New Financial Product Regulations in the U.K. — The Insurance Industry's Stance on the Expansion of CAT Standards

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1. Backdrop to the Introduction of CAT Standards

On December 1, 2001, a new financial regulatory framework was established in the U.K. when the Financial Services and Markets Act 2000 came into effect. The law gives statutory powers to the Financial Services Authority (FSA) to be the single regulator of deposit taking, insurance, and investment companies.

The FSA's statutory objectives are to: (1) maintain market confidence, (2) promote public awareness of financial services, (3) protect consumers, and (4) reduce financial crime. The FSA has been empowered with comprehensive regulatory authority to achieve these objectives.

In particular, the objective of promoting public awareness is aimed at reducing the asymmetry of information between businesses (or advisors) and consumers, and enhancing consumers' understanding of financial services.

In the past, regulations designed to achieve these objectives have included: (1) regulations regarding advice (best advice duty, etc.), and (2) product disclosure regulations (prior distribution of Key Features document describing product characteristics, commissions, etc.). These regulations, which leave product design to companies, aim to optimize the process of selecting products by giving consumers sensible product information and advice, and thereby reduce the information disparity between vendors and consumers. In all cases, consumers are assumed to be responsible for their decisions.

Generally, achieving such objectives in a deregulated market setting calls for remedying the lack of consumer information with extensive disclosure. However, as a practical matter, the complexity of financial products and limited financial knowledge of consumers makes this an incomplete solution.

The limitations of consumers (limited financial knowledge, low self-confidence, and lack of access to affordable advice) hinder access to financial products particularly among low and middle income consumers, raising troubling concerns about their absolute shortage of savings.

The government sought to address this issue by introducing financial product regulation aimed to improve access to financial products and systematically support product purchases.

As a result, in December 1998 the government (U.K. Treasury) established what are called CAT standards (a governmental seal of approval), which were first applied to a new savings plan introduced in April 1999 called Individual Savings Accounts (ISA). CAT standards were next applied to mortgages in March 2000, and are likely to be expanded to other areas.

While CAT standards are based on the idea of supporting consumers with extensive disclosure in the context of free competition, they also recognize that in practice consumers are limited in their financial knowledge and ability to bear costs. Thus the standards represent a supplementary policy by which regulators can ensure that adequate (not optimal) products are available to consumers.

CAT standards present an instructive lesson for Japan as well, where the complexity of financial products has created a need for consumer protection measures based on consumers' limitations. This paper thus examines the introduction of CAT standards for Individual Savings Accounts, and discusses the response of the life insurance industry to the intended expansion of CAT standards.

2. Description of CAT Standards

(1) Definition and Objective

CAT is an acronym for the three aspects of financial product standards: charges, access (minimum transaction unit and other conditions of use), and terms (interest rate and other contract terms). If the standards are met (or exceeded in the consumer's favor), products are given the CAT stamp of approval. For example, an approved ISA product can be marketed as a CAT ISA.

While CAT standards themselves are stipulated by law, compliance is voluntary, and approval merely represents an endorsement (non-CAT products can be sold as such).

The objective of CAT is to enable consumers to purchase products with reasonable confidence. Thus CAT standards are intended to promote fair and suitable product purchases, and not to ensure optimal product purchases.

Consumers who seek to purchase products best suited to them can seek the advice of a paid independent advisor. In this sense CAT standards represent a benchmark for minimum acceptability, and are expected to support sound purchases by identifying good value products.

Ultimately, CAT standards are a product-design screen for people with limited financial knowledge and means to purchase affordable products offering an acceptable (but not optimal) level of satisfaction and safety.

(2) Description of ISA

ISA is a new savings plan introduced in April 1999 to encourage savings among low and middle income consumers. While deposits are not tax deductible, investment returns are tax exempt. When the ISA was introduced, it effectively replaced two other existing savings plans — personal equity plans (PEP, introduced in 1986) and tax exempt special savings accounts (TESSA, introduced in 1990).

