

## REGULATORY IMPACT ASSESSMENT (RIA)

### Regulations to allow all stakeholder medium term and cash products and insurance products into the 'stocks and shares' component of the Individual Savings Account

#### Purpose and intended effect of the measure

##### *The policy objectives*

1. To implement the recommendations of the review by Ron Sandler on *Medium and long-term Retail Savings in the UK*, published on 9 July 2002, by providing investment products of a similar nature with similar tax treatment within the Individual Savings Account (ISA). To achieve this specifically by bringing stakeholder medium term products into the ISA and providing all collective investment products, whether unit based or insurance based, with the same treatment within the ISA regime.

##### *Background and introduction*

2. The Individual Savings Account (ISA) was introduced in 1999 to replace the TESSA and PEP. It was aimed at encouraging saving particularly among those who do not save, such as those on low incomes or the less financially aware.
3. The ISA allows individuals to save, with no tax to pay on income or gains, in a wide range of savings and investment products. Currently these products must fall into one of three investment types or 'components' - cash, stocks and shares, or insurance. Each component has separate investment limits:
  - cash - £3000 maximum,
  - stocks and shares - £3000 maximum or up to £7000 where a single Maxi ISA account is held, and
  - insurance - £1000 maximum.
4. Over 15 million people – 1 in 3 adults – hold an ISA with over £130 billion subscribed since 1999 in products provided by over 430 ISA managers.

##### *The risks being addressed*

5. To bring the stakeholder medium-term investment products in to the ISA regime in a way that minimises complexity for investors and tax distortions between similar types of investment product.

6. To reduce market distortions created by the current ISA investment rules, which limit development of life insurance investment products within the ISA and to minimise complexity for investors when comparing the relative benefits of saving in life insurance, stakeholder medium-term insurance products and other collective investment products through the ISA.

### **Definitions and abbreviations**

7. The following abbreviations are used in this paper:
  - FSA – Financial Services Authority
  - IFA – Independent Financial Advisor
  - ISA – Individual savings Account
  - PEP – Personal Equity Plan
  - Providers – providers of financial services, such as insurance companies, Friendly Societies and investment companies

### **Options**

8. There are four options available to us:
  - A. **Do nothing.** Excluding stakeholder medium-term products from the ISA and continuing to limit life insurance to the insurance component lower investment limit;
  - B. **Fit the stakeholder medium term products within the existing ISA components.** This is the option that imposes least change on the ISA regime whilst allowing stakeholder products into the regime. It brings the stakeholder medium-term unitised product into the ISA 'stocks and shares' component while limiting the stakeholder medium term insurance based products, whether unitised or smoothed, to the ISA insurance component;
  - C. **Treat the stakeholder medium term products as a new type of collective investment product and bring them all into the ISA stocks and shares component.** Allowing all stakeholder insurance products in to the ISA stocks and shares component, with its higher investment limits, but retaining the existing limits for non-stakeholder life insurance.

**D. Remove the distinction between life insurance and other investment**

**products:** bringing all stakeholder medium-term products and non-stakeholder insurance products into the same component and removing the separate ISA insurance component. As a result this will increase the investment limit for the 'stocks and shares' component.

9. The preferred option is the fourth option – Option D. This will provide investors with the simplest range of investment options – both between similar insurance and non-insurance based investment products and stakeholder and non-stakeholder investment products – and remove the distortion tax has on investment decisions.
10. **Option A** would not achieve the main objective of the stakeholder regime - to provide savers with a range of simple transparent investment products that are easy to understand and subject to a simplified sales process. Excluding the new stakeholder products from the ISA will increase complexity for the less sophisticated investor, when comparing the benefits of stakeholder products with other collective investment schemes within the ISA regime.
11. **Options B and C** would impose different ISA investment limits on very similar investment products. This increases complexity for investors and the need for more complex advice to savers on the relative merits of such products. Retaining the lower investment limits for insurance products in the ISA regime risks distorting consumers' medium-term investment decisions and potentially providers' incentives to enter the stakeholder product market.
12. **Option D** provides all the medium term stakeholder products, whether unitised or insurance based, and all ISA life insurance products with the same ISA benefits as other equity based collective investment products. Providing a level playing field for all similar products, as recommended by Ron Sandler in his review, should remove the impact tax has on investment decisions and encourage more open competition. This option should remove existing distortions and prevent the need for complex investment advice arising because of a difference in ISA investment limits.

