which may exist with different types of products. One particular aspect of this is that taxation implications will vary by individual in addition to product type. I think that explaining these differences is best left to advisors (e.g. intermediaries, accountants). I think that the product document should concentrate on explaining how that particular product works. I suggest that the product literature (on any financial product) should highlight the need for appropriate tax advice.

2.17. How should consumers be told about particular tax implications?

If there are particular taxation implications specific to particular types of Trackers, how should these be brought to the attention of consumers?

Most investors will not be exempt from tax such as DIRT or exit tax on insurance products. Therefore I believe it appropriate that all forms of Tracker should therefore show returns after standard product tax in standard product literature.

If an investor is exempt from tax then the provider should be allowed to produce a specific illustration for that individual, effectively with a zero tax rate.

F. Geared Trackers

2.18. Specific Restrictions

Should there be restrictions on the marketing of "Geared Tracker"? If so, what restrictions would be appropriate? If not how can inappropriate targeting be addressed?

I believe that it is important that the whole package should be presented together, i.e. loan and tracker, even if there is legally a split between these two parts of the product. This would avoid any disclosure arbitrage that might exist between the two elements of the product.

If the whole package was subject to producing projected returns according to the probability distribution of returns (see comments on 2.13 above) then the true risks associated with this form of investment would emerge. In particular the measure which provided an indication of spread of possible returns would highlight the exceptional risk that can exist in Geared Trackers by indicating the very wide range of possible returns, from poor to good.

This would in itself help to ward against inappropriate investment. Note that if disclosure of projected returns only includes "average" returns (and no indication on spread of returns) then the risk inherent with these products would not be captured by standard disclosure and additional disclosure on the risk would be required.

It has been my experience that gearing of any investment alters the investment profile beyond which most people can easily understand. The first obvious impact is that the ups and downs in the investment are accentuated, however in addition to this the pivotal point where returns change from positive to negative increases (to service the debt) and finally and probably most difficult to understand the level of gearing itself alters as the underlying investment increases and decreases in value (gearing increasing as the investment falls in value, and decreasing as the investment increases in value). This final feature can lead to spiralling losses when the value of the underlying investment is decreasing.

Whilst I do not like the prohibition of any investment on the basis of risk (in the belief that there will always be some people who find extreme risk acceptable) there is a real danger of geared products being mis-understood and investors not fully appreciating the risks. In this regard if appropriate

disclosure on the risk is not achieved then I think we need to consider the lesser sin of limiting the level of gearing that is permissible on retail investments.

2.19. Disclosures about "Geared Trackers"

What types of disclosures should be made about "Geared Tracker"

The most important element of disclosure should be some mechanism that highlights the risks involved in the product, and not just "expected returns".

There are various risks that need to be highlighted. Below is a non-exhaustive list of those risks which may be regarded as specific to Geared Trackers:-

- i) The spread of returns increases dramatically as gearing increases, and that gearing itself increases if the value of the underlying investment reduces
- ii) The risk of interest rates increasing
- iii) The risk of exiting from the policy at a time when the underlying guarantee (if any) does not apply
- iv) Who covers the repayment of borrowed capital if the underlying guarantor of the Tracker defaults?

G. Complexity

2.20. Signing a declaration

Should the vendor and the investor be required to sign a declaration in which:

- The vendor confirms that they provided all the documentation relating to the product before the consumer purchased the product?

and

- The purchaser confirms that he/she has received a copy of all the documentation?

In general I agree with this proposal, although I would drop the requirement to have seen **all** documentation and instead believe that it would be preferable to refer to **one or two specific** pieces of marketing material which have been specifically designed with the aim of informing the client about the product.