The ISA has an annual contribution limit of £5,000, and assets can be invested across a broad spectrum of financial products including stocks and securities, savings accounts, and life insurance. There are two categories of ISA: (1) Maxi ISA, which mainly contains stocks but also includes savings and life insurance products all bundled into one account, and (2) Mini ISA, in which securities, savings and life insurance products are held in separate accounts. The former is designed for people who, given the contribution limit, want to invest mostly in securities, and the latter for people who want each product to be separately managed.

(3) CAT Standards for ISA

Since ISAs contain three elements (securities, cash savings, and life insurance), three separate sets of standards are applied, as described below.

(a) Life insurance ISA

CAT standards for life insurance ISAs are shown in Figure 1. Applicable products include unit link insurance and traditional with-profit life insurance.

Figure 1 CAT Standards for Life Insurance ISA

Item	Description
Charges	• Annual charges must not exceed 3% of account value. • No other charges can be applied.
Access	• Minimum refundable premium must be no more than £25 per month, or a lump sum of £250.
Terms	• Surrender value must reflect number of years elapsed and value of applicable assets. • There must be no special surrender penalties. • After 3 years, surender value must exceed paid-in premiums.

(b) Share ISA

CAT standards for share ISAs are shown in Figure 2. Applicable products include:

* Stocks and bonds traded on authorized stock exchanges worldwide
* Government bonds issued by the U.K. and European countries
* Units of authorized unit trusts in the U.K.
* Shares of open-end investment companies in the U.K.
* Shares and securities of approved investment trusts

Figure 2 CAT Standards for Share ISA

Item	Description
Charges	• Total annual charges must not exceed 1% of net asset value. • No other charges can be applied.
Access	• Minimum savings amount must be no more than £500 per year in lump sum, or £50 in regular monthly payments.
Terms	• Assets can be invested in unit investment trust or open-end investment company. • At least 50% of investment fund's portfolio must consist of ISA-approved stocks & securities listed on EU exchanges. • Units and shares must have a single price (buy and sell prices must not differ). • Investment risks must be described in Key Features.

(c) Cash ISA

CAT standards for cash deposit and savings accounts are shown in Figure 3. Applicable products include:

* Accounts in banks and building societies
* Units of money market funds related to approved unit trusts, and units of other approved unit trusts that invest in money market funds (fund of funds)
* National savings products designed for ISAs

Figure 3 CAT Standards for Cash ISA

Item	Description
Charges	• Charges cannot be levied on cash withdrawal and other services. • However, this does not apply to the replacement charge for lost cards.
Access	• Minimum transaction unit must not exceed £10. • Depositors must be able to withdraw cash within seven days.
Terms	• Deposit rate must be no more than 2 percentage-points below minimum loan rate. • Deposit rate must be increased within one month of increase in minimum loan rate. However, this time limit does not apply for a deposit rate decrease. • Limit on number of withdrawals or other terms must not be imposed.

(4) Disclosure Related to CAT Standards

Prior to selling an ISA, a disclosure document called Key Features (a prospectus-like statement several pages long that briefly describes objectives, product characteristics, and risk factors) is distributed to customers that describes the product's CAT compliance status. Products that do not meet CAT standards must clearly say so, but need not explain why.

The disclosure regarding CAT standards (for a life insurance ISA) contains the following:

* Explanation that the life insurance ISA has been designed to meet government-defined CAT standards for ISAs
* Itemized comparison of the life insurance ISA against CAT standards
* Explanation that CAT compliance does not necessarily ensure that investment methods are appropriate, or guarantee future performance
* Explanation that customers dissatisfied with a CAT product will need to obtain advice from another advisor

3. The Intended Expansion of CAT Standards to Other Products

In a released statement, the U.K. Treasury declared that its introduction of CAT standards for ISAs and mortgages has been successful in enabling consumers to make good product purchases.

The assessment was based on the observation that CAT ISAs comprise the majority of the ISA market, while CAT mortgages have shown strong growth. The Treasury thus believes that CAT standards have started providing support for customers as intended.

Against the backdrop of this favorable assessment, from late 2000 to early 2001, the Treasury began aggressively moving to expand CAT standards into other product areas.

The first such effort was in long-term care insurance. In December 2000, the Treasury declared the need to introduce CAT standards for long-term care insurance so that policyholders can accurately understand the coverage, compare different plans, and purchase the products suited to their individual financial situation.