**Business sectors affected**

13. The ISA is a tax-free savings product available to all adults resident in the UK. Around 435 financial providers are currently authorised to act as ISA managers or provide savings or investment products within the ISA regime. These include:

- Banks, Building Societies and the National Savings and Investments
- Persons authorised by the Financial Services Authority,
- Insurance companies and
- Friendly Societies

Individuals can access advice and information on ISA products directly from ISA providers and managers or through Independent Financial Advisors (IFAs).

14. Option D affects all ISA components and this will affect all ISA providers as
- existing and new ISA providers may wish to develop and sell the new stakeholder medium term products within the ISA; and
  - the increased investment limits available to life insurance products may encourage a wider range of insurance providers to develop ISA products, including products with cash-like returns.
15. The major impact will be on those financial providers who currently sell ISA life insurance products. Less than 20 organisations are authorised to sell insurance products compatible with an ISA, and do so to slightly more than 3% of ISA savers.

### **Issues of equity and fairness**

16. All individuals over the age of 18 can hold investments in an ISA. The proposal to bring all medium-term stakeholder products into the same ISA component will allow those individuals equal access to a wider range of tax-free investment products and remove some of the distortions tax may have on their investment decisions. The proposal to allow life insurance products into the same ISA component in the same way as other investment products removes the current distortions created by the ISA investment limits. This should increase providers' abilities to compete more equally within the ISA regime and opens up the ISA to a wider range of providers.

### **Benefits<sup>1</sup>**

17. Option D should, over the longer term, make the ISA simpler to understand and reduce the complexity of investment decisions. Advice on investments can focus on the relative merits of the features of the investment products being considered not the tax impacts of saving in those products.

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<sup>1</sup> The impacts of providing the stakeholder products are not dealt with here as they are covered in detail in the regulatory impact assessment accompanying the consultation on stakeholder products.

18. The changes should extend the choice of products available as ISA managers providing investment products will, from April 2005, be able to develop or provide products that qualify within:

- a Mini ISA 'cash' component - as this will include 'cash-like' insurance and collective investment products;
- a Mini ISA 'stocks and shares' component – as this will include non 'cash-like' insurance and collective investment products;

or

- a Maxi ISA - which can include cash, medium-term stakeholder, life insurance and other investment products.

19. Life insurance firms have been reluctant to participate in the ISA Insurance market previously. The principle reason being the low ISA subscription limit. Consumers of financial products may as a result have been unable to purchase life insurance products. The proposed change removes this barrier by giving providers access to higher investment limits, to enable them to develop cost effective products, and allowing them to compete equally with other types of investment product. Several providers of insurance and other ISA investment products have indicated that they would enter this market if the proposed changes were to proceed because of the benefits the higher limits provide.

## **Costs**

### *Policy costs*

20. Option D should impose little or no change to the ongoing compliance costs of the majority of ISA providers or financial advisors, as the basic investment rules and reporting requirements will not change. Investors will still be limited to one ISA manager for each component and will be constrained by investment limits within those components. All ISA providers and advisors, such as IFAs, will need to understand the impacts of the revised ISA regime on investor's choices.

21. The main additional burdens will fall on those financial providers who wish to sell insurance and medium term stakeholder products within the ISA. They will be required to apply a test to assess whether the products they provide are cash-like in nature. The introduction of the 5% test for UCITS schemes (on which this test is based) indicates that applying such a test is relatively simple in all but a very small minority of cases. Greater burdens may arise for providers looking to create more complex investment products, aimed at providing secure returns that are not cash-

like. The majority of providers are not likely to sell such complex products in the ISA because of the low investment limits allowed so policy costs are likely to be minimal.

22. Options A to C rely on the retention of a separate insurance component. Option A would impose no change and therefore no compliance costs on providers but would not fit with the Government's main policy aim for the stakeholder suite of products. That is to support the development of cost effective stakeholder products for the less sophisticated saver and to minimise the distortions on investment decisions caused by taxation by giving all such products the same ISA treatment.
23. Options B and C also minimise changes to the ISA regime and potentially reduce administrative burdens for the small number of existing ISA insurance providers who may not wish to provide stakeholder products or extend the ISA insurance product they currently sell. Both options would increase complexity of sales advice as between similar investment products and potentially increase compliance burdens for those wishing to provide insurance-based stakeholder or other life investment products in future. These arise because of the disparity in treatment both options would give to stakeholder medium-term insurance products and/or other life insurance products compared to other investment products.
24. We have been advised by the FSA and others in the financial industry that both options would impose additional burdens on providers and financial advisors offering stakeholder medium-term or life insurance products. They would not only have to explain the merits of potentially very similar types of products but also how the ISA limits and the individuals tax status could affect the value or benefits from investing in those products. No estimates of the costs or impacts of these options have been provided by the financial industry.

*Implementation (compliance) costs*

25. One-off costs will arise on implementation of Option D for most providers. This includes costs of changing ISA systems, training staff and advisors, and changing investment advice and literature. All providers would need to reflect the changes to the types of investments that could fall in to the 'cash' and 'stocks and shares' components, removal of the insurance component, and the increased stocks and shares component limits. All providers will have to advise existing ISA savers about their options from April 2005.

26. The highest compliance costs will fall on a very small number of providers who currently sell ISA insurance products – less than 20 of the 435 ISA managers. They will need to understand the impact of the changes on existing policies and advise savers holding those ISA insurance policies of the impacts or choices they face on April 2005, if they want to continue to save in those products.
27. The draft regulations aim to reduce burdens for insurance providers as far as possible. A key feature of Option D is that savers who want to continue saving in an existing insurance policy can do so without having to reapply for a new ISA within one of the new components. Providers will not face the burdens of carrying out compliance checks and setting up a new account nor the risk of losing investment when savers do not respond with the necessary confirmations of information.
28. Initial discussions with existing ISA insurance providers indicate that the one-off administrative costs arising from explaining this change to investors would be less than £1 million. On average this amounts to £3 per ISA insurance saver, though the cost per individual will be higher for smaller providers with fewer ISA investors.
29. Those currently providing insurance ISA and stocks and shares ISA products will incur additional costs in changing their systems. Initial discussions with providers indicate that the order of magnitude of these costs will be less than £10 million across all providers. The bulk of these costs would fall on the largest providers.
30. Some financial providers have indicated that they may consider entering the ISA market, or developing new ISA insurance products. By doing so they will incur set-up costs in order to comply with the ISA management and reporting requirements. These costs and burdens should be no different from those imposed on all ISA providers who choose to start providing an ISA investment.
31. Finally financial providers have indicated that both these one off systems costs and also the ongoing administrative costs would increase substantially if the reporting requirements, in relation to the types of investments purchased, were changed. No estimates of these increased costs were provided. For this reason these changes are not being imposed at this stage.

#### *Policy and Implementation Costs of Options A to C*

32. Initial discussion with providers on both the **policy** and **implementation** costs indicate that the higher implementation costs arising from option D would over time be far lower than the on-going costs of either Options B or C. It was for this reason that the industry proposed Option D in October 2003. We have been unable to quantify the impacts and cost on providers of the options B and C. The industry has assured us that both would increase the complexity of the ISA regime and the provision of the stakeholder products within it.

33. Option A, although imposing no change on the ISA regime, would increase complexity for financial advisors and providers of the stakeholder products and reduce the simplicity and cost effectiveness of those products. Therefore the benefit of lower implementation costs arising from options A to C would soon be outweighed by higher ongoing administrative costs.

#### *Exchequer effect/distributional impacts*

34. The cost to the Exchequer of allowing all stakeholder medium-term investment products and insurance products into the ISA 'stocks and shares' component is £ nil in 2005/6 rising to £40m by 2007/8.

#### *Other costs and benefits (public & private sector)*

35. The wider consultation on stakeholder products assesses the impact of introducing the stakeholder medium-term investment products. The changes to the treatment of insurance within the ISA should allow insurance products to compete more effectively in the ISA market with similar collective investment products and the stakeholder medium-term products.