The Treasury demonstrated a flexible approach by altering the traditional components of CAT (charges, access, and terms) to a new one specifically adapted to long-term care insurance: cover, access, and terms. This, they say, is because policyholders need an accurate understanding of what benefits are appropriate in a changing environment, and must have their care needs evaluated by specialists. Introducing CAT standards is supposed to prevent confusion among policyholders (and their families) regarding which products are suitable, and prevent the administration of inappropriate care. Thus standards must be established regarding how quickly claims processing and benefit payments can be made.

In addition, in January 2001, the Treasury announced its intention to expand CAT standards to credit cards and basic bank accounts. Again, the CAT concept was expanded, this time by replacing "charges" with "comparability" to better support rational product purchases in a different product environment. In other words, the Treasury has taken a broadly defined approach to CAT standards, ranging from setting cost limits for ISAs (price regulation) to promoting price competition for other products (comparability), all to better induce rational product purchases.

As a result, the Treasury is attempting to promote price competition by creating regulations that emphasize comparability for products such as credit cards, and that standardize contract terms for greater clarity. Furthermore, the government has expressed an intention of introducing CAT standards into other retail products including some insurance and pension products, and has solicited opinions from industry groups and other concerned parties.

In this way, the government's flexible approach to applying CAT standards across a broad range of retail product groups represents an entirely new regulatory direction — inducing rational purchasing behavior of consumers. Further developments will be followed with interest.

4. Stance of the Insurance Industry

To create a competitive environment through deregulation and an emphasis on individual responsibility, measures are needed to correct the information disparity between businesses and customers.

Typically, this is done by resorting to the regulation of sales methods (such as best advice regulations) and product disclosure.

However, under CAT standards, regulators are able to directly restrict products at the design level, which at first glance seems somewhat dubious from the perspective of promoting innovation and competition in the retail market. But considering the level of consumers' financial knowledge, the introduction of a regulatory framework that provides consumers with a simple product selection method is not without justification.

The government is keen on expanding CAT standards into products that:

* Are difficult for consumers to understand
* Are difficult for consumers to compare with similar products
* Compete in factors other than quality or value (compete in price)
* Satisfy many consumers if offered simply, clearly and fairly
* Are chosen from among several vendors based on individual needs

Since these conditions generally apply to all financial products, we may see CAT standards being expanded across a very diverse range of retail products at the discretion of regulators.

Regarding this orientation, the Association of British Insurers (ABI) welcomed the intention to expand CAT standards to long-term care insurance on the basis that consumers could purchase products with greater confidence. However, the ABI has been unenthusiastic about the intention announced in 2001 to expand CAT standards to retail products including insurance.

The insurance industry wants to halt certain aspects of the government's ambitious plan because: (1) excessive expansion of CAT standards will restrict business freedom, (2) the industry's self-regulation efforts should receive more recognition, and (3) misunderstanding of CAT standards could stigmatize non-CAT products, or cause (fee-based) suitable advice opportunities to be lost.

Specifically, with regard to self-regulation, the industry has been formulating its own product quality standards since October 2000 (Raising Standards quality mark scheme), which would improve policyholder services by certifying life insurance and pension products that meet conditions such as: (1) standardized policy documents for enhanced transparency and comparability, (2) transparency in collection of expenses (eliminating transaction spreads, etc.), and (3) expansion of the cooling-off period from 14 to 30 days. Certification would be done by an independent organization called the Pensions Protection and Investments Accreditation Board (PPIAB).

As a result of this effort, five companies including Norwich Union and Scottish Equitable received certifications in October 2001. The insurance industry expects the system to take root, with approximately half of the companies being certified by the end of 2002.

In the U.K., the basic concept behind deregulation is to ensure market discipline by guaranteeing maximum freedom for businesses while curbing excesses with disclosure. But in view of the limited financial knowledge of customers, the introduction of CAT standards to provide information necessary for consumer protection is of interest as a new regulatory scheme. CAT standards are still in the initial stage of introduction, and considering the government's intention to expand the scope across a broad range of retail products, much more time is needed to determine their success, including the receptiveness of regulated industries. Thus the developments among regulators and industry groups warrant continued monitoring.