#### **Small Business impacts**

36. Evidence indicates that around three small firms selling an ISA insurance component product will fall into the category of small businesses. These are all small Friendly Societies with few permanent staff and a relatively small number of investors saving relatively small amounts. As such we have given consideration to the Small Business Impact Test and consequently held face to face discussions with the concerned parties, and indeed all current insurance ISA providers.

37. The small businesses affected focus on providing low-level insurance-based savings products to 'members'. Those members are drawn from specific groups within a particular local, or work-related, community. The limited nature of the ISA insurance

component fitted with the aims of these small organisations. Two of the Friendly Societies, falling into the category of small businesses, have attracted a new range of non-traditional members, and increased investment, through actively selling niche ISA products to savers who want to top-up their other ISA savings.

38. Discussions indicate that all but one of those small providers can, and intend to, provide the same or similar products within the higher investment limits of option D. Given the smaller number of investors the unit cost of preparing for change and advising investors may be higher. We understand that most believe that the costs are outweighed by the benefits from the extended range of savers who may be attracted under the more generous ISA limits.
39. One organisation believes it will suffer from the increased investment limits provided by option D, because of the nature of the policy it had designed. It currently provides an ISA insurance product that guarantees to return capital subscribed whenever the policy is surrendered plus a generous level of life protection. Both make the policy very attractive to these new non-traditional savers but the capital requirements to cover them mean that the number of policies issued is limited, around 200 new policies a year, and subscription limits cannot be increased.
40. The risk faced by this organisation is that new non-traditional savers, those attracted over the last 2 years who also invest in other ISA products, will shift to a new provider who can provide products under the higher subscription limit. The concerns expressed are limited to the impact on these existing investors, not future business and evidence suggests that the more traditional members who have bought policies over the past 5 years are unlikely to be affected. No estimate of the extent of this loss has been provided or of the proportion of that organisation's total insurance business would be affected. The option to market a revised product, within the higher investment limits Option D provide, is open to them.
41. The alternative solution proposed by this organisation is to retain the existing separate ISA investment rules, available only to savers who hold an ISA insurance policy before April 2005, alongside the new rules under option D. The intention would be to allow savers to choose to continue investing in a £1000 limit insurance product alongside their other ISA component savings. These rules would only apply to a very small number of savers and would benefit few life insurance providers as it provides no advantage for policies sold after 2005.

42. The solution will impose burdens on all ISA providers, as all providers will have to ensure they can operate both sets of ISA rules in case an individual with an insurance policy under the old rules chooses to save with them for their other ISA savings. It would also make future advice on ISA saving options more complex. Future advice on the level of savings in a certain product or whether that individual could save in that product at all would depend on a decision made on 5 April 2005.
43. On balance we believe the limited benefits provided to a single small business would be outweighed by the burdens imposed on all other providers, including two other small businesses who have expressed an interest in entering the wider market.
44. Other small businesses affected by the change are small firms of IFAs. All IFAs will need to reflect the impact of the ISA changes in the financial advice they provide. We believe that the impacts of Option D should be minimal. To provide best advice, IFAs are required to maintain an understanding of the types of investment products available in the market place, this will include the structure of the ISA.
45. The Revenue will be issuing guidance to all providers on the impact of Option D on the structure of the ISA as soon as practicable after the regulations this year. The FSA has also agreed to issue a fact sheet on these changes at least 12 weeks before the changes come into effect, to help providers and investors with the issues they may need to consider. Option D will still allow the same insurance products to be sold within the ISA, they will merely qualify under a different component. The burden of identifying and informing investors and IFAs if a product satisfies the ISA requirements, including the component it falls into, will fall to the ISA manager and the product provider. So burdens of small IFAs should be minimal.
46. Option D will ensure IFAs can focus on the features of investment products rather than the impact the investors tax status may have on which investments he holds. Options B and C complicate the advice required because of the different treatment given to very similar products. Advice on the most appropriate investment could depend on the marginal tax rate a person pays. This would impose ongoing burdens on all IFAs, including those categorised as small businesses.

### **Unintended consequences**

47. None identified.

## **Other impacts**

48. None identified.

### *Devolution*

49. No issues identified.

### *Human Rights*

50. The policy should have the same coverage and effect as the current ISA scheme.

### *E-policy*

51. None identified.

### *Environmental impacts and Rural proofing*

52. None identified.

## **Competition assessment**

53. The competition filter has been applied. It indicates that Option D is not expected to give rise to competition issues, the general response from the industry to the option D was that the increased limits available to insurance products should increase competitiveness and encourage a wider range of products within the ISA market. The changes to the insurance component in the ISA regulations will mainly impact on ISA insurance providers currently selling insurance products.

54. We also anticipate that the wider ISA changes, to bring in stakeholder medium-term products, impose no greater burden on any particular sector and costs and benefits of those changes should affect all those providing or aiming to provide insurance and non-insurance collective investment products equally.

## **Securing compliance**

55. Bringing the stakeholder products and insurance into the same ISA component as other collective investment schemes should have no impact on compliance. The stakeholder medium-term products will be subject to the same compliance rules as existing ISA products and other collective investment schemes. The changes will enable the same types of insurance product to have access to a higher investment limit but the ISA reporting and compliance requirements imposed on those products within the ISA stocks and shares or cash components should not change as a result.

## **Consultation**

56. The Treasury held a consultation on the Stakeholder proposals between 17 June and 10 September 2004 and alongside this the Revenue published a discussion document to consider the ISA implications and to seek views on whether:

- applying the 'cash like' test for stakeholder and non-stakeholder insurance products, and
- bring existing ISA insurance products into the new regime, would achieve the aims of protecting investors interests and the Exchequer whilst minimising burdens on the industry and the extent of the burdens imposed.

57. Meetings were held with existing insurance providers, representative bodies and other organisations interested in providing the stakeholder or insurance products within the ISA. These meetings have informed the results of this impact assessment.

## **Monitoring and evaluation**

58. Quarterly statistics on take up and annual statistics on the level of funds held in different investment products, are already provided for the ISA and PEP regime. These will inform the ongoing assessment of the impact the changes may have on investment preferences and development of new products. In addition we intend to continue informal discussion with key representative bodies on the impacts of the changes on providers, and monitor the effectiveness and suitability of the 5% test. The Government is already committed to a general review of the ISA for 2006 where impacts of these changes can be re-evaluated in the light of the ongoing discussions.

59. However, to monitor the impact on providers and investors effectively we will consider whether we need to change the information requirements on the ISA manager's return. We will be exploring the impacts of requiring providers to provide data on the different stocks and shares products provided by them, including the types of insurance based and non-insurance based stakeholder medium-term products and non-stakeholder products provided.

## **Summary and recommendation**

60. The policy change is expected to simplify the ISA and expand the type of investment products available to investors, whilst protecting the Exchequer against the cost of existing cash savings being transferred to tax free savings accounts. Only one

organisation, a small business, objects to option D and proposed an alternative structure to minimise the impacts on them. This alternative would impose burdens on all other providers and advisors, including other small businesses. We are unable to quantify the extent of the risk that provider is exposed to or the level of burdens imposed by the alternative but discussions with all providers indicate that the burdens would be disproportionate to the benefits for that one organisation.

61. The discussions with ISA providers indicate that Option D provides financial providers the opportunity to develop stakeholder medium-term and insurance business within the ISA. We conclude that Option D achieves the stated policy aims whilst minimising burdens on providers of ISA investment products.

### **Declaration**

**I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.**

Signed:

Dated:

**Stephen Timms MP  
Financial Secretary to the Treasury  
HM Treasury**

### **Contact point**

For questions on the content of this RIA or the regulations please contact:

**David Ensor**  
**Savings and Pensions  
Policy**

Tel: 020 7438 7749

Fax: 020 7438 67237

E mail: [david.ensor@ir.gsi.gov.uk](mailto:david.ensor@ir.gsi.gov.uk)

Inland Revenue  
Room 111  
New Wing  
Somerset House  
Strand  
London  
WC2R 1LB